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CHECK AGAINST DELIVERY

Canada's Competitive Imperative: Investing in Productivity Gains

Introduction

I am honoured to be here to launch Productivity Alberta's luncheon series. In addition to offering opportunities like today's to network, learn, and discuss, Productivity Alberta is providing leadership and vision—together with practical tools and resources—to support business and industry in enhancing their competitiveness.

Canada's advantages were very apparent through the financial crisis. They sheltered us from the worst of the storm and put Canada at the front of the pack coming out of the recession. Indeed, Canada's international brand for sound economic and financial management has rarely been stronger. This is an opportunity to capitalize on, but only if our relative success does not blind us to our own vulnerabilities.

As the title of my remarks suggests, today I want to talk to you about the erosion of Canada's international competitiveness in recent years, how this is affecting the Canadian economy, and the competitive imperative for businesses in Canada to sustain a durable rebound in investment spending and translate this into productivity gains. With household balance sheets stretched and fiscal stimulus set to wind down, the Canadian economy must regain its competitive edge to sustain a lasting expansion.

Of course, this is easier said than done. Business decisions to invest and innovate inevitably entail risk. And we continue to face elevated global risks. In this environment, it may be tempting to conclude that the best business strategy is to delay investing until risks recede.

This appears misguided.

Our competitors are not waiting. They are raising their game. So while investment is not without risk, failure to invest will almost certainly doom Canadian business to a continuing loss of competitiveness and a shrinking share of global markets.

This need not be our fate. Indeed, after a very sharp decline through the recession and a delayed recovery, business investment in Canada is finally rebounding strongly. But it is still 15 per cent below its pre-recession level. There is much lost ground to make up.

Moreover, while individual firms can point to many investments that have produced tangible productivity gains, at the aggregate level, the productivity dividend of the investments made over the past decade has been alarmingly low. This has to change. We need more investment that enhances productivity and improves our international competitiveness so that Canadian businesses can seize the opportunities that arise as the global economic recovery proceeds and markets expand.

Canada's productivity underperformance is an enduring and much-studied feature of our economic landscape. And truth be told, puzzles remain. Nevertheless, the concerted research effort over the past two decades points to several clear conclusions as to what makes some firms more productive than others. I will come back to these lessons.

But first let me review the outlook for the global and Canadian economies, and explore the evidence, the causes and the consequences of Canada's declining competitiveness.

The Global and Canadian Outlooks

Two weeks ago the Bank of Canada published its updated economic outlook.

The good news is that the global economic recovery has gained momentum. Global markets are expanding, and prices of the commodities Canada exports have increased.

Private domestic demand in the United States has picked up and will be reinforced by recently announced monetary and fiscal stimulus. Growth in Europe has also been slightly stronger than anticipated, although ongoing challenges associated with sovereign and bank balance sheets will limit the pace of the European recovery. Continued strong growth in emerging markets is supporting commodity prices, which have increased significantly since last autumn (Chart 1 and Chart 2). With some emerging-market economies overheating, authorities there have begun implementing more restrictive policies with the goal of containing rising inflationary pressures.

The recovery in Canada is proceeding broadly as anticipated, with a period of more modest growth following the strong recovery experienced in late 2009 and early 2010 (Chart 3). Going forward, demand in Canada is projected to rely less on government and household spending and more on investment and net exports (Table 1). This rotation of demand is essential to sustaining a durable expansion.

Through 2009–10, government spending contributed one percentage point or more to growth each year, dampening the recession and spurring recovery. But with fiscal stimulus set to unwind as governments begin the return to fiscal balance, the contribution of government spending to growth is expected to turn negative.

Household spending, supported by extraordinary monetary and fiscal stimulus, has provided the most important source of growth since the start of the recovery in the third quarter of 2009, increasing at an average annual rate of 4.3 per cent. With disposable income growing by 2.3 per cent over the same period, the ratio of household debt to disposable income has risen to a record high of 148 per cent, surpassing the comparable ratio for U.S. citizens (Chart 4).

With household balance sheets becoming increasingly stretched and consumption unlikely to be bolstered by further gains in house prices, household spending is expected to moderate in line with income growth. But even with this moderation, the savings rate is projected to remain near historic lows, household debt near historic highs, and the share of the economy accounted for by household spending well above its historical average (Chart 5 and Chart 6). Prudent consumers should do no more and could well decide to do less.

This leaves business investment and net exports to pick up the slack.

The prospects for investment are very favourable, reflecting both propitious conditions and business imperatives. The financial positions of Canadian firms are strong. Borrowing costs for Canadian businesses are exceptionally low, access to financing has continued to improve, and the Canadian dollar has appreciated making imported machinery and equipment less expensive in Canadian dollars. Moreover, given the historically large drop in investment through the recession—almost 25 per cent—and the delayed recovery, firms have much depreciated capital to replace. This is reinforced by the imperative to improve productivity amid heightened pressures to become more competitive.

Surveys of business intentions, such as the Bank of Canada's *Business Outlook Survey* and the Conference Board's survey, confirm that firms plan to invest heavily in the year ahead for a variety of purposes, but increasingly to seize new opportunities and improve productivity (Chart 7). Reflecting all these factors, the Bank is expecting a historically strong and sustained rebound in investment, with investment growing at more than 9 per cent this year and next (Chart 8).

What about net exports? With the United States—our major trading partner—experiencing its worst recession since the Great Depression, our exports were particularly hard hit, falling more than 16 per cent (Chart 9). And with a moderate US recovery through 2010, an appreciating Canadian dollar, and relatively strong domestic demand supporting imports, Canada's trade balance turned sharply negative, subtracting 2.3 percentage points from growth in 2010.

Looking forward, the Bank expects an improvement in net exports over the next two years as external demand continues to recover and domestic demand moderates from its previous rapid pace. Nevertheless, competitiveness challenges are likely to mean that Canada will benefit less from improved global demand than in past recoveries. Consistent with the strong rebound in investment, this projection assumes a recovery in trend labour productivity growth from 0.6 per cent in 2010 to 1.1 per cent in 2012. At best this will stop the slide in our relative productivity performance. Making up lost ground will require superior performance by Canadian business.

A key risk to the outlook is that even this modest assumed improvement in productivity could fail to materialize. Particularly if combined with persistent strength in the Canadian dollar, this would jeopardize the recovery in net exports. Moreover, renewed tensions in foreign exchange markets could put additional upward pressure on freely floating currencies.

Canada's Deteriorating Competitiveness

Canada's current account balance has declined substantially in recent years, reaching a deficit of 4.3 per cent in the third quarter of last year—the largest deficit in 20 years (Chart 10). This sharp deterioration reflects a large decline in Canada's merchandise trade balance, owing to both strong imports and weak exports. Part of this shift is likely cyclical, reflecting the fact that domestic demand has been much stronger in Canada than in the United States in recent years. This suggests that we should see some cyclical recovery in the trade balance as growth in household spending in Canada moderates while it picks up south of the border.

But another more structural and more worrisome explanation also appears to be at play—increased import penetration into Canada and a loss of market share among Canadian exporters abroad. Canadian exporters have lost considerable market share in their largest market. From 2000 to 2010, China increased its share of U.S. imports from 8 per cent to 19 per cent, surpassing Canada as the largest exporter to the United States (Chart 11). Over the same period, Canada's share of U.S. imports fell from 20 per cent to 14 per cent, with about two-thirds of this decline occurring since 2005. Moreover, while the large rise in China's share is also affecting other countries, a number of countries, notably Mexico, have fared relatively better than Canada.

Over the same period, Canada's competitiveness has declined, with a sharp rise in the labour cost of producing a unit of output in Canada compared with other countries, adjusted for exchange rate movements. The Organisation for Economic Co-operation and Development (OECD) calculates that the Canadian real exchange rate in terms of unit labour costs has appreciated about 17 per cent since the beginning of 2005. The bilateral Canada-U.S. measure shows a 31 per cent increase in relative Canadian unit labour costs over the period.

Relative unit labour costs can be broken down into three components: the nominal exchange rate, relative hourly compensation and relative productivity (Chart 12). Since the beginning of 2005, the appreciation of the Canadian dollar explains about two-thirds of the increase in unit labour costs in Canada vis-à-vis the United States. Wage growth in the two countries has been broadly similar over the period, leaving productivity underperformance to account for the remaining deterioration in this measure of competitiveness: labour productivity in Canada has grown at an average annual rate of just 0.5 per cent since the first quarter of 2005, compared with 2.1 per cent in the United States.

After a long period of productivity underperformance starting in the 1970s, productivity growth in Canada accelerated in the second half of the 1990s, keeping pace with a roughly coincident pickup in U.S. productivity growth (Chart 13). But since 2001, productivity growth in Canada has slowed to historically low rates. It has languished well below U.S. rates, and has been at the low end compared with our competitors in the U.S. market. This is showing up in our international rankings across a range of competeveness measures. For example, the World Economic Forum, while rating Canada's banking system the soundest in the world three years in a row, dropped Canada's ranking in world competitiveness from 7th in 2000 to 10th in 2010.

Enough measurement. What do we need to do to restore Canada's sagging competitiveness?

Restoring Competitiveness

The public sector plays an important role in creating conditions to support productivity growth, and it is important to recognize that successive governments in Canada have done many of the right things. Canadian businesses benefit from a sound policy environment with low and stable inflation, sustainable fiscal policy, and well-regulated financial institutions. A series of important trade agreements have improved access to key markets, and tariff reductions have lowered the cost of intermediate inputs. In addition, a number of measures have substantially improved Canada's tax competitiveness for new investment, making it among the most attractive in the industrialized world.

But while the public sector can sow the seeds of productivity gains, it is up to the private sector to reap the harvest. And it is time for business to step up and deliver. That means getting on with the job of investing, innovating, developing new markets, and finding new, more efficient ways of organizing and executing production.

Needless to say, there are many different business strategies to achieve success. But the results of research over the past two decades are increasingly suggesting a number of specific directions for businesses in search of improved productivity. In particular, while productivity puzzles remain, what has come into clearer focus is that the more productive firms tend to:

- invest more in machinery and equipment (M&E), particularly in information and communications technology (ICT),
- invest more in research and development (R&D) and innovation,
- employ more workers with higher educational attainment,
- and compete in foreign markets.

Looking at how Canadian businesses stack up along these dimensions, there is room for improvement.

Canadian businesses on average invest less in M&E and ICT than their U.S. counterparts. Between 1987 and 2009 Canadian investment per worker in M&E and ICT averaged 77 per cent and 59 per cent, respectively, of that invested in the United States. By 2009, on average, Canadian workers had only about half as much M&E and ICT capital stock to work with as their U.S. counterparts.

Canada has a well-educated workforce that compares favourably when it comes to primary and post-secondary education, but Canadian firms lag in the employment of PhDs and other post-graduates, especially in the sciences, engineering, and business. There are both demand and supply elements to improving along this dimension, but business has an important role to play by placing greater value on advanced education.

In business sector spending on R&D, Canada ranks a disappointing 17th among OECD countries, and when it comes to innovation, the World Economic Forum rates us 19th, far behind the United States, Germany and Japan. Admittedly this may exaggerate the R&D gap as Canadian firms also import a significant share of R&D from foreign countries and by some other measures the gap looks smaller: for example, the World Economic Forum ranked Canada 7th for university-industry collaboration in R&D. Our biggest trading partner ranked first.

On openness and competition, we are a trading nation and have been very fortunate to be right beside the biggest market in the world. But as growth shifts to emerging markets, finding new markets in Asia and Latin America will be critical. Emerging-market economies now represent one-half of all import growth and about two-thirds of global economic growth.

Let me conclude.

Conclusion

Canada's poor productivity performance is not a new story. And there are certain facts we cannot avoid. Our workforce is aging and our labour force growth is declining. We have to compete against more countries in a globalized marketplace, and we are facing greater direct competition as emerging-market economies move up the value chain. These forces put a premium on raising our productivity growth.

But our productivity performance has been particularly weak in recent years. And this now risks holding back the recovery if competitiveness challenges restrain net export growth. As stretched households in Canada pull back and government stimulus unwinds, business investment and net exports must play bigger roles in driving growth. If we needed another more immediate reason to invest in productivity gains and improve our competitiveness, this is it.

At the Bank of Canada we don't forecast the value of the Canadian dollar, but counting on a much weaker dollar to regain business competitiveness looks like a risky business model. A cheap currency is not a business strategy. Business needs to get on with investing and turning these investments into lower unit labour costs and improved competitiveness. The first part—more investment—is at least under way, and the latest productivity numbers offer a glimmer that we could begin moving in the right direction on competitiveness.

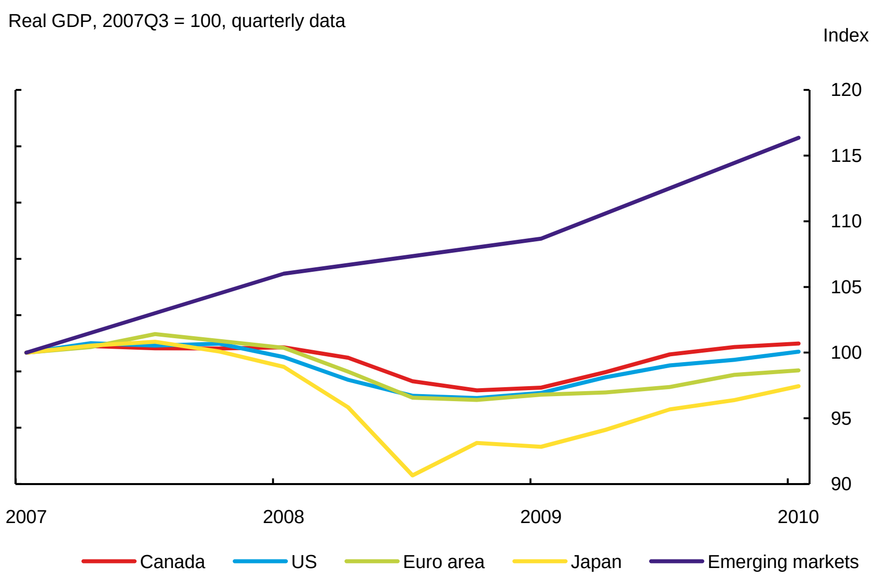
Businesses in Canada can let things happen, make them happen, or see what happened. Let's make them happen.

Thank you.

Appendix

Canada's Competitive Imperative: Investing in Productivity Gains

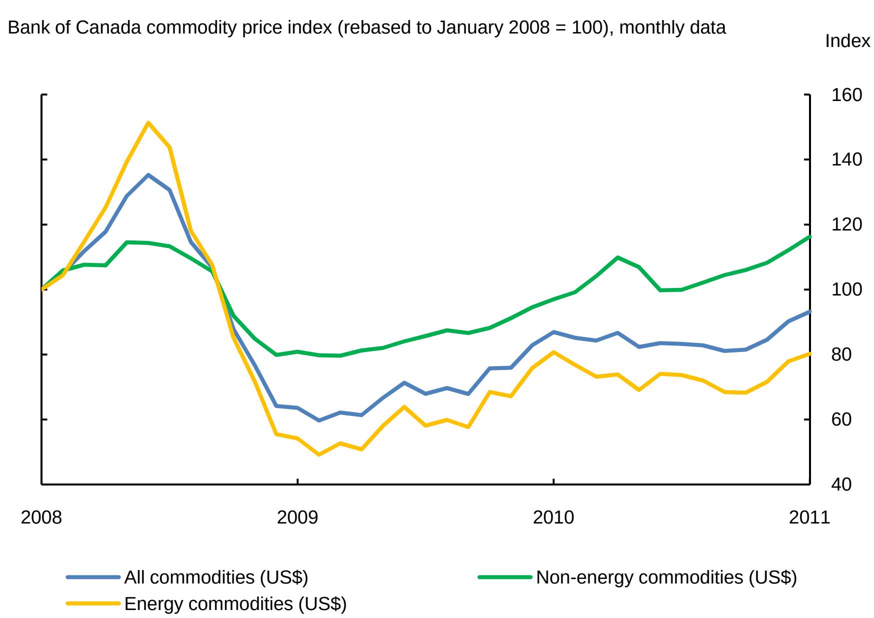
Chart 1: Emerging-market economies drive global growth



Note: For advanced economies, quarterly data are shown. For emerging-market economies, only data for the third quarter of each year are shown.
Sources: Statistics Canada, U.S. Bureau of Economic Analysis, Eurostat, Japanese Cabinet Office and International Monetary Fund

Last observation: 2010Q3

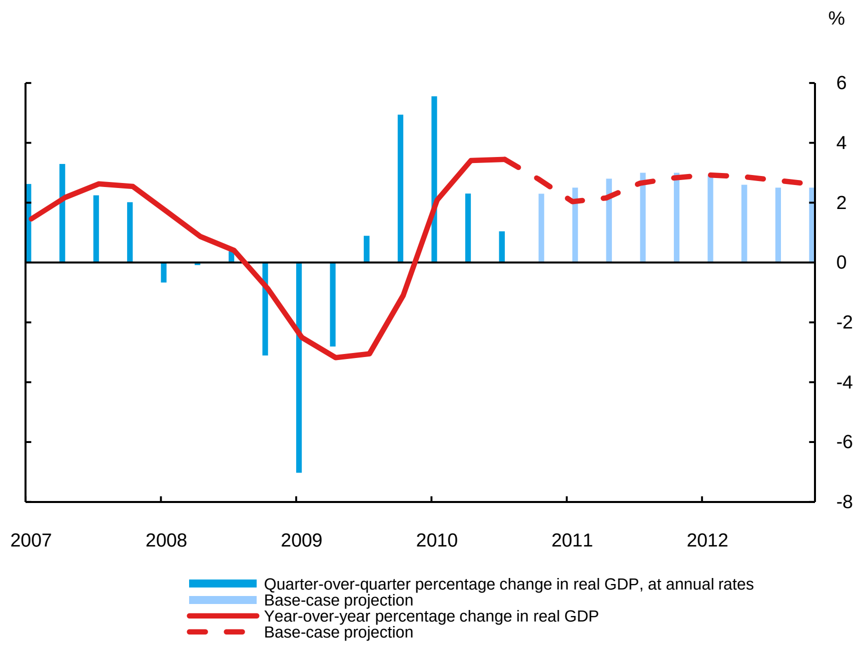
Chart 2: Global commodity prices have risen



Note: Values in January 2011 are estimates based on the average daily spot prices up to 14 January 2011.
Source: Bank of Canada

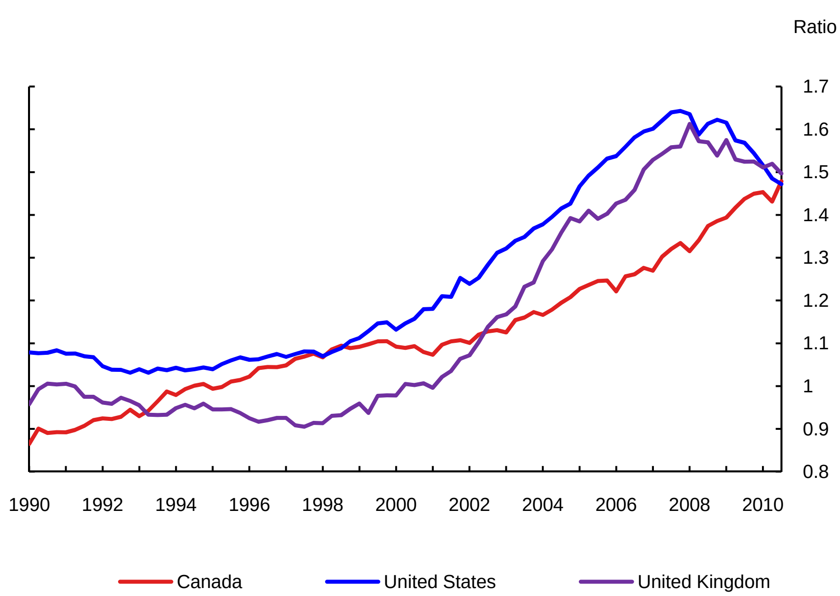
Last observation: January 2011

Chart 3: Real GDP growth in Canada



Sources: Statistics Canada and Bank of Canada projections

Chart 4: Canada's household debt-to-income ratio on the rise



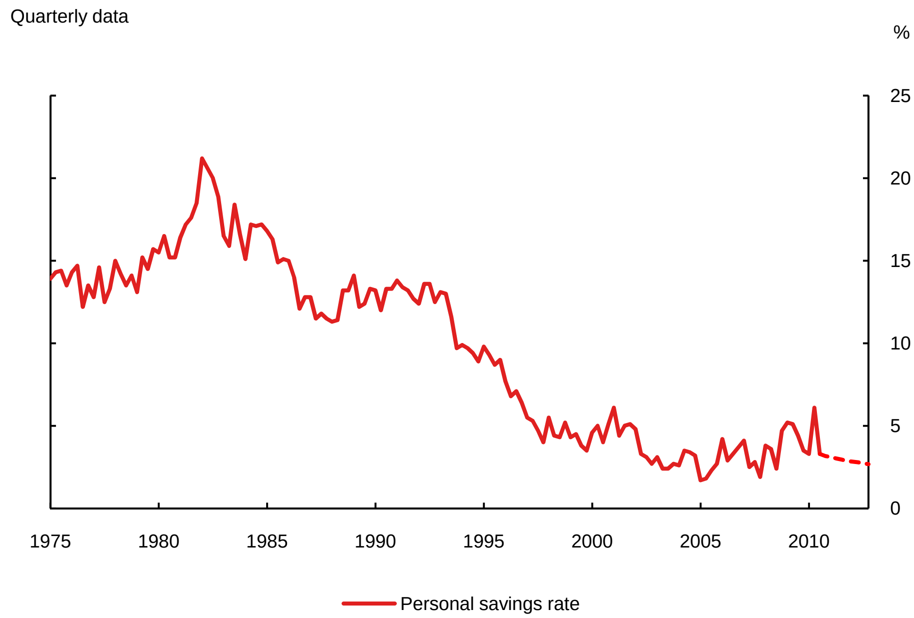
Sources: Statistics Canada, U.S. Federal Reserve, U.K. Office for National Statistics

Last observation: 2010Q3

Table 1: Contributions to average annual real GDP growth (percentage points)

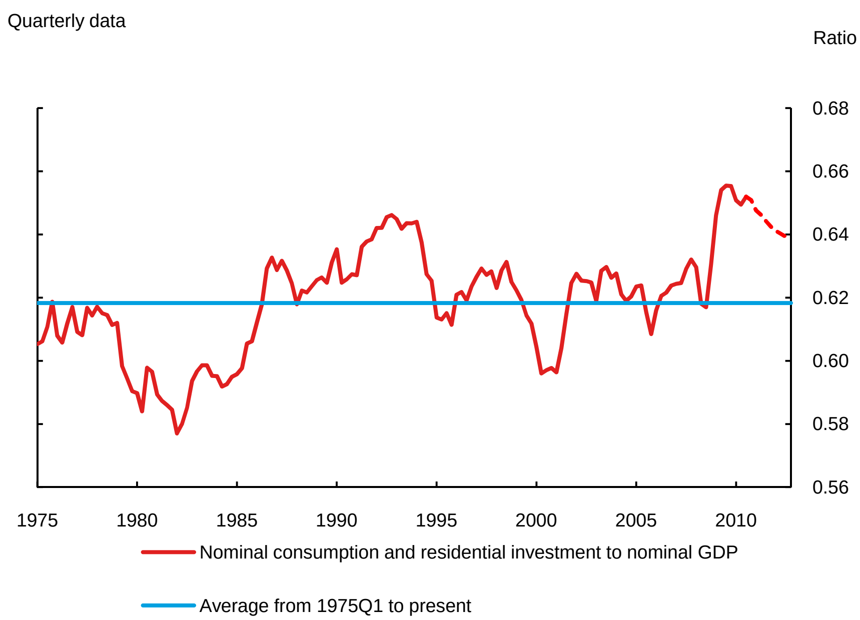
	2009	**2010**	**2011**	**2012**
Consumption	0.2	1.9	1.4	1.2
Housing	-0.6	0.7	-0.1	0.0
Government	1.2	1.0	0.0	-0.5
Business fixed investment	-2.6	0.6	1.1	1.2
Subtotal: Final domestic demand	-1.8	4.2	2.4	1.9
Exports	-4.7	1.9	1.8	1.9
Imports	4.9	-4.2	-1.7	-1.2
Subtotal: Net exports	0.2	-2.3	0.1	0.7
Inventories	-0.9	1.0	-0.1	0.2
GDP	**-2.5**	**2.9**	**2.4**	**2.8**

Chart 5: Personal savings rate in Canada projected to remain near historic lows



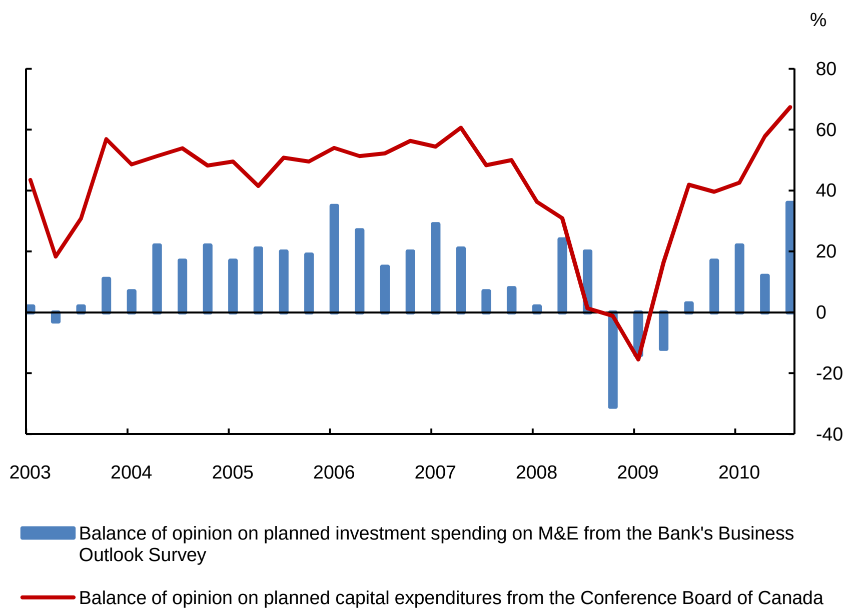
Sources: Statistics Canada and Bank of Canada calculations and projections

Chart 6: The contribution of household expenditures to GDP is expected to fall but remain well above its historical average



Sources: Statistics Canada and Bank of Canada calculations and projections

Chart 7: Firms intend to invest

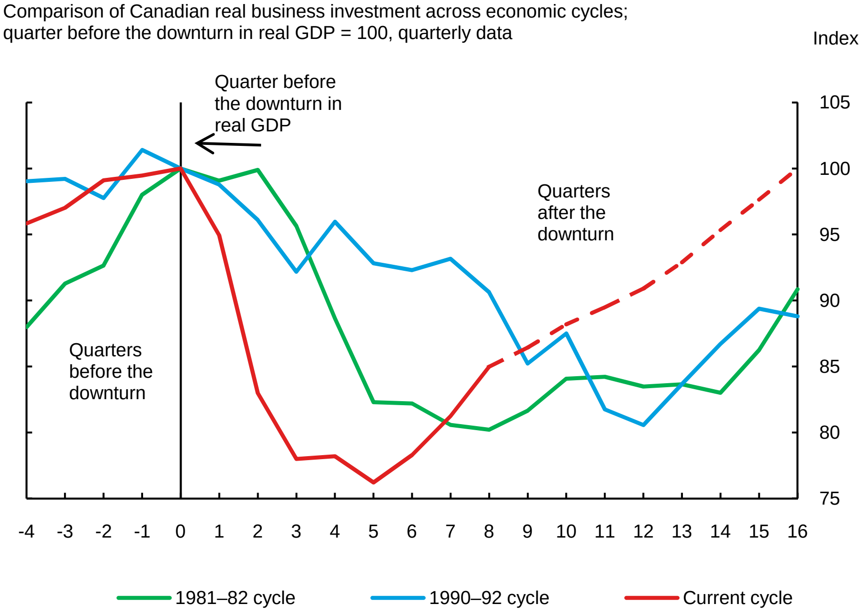


Sources: Statistics Canada, Conference Board of Canada and Bank of Canada calculations

Last observations: 2010Q3

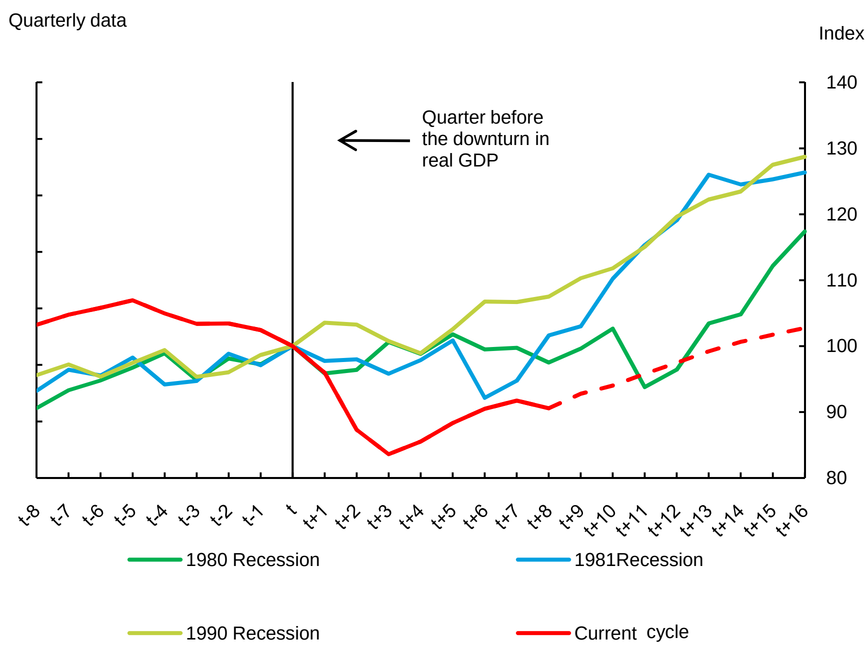
Chart 8: Business fixed investment is expected to rebound strongly

Comparison of Canadian real business investment across economic cycles; quarter before the downturn in real GDP = 100, quarterly data



Sources: Statistics Canada and Bank of Canada calculations and projections

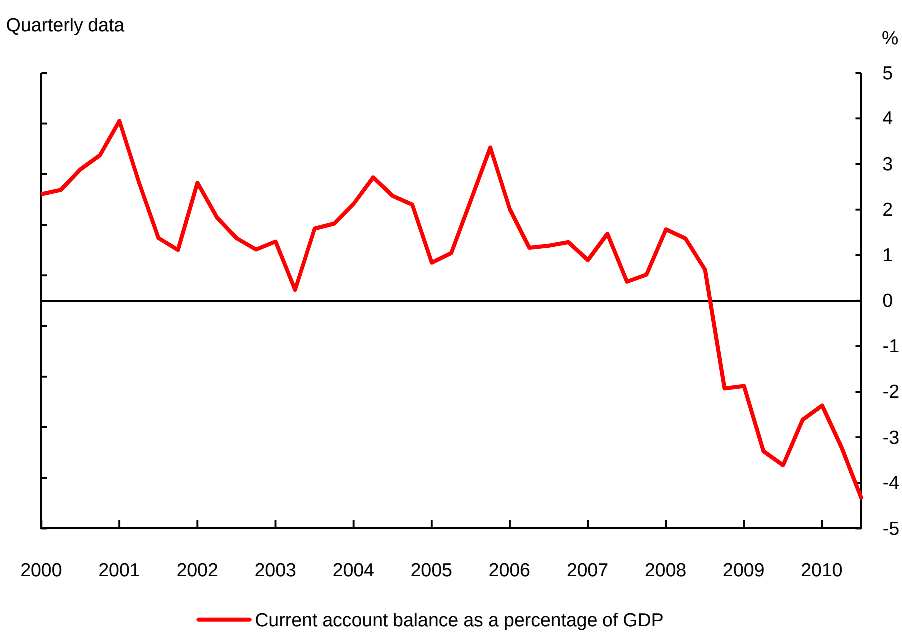
Chart 9: Canadian exports fell sharply in the recession



Sources: Statistics Canada and Bank of Canada calculations and projections

Last observation: 2010Q3

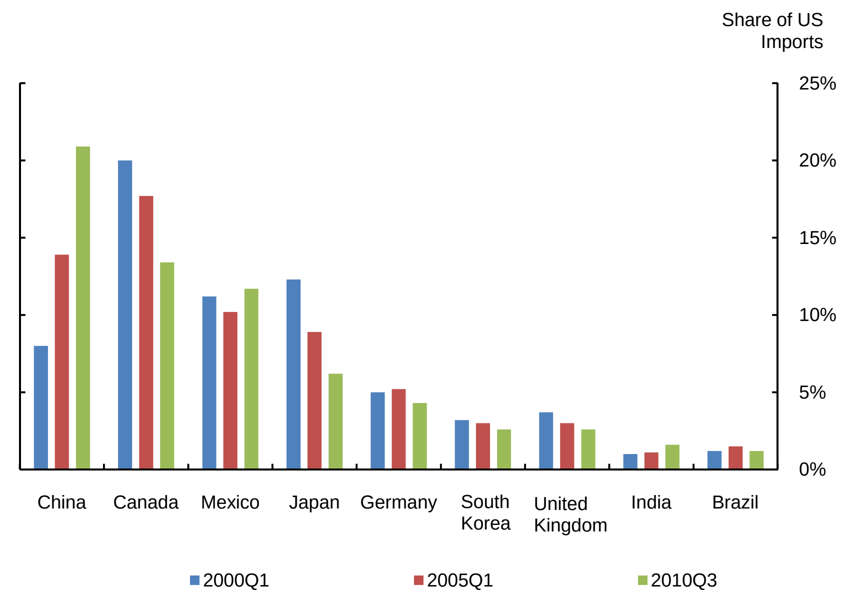
Chart 10: Canada's current account balance has declined sharply



Sources: Statistics Canada and Bank of Canada calculations

Last observation: 2010Q3

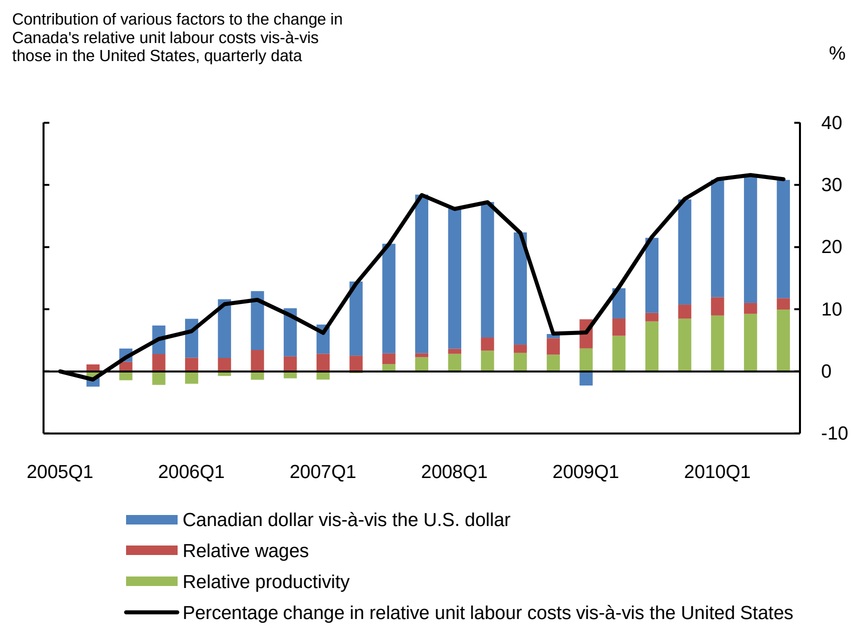
Chart 11: Canada is losing share of the U.S. import market



Source: U.S. Census Bureau

Last observation: 2010Q3

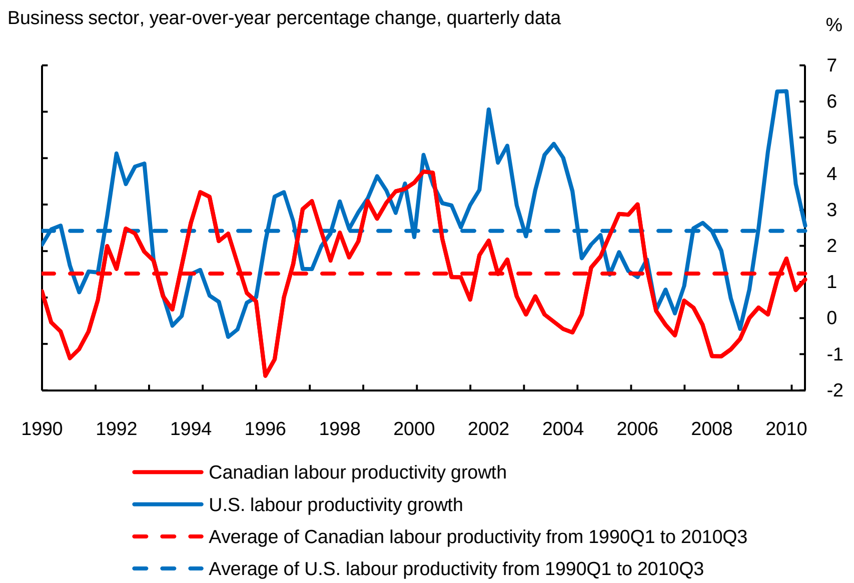
Chart 12: A strong Canadian dollar and poor productivity explain Canada's weak competitiveness



Sources: Statistics Canada, U.S. Bureau of Economic Analysis and Bank of Canada calculations

Last observation: 2010Q3

Chart 13: Labour productivity growth: Canada and the United States



Sources: Statistics Canada and Bank of Canada calculations

Last observation: 2010Q3