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HIGHLIGHTS

- › Canada has suffered a drastic decline in competitiveness since 2000, and is now 30% shy of the U.S.
- › However, we believe Canada’s competitiveness problem is understandable, unavoidable, unlikely to vanish and it does not constitute a mortal danger to economic well-being.

# SHRUGGING OFF CANADA’S COMPETITIVENESS SHORTFALL

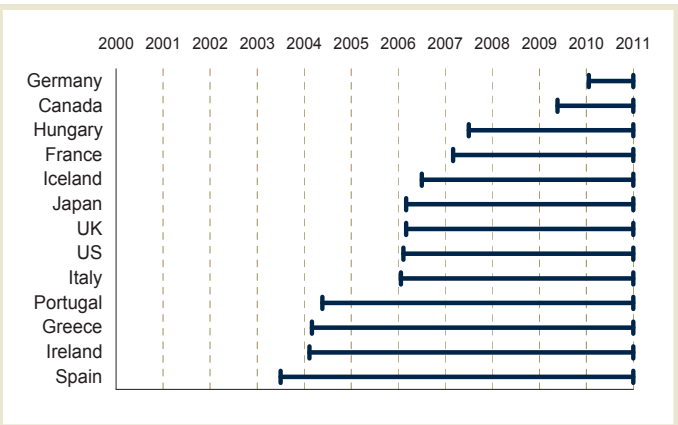
Canada cried fewer tears than most during the financial crisis and its economy lost far less time afterwards (Exhibit 1). But this has not altogether shielded the country from trouble. In fact, Canada has a surprising number of swords dangling over its head. This airborne armoury of domestic risks includes overheated home prices, excessive household debt, a sneakily large government debt, a substantial current-account deficit and dismal competitiveness. None of these threats are existential, but several are material (Exhibit 2).

This report addresses the last of these threats: Canada’s competitiveness shortfall. But we bring quite a different attitude than the usual hand-wringing, with an interpretation that is equal parts fatalistic and benign.

The “fatalistic” element is that there looks to be very little that can be done about Canada’s gaping competitiveness shortfall. After all, three-quarters of the gap is due to the strong currency, and the remaining quarter – the productivity part – looks to be largely the unavoidable consequence of being a nation endowed with resource wealth. There are no glaring failings on the part of Canadian policymakers, workers or businesses. Barring a sharp drop in commodity prices and/or the currency, the competitiveness gap is simply not going away.

The “benign” element of our view is that Canada’s poor competitiveness just doesn’t matter. To be sure, some sectors struggle. But the overall economy continues to push ahead with remarkably little damage. In fact, Canada continues to outperform the U.S. by most economic metrics despite swooning competitiveness. Resource wealth may have cursed Canada’s competitiveness, but the financial windfall from the resource sector also cast a spell of protection warding off the

Exhibit 1: Time Travel Machine: Canada’s Economy Has Retreated Less than Others



Notes: Chart calculates how far back in time economies have retreated based on the decline of several economic and financial metrics.  
Source: Haver Analytics, Economist Magazine, RBC GAM

consequences of the very same poor competitiveness. This is an impressive – and likely durable – balancing act.

## Measuring Competitiveness

Economic competitiveness exists at the intersection of productivity, wages and exchange rates (Exhibit 3). Productivity is an important component of competitiveness, but they are not the same. China has poor productivity, but its economic competitiveness rates highly because it pays salaries commensurate with its poor productivity, and it has enjoyed a weak exchange rate. In contrast, Australia has higher productivity but worse competitiveness due to relatively high salaries and a strong exchange rate.

**Exhibit 2: Made-in-Canada Challenges**

We have previously written on Canadian home prices and household debt (*Economic Compass – Issue 7, “Canada’s Debt Threat”*), and maintain the view that higher interest rates will prove the necessary catalyst for a moderate housing market correction, with the economy suffering notably slower growth as a consequence. The household debt-to-income ratio should also begin to fall once the cost of servicing debt begins rising.

Canada’s federal finances look to be on a credible path back to balance, but some provinces have a rougher road than others. This is Canada’s dirty fiscal secret: manageable federal debt, but precarious regional debt relative to the international norm. The fact that ballooning health-care costs accrue to the provinces exacerbates this. The current fiscal excesses can be solved, but will take several years to do so, and will involve unpopular and modestly growth-depressing austerity.

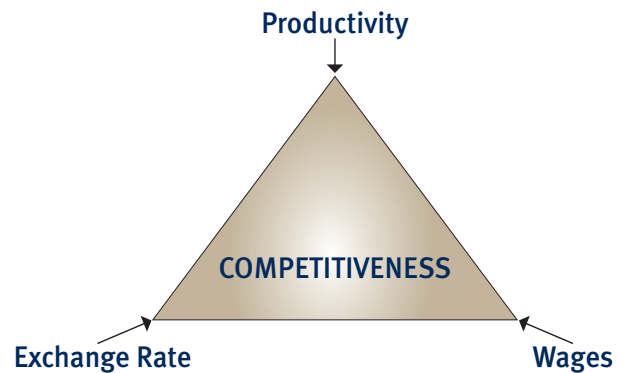
As a percentage of GDP, Canada now has a larger current-account deficit than the U.S. This is out of keeping with Canada’s reputation as a frugal nation, and means Canadians are net borrowers on the global stage. The current-account deficit should eventually fade as the combination of ultra-low interest rates (which induce spending), fiscal deficits (which governments have now targeted for elimination) and weak foreign demand gradually recede. Nevertheless, a portion is due to Canada’s poor competitive position, and so may be more difficult to eliminate.

Competitiveness is usually central to a country’s standard of living. As Greece has painfully learned, when nations choose to paper over their competitiveness problems by living well beyond their means, the resulting debt eventually crumbles under its own weight. It is thus rather worrying that Canadian competitiveness has decayed so profoundly over the past decade.

The standard measure of competitiveness is the relative unit labour costs between countries. This indicates whether workers are being paid more in one country than another per unit of output they produce. By this metric, Canada has become frightfully uncompetitive. Relative to its trading partners, the OECD calculates that Canadian manufacturing competitiveness has deteriorated by 61% since 2000 (Exhibit 4).

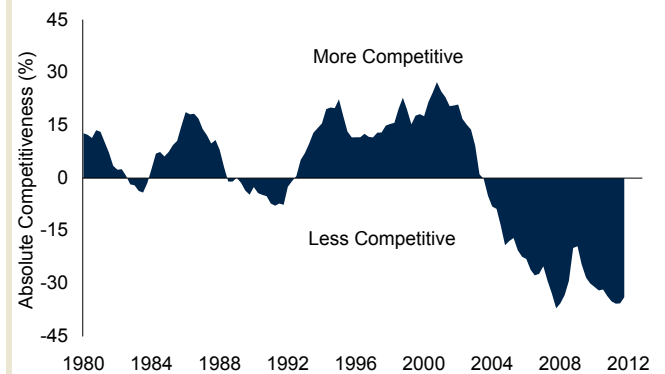
Versus the U.S. – Canada’s single most important trading partner by an astonishing factor of 19 – we calculate that

**Exhibit 3: The Competitiveness Intersection**



Source: RBC GAM

**Exhibit 4: Canada’s Competitiveness Has Tumbled Versus World**



Note: Absolute Competitiveness calculated as currency-adjusted unit-labour cost ratio between Canada and its trading partners, vs. the average relationship from 1981 to 2011. Source: OECD, Haver Analytics, RBC GAM

**Exhibit 5: Canada–U.S. Economic Competitiveness**



Note: Absolute Competitiveness calculated as currency-adjusted unit-labour cost ratio between Canada and the U.S. versus the average relationship from 1981 to 2011. Source: Haver Analytics, RBC GAM

Canadian private sector competitiveness has deteriorated by a similar 52% since 2000. This is not quite as bad as it seems, since Canada initially enjoyed a significant competitive advantage over the U.S. But this sunny hillock has since eroded into a ditch, leaving an absolute competitive disadvantage of 30% (Exhibit 5).

Putting this into stark relief, Greek competitiveness only deteriorated by 27% versus Germany – Europe’s productivity powerhouse – over the same period.

Other metrics corroborate Canada’s deteriorating competitiveness. Consumer prices in Canada are now 12% higher than its trading partners. Canada has recently descended into current-account deficit. And Canada’s share of American imports has deteriorated (Exhibit 6). Canada is evidently struggling to compete.<sup>1</sup>

## Understanding the Competitiveness Problem

The bulk of Canada’s competitiveness problem can be chalked up to a single cause: almost three-quarters of the gap is due to the loonie’s remarkable ascent since 2002 (Exhibit 7). Without the currency gain, only a shadow of Canada’s competitiveness problem remains (Canada would be just 8% less competitive than the 30-year norm).

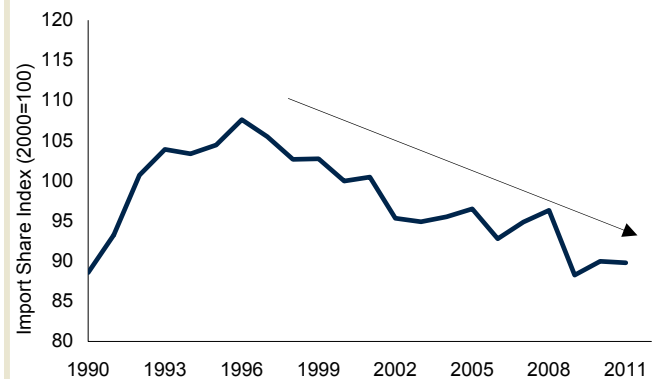
This residual is probably even smaller than it looks. The standard competitiveness definition – relative unit labour costs – is an imperfect one. It endeavours to explain everything through the lens of labour costs. But businesses have other costs, such as capital and raw materials. These tend to be priced on an international basis, meaning that the shift in relative labour costs likely overstates the deterioration of Canada’s competitive position.<sup>2</sup>

## Revising Canada’s Productivity Damage

Excluding the currency effect, the primary explanation for the remaining competitiveness hole is Canada’s long-standing productivity gap, exacerbated by recent lacklustre productivity growth. Canada’s labour productivity is estimated to be just 78% of the U.S. (Exhibit 8), and only 70% in the business sector. These are veritable chasms, and have grown over the past decade.

Multi-factor productivity (MFP) is an alternative and arguably purer productivity metric. Whereas labour productivity can be juiced by adding capital to a business (and capital productivity can be enhanced by adding labour), multi-factor productivity is

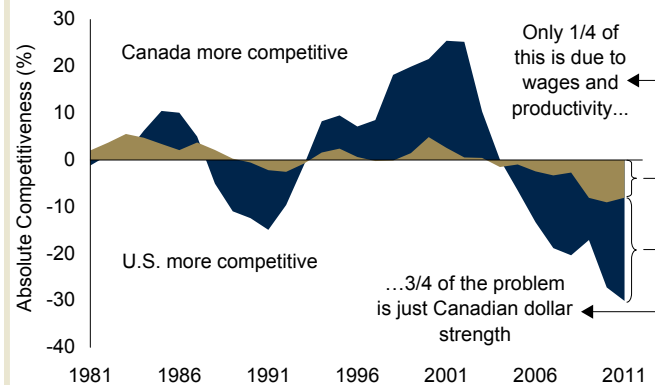
**Exhibit 6: Canada’s Share of U.S. Imports Is Declining**



Note: Canadian share of U.S. imports, adjusted for Canada’s declining share of global GDP.

Source: Haver Analytics, RBC GAM

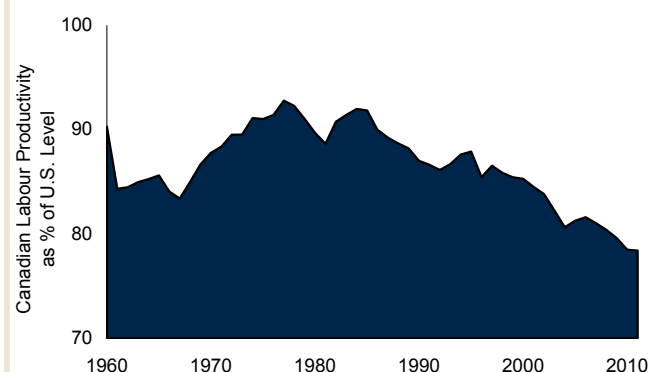
**Exhibit 7: Disaggregating Canada – U.S. Economic Competitiveness**



Note: Absolute Competitiveness calculated as currency-adjusted unit-labour cost ratio between Canada and the U.S. versus the average relationship from 1981 to 2011.

Source: RBC GAM, Haver Analytics

**Exhibit 8: Canadian Productivity Declining Versus U.S.**



Source: The Conference Board Total Economy Database™, January 2012, <http://www.conference-board.org/data/economydatabase/>, RBC GAM

immune to these effects because it distills productivity purely from efficiency gains. This is the holy grail of productivity – getting something for nothing – and trickles forth from new technologies, procedures and business structures. Canadian multi-factor productivity currently operates at around 85% of U.S. levels for the overall economy, and 80% for the business sector.

However, as with Canada’s competitiveness shortfall, the productivity shortfall may be moderately smaller than it first looks. Due to subtly different statistical constructs, Canada’s labour productivity gap may be as much as five to 10 percentage points smaller than officially reported, eliminating anywhere from 15% to 25% of the gap.

Meanwhile, there is good reason for most of the remaining gap, and perhaps even for the underperformance over the past decade.

For one, Canada and the U.S. have different industry compositions. Canada has larger construction and government sectors, for instance, and these are low value-added sectors plagued with minimal productivity growth. Research estimates that this may explain as much as 20% of the Canada–U.S. labour productivity gap.<sup>3</sup>

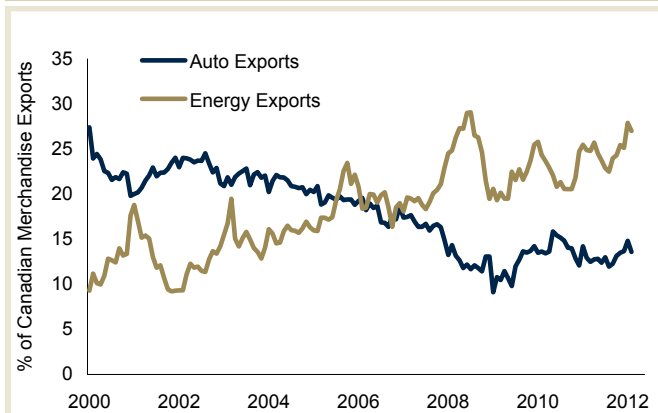
### A Broader Commodity Curse

It is widely accepted that resource wealth can be a “curse” for poor nations. The windfall of government royalties, soaring profits in the resource sector and job creation is regularly and depressingly outweighed by corruption, political instability, extractive management and a diminished emphasis on education. Frequently, little benefit trickles down to the average citizen.

The developing countries that have managed the greatest prosperity gains in recent decades have been those with the fewest natural resources. Prominent success stories include Japan, South Korea, Taiwan, Hong Kong and Singapore. Without the distraction of commodity wealth, they have focused on their only resource – their people – and educated and innovated their way towards the First World. Resource-rich countries such as Russia, Argentina, Venezuela, Mexico and Nigeria have been left in their dust.

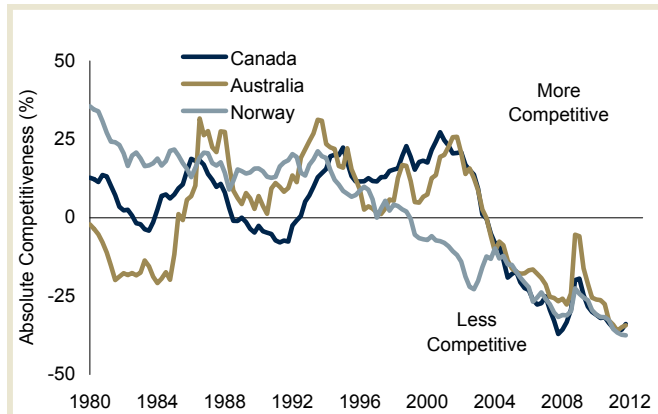
It is commonly acknowledged that Dutch Disease – essentially, a mild version of the resource curse – regularly takes root in rich nations with resource wealth. As the resource sector blooms, the manufacturing sector rots due to a rising exchange rate and greater competition for skilled workers (Exhibit 9). The tech sector – an important source of innovation and well-paid

Exhibit 9: Dutch Disease at Work



Source: Haver Analytics, RBC GAM

Exhibit 10: Competitiveness Has Declined Equally in Canada, Australia and Norway



Note: Absolute Competitiveness calculated as currency-adjusted unit-labour cost ratio between country and its trading partners, vs. the average relationship from 1981 to 2011. Source: OECD, Haver Analytics, RBC GAM

workers – also frequently suffers given its heavy tilt toward labour costs.

Provocatively, we hypothesize something with more bite than this. We believe rich commodity-intensive nations may also be suffering from a full-fledged, if under-acknowledged resource curse of their own. This operates through the keyhole of inferior competitiveness and productivity. It is not likely a coincidence that fellow resource heavyweights like Australia and Norway have sustained an identical competitiveness collapse since commodity prices turned higher (Exhibit 10). Canada’s resource windfall may ultimately explain quite a lot of its competitiveness and productivity failings.

A sprinkling of academic research supports this thesis, as do our own calculations. In the OECD, resource-rich nations have

suffered 0.5% slower productivity growth per year since 2000. Since 1960, the productivity-growth shortfall has averaged twice that (Exhibit 11). Multi-factor productivity has also grown less quickly for commodity nations (Exhibit 12).

Why this is the case remains somewhat murky. The resource sector itself is in fact fairly productive versus the average sector. However, Canada's productivity growth in the sector is underwhelming, presumably due to the sheer profitability of the sector and increasingly costly unconventional energy sources. Resource wealth may also be dampening the education premium, and encouraging a shift into lower-value manufacturing of the sort that perches immediately atop resource extraction. Alberta's productivity performance in particular has dragged since the late 1990s, and much of this can be pinned on the mining and energy industries.

This is loaded on top of the more conventional interpretation of Dutch Disease – a manufacturing sector that struggles to compete for workers and is priced out of its export markets – prompting some manufacturers to conclude that no amount of costly productivity initiatives could ever hope to overcome their troubles. Others may find themselves saddled with excess capacity, with the consequence that they are inadvertently using their overall capital base less productively.

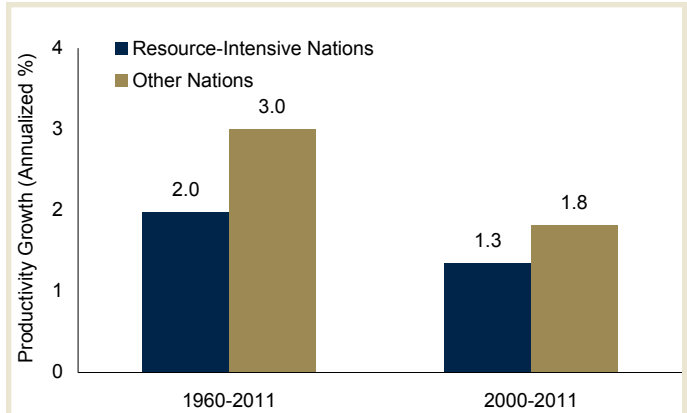
### America's Gravitational Pull

Canada's smaller economy and proximity to the U.S. could also contribute to its poor productivity performance. It is indisputable and possibly not coincidental that both Canada and Mexico have had especially dismal productivity growth relative to the U.S. over the past decade (Exhibit 13).

One possible explanation is that it is hard to compete with a nearby market that is five times larger than Canada and Mexico combined. The Canadian economy is smaller than the U.S., less urban, and more geographically disparate. Each of these hinders economies of scale and so hurts productivity. The rare Canadian manufacturer as large as its American counterpart is equally productive, but the smaller firms simply are not. Tiny unincorporated businesses make up a large fraction of Canadian firms, and manage just half the productivity of the rest. One source estimates that Canada's smaller manufacturing plant sizes accounts for between 8% and 20% of the manufacturing labour productivity gap. We figure Canada's lower population density may explain as much as 25% of the gap.<sup>4</sup>

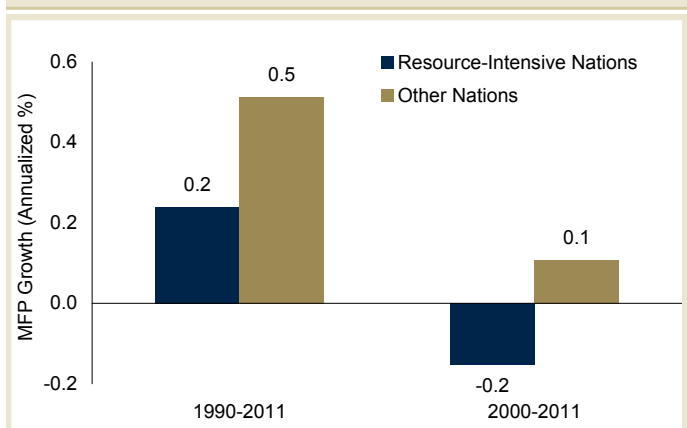
Canada's lower population and smaller economy may be especially relevant in an era when scalable innovations – ones that can be ramped up to a million customers as easily as a

**Exhibit 11: Resource-Intensive Nations Have Slower Productivity Growth**



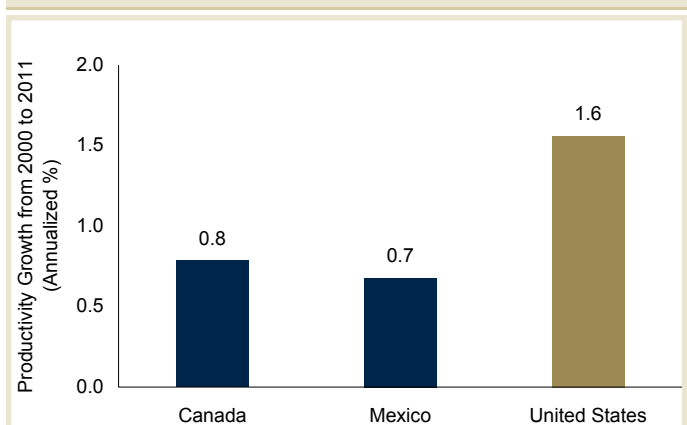
Note: OECD nations examined. Resource-intensive OECD nations: Australia, Canada, Chile, Iceland, Mexico, Netherlands, New Zealand, Norway, Sweden. Source: The Conference Board Total Economy Database™, January 2012, <http://www.conference-board.org/data/economydatabase/>, RBC GAM

**Exhibit 12: Resource-Intensive Nations Have Slower MFP Growth**



Note: Multi-factor productivity growth (MFP) of OECD nations. Resource-intensive OECD nations: Australia, Canada, Chile, Iceland, Mexico, Netherlands, New Zealand, Norway, Sweden. Source: The Conference Board Total Economy Database™, January 2012, <http://www.conference-board.org/data/economydatabase/>, RBC GAM

**Exhibit 13: Canada and Mexico Lag U.S. Productivity Growth**



Source: The Conference Board Total Economy Database™, January 2012, <http://www.conference-board.org/data/economydatabase/>, RBC GAM



thousand – are king. Having the largest possible initial market is key, and this partially explains the unparalleled success of the dot-com sector in the U.S. This American advantage lures Canadian and Mexican entrepreneurs and innovators across the border, worsening domestic outcomes.<sup>5</sup>

### A Wider Perspective

In evaluating Canadian productivity, some international perspective is useful as the U.S. is an extraordinary productivity outlier.

Fortunately, Canada fares somewhat better in this context. Although Canada’s overall productivity ranking has fallen to 15<sup>th</sup> out of 34 OECD nations (down from second in 1960 and 12<sup>th</sup> in 1990), there are good reasons. In 1960, Europe was still piecing itself together after the Second World War. European nations have since reclaimed their traditional spots near the top of the productivity rankings. Furthermore, several nations now ahead of Canada are quite small (like Luxembourg), and specialize in high-value industries – a model that a mid-sized country like Canada cannot hope to emulate.

Canada’s sub-par productivity gains relative to the OECD average are due in significant part to the naturally higher economic speed limit poor countries enjoy as their economies converge toward advanced nations. This is mainly accomplished by cribbing technologies, processes and management techniques. This chase pack could yet catch Canada, but it will prove just as hard for these upstarts to forge ahead as it has for Canada to make gains itself. It is simply tougher sledding for those already near the top. Contrary to popular perception, Canadian productivity growth since 1990 has very nearly kept pace with the average nation ahead of it in the rankings (Exhibit 14).

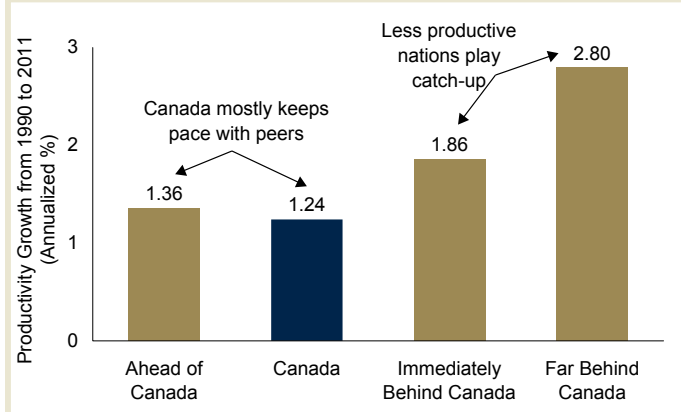
### Fixing Competitiveness

So Canada’s competitiveness and productivity problems are smaller than they initially appear and the remainder is mostly understandable. But these shortfalls nevertheless remain undesirable. Can they be fixed? Regrettably, the problem is mostly out of Canada’s control (Exhibit 15).

### Accept the Unalterable

Given that the Canadian dollar’s strength represents fully three-quarters of the competitiveness problem, fixing the bulk of the competitiveness gap requires a materially softer currency. But this is determined by markets, and is not likely in the cards.<sup>6</sup> So the bulk of the competitiveness gap should persist.

**Exhibit 14: Canadian Productivity Growth Mostly Keeps Pace With Peers**



Note: Rankings based on level of productivity of 33 OECD countries in 1990. Source: The Conference Board Total Economy Database™, January 2012, <http://www.conference-board.org/data/economydatabase/>, RBC GAM

**Exhibit 15: How Canada Stacks Up**

Measure	Canada's International Ranking (Percentile)
<b>Public Policy</b>	
WB World Governance Indicators	96
WB Ease of Doing Business	93
WEF Global Competitiveness Index	92
<b>Labour</b>	
WEF Higher Education and Training	92
WEF Labour Market Efficiency	99
<b>Innovation</b>	
WEF Technological Readiness	89
WEF Innovation	92
MPI Global Creativity Index	92

Note: WB refers to World Bank; WEF refers to World Economic Forum; MPI refers to Martin Prosperity Institute. World Governance Indicators refer to government effectiveness, regulatory quality, the rule of law and control of corruption. Source: WB, WEF, MPI, RBC GAM

## Not a Policy Problem

Canada's remaining competitiveness shortfall – basically, a productivity problem once the currency is stripped out – is not due to poor public policy.<sup>7</sup>

The World Bank's Worldwide Governance Indicators rank Canada in the 96<sup>th</sup> percentile in Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. Another World Bank measure – the Ease of Doing Business database – puts Canada in the 93<sup>rd</sup> percentile. The World Economic Forum (WEF) has identified 12 economic and public policy pillars necessary for a highly competitive economy. Canada ranks in the 92<sup>nd</sup> percentile across these. A structurally uncompetitive nation like Greece plods along in just the 37<sup>th</sup> percentile. Canadian policymakers have clearly got the broad strokes right.

Moreover, the Canadian government has made major strides over the past 15 years in implementing a productivity-friendly agenda. If anything, Canadian productivity growth should be accelerating, not decelerating, due to the recent actions of policymakers.<sup>8</sup>

It is fascinating that resource-intensive nations as a whole fare rather well in the WEF's Competitiveness Index. This corroborates our thesis that actual competitiveness shortfalls are an unlucky consequence of being commodity-rich, and not because of bad policy.

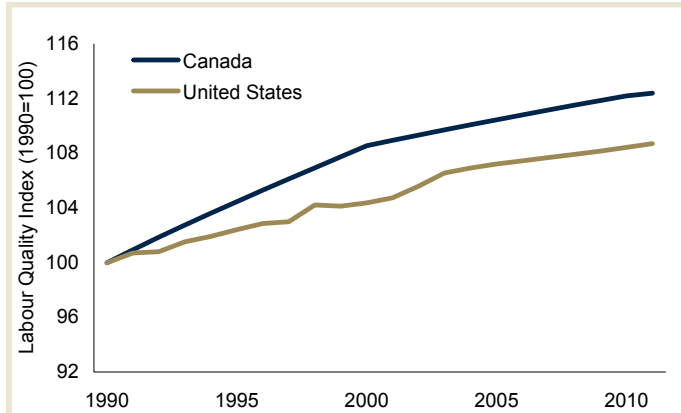
## Not a Worker Problem

If policymakers aren't to blame, could Canadian workers be the problem? Again, the answer seems to be "no." In fact, Canadian workers are one of the reasons why Canadian productivity is not even worse.

Canada has among the highest rates of post-secondary education graduates in the world, averages an impressive number of years of schooling, performs well above average in international testing and has a better overall labour quality than the U.S. What's more, Canadian labour quality continues to steadily improve, and has been rising with slightly more zest than in the U.S. (Exhibit 16).

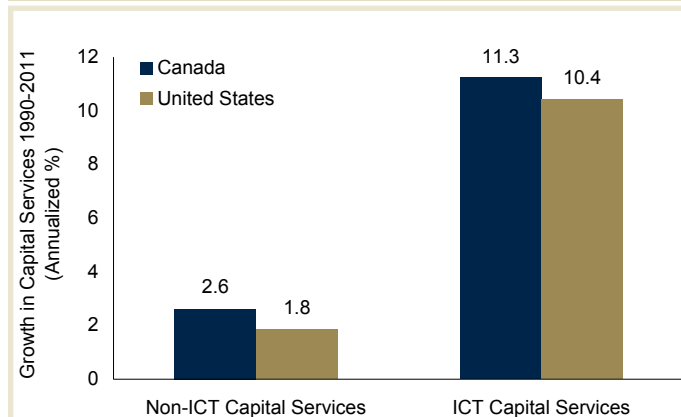
The World Economic Forum rates the quality of Canada's higher education and training in the 92<sup>nd</sup> percentile, and the efficiency of the labour market in the 99<sup>th</sup> percentile. Explanations for Canada's productivity slowdown over the past decade need to be found elsewhere.

**Exhibit 16: Canadian Labour Quality Growth Outpaces U.S.**



Source: The Conference Board Total Economy Database™, January 2012, <http://www.conference-board.org/data/economydatabase/>, RBC GAM

**Exhibit 17: Canadian Capital Growth Outpaces U.S.**



Note: ICT refers to information, communications and technology.  
Source: The Conference Board Total Economy Database™, January 2012, <http://www.conference-board.org/data/economydatabase/>, RBC GAM

## Not a Business Problem

Are businesses to blame for Canada's poor competitiveness? The evidence is more mixed here, but there is no smoking gun.

Canadian businesses are regularly criticized for insufficient investment in productivity-enhancing capital. But this criticism may be misplaced. First, it is not such a mystery why businesses have failed to load up on cheap U.S.-priced machinery: studies find that this benefit is fully neutralized by the challenge of finding buyers for the resultant goods priced in the higher Canadian dollar.

Second, Canada's rate of capital investment is more than adequate – it continues to grow steadily, and is outpacing the U.S. (Exhibit 17). Third, properly calibrated figures show

that Canadian businesses actually have a capital intensity around 10% higher than in the U.S., not lower as is commonly assumed. Canadian businesses have an ample capital stock.<sup>9</sup>

More generally, the fact that Canadian productivity is inferior to the U.S. in all provinces, that the deceleration has occurred in every province, and that Canadian productivity is lower in 10 out of 12 economic sectors and 15 of 17 manufacturing sub-sectors strongly points to macroeconomic issues, not a scourge of complacent CEOs and uninspired boards.

### An Innovation Problem

If the metrics gauging public policy, labour quality and capital intensity all reveal nothing out of the ordinary, the problem must be something more subtle. Empirically, we can establish that the source of Canada's productivity underperformance versus the U.S. since the turn of the millennium is almost entirely due to inferior multi-factor productivity growth – the way in which existing labour and capital is being deployed.

Woefully, Canada has suffered an outright decline in its multi-factor productivity level over the past decade. Canada simply hasn't invested enough in research and development (R&D), ranking a middling 15<sup>th</sup> in the OECD.<sup>10</sup> This appears to constitute the central villain in explaining inferior multi-factor productivity, though it does not justify the recent outright decline.

The explanation for that appears to circle back around to resource wealth. Other resource-intensive nations have also suffered an outright decline in multi-factor productivity since 2000. The precise reasons for this are unclear, but the common commodity bond is undeniable.

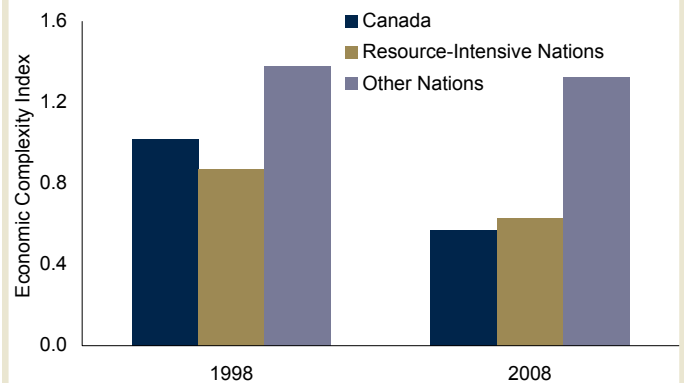
To their credit, policymakers and business leaders are well aware of Canada's innovation shortcomings, and have undertaken to remedy them. The World Economic Forum ranks Canada's technological readiness in the 89<sup>th</sup> percentile and innovation in the 92<sup>nd</sup> percentile – hardly a dismal showing. Meanwhile, the Martin Prosperity Institute's Global Creativity Index places Canada in a solid seventh position within the OECD. This would seem to foreshadow future innovation gains.

### What Problem?

Despite poor competitiveness, low productivity and insufficient innovation, most people will tell you that Canada doesn't feel especially bleak.

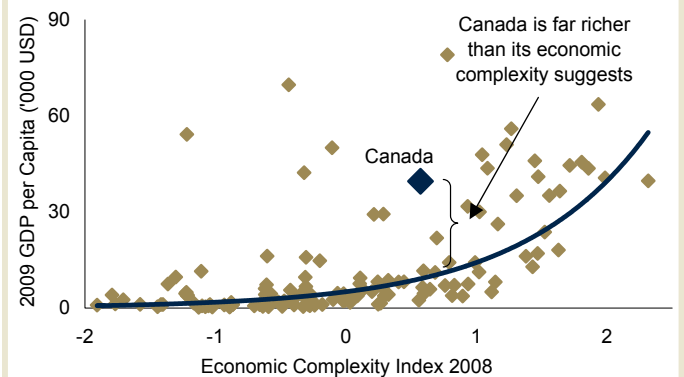
There is a reason for this. Canada's poor competitive position is confirmed by the inferior and declining complexity of its exports relative to peer nations (Exhibit 18).<sup>11</sup> National income

**Exhibit 18: Resource-Intensive Nations Have Less Complex Exports**



Note: Among 32 included OECD nations, resource-intensive nations defined as Australia, Canada, Chile, Mexico, New Zealand, Norway and Sweden.  
Source: The Atlas of Economic Complexity, Hausmann, Hidalgo et al., RBC GAM

**Exhibit 19: Income Usually Rises With Economic Complexity**



Source: The Atlas of Economic Complexity, Hausmann, Hidalgo et al., RBC GAM

is usually quite closely tied to this competitiveness proxy. However, for resource-intensive economies like Canada, the link is flimsy to non-existent. Canada earns tens of thousands of dollars more per person than a simple snapshot of its export complexity would appear to justify (Exhibit 19). It is the same for the likes of Australia, Norway and Saudi Arabia. The key point is this: resource wealth contributes to poor competitiveness, but the pernicious effects of poor competitiveness are in turn neutralized by the direct benefits of the resource wealth itself.

Arguably, Canada even feels outright better than the U.S., despite its competitiveness shortcomings. Canada has sustained broadly similar GDP growth relative to the U.S. since 2000, but concocted in a different fashion. Compensating for weak productivity growth, Canada has managed stellar job creation.<sup>12</sup> In the context of recent economic travails, many



envy Canada's tilt toward hiring over productivity. Productivity is certainly important as a long-term driver of prosperity, but Job Number 1 after a recession is to absorb the unemployed back into the workforce. Canada has managed this, and then some. The U.S. has not.

Amazingly, Canada has even shed fewer manufacturing jobs than the U.S. since 2000.<sup>13</sup> This appears not to be a fluke: resource-intensive nations – despite the evident challenges of Dutch Disease – have as a group (and almost to a nation) gained more overall jobs and lost fewer manufacturing jobs than other countries (Exhibit 20). A rising resource tide appears to lift all boats.

Equally, it is debatable whether relative GDP deserves all the attention it receives. An alternative measure, Gross Domestic Income (GDI), arguably more closely approximates the “feel” of the economy for the average person. The difference is that GDI layers Canada's beneficial terms of trade<sup>14</sup> on top of the classic GDP measure. Redefined in this fashion, Canadian income per person has increased by an eye-popping 8% more than the U.S. since 2000 (Exhibit 21), not the relative 8% decline that simple productivity statistics suggest, let alone the 52% landslide that classic competitiveness metrics convey.

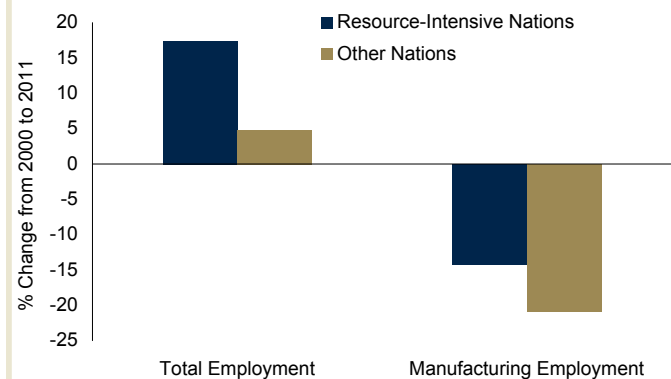
Still dubious? The UN Human Development Index – arguably the ultimate judge of prosperity – pegs the well-being of Canadians in the 97<sup>th</sup> percentile globally. This continues to rise, and is gaining on the U.S.

Could this charmed existence that runs so counter to limp competitiveness eventually prove unsustainable, as it did for Greece? The possibility cannot be dismissed altogether, but Canada's excesses are not so visibly outsized. The current-account balance is in deficit, but not enormously so. Fiscal deficits are sizeable, but shrinking. And Canada's international investment position – a measure of the extent to which Canadians have pawned their domestic assets in exchange for short-term gain – shows a much smaller deficit than usual (Exhibit 22).

## Conclusion

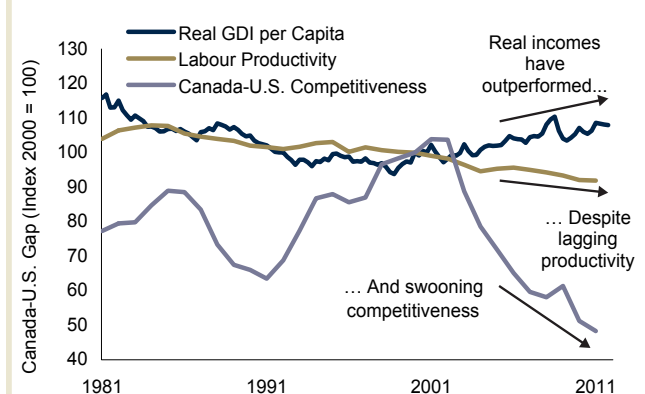
To conclude, Canada's competitiveness woes are predominantly a function of a very strong Canadian dollar, and to a lesser extent a productivity problem. Contrary to popular perception, this challenge is not unique to Canada. In fact, these twin deficiencies are familiar to many resource-intensive nations. Unfortunately, there is no obvious, easy solution to them.

**Exhibit 20: Rosier Employment in Resource-Intensive Nations**



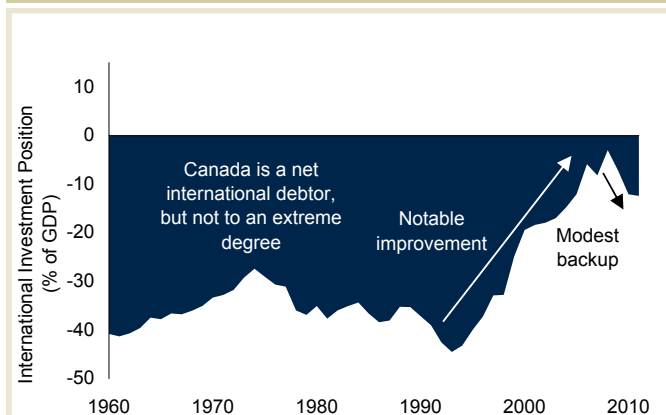
Note: Resource-intensive nations include Australia, Canada, New Zealand, Norway, Sweden. Other nations include France, Germany, Japan, Switzerland, U.K., U.S. Source: Haver Analytics, RBC GAM

**Exhibit 21: Why Canada Hasn't Felt So Bad Versus U.S.**



Note: Canada-U.S. Competitiveness calculated as currency-adjusted unit-labour cost ratio between Canada and the U.S. versus the average relationship from 1981 to 2011. Source: Haver Analytics, The Conference Board Total Economy Database™, January 2012, <http://www.conference-board.org/data/economydatabase/>, RBC GAM

**Exhibit 22: Is Canada Living Beyond Its Means?**



Source: Haver Analytics, RBC GAM

By all means, Canada should continue to implement competitiveness-enhancing public policy, to educate its citizens more, to strengthen its capital base and to conduct more business-specific research and development. But Canada is already doing well in most of these areas, and the resulting competitiveness gains will be incremental at best.

Instead of bemoaning this curse of poor competitiveness, Canadians should instead applaud the remarkable resilience of their economy. Yes, during periods of high commodity prices, resource-intensive countries tend to lose competitiveness. But this is paired with no obvious diminishment to well-being. Meanwhile, during periods of low commodity prices, the resource sector struggles, but rejuvenated competitiveness permits manufacturing to regain the offensive. Regardless of which way the wind blows, well-being remains effervescent.

So Canada's poor competitiveness is understandable, unavoidable, unlikely to vanish, and it does not constitute a mortal danger to economic well-being. The same applies to investors, who have felt little discernable effect on investment returns. Canadian stocks have substantially outperformed the U.S. since 2000, and government bonds have very nearly kept pace. One might even be so cheeky as to argue that Canada's resource-laden stock market can be expected to thrive during periods of diminishing competitiveness due to their mutual foundation in rising commodity prices. Investors and Canadians alike are right to shrug off Canada's competitiveness shortfall, and to focus on other more material risks.

**Notes:**

- <sup>1</sup> This is frankly rather frustrating since real Canadian manufacturing labour costs have declined for each unit of output. A serious effort has been made. It is just that U.S. real wages per unit of output have fallen by even more.
- <sup>2</sup> Moreover, it makes a fetish of minimizing labour costs as a share of GDP, which is not optimal from the worker's perspective.
- <sup>3</sup> Canada's construction excesses will eventually unwind, removing this productivity dampener. The large Canadian resource sector is reasonably productive as a whole, but experiencing subpar productivity growth. This also drags.
- <sup>4</sup> This is accomplished by extending U.S. state-by-state density findings to Canada.
- <sup>5</sup> Tempering this theory, one hears notably less about the Canadian "brain drain" today than ten years ago, when the currency rendered American wages irresistible to Canadian talent. Perhaps the effect is restricted to a smaller but more important group today.
- <sup>6</sup> The Bank of Canada could intervene in the currency market or cut rates, but the first would be of uncertain success, and the second would be inappropriate given the state of Canada's economy.
- <sup>7</sup> This is in stark contrast to many peripheral European nations, for which a great deal of the blame can be pinned on poor public policy.
- <sup>8</sup> Running through Canada's various policy virtues, overall macroeconomic policy has been positive, focused upon stable and prudent fiscal policy, low and steady inflation, good institutions and public infrastructure, strong health care and education services, competitive taxes, minimal regulatory hurdles, well-regulated banks, liquid and transparent financial markets, an efficient labour market, and expanding access to international markets. There is nothing that would explain the productivity slowdown – just the opposite, in fact.
- <sup>9</sup> In fairness, the allocation of capital in Canada is disproportionately towards engineering structures, and less so to machinery and equipment and especially information, communications and technology (ICT). These are purported to provide a better productivity pop. This allocation toward engineering structures may be a nod to Canada's large and difficult geography, or to Canada's resource and heavy industry base. Without dogmatically insisting that businesses can do no wrong and are always profit-maximizing, it would be enormously odd if firms continued year after year to invest in lower-yielding engineering capital unless their businesses demanded it.
- <sup>10</sup> The government is endeavouring to fix this by shifting R&D support towards the international norm by backing away from R&D tax credits, and increasing direct governmental support for research projects.
- <sup>11</sup> Complexity is defined as a country's breadth of export products and the relative uniqueness of those products in the world.
- <sup>12</sup> This runs contrary to orthodox theory, but in practice sometimes workers and productivity are indeed substitutes. Canada's working-age population grew at a faster pace than the U.S. since 2000, potentially explaining Canada's better hiring and worse productivity. Over the next decade, the tables will turn. U.S. working-age population growth will trump Canada, potentially allowing Canada to recoup earlier productivity losses.
- <sup>13</sup> Possible explanations for Canada's less baleful manufacturing employment numbers is that Canada may have lost many high-value manufacturing jobs, but has augmented the manufacturing roles that directly support and process extracted resources. Alternately, the wealth generated by Canada's strong resource performance has sustained demand for all goods better than in the U.S.
- <sup>14</sup> Canada's recent terms of trade benefit can best be explained as the fact that, on the international market, Canada sells oil, whose price has gone up, and buys machines, whose price has gone down – this is an effective increase in Canadians' real income even though the volume of output may not have changed.

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