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ON THE OTHER HAND ...

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Sylvia Ostry
Chairman - Présidente

We are becoming increasingly aware of the perils of progress. Even as medical science makes impressive strides in reducing the risk of fatal and debilitating disease, worrisome new maladies arise and epidemics strike with fearful speed as immunizing vaccines continue to elude us. For example, for many years now I have been preoccupied with the dangers of statistical hypochondria. By far the best description of this insidious sickness I have yet discovered comes from that venerable journal Punch. I feel I must quote it -- and I apologize to those who have heard it before -- in case there are some poor sufferers here who don't realise they've got the germ. It's highly contagious. I quote:

> "The tragic trade deficit of half-past nine this morning was already offset by ten o'clock by forecasts of an unprecedented boom from Mr. Peter Walker. "The next twenty-five minutes or so look like being the best period for British industry since the turn of the century, or, at any rate, tea-time yesterday," he told economic journalists at his morning press converence. Unhappily, as they were leaving, the worst trade slump for many years struck the country, and share prices fell drastically, matched by a drop in the pound to slightly less than fourteen cents. But, as they turned and ran back up the stairs, an announcement by Mr. Anthony Barber

who appeared on the landing, confidently assured them that an upturn in the economy was expected before lunch. During the early afternoon, however, the economy went bankrupt, and it was not until almost five p.m. that the Prime Minister was able to note that Britain was now enjoying a prosperity unparalleled since breakfast."

I'm sure you will agree that statistical hypochondria remains a serious danger to mental health and public policy but I'm sad to report that I have recently observed the emergence in this country of a new but related illness -- economic melancholia -- a morbid social depression which results in a persistent and pervasive pessimistic outlook regarding any and all economic news. The American business journalist who uses the nom de plume Adam Smith has termed the phenomenon Establishment Dire -- "a visceral malaise like a dark shadow in a half-remembered dream". We have all brooded over the dangers of imminent deindustrialization, a plummeting dollar, the inevitability of soon freezing to death in the dark and sundry other horrors lurking just around the corner. I have observed that this particular disease seems to be an occupational hazard of journalism (good news is no news) but all of us suffer from it on occasion.

As well as destroying confidence, this pernicious melancholia has led to extensive introspection, to a search for villains, for breakdowns in our economic machine and in our policies. The miracle cure is sought with the fervor of an Arthurian quest for the Holy Grail, and as in the legend, none readily appears. More dangerous, perhaps is the temptation

to seek the services of quacks who prescribe what my friend Clarence Barber describes as the economic equivalent of laetrile.

One way of dealing with this disease is to try to seek some perspective on and understanding of the strength and weakness of the economy. That's the task I have set myself today. Given the constraints of time I can only skim lightly over the subject, focussing on the recent evolution of the manufacturing and the service sectors of the Canadian economy. The picture is neither entirely rosy, nor entirely black. Like most members of my profession I will be presenting an ambidextrous view; on the one hand our situation is not as bad as many say, on the overworked other hand, we must realize that we face some very serious difficulties and challenges.

There seems to be a natural Canadian tendency when analyzing the current health of our economy to concentrate on developments in the primary sectors, like agriculture, forestry, and mining, and in the manufacturing sector. Rarely, if ever, is the service sector and its attendant problems given a fair share of our concern. Today, though, I would like to go against this tendency by spending some time discussing this very important area of our economy.

As you may know, service sector growth has been essential in providing employment for our rapidly growing labour force. According to OECD figures, from 1965 to 1975, both the Canadian labour force and employment grew more quickly than those of any other OECD nation. Over the last 3 decades total employment in Canada has roughly doubled; some 90% of this net increase is due

to increases in the service sector, an increase of some 4.5 million jobs. Two out of three jobs in our economy are now in the service sector. Eighty per cent of employed women work in the service sector.

Before going further I should perhaps make clear just what constitutes the service sector. A service is probably best defined as almost anything that can be produced but which you can't actually drop on your foot. This includes transportation, communications, retail and wholesale distribution, entertainment, medicine, education, law, research and more -- just about every function, other than the direct physical production of food and materials, needed to ensure the efficient functioning of our markets and to satisfy the needs and wants of our increasingly demanding, heterogeneous society.

These service industries and the goods-producing industries are inextricably linked. You simply "can't have one without the other", as evidenced by the recent growth record. Since 1951, the annual rates of real output growth in both sectors have been almost identical and final expenditures on services as a share of total expenditures have remained almost stable. If our economy is de-industrializing, as the gloom merchants often claim, then it is not evident from these data.

One source of the de-industrialization view, however, is the employment data. Simply, it shows that in 1948, one in every four employed persons worked in goods-producing industries. By 1977, this ratio had fallen to one in five; service sector employment gains, as I mentioned earlier, far outstripped the gains in other areas.

The divergent employment patterns between manufacturing and services despite similar output records is, in part, due to the fact that the service sector hires an enormous amount of part-time help with one employee in seven being part-time versus one in 25 in the goods sector, and the percentage of part-time workers has grown more rapidly in the service sector. Althouth this factor alone has tended to reduce the growth of output per employee in the service sector, it is not in and of itself sufficient to explain the divergence of output and employment. Even when we make allowance for the number of hours worked, and do not include certain parts of the service sector where measurement difficulties preclude meaningful estimates, service sector productivity growth has fallen well below the achievements of the manufacturing industries. On average, for example, from 1950 to 1977 output per manhour in manufacturing grew by 4.3% per annum. The same calculation made for the service sector yields an average gain of just 1.8% -- or 2.9% for those services where measurement problems are less significant.

What is the problem? Is this an inherent feature of the service sector or can we reasonably expect more productive use of labour in these industries?

The structure and composition of employment in the service sector differs considerably from manufacturing. Services, although employing many professionals and other highly skilled people have also large clerical and semi-skilled staff. Indeed a large segment of the service sector employment is still only modestly skilled while the proportion of unskilled workers in

goods-producing industries has been shrinking rapidly. As well, the service sector employs a large number of secondary earners and other employees whose job-related experience is shorter than average.

Another factor worth noting stems from the employment pattern. With a large supply of relatively lower paid employees available to the service sector, there was less pressure on firms to increase their levels of capital investment. As a result, although over the past 27 years total capital investment has grown at about the same rates in the service and goods sector, in 1977, the service sector had about 37% less plant, machinery and equipment per worker than the goods sector.

So a relatively unskilled, unequipped, inexperienced labour force in the service sector has not been able to achieve the productivity growth rates of the goods-producing industries. As a result, with wage increases in the sector equalling, in percentage terms, those of workers in other areas, price hikes for services have been roughly twice as high as for goods, with particularly notable increases for hospital care and education services.

Despite such price hikes, the demand for services grew very strongly. The reason is fairly straightforward. It is due to the way in which we consumers change our spending pstterns in response to changes in both the relative prices of goods, and our own incomes. In the case of services, our estimates have shown that in the past thirty years, the positive effects of our rapidly growing incomes on our demand for services has more than offset the negative effects of the relative price

increases. For goods, however, we respond less strongly to incomes and more strongly to relative prices, the opposite of services, and as a result the growth of demand for goods and services has been quite similar despite the relative price change in favour of goods. If I have managed to obscure this point for you, let me put it simply this way. The past growth of the service sector depended a great deal on income growth and would have been even greater had it managed a more respectable price performance

Now the effects of poor productivity gains appear to be catching up to the service sector. In the past few years, we have begun to see signs of growing consumer resistance to further service price rises with signs of response from the service industries. A substitution process has begun. Around the home, and at simpler jobs, people are taking on tasks normally carried out by employees in the service sector. Do-it-yourself home and car repair courses proliferate while self-service gas stations, virtually unknown five years ago, are rapidly becoming the norm. In other areas, such as banking and administration, computers are being substituted for labour to perform routine clerical functions, and high technology has entered every field from brain surgery to car repairs.

In addition to the domestic problems caused by this relatively poor productivity performance, our balance of payments situation has been exacerbated by growing trade deficits in tourism and travel.

In 1950, just a few years ago, Canadians spent less money -- almost $50 million less -- outside the country than was spent here by visitors. In 1977, Canadian travellers

managed to outspend our visitors by some $1.6 billion. Part of this deterioration is due to the rise in Canadians' standard of living. People with more money travel more. But part must be attributed both to our failure to develop more fully our own tourism industry and to the relatively high costs of travelling within Canada -- high costs due at least in part to the increasing of minimum wage levels and high transportation costs associated with the energy costs and the distances involved. Of late, both federal and provincial governments and the tourism industry have renewed their efforts to promote tourism in Canada through intensified promotional campaigns and tour programs. The most recent trade data, for the third quarter of 1978, indicate that the effects of the devaluation combined with these governmental programs have had some salutary impacts on our deficit position -- or am I,also afflicted by statistical hypochondria. Long-run enduring improvements in our balance of payments will depend heavily on our ability to limit price increases in our tourism industry therefore making travel in Canada more attractive both to Canadians and foreign visitors. I would like, however, to dispel the rumours that the government is actively engaged in efforts to purchase the entire State of Florida simply to improve our travel deficit.

Perhaps I should summarize here. On the one hand, the service sector growth has been, until recently, quite strong and has resulted in the creation of many jobs; on the other hand, productivity, investment, and price performance have been much less than fully satisfactory.

The outlook then is mixed. At present relative wages and price levels and with past productivity performance, growth at previous rates in the service sector would be, at best, unlikely. However, there are significant opportunities to improve on past productivity and price performance, and therefore to take advantage of renewed demand. One positive sign is that services are becoming industrialized with increasing emphasis on efficiency -- the "Big Mac" model if you like -- with plans to utilize fully the efficiencies of scale and specialization generally ignored in the past.

This increased productivity, while unquestionably needed, could, however, further exacerbate the unemployment situation, especially among the inexperienced and semi-skilled workers dependent on service sector employment. Several factors militate against this happening. First, by moderating price increases the increased productivity should result in greater demand for services creating more, not fewer, jobs. Second, the labour force growth rate will soon begin to decline. For example, between 1970 and 1975 the labour force grew at average annual rates of some 3.7%. A recent OECD projection indicates that between 1980 and 1985, this growth rate should moderate to less than 2%. Finally, the service sector workers have shown high levels of frictional or turnover unemployment due in part to the large number of young and secondary income earners in the service sector, the nature of the jobs, and the seasonal nature of many service industries. As the sector industrializes, and as the

labour force attachment of many service sector employees increases, as might be expected, this sort of unemployment problem should diminish.

In marked contrast to the service sector, which has been little studied, is the manufacturing sector which has been the focus of considerable concern over the past few years. We have witnessed falling manufacturing employment, a deteriorating trade position with respect to many manufactured goods, and investment activity proceding at a snail's pace -- a slow and slightly contrary snail at that. As a result, the longer term viability of this sector is now seriously questioned.

As with most general economic sectors, this is a very diverse, highly heterogeneous grouping of activities which consists of some 30,000 firms producing a vast array of goods from high technology items such as electronics, telecommunications, and chemicals to basics such as tobacco products and primary metals. The prospects for individual firms, products and industries can and do differ markedly from those of others in this sector. Hence we now witness simultaneously industries and individual firms in such diverse areas as food processing, telecommunications, steel products, aircraft and aircraft parts, even some parts of the textiles industries, which compete very successfully in international markets with high quality, competitive products, and other industries and firms which are, to say the least, in serious difficulty.

On the whole, as with the service sector, output growth in manufacturing over the last 3 decades has been quite strong. From 1950 to 1961, there were two periods of relatively rapid

growth, a total of some 21 quarters at average annual growth rates of 8.0%, and there were two poor periods with average annual gains of only .9%.

Then came the 1960s, the period which we now nostalgically view as the golden age of growth. From 1961 to 1966, manufacturing output boomed at average annual rates of 8.4% and even during the following five year period of slower growth, output gains averaged 4.2% per year. This boom has been attributed to the conjuncture of a number of factors including the devaluation of the Canadian dollar, rapidly growing world trade, the signing of the auto pact, U.S. economic strength, and the Defence Production Sharing Arrangement.

The strength continued from the 1960s into the 70s -- until the crunch of 1974. From 1971 to 1974, manufacturing output increased by roughly 7.9% per annum, then in 1974 it dropped by 9.2%. In the years since, although still weak compared to the salad days of the 60s, manufacturing growth has recovered slightly to average 4.0% annual gains.

On the one hand, this has been a very respectable performance given the universally weak demand conditions; on the other hand the growth has not been sufficient to mask the fact that there are additional, seemingly intransigent structural problems within the manufacturing sector -- problems which detract seriously from the long run potential success of Canadian industry -- and many remain deeply pessimistic about the future competitive performance of Canadian industry. This pessimism is not entirely unwarranted.

Although output per man hour growth was, from 1961 on, slightly higher in Canada than in the U.S., a recent report of the Senate Committee on Canada-U.S. Relations suggested that there still often remains a significant productivity gap between the two countries. This confirms another study of 33 manufacturing industries which found that in 1974, output per man hour in Canada averaged only about 80 per cent of the U.S. level. There is an important element of diversity in play here. While durable goods industries averaged 95% of U.S. levels, non-durable industries averaged only 70%. Not surprisingly, those industries with the best productivity records also are heavily export based and compete openly on world markets.

Even in relation to Japan and the "new Japans" -- the newly developed and developing nations -- our overall productivity performance has not been adequate. In 1958, output per man hour in Japan was only some 27% of the Canadian level; by 1976, it had reached almost 90 per cent. What's more, it does not seem to me to be unreasonable to expect the now emerging new Japans to close the productivity gap with equal if not greater speed.

So, on the one hand, our productivity performance has not been great, and on the same hand, our wages have managed to rise much more rapidly than have American wages. In 1968, Canadian manufacturing hourly compensation costs, that is wages plus other benefits, amounted to just 77% of the corresponding American figure; by 1977 this had risen to over 103% of U.S. costs before falling with the exchange rate to 98%. Other recent estimates show Japanese compensation rates, despite the revaluation of the Yen, to have been a full 25% <u>less</u> than Canadian rates as of June of this year.

The parallel to the service sector must be obvious; our overall productivity performance has not been sufficient to mitigate the effects on prices and hence on competitiveness, of higher production costs. This, I would like to emphasize, is not a comprehensive indictment of all firms nor industries. As I noted earlier, in many individual manufacturing areas, Canadian firms are world leaders, both technologically and in terms of productivity, and compete very successfully in world markets. But the fact remains that a significant portion of Canadian manufacturing is not performing up to international standards.

Much ado has been made recently of the need for increased research and development activities in Canada, particularly in light of the activities of the Science Council, and there seems to be a broad consensus emerging that this might be a desirable goal. In fact, prominent features of several recent budgets including the most recent have been incentive plans to encourage R & D work in Canada. I have no doubt a selective strategy in this field can aid the Canadian economy, but it is very clear that it will not single-handedly resolve all outstanding problems. Benefits will be dissipated if we develop new technologies for products which we can't sell due to high production costs.

There is at least one area though, where additional research and development work, and investment activity is urgent and will very clearly pay extra dividends. This is in the area of efficient energy utilization. As I have noted in a recent speech

to the Conference Board in Canada, relative to the United States, we in this country use more energy per unit of output. Therefore, any energy saving we can achieve will have even greater beneficial effects here, and the consequences of not conserving, will be more damaging.

One prime and often-cited source of inefficiency in Canadian industry is the organization of our in-plant production process. In particular, many studies, including those of the Economic Council, have shown that individual Canadian plants produce a wider range of products than similar American plants, thus preventing the Canadian plants from taking advantage of longer, more efficient production runs. According to Dr. Don Daly of York University, "this is the most important single source of the differences in cost and productivity between the two countries."

This being so, what can we do to resolve the problem?

Basically, there are two major steps to be taken. First Canadian producers should strive to enlarge their markets to permit longer single unit production runs. The depreciation of the dollar and the prospects of lower tariffs from the ongoing GATT negotiations should provide an impetus and opportunity for Canadian manufacturers to increase their share of rapidly growing world markets. The size and potential of these markets is enormous. China alone, for example, currently imports between $6 and $7 billion per year. In the next 10 years, this is expected to grow to between $30 and $40 billion per year. These are markets for which the competition is, and will be, intense but where the rewards may be enormous --

and the contest is now on. Since January of this year, for example, Japan has sent more than 10,000 people on trade missions to China.

However, gaining access to these markets will be even more difficult without some initial improved productivity performance.

The second method of achieving more efficient production runs is greater specialization or rationalization: produce fewer product lines in any one plant. Perhaps the best example of this "rationalization" process is the auto industry where following the signing of the auto pact,the major firms began to divide production between plants in the U.S. and in Canada, with considerable productivity increases resulting especially in the Canadian plants. In more general cases, firms would be encouraged to specialize, either between themselves and their foreign parent or subsidiary, as in the auto pact case, or even between their competitors in Canada, as might be necessary to maintain the efficiency achieved with full size plants. Lower tariffs, either through specific exemptions, or broad agreement would aid in encouraging the international rationalization. Domestically, provisions in the law to allow such inter-firm cooperation as would be necessary to initiate this action, have been incorporated in the proposed revisions to the Competition Act which have been introduced but not passed in recent parliamentary sessions.

Finally, let me raise what has become one of the public's favourite hates, regulations. Next to lung cancer, regulations must be ranked as the major source of respiratory failure. After all, regulations are said to strangle initiative, suffocate entre-preneurship, throttle productivity, choke off incentive, and

drown development in a sea of red tape. Concern with this menace was manifested by the decision of First Ministers last February, to refer the whole issue of economic regulation to the Economic Council. As I have discussed elsewhere, our research in this matter will not set out to measure directly the effects on productivity of regulation, but will focus on private and social costs of regulation by all levels of government. The studies will be undertaken with the explicit recognition of the fact that although there are costs associated with regulatory activity, there are also benefits. Thus, while our mandate may lead to some de-regulation, most importantly, we hope the major outcome will be the adoption of policies and procedures to ensure that regulation is as appropriate and cost-effective as possible in fulfilling the goals and objectives established for it.

We all know that there are other areas where significant improvements are possible, but I won't tackle them today. Instead, let me close this discussion with a brief overview.

The Canadian economy is a very complicated instrument for the production and distribution of goods and services. It has to this point in time in many ways served most Canadians remarkably well. Indeed its very success has served to highlight the weaknesses and problems which we now face. It is unreasonable to face the future with the excessive melancholia of our present mood, but sporting rose coloured glasses is equally out of place. We should instead acknowledge the current realities and attempt to understand and deal with the constraints imposed by the past, the present, and the problems of the future. In the words of the Economic Council's Fifteenth Annual Review, "...It is a time for realism, but most of all, a time for reason."