



Canada's Challenge – From Good to Great

A CHANGING WORLD, IN TRANSFORMING TIMES

Kevin Lynch

“Canada’s challenge,” writes Kevin Lynch, **“is going from good to great.”** The fundamentals of the Canadian economy, our fiscal frameworks, and our financial system are among the strongest in the entire world. But Canada also faces challenges on productivity, R&D, and diversifying markets beyond the United States, notably to Asia, which within a decade will account for half the world’s output.

« *Les perspectives du Canada varient de bonnes à excellentes* », écrit Kevin Lynch, pour qui les éléments fondamentaux de notre économie, nos cadres bud-

gétaires et notre système financier sont parmi les plus solides du monde. Mais le Canada doit aussi relever d’importants défis en termes de productivité, de R-D et de

diversification des marchés. Par-delà les États-Unis, il doit surtout se tourner vers l’Asie, qui comptera dans 10 ans pour la moitié de la production mondiale.

Three decades ago, like today, the mantra was that the world was changing, and so must we in Canada to compete and thrive. But what a different world today, and what a transformed Canada.

It is timely to remind ourselves of the early 1980s. The United States was far and away the world's dominant economy and, with the crumbling of the Union of Soviet Socialist Republics, was equally becoming preeminent in global political and military affairs. The Organisation for Economic Co-operation and Development (OECD) club of rich nations were beset with slowing growth, large government sectors, rising public debt, inflationary cycles, and constricted markets. The impetus for change largely came from within, and was heavily policy driven. At its core, this "new agenda for growth" in OECD countries was based on the view that we needed to rebalance our economies towards the private sector and away from a government sector with excessive rules and regulations stifling entrepreneurship; government corporations providing not just public services but also commercial services, and poorly; endless deficits, increasing taxes, and rising debt crowding out private sector financing; and too many barriers to competition, both inside countries and between countries.

But 25 years on, the world is changing again, profoundly. We are entering a new global normal, a structural change, not a cyclical episode, and things will not be as they were. The centre of global economic gravity is shifting to Asia and other dynamic emerging economies.

This rebalancing proceeded in different ways and at different paces in the OECD countries, but everywhere it amounted to a sea change in how markets work, how governments operate, and where we look for sustained job creation and growth. The transformation of the Canadian economy over this period was quite remarkable. Gone are endless structural fiscal deficits, replaced by the lowest net public debt in the G7. Gone is a swath of government corporations ranging from national airlines to national oil companies to national railways. Gone are high and volatile inflation expectations, anchored by explicit monetary inflation targets. Gone are high corporate tax rates and decrepit manufacturing and sales taxes that hindered our competitiveness, replaced by a corporate tax rate that is now 12 percentage points below the US and a national GST system that is harmonized with most provinces. Gone are tariffs and many trade barriers with the US and Mexico, replaced by the Canada-US Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA). Not gone sufficiently are internal trade barriers, restrictions on competition and corporate attitudes to productivity and innovation. And gone for good, particularly among younger Canadians, is any sense of global inferiority. The

FTA had a profound impact on attitudes – a new sense that we could win without protective trade barriers. In short, policy matters.

Globalization is challenging our traditional notions of markets, consumers, and comparative advantage, and the Information Revolution is shattering them. The digital universe is transforming what markets mean and how social interaction and communication take place.

But 25 years on, the world is changing again, profoundly. We are entering a new global normal, a structural change, not a cyclical episode, and things will not be as they were. The centre of global economic gravity is shifting to Asia and other dynamic emerging economies. In the coming decade, Asia will account for 50 percent of global GDP, the Chinese economy will surpass that of the US, and a two-speed world will emerge in which the dynamic non-OECD economies will set the global growth tempo and many OECD economies will be stuck in the slow lane.

Globalization is challenging our traditional notions of markets, consumers, and comparative advantage, and the Information Revolution is shattering them. The digital universe is transforming what markets mean and how social interaction and communication take place.

And then there are the seismic demographic trends. We are aging collectively in most OECD countries (and even in some non-OECD countries such as China and Russia) for the first time in modern times, and the implications are enormous. Canada is entering a period where declining proportions of the population are working and, as this continues, the availability of skilled labour will become a significant constraint on growth. Labour market policies must switch away from yesterday's challenge of excess labour chasing too few jobs to tomorrow's reality of too many jobs desperately seeking skilled knowledge workers.

In this changing world, the drivers of success are also shifting. A truly global marketplace requires an international perspective and a capacity to serve markets that transcends traditional boundaries in order to succeed. The ability to attract and retain talent globally is vital, and that is why immigration is so important – one quarter of all the new high technology companies started in the US over the last decade had a foreign-born founder. Driving competitiveness through stronger productivity and faster innovation is crucial to competing with high scale, low cost competitors. And, in a more volatile and uncertain world, stable and trusted institutions and sound fundamentals create competitive advantage.

Now, in this profoundly changing world, Canada has a good story to tell. We withstood the financial crisis better than most countries, and our recovery from the global recession has been faster and stronger than many G7 countries, par-

ticularly the US. Our relative global strengths include: solid macroeconomic policies; robust natural resources; a sound financial system; a resilient, diversified economy; and strong civic institutions which adhere to the rule of law.

Driving competitiveness through stronger productivity and faster innovation is crucial to competing with high scale, low cost competitors. And, in a more volatile and uncertain world, stable and trusted institutions and sound fundamentals create competitive advantage.

But these strengths are platforms upon which to build, to adapt, and to transform in response to today's changing world. They are not reasons for complacency nor excuses to embrace the status quo and hold to the way things were. The FTA was an enormous pivot in Canadians' thinking about competitive markets and our capabilities. We are at a similar inflexion point now, where the winds of change are global not local, and the adjustments are more complex because they are less policy levers to be pulled than attitudes to be altered.

Canada is a sophisticated economy, with a well-educated and multicultural workforce, and a very high standard of living. But the global marketplace we operate in is dynamic, not static. The "rise of the rest", in Fareed Zakaria's evocative phrase, is changing the competitiveness model of "the rich". In this changing world we are a high wage economy and a chronic underperformer in innovation and productivity. Canada simply cannot sustain above-average living standards and below-average innovation investment and productivity growth.

The "rise of the rest", in Fareed Zakaria's evocative phrase, is changing the competitiveness model of "the rich". In this changing world we are a high wage economy and a chronic underperformer in innovation and productivity. Canada simply cannot sustain above-average living standards and below-average innovation investment and productivity growth.

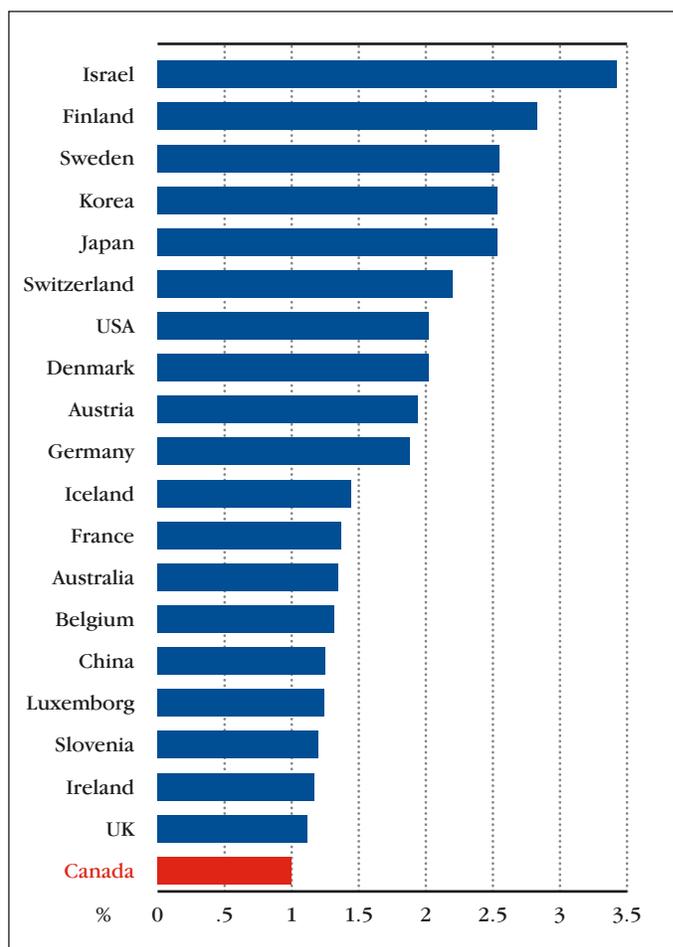
The transformational challenge facing Canada today is that we are wedged between a changing global reality and an economy that has not stressed productivity, innovation, and diversification. Consider a few, rather telling, facts:

- Canada's business productivity levels are only 72 percent of US business on average, and we no longer have a low dollar to subsidize poor productivity.

- Canada's business spending on R&D is 1.0 percent of GDP, well below the OECD average of 1.6 percent, and half that of US business. Canadian business has the dubious distinction of ranking 20th in the OECD in research.
- Canadian business spends less than 55 percent as much as US business on ICT (information and communications technologies) and less than 75 percent as much on leading edge machinery and equipment – both instrumental to productivity growth.
- Canada's trade is highly concentrated with the US (over 72 percent of Canada's exports), and no dynamic emerging economy accounts for more than 1 percent of Canada's exports (except for China, which is only 4 percent).
- Canada leads the OECD in the proportion of the population with some post-secondary education, but we rank 8th in undergraduate degrees, 24th in new doctoral graduation rates, and lack effective apprenticeship training.

Simply put, in this changing world, there are pressing transformations that we need to get our minds around, and act upon with the speed, flexibility, and creativity that the new global reality demands. First, we need

BUSINESS SECTOR R&D EXPENDITURES, OECD COUNTRIES (PERCENT OF GDP)

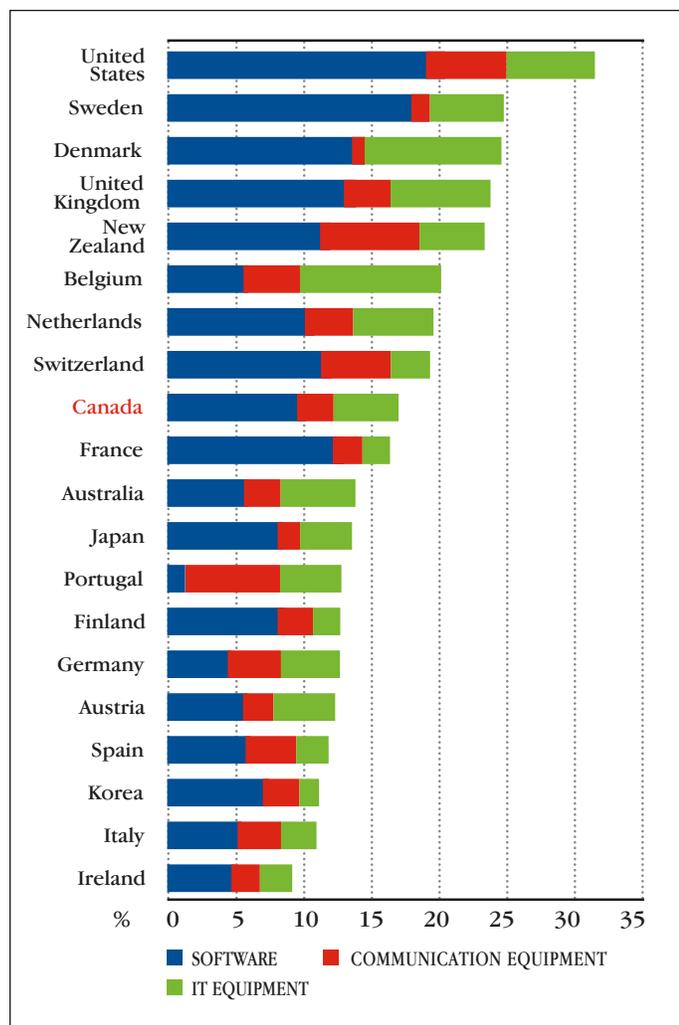


SOURCE: OECD, Main Science and Technology Indicators Database, June 2011.

to diversify again, this time to the dynamic emerging economies in Asia, South America, and elsewhere. Second, we need to reorient our competitiveness approach to one based on productivity and innovation – continually turning new ideas into new, commercially viable goods and services, and selling them around the world. And third, we need a relentless focus on talent in a demographically challenged world. While all this may sound daunting, the positive news is that we don't have the fiscal challenges of many OECD countries (including the US), we are blessed with abundant natural resources, and we appeal to the global talent pool as a great place to study, live, and work.

- Canada needs to diversify its trading partners, its foreign investment links, its exportable goods and services, and its exporters. Too much of our trade is concentrated with the US, still the world's richest market but now a more slowly growing and mature economy, and too little with the rapidly growing and increasingly large dynamic emerging economies in Asia, South America, and elsewhere. Too

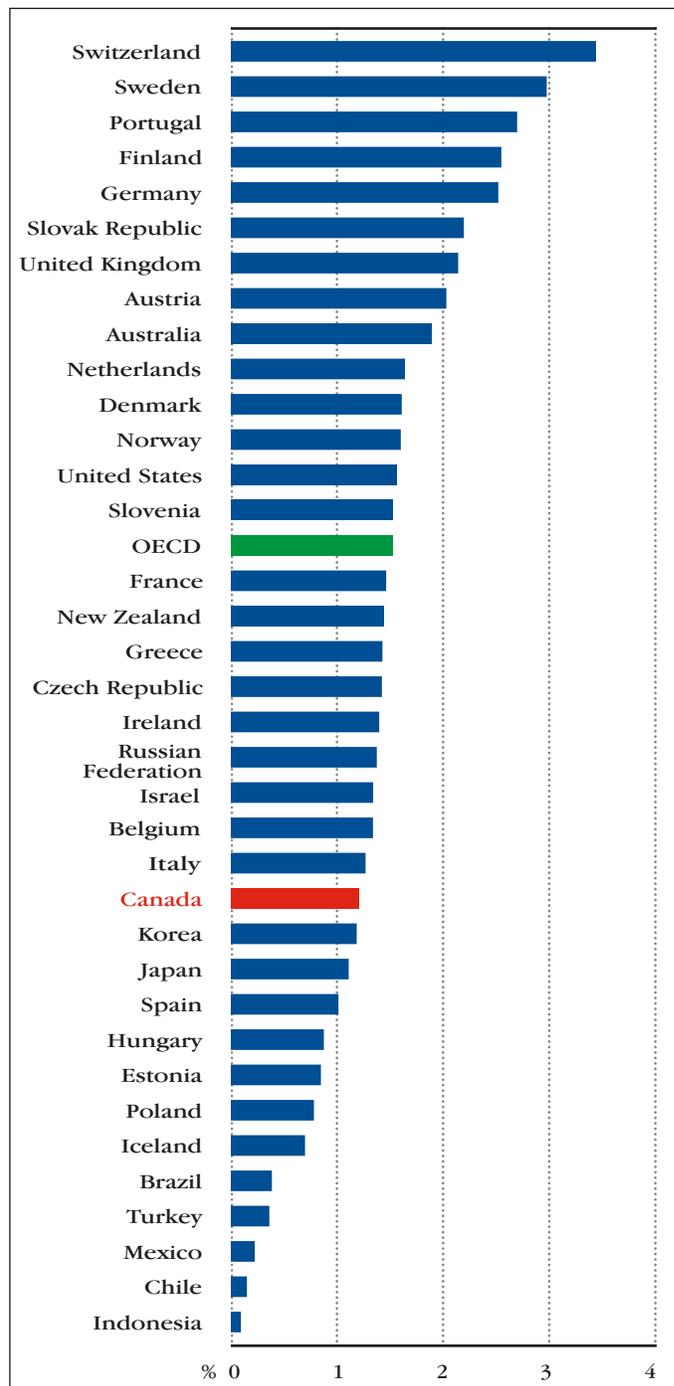
**ICT INVESTMENT BY ASSET IN OECD COUNTRIES, 2009
PERCENTAGE OF NON-RESIDENTIAL GROSS FIXED
CAPITAL FORMATION, TOTAL ECONOMY, OECD
PRODUCTIVITY DATABASE, MAY 2011**



SOURCE: OECD Science, Technology and Industry Scoreboard 2011

few Canadian small and medium sized enterprises (SMEs) are engaged in trade beyond our borders, let alone outside the NAFTA region, and this impedes their ability to sharpen their competitiveness skills and build new marketing networks and constrains Canada's ability to grow and create jobs. Too little of our exports of goods and services to these dynamic emerging economies are innovative, value-added, or designed for the huge middle class markets

**GRADUATION RATES AT DOCTORATE LEVEL, 2009
AS A PERCENTAGE OF POPULATION IN REFERENCE
AGE COHORT**



SOURCE: OECD (2011), Education at a Glance 2011: OECD Indicators and (2009) Education at a Glance 2009: OECD Indicators, OECD, Paris.



The skyline of downtown Toronto, capital of Canada's financial services industry. The strength of Canada's banks, ranked the strongest in the world for the last five years by the World Economic Forum, is one of the reasons for Canada's comparative advantage on the international stage. Photo courtesy BMO Financial Group.

developing in these countries. To achieve this diversification, we will need new and targeted strategic trade agreements, better alignment between governments, business and the education system to tackle these markets in a cohesive and long term manner, and a major push to make Canada both a global trading nation and a nation of successful global traders.

- The new global competitiveness in advanced economies with high standards of living is driven by innovation and productivity. It is based less on standardized products, low costs, and massive scale, and more on creativity, flexibility, and continual innovation in products, services, distribution, and production. It is more about capacity, ideas, and the ability to turn them rapidly into commercially-viable new goods and services than about geography. In the words of *New York Times* columnist Tom Friedman, in a hyper-connected world the mantra for an innovation-driven global corporation is “imagined here, designed there, manufactured elsewhere, sold everywhere”. Canada needs a much greater innovation and productivity focus in our business strategies, and governments need to find the right balance between pressure for change and

support to change, in their programs and incentives to encourage firms to innovate. We also need more ambitious innovation and productivity objectives. Are we really going to be globally competitive over the next five years if we don't double our private sector R&D spending (as a percentage of GDP), bringing Canada from well below the OECD average to above it, and cut in half our private sector productivity deficit with the US?

- A key element to help make such diversification and innovation happen, firm-by-firm, and sector-by-sector, is *talent* – a well-educated, entrepreneurial, outward-looking, multicultural, and multilingual workforce for a changing world. Here, Canada's challenge is going from good to great. This underscores the importance of attracting skilled immigrants, of entrepreneurship in all our educational curriculums, of language and culture training, of more graduates with PhDs in engineering and sciences, of more women in the natural sciences, of better collaboration between business and applied researchers in our universities, and updated apprenticeship training for high tech manufacturing.

Over the last quarter century, Canada has demonstrated an impressive capacity to adapt well to a changing world, anchored by the FTA that changed our mindsets even more than our tariff schedules. Going forward, Canada needs to adjust again in response to a changing world. There is no reason why Canada cannot diversify its trade, improve its innovation and productivity performance, and be a world leader in talent. But it will take change, it will require leadership, and it will necessitate public engagement. Our ongoing public dialogue in Canada must include this question: “what will it take for Canada to be more global, more innovative, and more productive and why is it so vital to our future and that of our children?” 

Contributing Writer Kevin Lynch, former Clerk of the Privy Council, is Vice-Chair, BMO Financial Group.

Canada's challenge is going from good to great. This underscores the importance of attracting skilled immigrants, of entrepreneurship in all our educational curriculums, of language and culture training, of more graduates with PhDs in engineering and sciences, of more women in the natural sciences, of better collaboration between business and applied researchers in our universities, and updated apprenticeship training for high tech manufacturing.