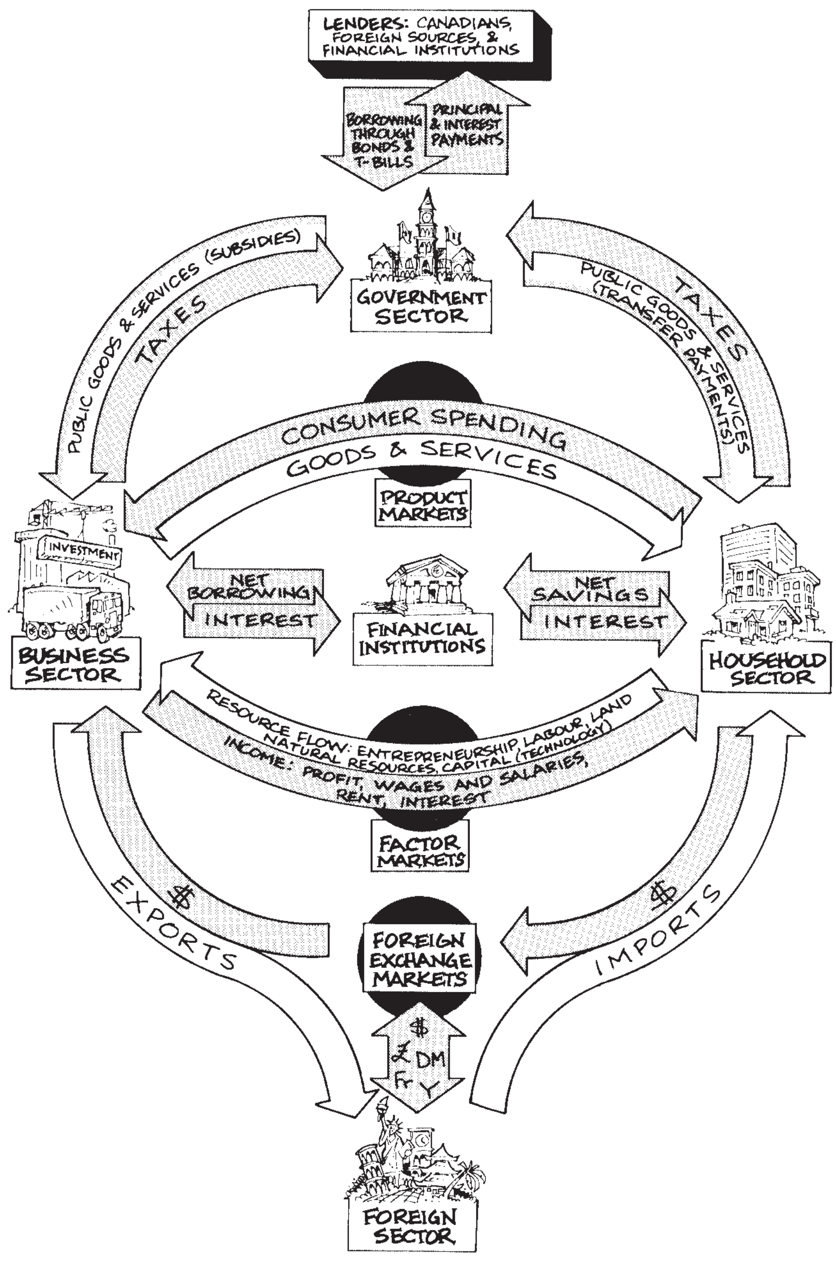
THE CANADIAN ECONOMY: THE BIG PICTURE



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by Gary Rabbior

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The Canadian Economy: The Big Picture

by Gary Rabbior
Canadian Foundation for Economic Education

Illustration: Kelly Brine
Editor: Judith Jackson
Desktop production: Lucia Travisano

2 St. Clair Avenue West, Suite 501, Toronto, Ontario M4V 1L5
Tel: (416) 968-2236; Fax: (416) 968-0488

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The Canadian Economy: The Big Picture

Life: Where does an economy fit?

Life has many dimensions. Most of us spend a good portion of our lives seeking fulfilment in the more emotional and spiritual areas – happiness, friendship, love. In our day-to-day personal and family lives, we also tend to seek out ways to improve our standard of living and quality of life. One way to improve our quality of life is through acquiring material things. We find there are products and services that can make life more enjoyable, more pleasurable or simpler. This is where our economy and economic system come into play.

Even some aspects of our emotional world are linked to the economy. Happiness, enjoyment and so forth can come from a wonderful trip, a family cottage, a good meal, a nice car, an extremely comfortable pair of shoes, a good book or a delightful movie. Our lives are complex and, in today's world, our economy is inextricably linked to our lives – in terms of our work and play.

Furthermore, people's lives are significantly linked to the economy of the particular country in which they live. Entire societies differ in some of the most fundamental ways based on the kind of economic system they have established. Every society has to decide what kind of system it will use to provide the products and services people are seeking. In traditional economic terms, every society has to decide (a) what to produce, (b) how production will be organized and (c) how to distribute what is produced.

Some societies have made efforts to establish a system in which goods and services are produced by **public** enterprises, that is, business activity owned by government. They have concentrated production activity in the hands of the **state** rather than encouraging **private** ownership (where production activity is left to the actions and decisions of private producers). We know that in Russia, for example, individuals have only recently been given the opportunity to own a business to produce a good or service. In establishing these privately owned businesses, they will try to produce something people want and will buy. If an individual is successful, **profit** is the reward for effort.

Over time, the societies that have permitted and encouraged private ownership, and allowed the quest for profit to serve as an incentive for production activity, have done considerably better than government-dominated economies. All the leading economies in the world today rely heavily on private ownership of business activity. These economies leave more decision making to the **marketplace** – the interaction between buyers (consumers) and producers – and less to centralized decision making by government.

Historically, Canadians have been encouraged to try to establish privately owned businesses to produce goods and services. In the early days, Canada's small population with relatively few buyers limited the opportunities for private enterprise. It's hard to run a profitable business if there aren't many buyers. As a result, the government tended to be more involved in the Canadian economy than it was in a country such as the U.S., which had a much larger population and many more buyers.

Over time, though, as our population grew, more and more private businesses were established and were able to earn a profit. The ability of some of our producers to sell to buyers in other countries through international trade also contributed to their successes.

A larger and larger Canadian population meant higher and higher demand for goods and services. Canada became a nation in which individuals were encouraged to become **entrepreneurs** and establish businesses to respond to these demands. In some cases, the government continued to play a role. In other cases, some demands were met by producers in other countries as we imported goods and services. In all cases, with goods and services provided by private Canadian producers, government and foreign producers, the quantity and quality of goods and services available to Canadians increased.

In general, our economy has come to rely most heavily on privately owned production activity, with entrepreneurs identifying a need or want (demand) and establishing businesses to produce a good or service (supply) in response. If the entrepreneur is successful, profits are earned, jobs are created and the business expands. If unsuccessful, the business fails and the entrepreneur and employees must seek alternative ways to earn an income to support themselves and their families.

Canada's entrepreneurs, complemented by government production activities, helped to build our economic system, producing more and better goods and services as our population grew and our needs and wants expanded. In this way, Canada has established an economic system similar to that of many other successful nations – largely market-based, encouraging effective and innovative private ownership while government maintains a strategic role particularly in the area of social services, broad economic policies and the provision of essential services such as education and health care. Our system is often referred to as **capitalist** because we allow and encourage the private ownership of capital – plants, factories, equipment and so on. This is the "economic system" we have built in Canada. But how does this system affect us as individuals?

Once again, we can note that life has many dimensions, and when we are young we are often predominantly interested in music, clothes, sports, movies, dances and affairs of the heart. But even at a young age we begin to learn about the links between our economy, work and well-being. To afford music, clothes, sporting events, movies and entertaining those affairs of the heart, most young people need to work to earn an income. The income earned, we learn, is affected by a wide variety of factors, including where one lives and one's age, ability, experience, connections and so on.

In the beginning, we tend to seek work as a means to an end. We enter the **labour market** and the economy to offer our services. In return for the labour services rendered, an employer pays a wage. And we then use all, or part, of that income to acquire things we want (we may choose to save a portion). Later, though, it usually starts to become apparent that our labour has a broader purpose than just to generate personal income. Our labour is also making a productive contribution to society. After all, if efforts were not made by many Canadians to produce and provide goods and services, the income earned wouldn't really matter – there would be nothing to buy.

We see, then, that once a society has put its economic system in place, that economy serves a number of key roles. First, it involves the efforts of all sorts of people doing all sorts of things to produce goods and services for people to buy. The need for an economy and production stems from people's desires for goods and services. In a market-based economy such as Canada's, this results in the establishment of business enterprises. These business enterprises are started by entrepreneurs to produce a good or service that people need and want and, most important to the entrepreneur, will buy. If the business produces what people want, the business will sell its output and, it is hoped, earn a profit for the entrepreneur (and perhaps other owners of the business). If the business continually loses money and is unable to earn a profit, the business will fail – the entrepreneur loses his or her income, employees lose their jobs and our economy loses the goods and services that were produced.

Production: It's a job – for some

The production activities of our businesses generate the goods and services we need and want. Without businesses, our needs and wants go unfulfilled or we rely entirely on government-owned production, which history has shown is less able to create wealth, jobs and higher standards of living. This paper is too brief to delve into the philosophical aspects of whether a market-based economy is the *right* kind of system. The fact is, it has shown itself as best at creating wealth – at least in those societies that have built an effective system. It may not be for every society. But most societies are trying to make a market-based system work for them in some way, shape or form.

We will return to look at the production activity of government in our economy later but, for now, we will concentrate on those who produce most of our goods and services – privately owned businesses.

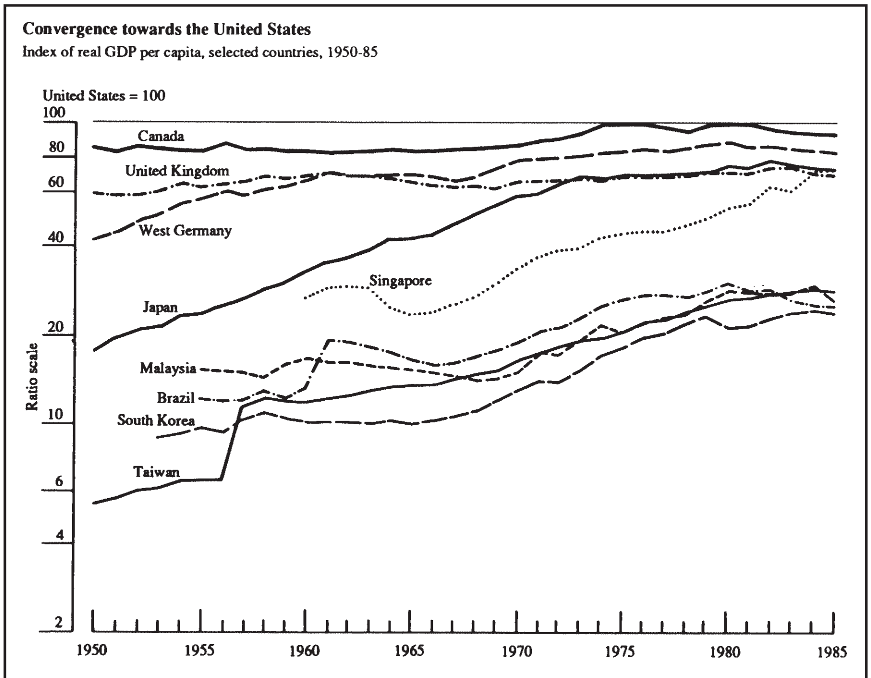
We have recognized that one role of our economy is to produce goods and services. A second key role of an economy is, through these production activities, to create jobs so that people can find employment. And third, through its efforts to produce goods and services and its employment of people's skills, the economy provides people with an opportunity to earn an income. In turn, those people who earn an income are then able to acquire the goods and services produced.

These, then, are the economy's key roles – to produce goods and services, to create employment and, thereby, to provide the means for people to acquire the ability to purchase goods and services that are needed and wanted. In an ideal world, our economy would provide gainful, meaningful employment for everyone, thus enabling everyone to acquire most of what they need and want.

Alas, as we know, we don't live in an ideal world. Some people earn more than others. Some earn little, if any, income. Some are able to acquire almost everything they want. Some can't afford the things they need. Some have jobs. Some don't.

Canadians are actually pretty fortunate. In fact, in 1991, the United Nations ranked Canada number one among all OECD countries in terms of a place to live and work.[1] The majority of those Canadians who wish to work are able to find work (even though we still have many people unemployed). Income levels are relatively high and the overall quality of life is pretty good. Most Canadians probably appreciate the benefits this country provides – even with its problems and shortcomings.

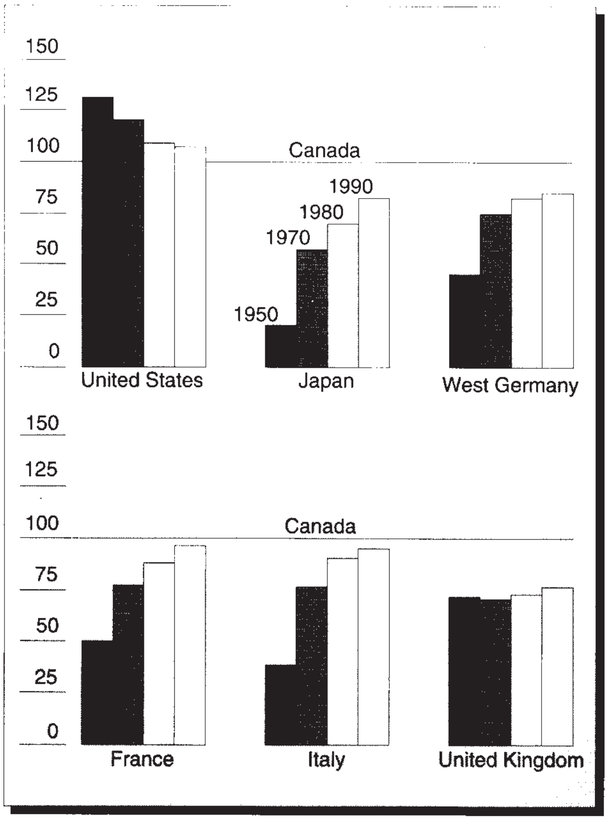
One of the reasons why we say Canada has done so well is because we have been successful in the past in our ability to compete with other nations. One way to measure "how well" an economy is doing is to compare the level of **output per person**, or Gross Domestic Product (GDP) per capita, in various economies. That is, you add up the total value of all that is produced in a country's economy and divide that total by the number of people. This provides one way of measuring a nation's **productivity**. This means of measuring productivity can imply that output is determined solely by people and their labour. In fact, output will actually be determined by many factors, such as the quality of capital (equipment, machines and so forth) and technology available to people. We will explore the various ways of measuring and examining productivity in Part III of this mini-series. But for now, let's examine productivity performance as measured by output per person. When that is done, many people are surprised to find that the United States, and not Japan, comes out on top. This chart shows the productivity performances of various nations. It compares the average GDP per capita of ten nations and their percentage change over a 35-year period, using the U.S. performance as the base (that is, U.S. performance equals 100). [Any country could have been used as the base; the U.S. is chosen here because it has the highest real GDP per capita over the years 1950 to 1985. The two charts on the next page use Canada as the base, that is, Canada's performance equals 100.] In the



Source: Economic Council of Canada. *Back to Basics.* Ottawa: Supply and Services Canada, 1988. (Twenty-fifth Annual Review)

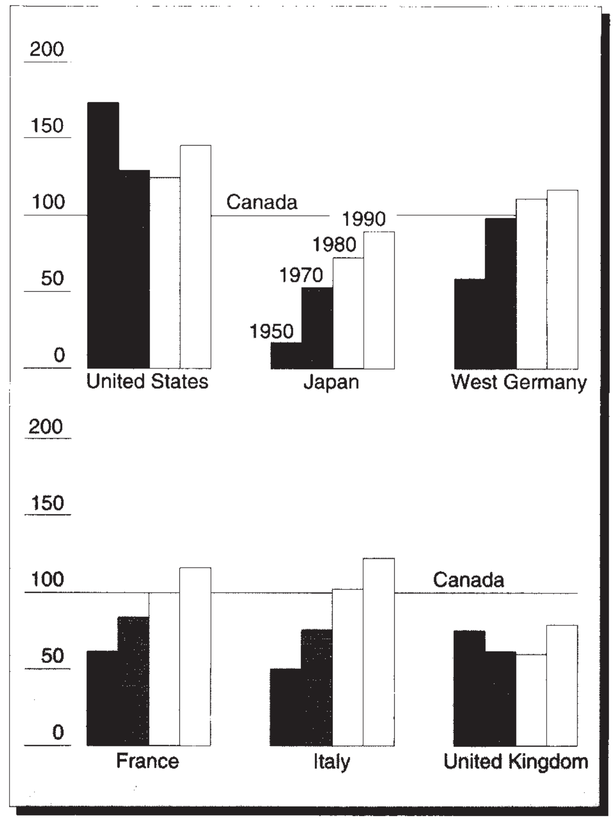
[1] The Human Development Index, compiled by the United Nations, measures three key indicators: national income, literacy and longevity.

Comparison of aggregate labour productivity levels,[1] Canada and six other industrialized countries, 1950-90 (selected years)



1 Real GDP per employed person.
Estimates by the Economic Council, based on data from the U.S. Bureau of Labor Statistics.

Comparison of labour productivity levels[1] in manufacturing, Canada and six other industrialized countries, 1950-90 (selected years)



1 Output per hour.
Estimates by the Economic Council, based on data from Statistics Canada and from the U.S. Bureau of Labor Statistics.

Source: Economic Council of Canada. *Pulling Together: Productivity, Innovation, and Trade.* Ottawa: Supply and Services Canada, 1992.

chart on page 4, the index line of the U.S. is higher than the index lines of the other nations – indicating that it has the best productivity performance for that time period. That is, the U.S. produced more output per person in its economy over the period shown than any of the other selected countries. Below the U.S. index line, though, we see none other than Canada. It surprises many people to see that Canada comes in at number two. But there is something else to note – other countries are catching up to us. Look at how other nations are closing the gap and note that the chart stops at the year 1985. The charts above bring us more up to date.

The chart on the right shows what has been happening to labour productivity levels if we consider only the manufacturing sector. Germany has come up and passed us. France has come up and passed us, as has Italy. [Note that this chart measures output per hour, one of the other ways of measuring productivity that we alluded to earlier.]

The chart on the left compares what is happening to labour productivity levels in the overall economy when all aspects of production activity are taken into consideration – not just manufacturing. Canada is still number two, but many other nations have been gaining on us. In short, in recent years, we have been losing some of our productivity advantage. And we are feeling the consequences of that. We have seen the impact as manufacturing companies have closed or dramatically downsized and people have lost their jobs.

The key point to remember is that Canada's "economic ability" compared with the "economic ability" of other nations is crucial to our well-being. As important as love, friendships, religion and other things are to us, we need to eat, be clothed, be housed and be healthy. And, let's be honest, most of us want more than that. Did I hear someone say cars, stereos, computers, boats, bicycles, "pumps" on shoes, leather jackets, skates, trips south in winter....? Where do those things we want to buy come from? They come from our economy. If we want such things, we need our economy. And we need it to be an able economy, one that can compete effectively with others. If we cannot compete, other nations will produce the goods and services that people want. Other nations will benefit from the jobs created, the incomes earned and the investment for growth that can take place.

To understand the challenges our economy faces, and the factors that will influence how well it does at production, job creation and income generation, we need to get a sense of the "big picture." How does the economic system work? How does it fit together? How is Canada linked to the rest of the world? Let's start to build a picture of what our economy looks like so we can understand it a little better.

We have noted that entrepreneurs set up businesses to produce the goods and services that we need and want. But they sure can't do the job alone. They need resources – land, natural resources, capital resources (factories, machines, equipment and so on) and labour. Where do these other resources come from?

We have noted that, in Canada, the majority of resources are privately owned. That is, individuals, or groups of individuals, can own land, natural resources, factories, equipment and, of course, their own labour.

Since resources are owned privately, they provide the means by which the people who own them can earn an income. By providing land, natural resources, capital equipment or their labour, people are able to earn various kinds of income – rent, interest, wages and salaries. If the entrepreneur is able to use these resources together effectively and successfully, we have seen that the entrepreneur will earn a profit in return. Later, we'll represent this in a diagram to help clarify the make-up of our economy. As we build the picture of our economy, you will see that two general kinds of things "flow." There are **real** flows – flows of real, tangible things such as goods, services and people. And there are **money** flows – flows of, well, money. There are money flows because, like most modern economies, ours uses money as a **medium of exchange**. People use money to acquire, or acquire the use of, a good or service. Most exchanges or trades in our economy have two sides. On one side is the good or service provided. On the other side is the money provided to complete the transaction. The amount of money required is determined by the price of the good, service or resource.

In simple economies, exchanges can take place largely through **barter**, trading one good or service directly for another. But in a modern, complex economy with millions of items and billions of exchanges, direct barter would be impossible. So economies use money as (1) a unit of account to establish prices, (2) a medium of exchange for transactions and (3) a store of value to save for use at some time in the future.

In our diagram, we will show how money flows through markets as exchanges are made – a good or service in return for payment. We will also show how some funds are not spent today but saved for the future – postponed spending, if you will. We will see that this postponed consumption, and the flow of some of our money into savings, plays a key role in our economy. All that lies ahead. We're going to build this picture one step at a time.

Putting the puzzle together: Let's start at home

First, let's begin with the fact that people live in households – all sorts of households. There is a wide variety of family structures, types of housing and so on. But in our diagram, let's represent these households, in all their various forms, by the image below.

All the resources that are available to use in production activities and that are privately owned are owned by people who live in some kind of household. Now, as we begin to look at the structure of our economy, we find that we quickly confront a "chicken and egg" problem. People who live in households provide the resources to enable goods and services to be produced. People in households also buy the goods and services that are produced. Producers will produce what people want to buy. But people only get incomes to buy something after their resources are used and compensated. So, what comes first? Do we start with people's willingness to buy, or do we start with people earning incomes that enable them to buy? In putting the "economic puzzle" together, we need to know which piece comes next.

To get us started, let's say that, in the beginning, there were entrepreneurs. The entrepreneurs ventured out into what is called the **private sector** or **business sector**, which is where privately owned production activities take place to produce goods and services.

As they leave the households[2] and venture out to set up and operate their businesses to produce goods and services, the entrepreneurs look back to the household sector for two main reasons. The first, as any good producer knows, is to determine what people living in those households need and

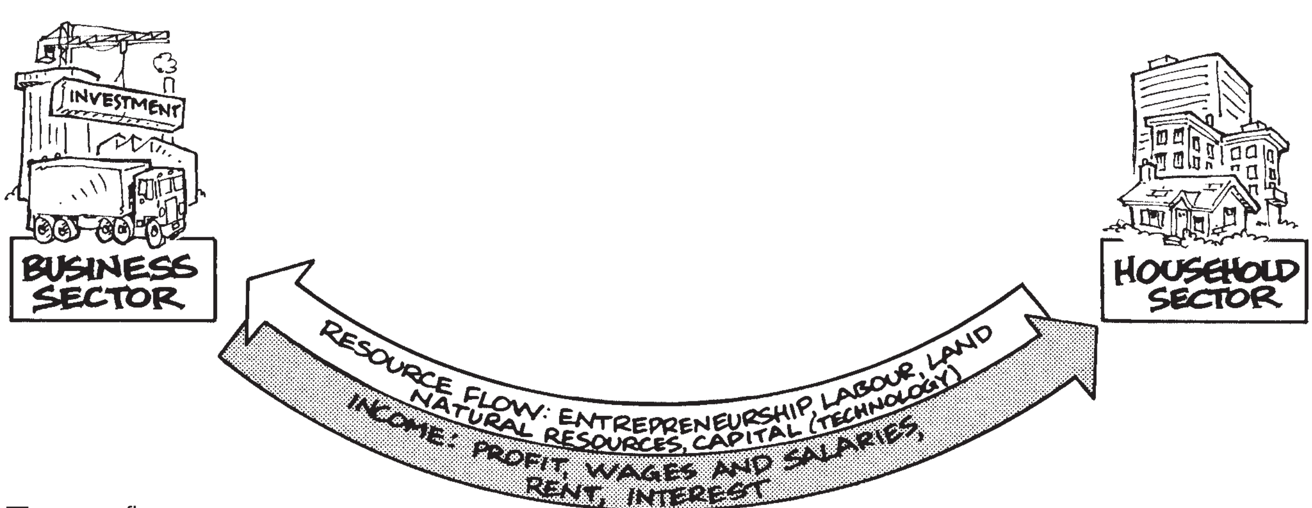
[2] Note that, in our society, people increasingly do not even have to leave their households but can set up a business in their home.

want – what they will be willing to buy. The second reason is to acquire the services of the additional resources that will be necessary for production. Once the entrepreneur has decided "what to produce," the decision must be made about "how to produce." This decision will determine what resources are needed and how they will be combined together in some production process. Once that is known, the entrepreneur will have to seek out those resources and provide the owner of the resources with some form of compensation. The resources represent a **cost** to the entrepreneur, but they represent **income** to the person who owns/provides the needed resources.

Some resources are used up right away in production, such as the wood used in a hockey stick. Some resources are used up more slowly, such as the saw used to cut out the stick. Some resources aren't used up at all but, instead, are employed, such as the people involved in producing a hockey stick. Not only are people not used up, they often get better over time as they gain experience, insight and more training. So, some resources become owned by the entrepreneur as costs are paid, whereas other resources are simply used/employed by the entrepreneur as rent, interest, salaries or wages are paid to the owner who maintains ownership of the resource.

Follow that entrepreneur: The flow of resources to production

We can add this provision of resources to private sector production activity to our diagram. Below we see a representation of the private sector, the provision of resources (including the talent and initiative of entrepreneurs) to the private sector and the return of incomes to the providers of resources (including the profits earned by the entrepreneurs). As mentioned earlier, the flow of resources is referred to as a real flow – real, tangible things are provided. The income flow is called a money flow since (unless you are paid in something else) it is a flow of money, which *represents* value rather than being valuable in and of itself. For example, a one hundred dollar bill has little value in and of itself. It is just a piece of paper. However, because it is widely accepted in our society, its value is in its **purchasing power**. It can acquire $100 worth of real, tangible things.



money flow
real flow

Why are real flows distinguished from money flows? There are a number of reasons, but a key reason is as follows. If you buy a CD player, that CD player is real –it stays the same. But money can change. It can change in terms of its purchasing power. If the CD player costs $100, there has to be an exchange of $100 to acquire it. However, if the price is $150, it takes more money to acquire it. In both cases, it's the same CD player, but the flow of money to acquire it is different. Prices in the economy affect the purchasing power of money, and money flows change when prices change. This is one reason for drawing the distinction.

In our economy, it is often very important to know not only *real* information (for example, the number of CD players produced and sold) but also *money* information (the amount of money it took to acquire the item). Money information is also frequently referred to as nominal information. In today's economy, we often measure things in dollar terms, but it is important that we also look for real information when we want to know how the economy is doing.

Why is it important to distinguish between real and nominal information? Well, if I tell you that 100,000 CD players were produced in 1991 and 110,000 were produced in 1992, you know that more CD players were produced in 1992. That's straightforward, real information. However, if I tell you that $1-million worth of CD players were produced and sold in 1991 and $1.1-million worth were produced and sold in 1992, can you tell me whether or not more CD players were produced in 1992? No, you can't. That's because the higher dollar amount may simply reflect higher prices. It's even possible that fewer CD players were produced in 1992. That's one reason why we distinguish between real and money flows. Both provide important information.

To market, to market to buy a...resource?

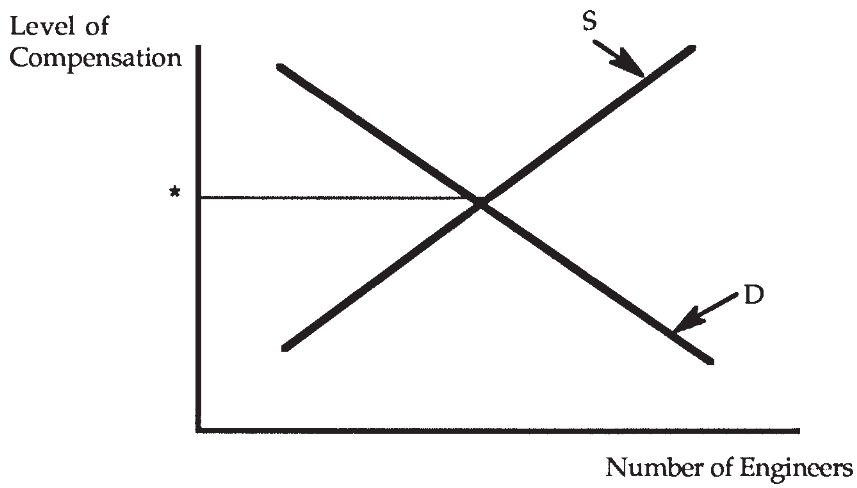
When you have a situation in which there is a seller of something and a buyer of something, you have a **market**. There is a market for all our resources. There is a market for land, for timber, for oil, for wheat, for minerals, for computers, for engineers, for tool and die makers, for computer software creators and so on. The interaction that takes place within each of these markets will determine the level of cost or **compensation** paid for the resource or use of the resource.

Consider, for a moment, the market for engineers. There are those who are seeking to employ the services and talents of engineers. They represent the **demand** in the market for engineers. The different businesses will make decisions about the engineers they will employ based on the talent they need and the cost that will be required to gain such services.

On the other hand, there are people who have chosen to be trained as engineers and who offer their services in return for income. They represent the **supply** of engineers.

The coming together, and decisions, of those who want to employ engineers and those who are offering services as engineers will determine the market compensation for engineers. Such a market exists for all our resources, and these markets will determine the costs (from the business point of view) and the incomes (from the resource owner's point of view).

We can show this in a simplified form below. Suppose line "D" represents the **demand curve** for engineers. The demand curve shows the number of engineers that would be sought by employers at various levels of compensation.



Note that as the level of compensation falls, more engineers would be sought. This makes sense when you think about it. Would you tend to seek more or less of something if its cost went down?

Suppose line "S" represents the **supply curve** for engineers. The supply curve indicates the number of people who will offer their services as engineers at various levels of compensation. Note that usually more people will offer their services as engineers as compensation levels rise.

These lines are a representation of market forces at work. They illustrate the employers' willingness to employ engineers and the engineers' willingness to offer services, at various levels of compensation.

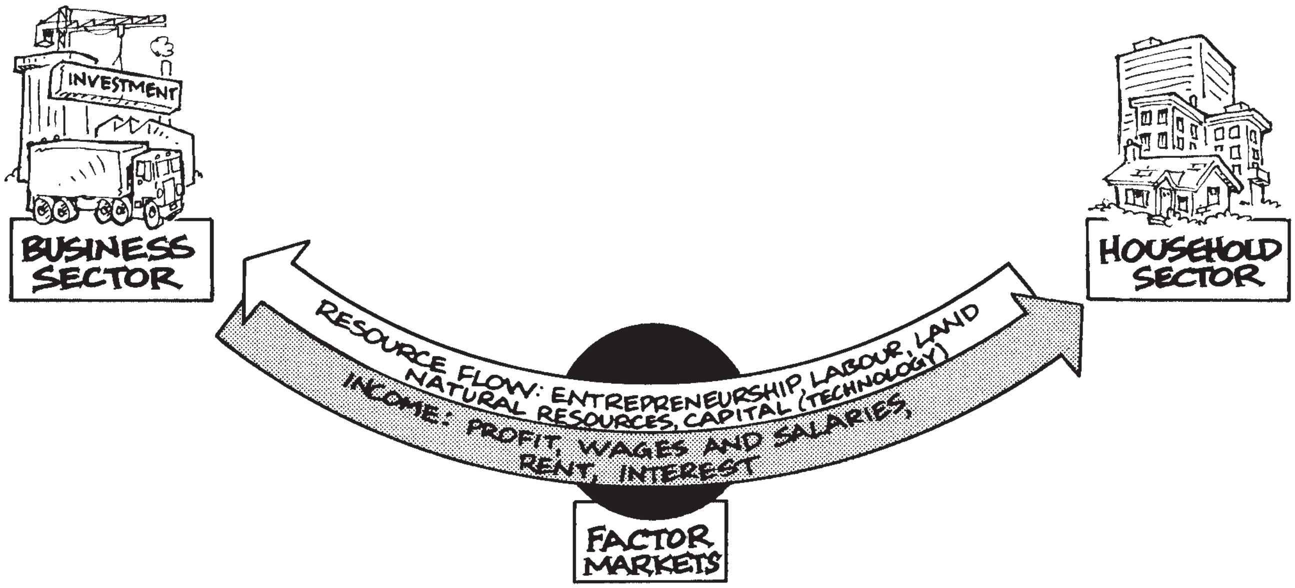
These market forces will put pressure on the level of compensation that results in the market. Above the compensation level shown as *, the quantity of engineers looking for work exceeds the number being sought. The result is unemployed engineers. And more engineers looking for work tends to exert downward pressure on the level of compensation.

Below the compensation level *, the number of engineers being sought exceeds the number seeking work. The result is a shortage of engineers. And as companies find it harder and harder to employ the engineers they need, there is upward pressure on the level of compensation.

At the level *, the number of engineers seeking work matches the number being sought by employers. It is sort of a balance point, a point of **equilibrium**. The market forces of demand and supply will push the market level of compensation toward that point. The market forces will seek out a point of balance. That's how markets work. And, in our economic system in Canada, there are a vast number of markets.

Another piece of the puzzle

We can add these **resource markets** to our diagram where they are given their more common name – **factor markets.** Resources are also called **factors of production**, hence, factor markets.



Who will buy?

Thus far, our diagram represents the production side of the economy and the resource markets that evolve for the **inputs** used to produce goods and services. But what use are goods and services if there are no users, no buyers? We now turn our attention to the other side of economic activity – **consumption**. Every dollar that comes into a household generally has one of four things happen to it. It is (a) spent to acquire goods and services, (b) saved, (c) paid to the government as tax or (d) given away. (We won't consider those dollars that unfortunately are lost or stolen.)

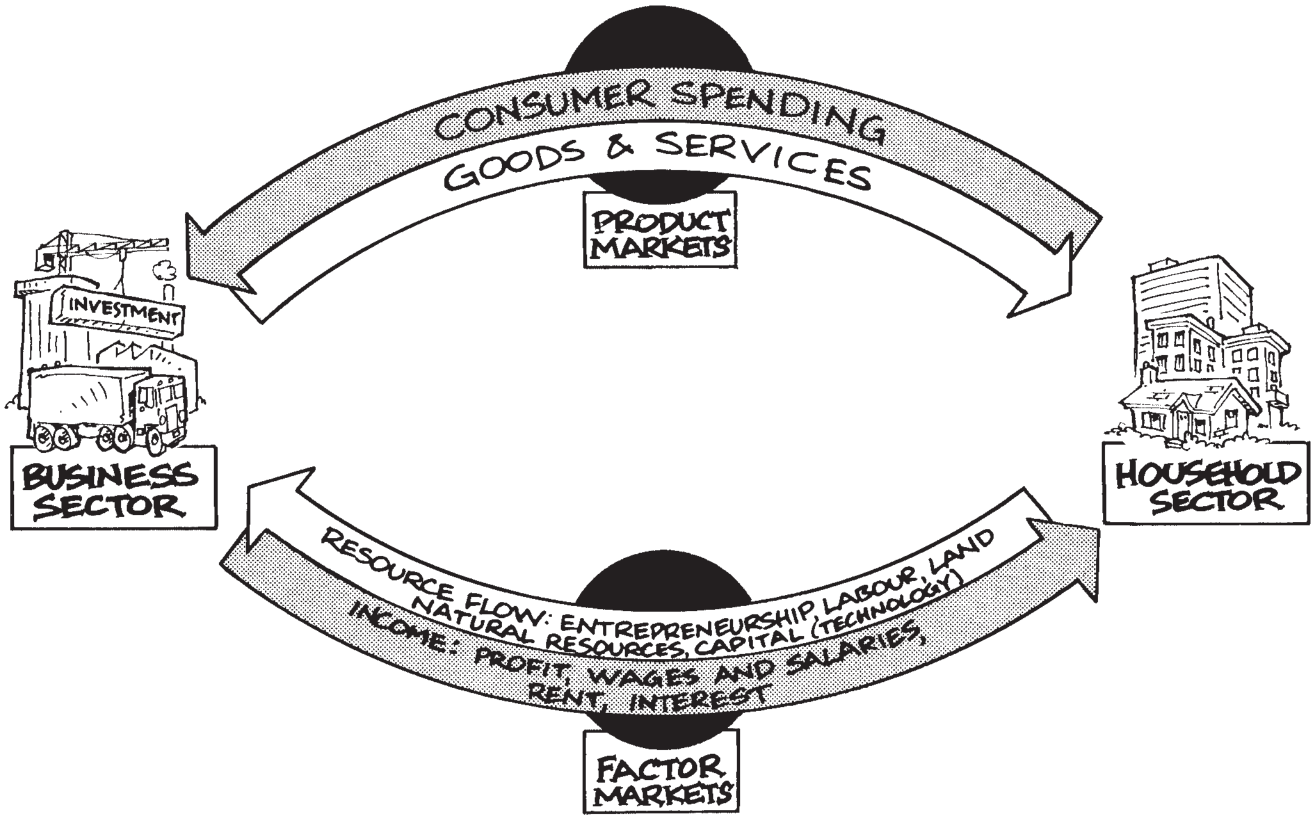
Those dollars that are spent on goods and services invariably find their way back to the businesses in the private sector. Households spend part of their incomes to pay the prices to acquire the goods and services that are needed and wanted. This provides funds (revenues) to the private producers. As with households, different things happen to the revenues of private producers. The revenues are used to (a) cover the producers' costs and are paid out as incomes to the resource owners, including the owners of the enterprise, (b) pay taxes, (c) save, (d) invest back into the business to expand/improve production or (e) give away.

Neither households nor businesses have total freedom of choice concerning what to do with each dollar. There are bills and costs and taxes that must be paid. Over time, though, both businesses and households should be managed in a way that enables more income to become discretionary, that is, the household or business can *choose* what to do with it. Businesses will try to manage affairs so that profits can rise and more productive investments can be made. Households will try to manage affairs so that income can be saved and investments can be made, with the result that **net worth** rises as the households' overall level of wealth improves.

The consumption decisions of households can be added to our diagram. When households spend on goods and services, revenues are provided to the private sector. The households receive goods and services in return. The flow of goods and services is a real flow. The flow of consumer spending is a money flow. This is shown below.

Just as resources are exchanged at costs determined by markets, goods and services are also exchanged at prices determined by markets. The willingness of households to buy goods and services represents the demand in the market. The willingness of producers to provide goods and services represents the supply in the market. The interaction of the producers and consumers, and their decisions to provide/purchase, determines the market price for each good or service that is produced. This, in turn, will determine the quantity of each good/service that is sold/purchased. These markets for goods and services, known as **product markets**, can also be shown on our diagram.

If we put together the pieces of our diagram so far, we essentially get a picture of our domestic private economy.



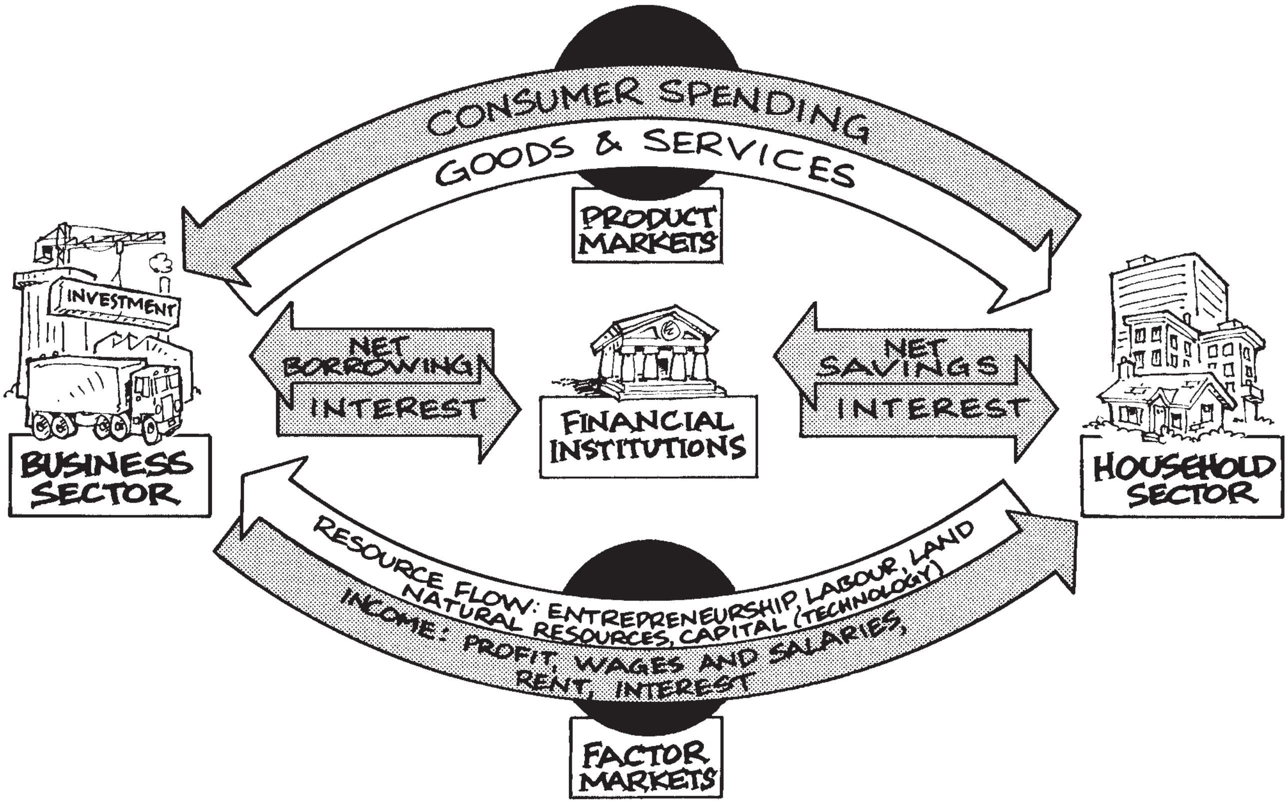
We're almost done – bank on it!

But there is a key part missing. As we mentioned, households can save funds. When they do so, they usually deposit them in financial institutions. In return for these deposits, households earn interest. Naturally, households also borrow from these institutions and pay interest for the right to use the borrowed funds. However, on average, households save much more than they borrow. We therefore say that households are **net savers.**

This can be shown on our diagram with savings flowing to financial institutions and interest flowing to households.

At the same time, businesses are, far and away, **net borrowers.** They borrow much more than they save, often for the purposes of investment – to expand or improve the production capabilities of the business. This, too, is shown on the next diagram.

All the flows into and out of the financial institutions are money flows since no real things are being exchanged. Instead, money is moving in and out of both sides of the markets for funds that exist in our financial institutions.



We now see that funds flow around the economy, and they can flow as spending or investment activities (which tend to generate production) or they can flow into areas that don't necessarily generate production. For example, funds that flow into savings aren't spent and don't generate production, unless they are borrowed. Funds that flow to government aren't spent and don't generate production, unless they are subsequently spent by government. And, as we will soon see, funds that flow out of Canada to purchase **imports** aren't spent here and don't generate production here, unless they come back to Canada to buy our **exports**. Therefore, funds that flow in the economy tend to be classified in one of two ways. If they are used for spending, they are called **injections** since they represent an injection into the economy that supports production activities. If they flow to savings, taxes or import purchases, they are referred to as **leakages** since, until they are put back into circulation through spending here, they are not generating production. Funds, then, flow around, into and out of the spending cycle.

At the same time, there are real things – goods, services, people and so on – flowing in exchange for money. Funds flow from the private sector to households to pay for resources. Funds flow from households to the private sector for goods and services. Funds flow into financial institutions as savings and out of financial institutions as loans.

Whose job is it anyway?

In this way, the economy does its job of providing goods and services and creating jobs, incomes and wealth. But, as we mentioned, it doesn't perform its job perfectly. We have some people without jobs and some with low or little incomes. Furthermore, if the economy is going to provide jobs, it will have to address the needs of our growing population. Where do the new jobs come from for our growing population? Our economy faces a persistent challenge of providing jobs for those who want to work and providing additional jobs as our population grows.

A key thing to note here is that, although we refer to the roles of the economy, we are really referring to ourselves. Canadians set up and run businesses. Canadians run our governments. Canadians provide the labour services – creativity, ingenuity and so forth – that run our public and private production activities. Although composed of non-human resources such as capital and natural resources, the economy is only as good as the people who run it and make the consumer, production, investment, saving and public policy decisions. While we hope the economy will provide the jobs necessary to give people meaningful employment, there is another key challenge.

Over time, most of us seek to earn and acquire more. Is that greed? Is it ambition? Is it a desire to be good providers? Is it some inner drive to do better? Who knows. But it's reality. If you are in school now, you are probably hoping to carve out a life that will enable you to progress, over time, in a material sense, as well as in other ways. How does our economy enable people to earn more and attain, what most of us hope for, more wealth and an improved quality of life?

Well, if the economy stood still, we would be in trouble. If we have more people, and people aspire to acquire more, but the economy has nothing more to offer, we're in a spot. That is one factor that isn't indicated in a diagram such as the one we've drawn. The economy appears to be static and fixed. But the economy doesn't stand still. An economy is very dynamic. New businesses are established. Existing businesses expand. In reality, an economy is very dynamic and things are flowing and changing all the time. All we can do to show change on our paper representation of the economy is to add a box labelled "Investment" to the business sector. It is through investment (funds used to increase and improve the quantity and quality of our resources) that the **productive capacity** of our economy expands and improves over time.

However, as you know, all aspects of our economy don't simply move forward and ahead to bigger and better times. Unfortunately, some businesses close and some businesses decline. Whether our economy expands and grows is significantly determined by the degree to which business success and expansion exceeds business failure and decline. Businesses can fail or decline for a variety of reasons, and we will be examining some of these later. Similarly, there are many factors that contribute to business success. But what leads to business growth and expansion? The key ingredient here is **investment**. The creation of new businesses and the expansion of existing businesses come from investment.

Investment refers to the creation of a new business, the expansion of an existing business or the improvement in the production capability of a business. This might mean a new factory, new equipment, better technology, better training for workers, new management techniques and so on. But for such investments to take place, investment funding (also known as **financial capital)** is needed. After all, it takes money to build a new factory, to acquire new equipment, to provide training, to develop new technology and so on.

Once funds are used for a specific investment, for example, a new computer system, the financial capital becomes **physical capital.**

Investment, then, is the key to growth and expansion in the economy's ability to create wealth, and jobs and incomes. But, for investment to occur, more than money is needed. Investors need a reason to invest. What is a good reason to invest? What would affect an investor's decision to invest? Well, most investors would be interested in:

(a) the potential pay back. What return can be earned on the investment? If the return is 3¢ on every dollar invested in a particular business, and a financial institution is paying more than 3 per cent, why not just put the money in the financial institution and earn the interest?

(b) the potential risk. What are the chances the investor will get the potential return? What are the chances the return will be higher? Or less? Or none at all?

(c) the options. If the potential return on an investment in a business is in the 3 per cent range, but represents some risk, why not buy a guaranteed investment certificate (GIC), which has a very low risk element.

So, funds flow into investment in search of a return, weighted against the risks involved and the options available. An investment is made in a business when it is felt that the funds will contribute to the success of the business and provide a desirable return. If a business doesn't provide such a potential for investors, the business is unlikely to attract investment funds. Overall, if Canadian businesses don't offer potential success and attractive returns, investment funds won't flow and we won't get the economic expansion we need for new output, new jobs, new incomes and new wealth creation.

Invest for growth – but where are the funds?

With that said, let's assume that there are businesses that are attractive to potential investors. Where do the funds for investment come from?

Funds for investment come from a number of sources. Some come from profits earned by a business. Rather than distributing all profits to owners, a business can decide to invest some profits to expand/improve the business.

Funds for investment can come from people's savings, their postponed spending/consumption. A person may decide to use his or her savings (and perhaps those of others) to establish a new business or invest in the expansion of an existing business. The investor hopes to earn a return that would provide more funds for the time when the investor gets around to spending those funds at some point in the future. Some people may invest directly in businesses. Other people's postponed spending may end up as investment without them knowing it. That is because some people don't invest saved funds directly, they put them on deposit in financial institutions. These savings create a pool of funds in financial institutions that may be loaned to businesses.

So, funds for investment can also come as loans from financial institutions. Financial institutions can use the savings of depositors to make loans to borrowers for investment.

Funds for investment can come to businesses as grants or loans from government.

And funds for investment can come from foreign sources, from people in other countries who wish to invest in the creation of a new business in Canada or the expansion or improvement of an existing one.

All of these represent potential sources of funds for investment. The most important of these is the flow of funds from savings to investment. Savings are the source of the largest quantity of investment funds. It is important, therefore, that households don't spend all their income. Those savings can play a key role in helping the economy expand and improve over time.

But, as always, there are markets to consider. There are those who have funds to invest. And there are those who need funds for investment purposes. Those who have funds to invest will be seeking a return on their investment. These investors will look at all the possible options, assess the risks involved, assess the potential rates of return and make a decision about whether to invest.

In Canada, the more new investment is attracted to create new or expanded businesses (over and above those that close or decline), the more our whole economy will grow and expand. **Economic growth** refers to an expansion in the total quantity of goods and services produced by an economy (GDP). The key fuel for economic growth is investment.

Through investment, new growth and expanded business activity, new jobs are created and new and higher incomes are earned. But there are things to think about as we seek to achieve economic expansion and growth.

Wise investment – wise growth – think before you grow

It would be difficult to expand our economy without available resources. We need to think about how we use our resources, the rate at which we use our resources and how we can renew and improve our resource wealth.

It doesn't do us much good to expand our economy and create new wealth if we pollute our air and water and diminish our quality of life by what we do to our environment. We have to think about that.

It isn't much of a goal, either, if our economy expands and creates new wealth only to have wider and wider disparity in our society. We have to think about that, too.

And there are other considerations. Creating an economy that grows and expands (and brings good things like new goods and services, jobs and incomes), also entails responsibilities. Growth for growth's sake is a pretty shallow ambition. Thoughtful, creative, considerate growth can bring great benefits – and we need them.

In summary, investment leads to an expansion of the private sector and business production activity. In turn, this should help create jobs and incomes as our population increases and our aspirations grow. Canada will compete with other nations in terms of its ability to attract investment. It will compete in terms of the quality of investments that are made. Investment in Canada will have a significant effect on our economy – its production ability and capacity – and, as such, it will affect the lives of Canadians.

But, before we examine how well our economy is doing in comparison with other nations, we need to complete the picture of our economy. There are a couple of pieces of the puzzle still to go.

The final pieces

We referred earlier to government, and we know that governments play a significant role in our society and in our economy.

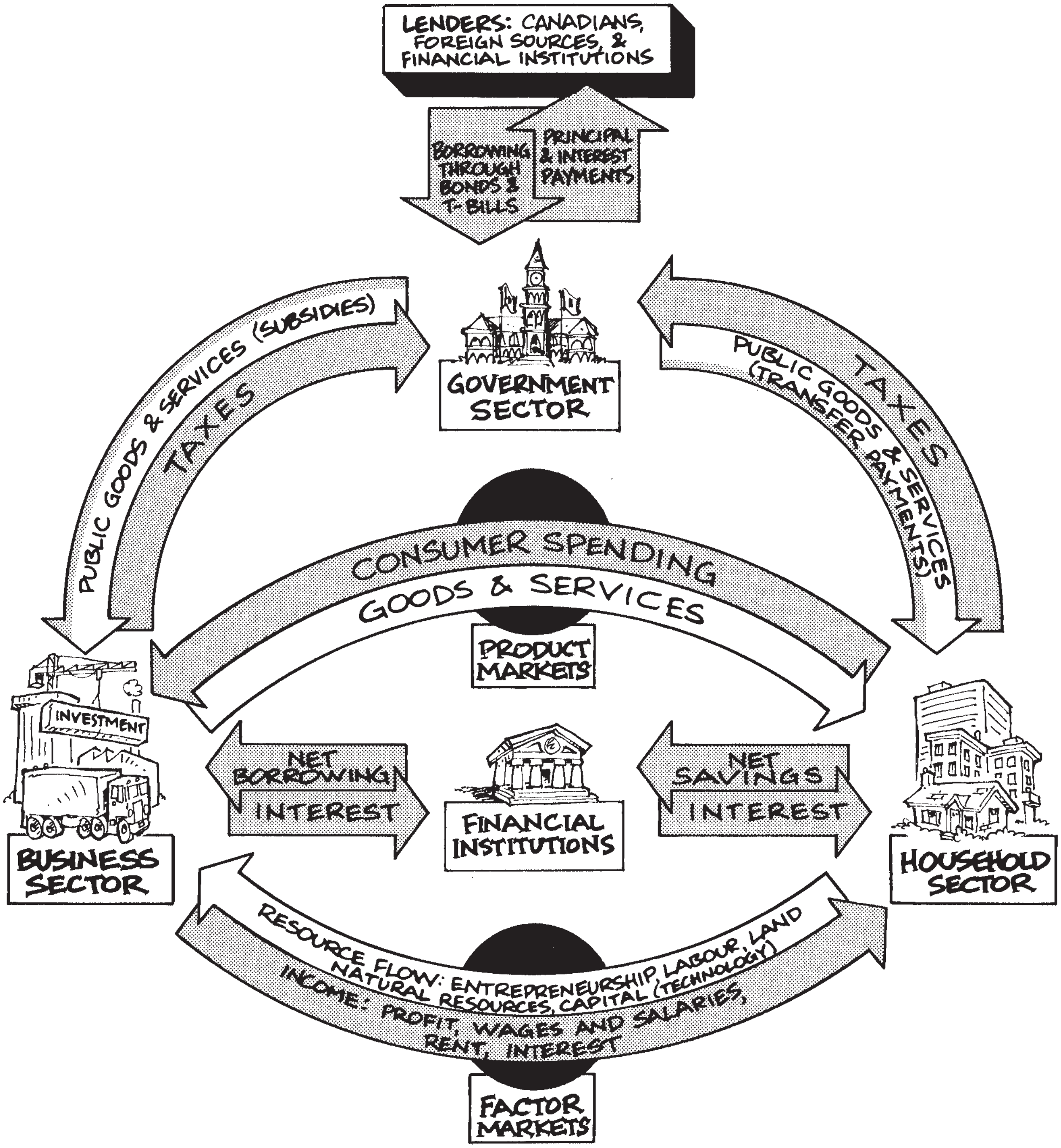
Governments do a number of things including:

a) providing public goods and services such as roads, sidewalks, bridges, schools and hospitals,
b) establishing regulations to protect workers and consumers,
c) providing grants, loans and subsidies to some businesses and households (including welfare, old-age security and so on),
d) restricting the production of certain things (for example, illegal drugs), and
e) employing people to produce the goods and services governments provide.

To do these things, governments require funds. They obtain these funds through taxes. We can now add this aspect to our diagram. Both households and the private sector pay taxes. In return, both sectors obtain the right to use roads, bridges, schools, hospitals and so on. Governments provide transfer payments (welfare, old-age security and so on) to households and some subsidies to businesses. And governments make payments to the private sector to produce certain things that governments want to provide but don't produce themselves (for example, a new road, hospital, school, coastal patrol ship, rail line, canal or airport).

So, funds flow to governments as taxes. And, in turn, governments provide a variety of goods and services (and, in some cases, funds) either directly or indirectly by contracting private sector producers. These flows are shown on the diagram on the next page. [N.B. The flows indicate that part of the flow from the government sector to the business sector and household sector is in the form of money as subsidies and transfer payments. In addition, there are the real flows of public goods and services.]

Note that tax flows are money flows. The flow of public goods and services is a real flow. But part of what flows from governments to businesses or households is a money flow as funds are transferred not for goods or services but as direct grants, subsidies, welfare payments and so on.



You will note that our diagram also indicates another key component of our economy – government borrowing. If, over the course of one year, government spends more than it receives in revenue, it runs a **deficit**. If government takes in more in revenue than it spends, it runs a **surplus**. Especially in the last two decades, governments (in particular, the federal government) have spent more funds than they received in revenue. As a result, governments have accumulated significant **debt** (the cumulation of annual deficits).

Where do governments get funds when their spending exceeds revenue? Like us, they borrow. They borrow by issuing bonds and treasury bills. Bonds represent longer-term borrowing. For example, you might acquire a Canada Savings Bond for one, two or more years. A bond is like an IOU. You lend the government money, you are paid interest and, at a set time, you receive your money back. A treasury bill is a short-term loan, for example, 30 days, 60 days, 90 days, 120 days.

These bonds and treasury bills can be acquired by Canadians (individuals or organizations) or by non-Canadians. In either case, they represent borrowing by governments to cover shortfalls in revenue. As with any debt, interest must be paid. The extent of government borrowing in Canada these days makes this a key part of the diagram.

But there is one more piece to the puzzle, one more key sector to show. Canada does not produce everything Canadians want to buy. Furthermore, Canadians do not buy everything our businesses produce. The fact is, nations engage in international trade. Our producers sell goods and services to buyers in other countries (our exports), and Canadians buy goods and services from producers in other countries (our imports). Canada has a very open economy, that is, we depend on trade for a significant portion of our total national income.

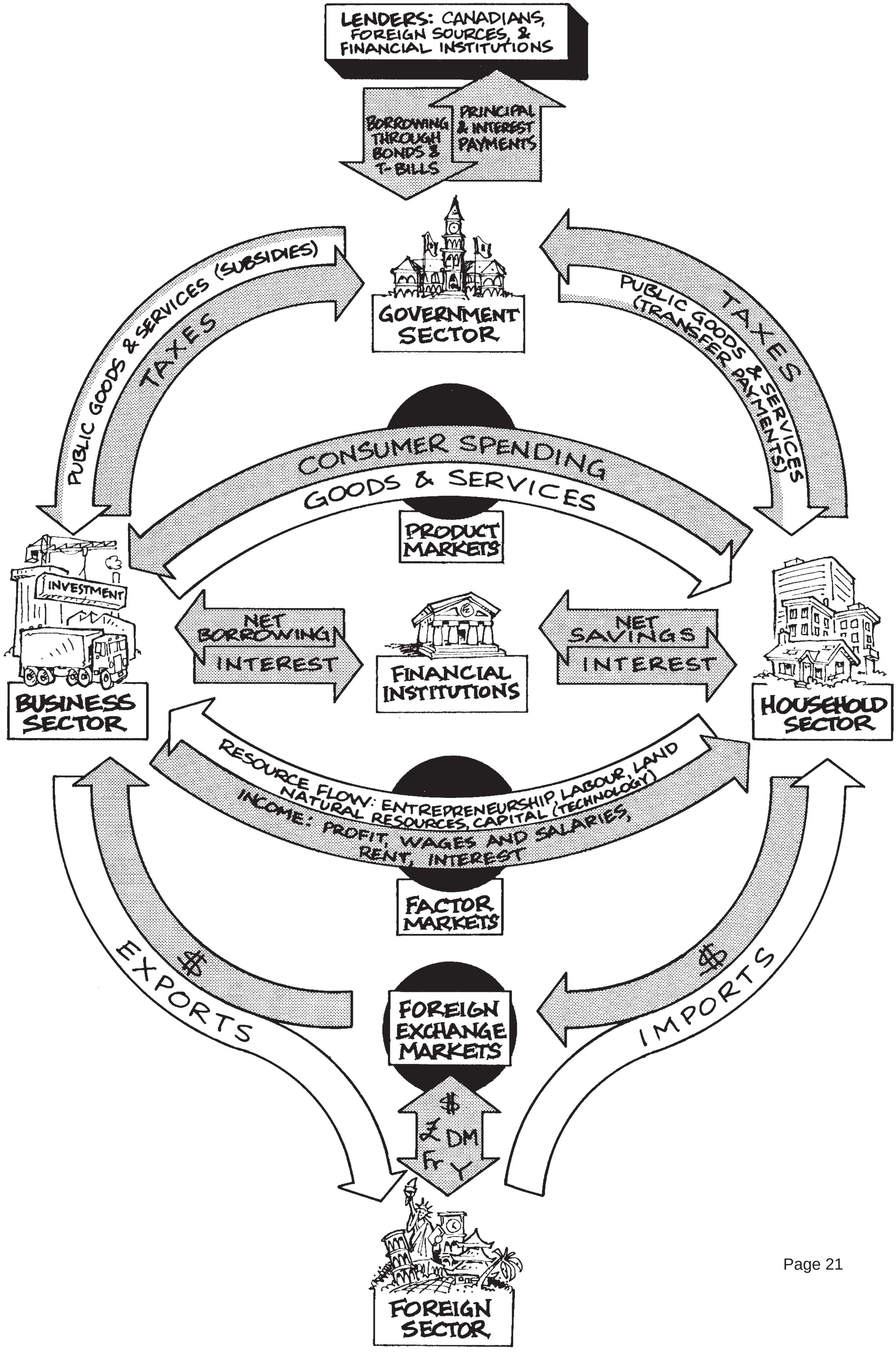
Again, there are money flows out (as payments for imports) and money flows in (as payments for our exports). But, although Canada uses money and the U.S. uses money and Japan uses money, we all use different money. Canadians use Canadian dollars, Americans use U.S. dollars, the Japanese use yen, Germans use marks, the French use francs, the British use pounds and so on. This means funds don't usually flow directly from buyer to seller, they go through a transition stage. When a Canadian producer sells something to a buyer in France, the Canadian seller usually wants Canadian dollars. Therefore, the French buyer uses **foreign exchange markets** to buy the Canadian dollars needed with French francs.

Currencies from virtually all nations of the world can be bought and sold through these foreign exchange markets. And the funds of one country will have to be exchanged for the funds of another before they can flow into that country's economy as spending, saving, investment or lending.

This flow of funds and goods and services into and out of Canada through the foreign exchange markets is shown on the diagram on the next page.

The complete picture – but not the complete story

That piece of the puzzle completes the "big picture." The diagram on the next page gives you a pretty good overview of how our economy works. At any given moment, the economy will be producing a certain level of goods and services. Total output may rise (economic growth) or total output may decline (economic recession / contraction). The capacity of the economy to produce output will be determined largely by the production capacity available through the private sector and how capable our producers are. Over time, then, the capacity of our economy to produce output, our productive capacity, will be affected by investment.


LENDERS: CANADIANS, FOREIGN SOURCES, & FINANCIAL INSTITUTIONS
BORROWING THROUGH BONDS & T-BILLS
PRINCIPAL & INTEREST PAYMENTS
GOVERNMENT SECTOR
PUBLIC GOODS & SERVICES (SUBSIDIES)
TAXES
PUBLIC GOODS & SERVICES (TRANSFER PAYMENTS)
TAXES
CONSUMER SPENDING
GOODS & SERVICES
PRODUCT MARKETS
INVESTMENT
BUSINESS SECTOR
NET BORROWING
INTEREST
FINANCIAL INSTITUTIONS
NET SAVINGS
INTEREST
HOUSEHOLD SECTOR
RESOURCE FLOW: ENTREPRENEURSHIP, LABOUR, LAND NATURAL RESOURCES, CAPITAL (TECHNOLOGY)
INCOME: PROFIT, WAGES AND SALARIES, RENT, INTEREST
FACTOR MARKETS
EXPORTS
$
IMPORTS
$
FOREIGN EXCHANGE MARKETS
$ £ DM Fr Y
FOREIGN SECTOR

But, given the capacity of an economy to produce, to what extent will that capacity be utilized? This is largely affected by the various flows shown in our diagram.

At various points, funds flow into our economy and funds flow out. By funds flowing into our economy, we mean funds that generate production. Funds tend to generate production when they are spent. Therefore, when consumers spend, they help to generate production. When governments spend, they help to generate production. When businesses spend, and acquire goods and services from other businesses, they help to generate production. And when buyers in other countries buy Canadian goods and services, they help to generate production here. Of course, when Canadians buy goods and services produced in another country, they help to generate production there.

Spending tells a tale

One way to get a sense of whether production levels in our economy will be high or low, expanding or contracting, is to take a look at the level of total spending in the economy. Total spending can be calculated by adding up all the various sources of spending that help generate production in Canada. At the same time, though, one has to subtract the spending in Canada that generates production in other countries, that is, our spending on imports.

Total spending, then, is equal to:

Spending by Consumers	+	Spending by Businesses (Investment)	+	Spending by Governments	+	[Spending by other countries on our Exports	–	Spending by Canadians on Imports from other countries]
(C)		(I)		(G)		(X)		(M)

Therefore, TOTAL SPENDING = C + I + G + (X - M)

The total spending in the economy will determine the extent to which the existing productive capacity of the economy is being utilized. Spending levels may be relatively low and, as a result, we may have idle, unemployed resources. On the other hand, spending levels may be relatively high and may be exerting pressure on our economy's ability to produce. Resources may be quite scarce or even unavailable. Spending, therefore, affects resource utilization and the extent to which the economy is using its capacity.

Over time, though, we hope the economy's productive capacity, in both quantity and quality, will improve. As we have noted, that is the key role that investment will play. On that point, it is important to note a key factor. Although we have identified one source of spending as G (government spending), it can really be broken down into two components. There is actually a "C" part of G and an "I" part of G. That is, some of what government spends goes for consumable items. The money flows and goes. The money, or what it acquires, is used up right away. But some government spending goes to things like roads, hospitals and schools. So government really engages in investment activities, too. When we look at factors that will influence the productive capacity of the economy over time, we have to consider both **private**

investment (shown as “I” in the equation) and **public investment** (which is part of “G”).

If one of our major goals is to have our economy expand so that it can create jobs and incomes for Canadians, as well as produce the high quality goods and services we need and want, the decisions made by these spenders, and most particularly the private and public investors, will be very important.

Where to spend – Canada or...?

The more Canadian consumers seek to acquire their goods and services from Canadian producers, the more funds will be directed to our producers. The more Canadian businesses wish to acquire goods and services from other Canadian businesses, the more funds will be directed to our producers. The more foreign buyers wish to acquire from Canadian businesses, the more funds will be directed to our producers. The more governments acquire from Canadian businesses, the more funds will be directed to our producers. The more investors, both Canadian and foreign, assess our businesses to be attractive, the more funds will be directed to our producers.

In general, then, the more successful our businesses, the more they will tend to receive funds through spending and investment. But then what?

If more funds flow to our producers, what is done with those funds? Are they invested wisely? Are they used for new, improved technology and research and development? Are they used to improve management and retain workers? Are they used to acquire new and better capital? Are they distributed to the owners of the business? In summary, if our producers are successful in generating funds from spenders and investors (both here in Canada and abroad), will they use those funds to ensure that they can continue to succeed, and be attractive to investors, in the future?

There is, of course, another scenario. Canadian consumers, businesses and governments may seek to acquire less from Canadian businesses. The same may be true of buyers in other countries. Canadian and foreign investors may not find our businesses to be attractive investments. There may be a decline, over time, in the flow of funds (both as spending and investment) to our producers.

In short, our businesses may be successful – or not. They may win – or lose. They may be attractive – or unattractive. They may do relatively well compared with those in other countries – they may do worse. So what?

Does it matter? Should we care?

Why should we care? Why do we care if Canadians, and spenders/investors in other countries, find our businesses attractive for investment or as sources for goods and services? Why do we care if our businesses use funds in any particular way?

We care if we are concerned about the ability of the Canadian economy to generate jobs, generate incomes and provide a significant portion of the goods and services we consume. We care if we are concerned about the standard of living and quality of life our economy is able to provide for Canadians. We care if we are concerned about whether we can generate additional wealth in Canada to enable us to address some of our existing and evolving challenges (for example, poverty, homelessness, the environment and so on).

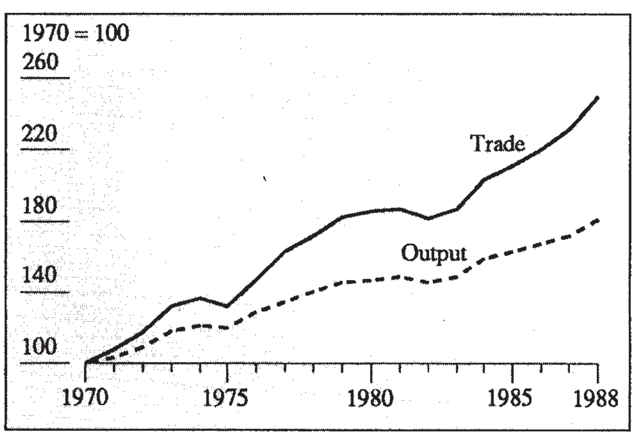
If we cannot generate new wealth to address these concerns, then we face one of two choices. We either don't address them or we reallocate wealth from where it currently is to these other areas of need. As possible as reallocating wealth may sound (even desirable to some), our society, although generous in many ways, has not shown itself able to reallocate wealth in such a way as to eliminate poverty, deal with some environmental problems and so on. Have we reason to hope it will be different in the future? And is it more desirable to achieve economic success so that problems can be addressed with new wealth, which is more easily redirected than existing wealth?

In summary, we care about the success of Canadian businesses if we care about jobs, incomes, our standard of living, our quality of life and our ability to generate new wealth to allocate to some key needs we have in our country. On that basis, it is probably fair to say that most Canadians care. If Canadians can't set up, operate and work for companies that produce what buyers want, both here and abroad, then the citizens of other countries will.

Our changing world – our challenging world

The world is evolving into a much more global economy. More and more things flow between and among nations, and they are flowing faster and in greater volumes. The chart below illustrates this clearly. It shows that an ever-increasing proportion of what is produced in the world is being traded between and among nations.

Volume of World Merchandise Trade and Output, 1970-88



Data from the GATT.

Source: Economic Council of Canada. *Transitions for the 90s.* Ottawa: Supply and Services Canada, 1990. (Twenty-seventh Annual Review)

Goods and services flow among nations. People flow. Ideas flow. Money flows. Information flows. Countries are becoming more interdependent.

Canada trades 30 per cent of everything it produces. Therefore, 30 per cent of our national income depends on our ability to sell goods and services in other countries. Canada depends on foreign lenders to finance a large portion of our government debt. Therefore, we depend on Canada being attractive to lenders. Many Canadian companies are expanding due to foreign investment. Therefore, Canada needs to be an attractive place for foreign investors to invest.

Canada, as well as other nations in the world, is becoming more and more linked and interrelated with other nations throughout the world. The economic welfare of our nation is significantly affected by the degree to which those in other nations buy our goods and services, invest in our country and lend us funds as we require them. When we sell goods and services to other nations, jobs are created and incomes are earned. When investment comes to Canada, businesses expand and improve, technology is developed and applied and jobs can be created. When we need to borrow, as many of our governments do, our ability to do so and the interest rate we have to pay will depend on the confidence foreign lenders have in our economy.

But other nations produce goods and services. Other nations provide attractive investment opportunities. And other nations have borrowing needs and seek to attract lenders. Canada must compete for sales. We must compete for investment. We must compete for lending.

There's the word – compete. If we need to compete, we are involved in competition. And if we are involved in competition, our **competitiveness** will determine our success.

Now, some people don't like the idea of competition. But what do we do about the 30 per cent of national output that we can't sell internationally if we can't compete? Who will buy that output? If it isn't sold, what about the lost jobs and incomes? What do we do when we need to borrow if we can't compete and can't attract funds? What do we do if we can't attract investment? What do we do if our own businesses can't compete with other nations' producers in providing what Canadians need and want?

The answer is that we wouldn't be ranked as the number one country in the world. The reality is, our country is involved in markets, markets for resources, goods, services and money. And we have been competitive. We have done well. But, as we saw earlier, other countries are catching up. If the truth be known, we have always had to be competitive. We have just had a position of advantage over most others that meant we haven't realized how hard we've had to work to be competitive. But it's getting harder. The world is becoming more competitive. There are more "players in the big leagues" – producing well, competing with us.

And we can feel it. We can feel the pressure and the challenges. We might not like it, but it's there. And Canadians have to respond. If we don't, we will have to accept the inevitability of a lower standard of living and quality of life. Like it or not, Canadians' ability to respond to global challenges is being tested. The question is, how well will we respond.

What are your thoughts and suggestions? We encourage you to think about it. And, more importantly, consider what *you* can do about it.

This brings us to the end of our introduction to the "big picture" – Canada's economy – how it fits together and why we are being challenged.

In the second part of this three-part series, we will look more closely at the factors that influence our competitiveness. In Part III, we will focus specifically on the concept of productivity. Productivity is an important concept and plays a major role in affecting our competitive position and our standard of living. But it is not a well-understood concept. We hope that the final segment in this mini-series will help to address that.

For now, we hope you will think about the challenges facing Canada and the potential impact of those changes on you, your family and your community. Once you have identified the challenges, we hope you will seek out the opportunities and get involved in initiatives that you believe are important – to your future and to the future of Canada. □