



Special Report

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Canada's Disturbing Productivity Performance

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The Canadian economy has clearly pulled out of recession with 5% growth in the fourth quarter and good momentum heading into this year. Excluding movements in inventories of unsold goods, final sales were up sharply last quarter, posting 6.5% growth compared to a much slower 1.9% pace in the U.S. Despite the relative strength in our economy, businesses in Canada, in their cautionary fashion, have been reluctant to step up their expenditures on machinery, equipment and innovation to offset the decline in competitiveness resulting from the surge in our dollar (*Chart 1*). A Conference Board survey shows that U.S. CEOs, however, are more confident about current and expected economic conditions than at any time in the past five years, though small businesses are a lot less cheerful.

Chart 1

Canadian Business Confidence Still Lacking

Conference Board (long-term average = 100)

Business Confidence

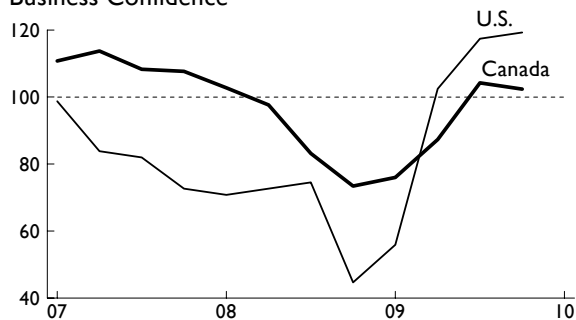
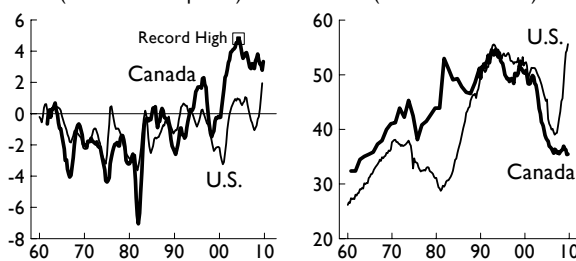


Chart 2

Businesses Risk Averse... Hoard Cash

Corporate Savings
(% of GDP : 4-qr ma)

Corporate Debt
(ratio to net worth)



Corp. Savings = Corp. Profits + Non-cash Expenses - Non-residential Investment

Healthy balance sheets are one reason for the improved sentiment. But balance sheets are healthy in Canada as well. In fact, Canadian businesses have lower debt ratios and higher savings than their cohorts south of the border (*Chart 2*). Although domestic demand remains soft in the U.S., costs are firmly in check. Over the past three quarters, drastic cost cuts (especially for labour) have led to the fastest productivity gains in half a century for U.S. nonfarm businesses.

Canadian business appears to be spooked by the continued rise in the loonie. Exports, until recently, plunged with the global recession and exporters are under increasing competitive pressure in selling their products in the U.S., U.K., Europe, and the emerging world. The loonie recently hit a 25-year high against pound sterling and a 2-year high versus the euro. We expect that the Canadian dollar will remain strong, straddling parity, for at least the next few years (*Chart 3*). With trade accounting for more than a third of our economy, living standards will decline unless we rebuild our competitiveness. This means a sharp rise in our productivity is essential to our future economic well being.

Using our resources more efficiently and improving the quality and the variety of our products and services boost our

Chart 3

Canadian Dollar to Stay Strong

(US¢ : as of March 22, 2010)

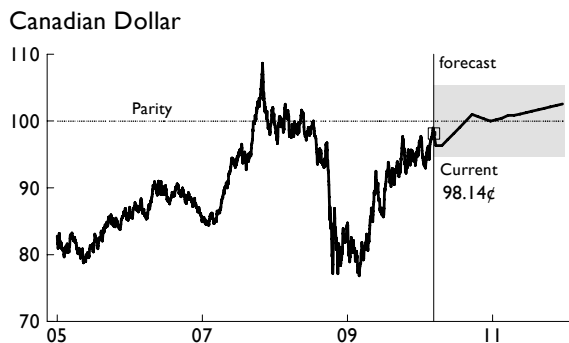


Chart 4

Productivity Lags in Canada

(y/y % chng)



competitiveness. For decades now, hard as we have tried, our performance in this regard has been dismal.

Canada's Poor Productivity Performance

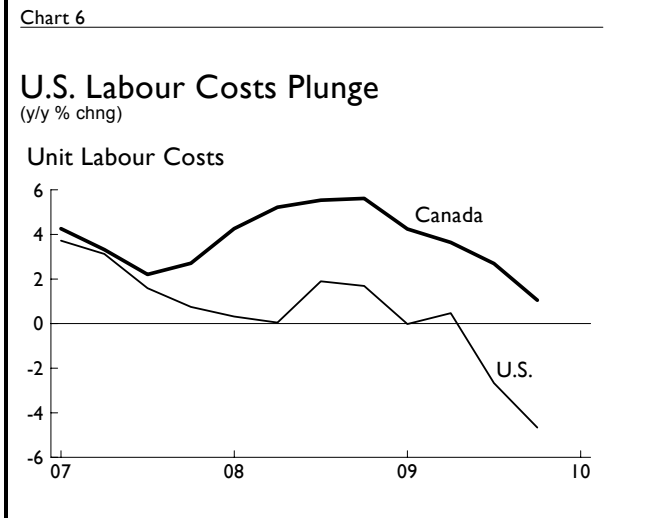
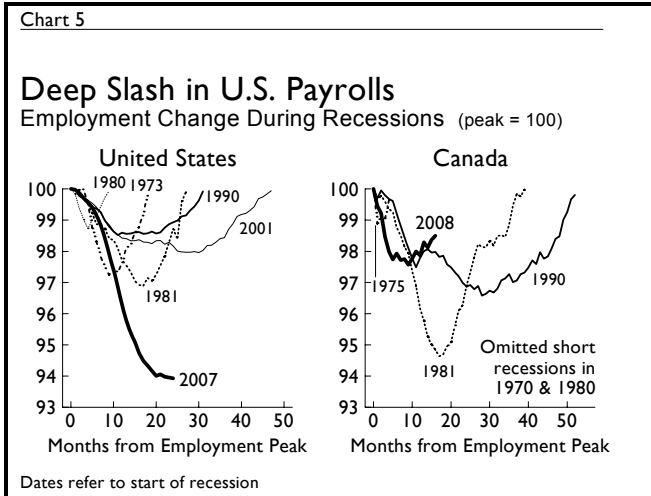
In recent years, the yawning gap between productivity growth in the U.S. and Canada has hit near record levels (*Chart 4*). U.S. productivity growth is surging, a precursor to future job growth. Business sector productivity in Canada jumped unexpectedly at a 5.6% annual rate in Q4, its fastest quarterly gain since the late 1990s, but that doesn't erase the dreadful performance of the past 3+ years, which had seen productivity essentially stagnate. Still, it left output per hour up 1.1% year-over-year, precisely in line with its 25-year average.

Productivity in the U.S. over the last three quarters of 2009 jumped at a remarkable 7.4% annual rate. At the first sign of crisis and economic slowdown in 2007, American business slashed labour to the bone, which apparently forced the remaining workforce to do the jobs of many that left. Businesses cut payrolls far more deeply than in any other recession in the post-war period (*Chart 5*). Even with the big layoffs in the auto sector and the surge in the Canadian dollar, the job losses in Canada were mild in comparison to the losses in the 1981 and 1990 recessions and trivial in comparison to the U.S. and other countries during the latest downturn.

This substantially reduced business expenses in the U.S. as unit labour costs plunged 4.7% last year, the fastest in at least six decades. This compares to a 1.1% increase in Canada (*Chart 6*). Profits are soaring at American businesses and decision-makers are confident enough to invest in capital equipment. U.S. business spending on equipment and software jumped 18% annualized in Q4, the fastest rate since the giddy tech-boom days of early 2000. A good chunk of the spending was on computer gear, which is driving the productivity gains¹. In comparison, Canadian business investment in machinery and equipment contracted

¹ U.S. business investment is likely to remain strong. According to a recent Duke University survey, U.S. CFOs expect earnings to increase 14.3% and capex to rise 8.9% this year. Employment is expected to rise only 0.2%, resulting in strong productivity growth this year as well. Even so, leading indicators of job growth in the U.S., such as temporary jobs and the PMI surveys for manufacturing and nonmanufacturing businesses, are showing encouraging signs.

Business spending, however, cannot be the sole driver of U.S. expansion this year. As capex accounts for just 6% of U.S. GDP (compared with a 71% personal consumption share), it can't possibly drive the recovery by itself, barring another tech bubble. In addition, business spending on new buildings is likely to retrench further in the face of high vacancy rates and tight credit standards. The U.S. recovery's best hope is if companies start to spend their cash on new workers. With credit still so tight, the current recovery, perhaps more than any in the post-war era, likely depends on employment and income growth to propel consumer spending and residential construction.



9.2% even though the strong loonie reduces the cost of imported technology. Ottawa is keen to address this deficiency, eliminating all tariffs on imported capital goods and other products used in manufacturing in the latest budget.

Causes of Canada's Productivity Problem

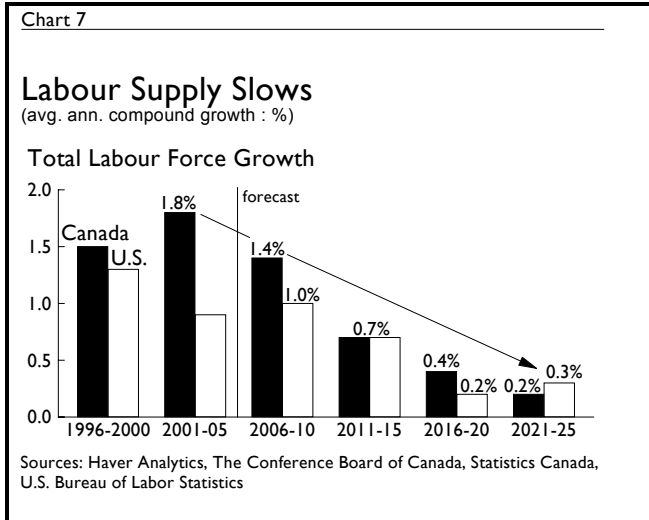
The reasons for the great productivity disparity between Canada and the U.S. are not fully understood. Productivity growth is the most important long-term determinant of living standards (along with the terms of trade and labour force participation rates). For decades, economists have studied the Canadian productivity problem and governments have corrected, at least in part, many of the structural contributors such as relatively high corporate tax rates, insufficient capital availability, relatively high interest rates, too much regulation and red tape, government subsidies to declining industries, inter-provincial trade barriers and impediments to foreign investment. The secular decline in the loonie also contributed to the problem by pushing up the cost of imported capital and encouraging the over-use of relatively cheap labour.

Readily available credit is also an important competitive advantage. Financial institution regulators must be careful not to stifle potential growth and improvement in living standards by over-regulating our already-strong banking system. Canadian

banks have an enduring competitive advantage in fostering business development and education and training for the decade to come.

Canada's debt burden is the lowest among the G7 and our economy has recovered relatively well from the Great Recession. Corporate tax rates have declined significantly and are slated to fall further. However, business sector productivity growth has deteriorated further over the past decade.

Confusingly, according to independent assessors, Ontario's auto manufacturing facilities were the most productive in North America, so measurement problems might be part of the disparity. Measuring output and factor inputs is very difficult, both conceptually and in practice. In the retail sector, for example, margins have been the conventional output measure. Increased competition has driven down these margins, but 'output' in retailing has not declined. The rise in the quality and variety of goods has been a major source of economic growth, but this is not accounted for in output statistics. Price declines for most



tech products further exacerbate the measurement problems. On the input side, there are analogous problems, particularly with respect to human and physical capital.

The academic literature² is extensive. **Generally, there are three main drivers of national productivity growth—investment in machinery and equipment, human capital development, and openness to trade and investment.**

Canada faces some challenges in this regard.

- Innovation and technology diffusion is more difficult in smaller open economies where most markets for new products are external; a large share of the world's knowledge is generated outside the country; and, foreign-owned multinationals have a large presence in the domestic economy. The major disadvantage Canadian plants face in technological adoption relative to the U.S. is the smaller market size, with some additional worries about labour market inflexibility and stronger unions.
- Canada has fewer or smaller regions of specialization (such as Silicon Valley, Broadway, Hollywood, Wall Street, The Garment District), so we miss out on the scale advantages as well as the dynamic knowledge spillovers, ease of communication and facilitation of learning these areas provide. As well, Canadian talent in these sectors is often lured away.
- Growth is fundamentally driven by the reallocation of resources from low to high productivity activities. Ironically, while economists in the 1990s blamed Canada's weak productivity performance on secularly weak aggregate demand, some now argue that the 16 years without a recession from 1992 to 2008 might have contributed to the productivity problem. Cyclical downturns facilitate the obsolescence of old technology and move resources to more highly productive uses.
- Enlarging our markets through globalization is also important. Canada benefited enormously from the free trade agreements, as exports grew from about 25% percent of GDP to in excess of 35% before the most recent recession. But the U.S. accounts for too much of these exports (70%). We need to diversify our customer base by strengthening business ties with Brazil, India and China, the growth leaders of the future.

Talent Management Is Key

Canada, like many other industrial countries, is disadvantaged by the aging of the population and the marked slowdown in labour force growth, which reduces growth

² See, for example, R.B. Harris, "Determinants of Canadian productivity growth: Issues and Prospects," *CIAR*, September 1999.

potential (*Chart 7*). A sharp rise in trend productivity growth is an important offset, as immigration will not entirely fill the gap. Productivity-enhancing technological development will help. So will medical innovation that allows boomers to retain their productivity longer in life, and incentives for the delayed retirement of productive workers. Innovation and a better educated workforce are drivers of productivity growth in the increasingly open global economy. Government spending on education per capita must be increased. The quality of education is also key as we strive for our students to achieve higher proficiency in math and science.

Best practices in hiring, developing, retaining and deploying talent has changed dramatically and this is a make-or-break driver of profitability and productivity. The most sought-after workers, those with the essential knowledge-based skills, trade in a global market. Canada must increasingly attract talent from outside the country to help transfer leading-edge protocols and innovation. Clearly a strong currency and lower tax rates along with the high standard of family living put Canada in an attractive position.

Canadian business needs to re-evaluate its talent management practices, especially with respect to recruitment, development and deployment. Too few Canadian businesses relative to their foreign competitors are willing to undertake international searches for top talent; this is a huge competitive disadvantage, not only in the C-Suite (senior executives), but below that level as well. Canadian businesses rely too heavily on generalists. It is crucial to put experts in roles that demand expertise.

As well, many large Canadian corporations continue to move people around for their professional development. Today's competitive business environment is no place for trainees in leadership roles. They move so often that they never have to live with their mistakes. Every time someone is moved into a new role, they undo most of what their predecessor put in place, further eroding the potential productivity of the team or department.

Bottom Line: Canada is in a much better competitive position to attract skilled labour and foreign investment than it was 15 years ago. Many of our structural employment and government tax and spending problems have been addressed. Moreover, the Internet and other communication technologies have spurred the growth of medium-sized cities and facilitated the development of small- and medium-sized businesses where employment growth has been the biggest.

Enhancing the productivity of labour now depends on business capital expenditures, which are far more affordable with our strong and rising currency.

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