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Perspective: Building a Resilient Post-Pandemic Canadian Economy

Lawrence National Centre
for Policy and Management

The True North Free Trade Forum
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Stephen Poloz, Chair of the Lawrence National Centre's Advisory Council and former Bank of Canada Governor, discussed current economic conditions, the importance of removing trade barriers, and how Canada's historic spirit of collaboration can propel it's future. He shared his perspectives at the True North Free Trade Forum where he was invited to deliver a keynote speech.

This conference on interprovincial trade comes at a very auspicious juncture. Each of us is here today as the unique consequence of myriad decisions over the course of our lives. Suppose you had a choice between three universities 20-30-40 years ago, whenever it was, and now suppose you had made a different choice than the one you made. You would have met different people, possibly studied different subjects, met a different on-campus recruiter, your first job would have been different, perhaps even a different spouse and so on it goes. Each of your past decisions represents a fork in the road of life – change any of those and you change your destination.

The same goes for Canada. Where we find ourselves as a country today began with Confederation in 1867, and the time between then and now is crammed with important forks in the road.

It is helpful to start Canada's story a bit earlier, at the time of the War of 1812, when Canada consisted of four colonies: Upper Canada, Lower Canada, and the Maritime colonies of New Brunswick and Nova Scotia. Our relationship with the US at the time was a little frayed – of course, there had just been a war between us – and the US was collecting high tariffs on our exports of raw materials. In contrast, Mother Britain had a system of highly preferential tariffs on trade with her colonies, so much of our trade at the time was trans-Atlantic.

This arrangement worked well for Canada for some time, but it was disrupted in 1846 when the British government eliminated its tariffs on grain imports to reduce British food prices. This meant that the Canadian colonies suddenly had to compete head-to-head with the US for grain sales in Britain. In response, the Canadian colonies sought a new arrangement with the Americans, and this resulted in the 1854 Reciprocity Treaty. This essentially created a Canada- US free trade zone in natural resources.

Manufacturing was just getting started in both countries. In those days, governments had no reliable source of revenue, except tariffs. Canadian tariffs on manufactured goods began to rise, both to meet the financial needs of government but also to help protect the fledgling Canadian manufacturing sector and encourage it to expand.

THE TRUE NORTH FREE TRADE FORUM

The Ontario Government in partnership with Canadian provinces and territories hosted the inaugural True North Free Trade Forum aimed at strengthening business ties across Canada to support economic recovery. The forum's 900 participants looked at the challenges and opportunities presented by COVID-19, as well as the benefits of increasing pan-Canadian trade. The forum ran for two days, from March 30-31st, 2021.

https://www.sourcefromontario.com/TNFTF

This did not sit well with the Americans, as you can imagine. Soon came the US Civil War, from 1861-65, during which Britain continued to trade with the southern states, which did not sit well with the northern states. After the war, with the northern states in the driver's seat, the US backed out of the Reciprocity Treaty with Canada. This was in 1866.

This was a *major* disruption to the Canadian business model. The intelligent response of our leaders at the time was, why not bring the Canadian territories together under one banner, and encourage more trade between them? What a novel idea! A free trade alliance between the regions of Canada, called "Confederation", designed to create future prosperity!

There were conditions, of course. For one thing, railways needed to be constructed to connect the regions together. In the east, construction of the Intercolonial Railway was a condition for Nova Scotia and New Brunswick to join Confederation. The Canadian government needed a western railway to assert sovereignty over the Prairies lest the US get more expansionist ambitions, and to entice British Columbia to join Confederation. The CPR was started in 1881 and completed in 1885, something I am quite certain we could never pull off today.

Now I know the lawyers have had a field day arguing about whether the letter of the constitutional law means that we should have free movement of goods and services within Canada. But it is clear to me that the intention of the architects of Confederation was to do exactly that. The Canadian government even raised external tariffs significantly at the time to promote internal manufacturing and trade.

Continuing my parable of the forks in the road, the Confederation agreement here in Canada certainly counts as a very big one. I am quite certain that without Confederation we would eventually have become part of America. The economic forces would have been too strong for it to be otherwise. They still are very powerful today. We have always resisted that pull, and what allowed us to do so was our willingness to work together. Our historical economic report card is not perfect, but we have generated a lot of prosperity here in Canada from that humble premise.

Along the way there have been many more forks in Canada's road, too many to count. And at many of them, one province or another has created some sort of barrier to the interprovincial movement of goods, services, or people. In fact, it seems to me, there have been so many forks in the road that Canada has lost its way.

This is not about tariffs on traded goods, of course. Rather, it is mainly about differences in regulations between provinces and territories. The list includes dairy quotas, rules around the sale of alcoholic beverages, trucking requirements, business registration, and professional licensing. These differences arise because the power to set those rules belongs to the provinces, and for various reasons they are not harmonized with those of other provinces. The differences generally arise from good intentions.

Under the constitution, the Federal government has the power to disallow any new provincial legislation that has the effect of inhibiting trade between provinces. When I read this, I interpret it not as the power to disallow, but a duty to disallow. But we all know there is no surer way to get nowhere than for the federal government to tell a provincial government what it needs to do. We have learned from the Supreme Court around such matters as securities regulations and transporting beer across provincial borders that the intentions of the constitutional drafters to establish free movement of goods, services and people simply did not translate very well into law.

So, let's set aside the politics for a moment and ask ourselves how serious these differences are for the Canadian economy. This is a very difficult question, and there have been many attempts to do this work, but by far the most rigorous is a paper published by the International Monetary Fund in 2019, by Jorge Alvarez, Ivo Krznar and Trevor Tombe. Professor Tombe has been working on this subject for many years, from the University of Calgary. Their paper gets cited often, because it shows very credibly that income per person in Canada would be about 4% higher if we dismantled these interprovincial trade barriers.

Perhaps that sounds like a small number to you, 4%. But would anyone here welcome a 4% raise in pay? For literally everybody? So that they were paid 4% more than today, every year, until the end of time? That adds up to a lot of money. The average income per worker in Canada is over $50,000, so we are talking about an extra $2,000 per year, every year, forever.

The IMF study is cited often, highlighting that 4% figure, but there are some other interesting details.

> **As is very often the case, the biggest gains from removing trade barriers would go to the regions of the country that have the most barriers to remove. This underscores a general finding in economics: that trade barriers, while well intentioned, generally backfire, by actually reducing income per person in the protected region.**

Alberta, Saskatchewan, Nova Scotia, BC, Ontario and Quebec would receive income gains of 3-5% by removing these various barriers, roughly the average result of 4% that I mentioned before. But Newfoundland and Labrador would see income gains of 13%, PEI 16%, and the other provinces and territories 6-8%. The big gains in jobs would also be in these more protected regions.

This last point about jobs is important. There could be a modest amount of interprovincial migration as a result of the removal of barriers, with modest declines in total employment in BC, Alberta and Ontario. Gains of jobs of 18% in PEI and 13% in Newfoundland and Labrador sound large, but of course this is because of the small base in those provinces. Often, we see trade negotiations get tripped up on details like this, however, with the consequence that the big picture gets lost.

Suffice to say that any individual job losses due to the removal of trade barriers would be manageable. Certainly, the federal government would be well placed to compensate those folks and help them transition. That is because the huge benefit to the economy as a whole – an additional $80 billion in total income for the country, every single year – could generate additional tax revues of at least $20 billion, also every single year. I dare say, we could do a lot with an extra $20 billion per year of free money – and I meant that literally – free money for the federal government. The rest of us would have no trouble finding a use for the other $60 billion of free money, either.

By the way, the IMF study also shows that if we were to completely liberalize our international trade rules, we would add yet another 6% onto our incomes. This of course is even bigger than the benefit from liberalizing internal trade. This is a good reminder that really big benefits come to small economies like ours from trading with large economies. This is how companies in Canada can reach a scale where they can truly compete in the global marketplace, sustain good jobs, and make some real money.
We have made some good advances in liberalizing international trade in my lifetime, as we now have 14 formal agreements with countries covering something like 60% of global GDP. Arguably, Canada is well positioned for success on that front.

To be fair, these are not actually free trade agreements. They are negotiated understandings between countries about how trade will happen between them, what recourse companies will have should a misunderstanding arise, and that sort of thing. There are still lots of barriers to free trade, and scope for overrides, as we experienced first-hand during the Trump Administration.

Fact is, Canada has been lucky to be a prime participant in the global trade liberalising trend for the past 50 years, but especially since China joined the WTO.

> **The burst of globalization of supply chains beginning around 2001 has led to a dramatic decline in the costs associated with many things we buy, thereby boosting our spending power. Economists can debate whether every single Canadian benefited directly – we know they did not, as some of them lost their jobs and needed to move on to something else – but the vast majority did benefit. What people rarely acknowledge is that the generalized income gains from international trade get spent across our entire economy, creating new jobs in every sector.**

A worker who is displaced by globalization and must transition to a new job never sees it this way, but that second-round growth in jobs due to increased trade is by far the most important consideration.

Even if we do not have free trade, we have all benefited from the global trend towards freer trade. Unfortunately, that trend appears to have come to an end, and we are now seeing signs of deglobalization, which would lead to the reversal of some of those gains. This was most obvious as the rivalry between the US and China came to the fore during the Trump Administration, but it has deeper roots. Let me summarize this argument briefly.

During the 1990s and 2000s we were witnessing the practical benefits of the Third Industrial Revolution, which was the deployment of the computer chip throughout the economy, that really got started in the late-1970s. We all knew this was going on, but many economists were puzzled at how little evidence there was of increased productivity. But things really started to come together in the 1990s, when we saw several years of faster productivity growth. This trend facilitated the globalization of supply chains, as companies were able to fragment their products into tiny components, source those components from the countries most adept at making them, and knit the entire chain together tightly using computer technology.

One of the by-products of these developments was that income inequality increased, for two reasons. First, domestic workers with low or moderate skills suddenly had to compete with workers with similar skills in developing countries with lower wages, so those domestic workers either lost their jobs or had their pay rate compressed. Second, the companies that either developed the new technology or deployed it rapidly made huge profits and these gains were unequally distributed. This trend continues to this day, and the Fourth Industrial Revolution – the digitalization of our economies, deployment of artificial intelligence, and advanced biotechnology – is just getting started.

Rising income inequality fosters discontent, and politicians are tapping into it. But rather than simply repairing a tax system that does not do a good job of redistributing income, they prefer to blame globalization, thereby creating international tensions that are putting the trade liberalizing trend at risk.

Well, that sets the scene for us today, but for one thing: COVID-19. The pandemic is a natural disaster of the first order. It will have far-reaching effects on our economies and our societies, too many for me to go into today. Our central banks and governments have responded as they should, buffering the effects of COVID on the economy, and laying the foundation for a good recovery. There will be some permanent damage, and there will be individual casualties.

But let's at least recognize that the Canadian economy was in the best shape it had been in years when COVID came along – a 40-year low in unemployment, and inflation right on target at 2%. Like a healthy and fit individual, the Canadian economy should be able to shake off the effects of COVID. And what we saw last summer and fall, and again this spring, is exactly that – a degree of resilience that has surprised most economists. This was lucky for us.

> **COVID-19 could have come at any time, but it happened to come when the Canadian economy was in its best situation for a long time. If it had come during 2015 the story might have been quite different, for it would have been piled onto an economy already in recession. We were also lucky that the federal government had a vastly stronger fiscal situation than it had back in the mid-1990s. Resilience is not accidental – it requires forward-thinking and investment, whether for individuals, companies, or governments.**

One of the side-effects of COVID, however, has been a huge increase in public debt. Global public debt has risen by more than 20% of global GDP, to over 100%. Canada is in better shape than this, but when you add provincial and federal debt together, as we should, we are not far away from these numbers. Everyone is asking how we can possibly pay for all this.

First off, we have been here before. This is not much different from the level of global public debt we were carrying at the end of World War II. I have been asking people in my age group if they remember their parents talking around the kitchen table about the huge burden of debt left to them after World War II. I have not found anyone who remembers such conversations. The reason is because we mostly grew our way out from under that debt burden.

Second, like a viable company that has both debt and equity in its capital structure all the time, a viable government never has to pay back its debt. It may wish to reduce its debt to rebuild its capacity to manage future crises, but that is a separate matter. In practice, its minimum requirement is only that it reliably service its stock of debt.

Today, the cost of debt service is about one-sixth of what it was back in the mid-1990s, because interest rates are so low. Some are worried that interest rates will not stay this low forever. I hope not. The recent increases in bond yields I see as a symptom of success. Markets are telling us that policies are working to get the economy back on track. Technically, all we need is that the rate of growth in the economy exceed the real rate of interest. This will mean we can service the debt in perpetuity, and the level of debt will shrink relative to the size of our economy through time. Economic growth of around 2% per year would achieve this easily.

> **Real interest rates today are essentially zero, so even if inflation returned to 2% and bond yields rose all the way to 3%, growth in the economy between 1 and 2% would lead to a declining debt to GDP ratio through time.**

Even so, people are wondering what sort of tax schemes governments are going to throw at us in the post-pandemic world. Personally, I would much rather see governments come together around one single commitment: To do everything in their power to move forward with no increase in taxes. To me, that would be the best way to launch a first-ministers meeting, or a Fed-Prov-Territory Finance Minister meeting. All they would need to do is target economic growth of 2% or more. And governments have the power to do this.

First and foremost, governments should restore Canada's raison d'etre, by recreating the free trade zone we were intended to be back in 1867. Not through years of complex give and take negotiations, but in one weekend of hard work of reconciling regulations. Not 135 pages of exceptions to free trade or regulatory gaps, which is what we have today. Zero exceptions. Everyone in the country would get a raise, instead of higher taxes, and billions in additional tax revenue would roll in, every single year.

Second, governments should seriously encourage companies to invest in Canada's future. A level playing field is not good enough given what companies have been through – four years of intense uncertainty under the Trump Administration, followed by COVID, and persistent regulatory uncertainty. By all means encourage a green tilt to new investment but give companies tax breaks that allow them to make those investments.

Consumers face a carbon tax to encourage them to reduce emissions, but are given a tax break at the same time so it does not eat into their purchasing power and reduce economic growth. The same concept should be applied to companies, for we need them to lead the energy transition.

Third, governments should invest heavily in productive infrastructure. Infrastructure pays for itself in terms of higher GDP, which in turn drives tax revenues long into the future. And in this respect, I think the biggest infrastructure gap we face in Canada is a shortage of accessible daycare services – accessible both in terms of quantity, and in terms of cost. This is a true market failure that is limiting female participation in the workforce. Boosting labor force participation would raise our economic growth trend meaningfully, making our COVID-19 debt much easier to manage.

Politics, they say, is the art of the possible. I see no reason why this is not possible, especially when the motivations for acting are so compelling – indeed, more compelling than they have been since 1866.

BIOGRAPHY

Stephen S. Poloz, PhD '82, served as Governor of the Bank of Canada from 2013 to June 2020. As Governor, he was also Chairman of the Board of Directors of the Bank. He currently serves as the Chair of Ivey Business School's Lawrence National Centre for Policy and Management.

Born in Oshawa, Ontario, Stephen holds a bachelor's degree in economics from Queen's University, a master's degree in economics and a PhD in economics, both from the University of Western Ontario. Stephen has over 30 years of public and private sector experience in financial markets, forecasting and economic policy. He first joined the Bank of Canada in 1981, and occupied a range of increasingly senior positions over a 14-year span, culminating in his appointment as Chief of the Bank's Research Department in 1992. After his departure from the Bank in 1995, he spent four years at BCA Research, where he served as managing editor of its flagship publication, The International Bank Credit Analyst.

Stephen joined Export Development Canada (EDC) in 1999 as Vice-President and Chief Economist, and in 2004 was promoted to Senior Vice-President, Corporate Affairs and Chief Economist, with added responsibility for Corporate Planning, Communications, Government and International Relations, Engineering, Corporate Social Responsibility, and Corporate Research. From 2008 to 2010, he was Senior Vice-President, Financing, with responsibility for all of EDC's lending programs, in addition to the Economics and Corporate and International Trade Intelligence groups. In January 2011, he was appointed President and Chief Executive Officer of EDC, a position in which he served until his appointment as Governor of the Bank of Canada.

Stephen is a Certified International Trade Professional and a graduate of Columbia University's Senior Executive Program. He has been a visiting scholar at the International Monetary Fund in Washington, D.C., and at the Economic Planning Agency in Tokyo, Japan. Stephen has taught economics at the University of Western Ontario, Concordia University and Queen's School of Business. He is a past president of the Ottawa Economics Association.

Stephen resides in Ottawa with his wife of 36 years, Valerie. He has two children, Jessica and Nicholas, and he is a grandfather.

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