SHOCK AND AWE: GOVERNMENT'S ROLE IN RECESSION AND RECOVERY

Kevin Lynch

As the economic recovery takes hold, governments will need "to develop exit strategies" from the monetary and fiscal stimulus programs they devised to fight the recession, writes the former clerk of the Privy Council. Canada's current deficit of $55 billion is still only 3.75 percent of GDP, compared with $1.6 trillion or 11 percent of GDP in the US, but our tax revenue base has been shrunk by the downturn and will need time to recover. Meantime, Kevin Lynch sees productivity growth and innovation as the keys for Canada's future growth.

À mesure que se consolidera la reprise économique, les gouvernements devront « élaborer des stratégies de sortie » pour les programmes de relance monétaire et financière qu'ils ont adoptés pour combattre la récession, écrit l'ancien greffier du Conseil privé. Même à 55 milliards de dollars, le déficit actuel du Canada ne compte que pour 3,75 p. 100 de son PIB par rapport aux 11 p. 100 du PIB américain que représente le déficit de 1,6 billion de dollars des États-Unis. Mais la récession a considérablement réduit l'assiette de nos recettes fiscales et il faudra du temps pour redresser la situation. D'ici là, Kevin Lynch juge indispensable de privilégier l'innovation et la productivité pour assurer la croissance future du Canada.

Let me begin at the end. I believe that public perceptions of the role for government are undergoing change, reflecting underlying global forces of structural change, combined with the shock of the worst global financial crisis since the 1930s and the awe of the first synchronized global recession in postwar memory.

While this is not a Canada-centric phenomenon, it is important to understand the extent of the public reaction in countries as diverse as the United States, the United Kingdom, France, Germany and Latvia, and the reasons for it. Embracing a "this time is different" mantra, international financial markets began to believe that business cycles had been tamed, rising debt and global imbalances were tolerable, financial innovations justified quantum leaps in risk taking and if you put enough bad mortgages together they actually became a good bundle. They were proved terribly wrong, and in the process public trust in business leadership has been eroded, particularly in the US and Europe. Public distrust of globalization has risen, particularly in the US and many developing countries. Public confidence in oversight bodies has declined, particularly in the US and the UK. And public faith in forecasters — who, to a person and a country, missed the timing, nature and incipient severity of the recession — remains as always.

The cyclical implication of the current financial crisis is a destruction of wealth of extraordinary magnitude, while the structural implications will be a shifting of wealth and capital and activities among countries with long-term economic consequences. Fareed Zakaria's "rise of the rest" has been accelerated by this financial crisis and recession. Asia is the global driver of recovery from the worldwide recession for the first time ever. Indeed, within a decade, China could approach the US in terms of the size of its economy measured by purchasing power parity. At the same time, a number of industrial countries have large and unsustainable deficits, and the process of fiscal rebalancing will require expenditure reductions and difficult policy trade-offs. Many of the same countries face the demographics of aging, which will mean that short-term concerns about a jobless recovery will shift to the medium- term challenge of a workerless expansion, and all its attendant implications.

In short, the times they are a-changing. Part of that change is in public expectations for governments, setting in motion changes in the role of government. While more government may not mean larger government, it will mean more active government. For example, the trend to less regulation that began with Reagan and Thatcher will likely reverse itself to varying extents and in various ways — witness the debates in the US Congress on financial sector oversight, CEO pay, health care and the environment as examples. In this reshaping of public expectations for governments, and of what governments can and should do, the voice of business is important, and needs to be an integral part of the evolving dialogue.

Parallel to these public debates about the changed role for government within countries, there is also a fundamental rethink under way about the role of government and institutions operating across countries: witness the evolving G20 process and the renewing of the International Monetary Fund.

Back to the beginning. Where does this line of reasoning take us on the evolving role of government?

The nature of the drivers of change in today's environment does not suggest a lessened role for government; rather, it points to public expectations for governments to better prevent and protect. These drivers are pervasive globalization and its attendant challenges; increased regulation of the domestic and international financial system in the aftermath of the financial crisis; transborder security and crime; product safety and information protection; aging that will increasingly hit our labour markets, pension systems and health care; dealing with climate change, where environmentalists want dramatic change, business wants certainty, citizens want an improved environment at little personal cost or inconvenience, governments want to find common ground, and the potential for arbitrage among national systems makes a doable, enforceable and comprehensive international system critical. In all this and more, strong institutions, strong public service capacity and sound regulatory systems will be essential for governments to meet changed public expectations.

I believe the value of strong institutions, such as the Bank of Canada, Finance Canada and the Office of the Superintendent of Financial Institutions, strong regulatory systems, strong government balance sheets and good interaction between public and private sector leaders was demonstrated over the last year in how Canada dealt with the financial crisis and recession.

Within this general context, I would like to highlight several areas where the nature of the evolving role of government will significantly shape Canada's future prospects: in the short to medium term, macroeconomic exit strategies; in the medium to long-term, productivity and innovation; and, on an ongoing basis, the Canada brand.

In the short to medium term, as the recovery takes hold and solidifies, governments will need to develop and execute their exit strategies from the monetary, fiscal and microeconomic actions taken to address the global financial crisis and recession. While circumstances clearly differ across countries, there are many similarities: large fiscal deficits, reflecting both stimulus measures and automatic stabilizers; massive injections of liquidity by central banks; and government ownership stakes in what were judged to be systemically important and troubled firms. Too slow an exit strategy risks inflation, entrenched structural deficits and rising debt; too rapid risks taking the wind out of the recovery; too uneven across countries risks large currency swings.

Canada has an estimated deficit this year of more than $55 billion, roughly 3.75 percent of GDP, while the US faces a $1.6-trillion deficit, more than 11 percent of GDP. Both countries returned to positive growth sometime in the second half of 2009. But governments tax nominal income, not real income. Canada is experiencing a decline in 2009 nominal growth that is almost double our fall in real activity, reflecting lower commodity prices, and this will affect tax revenues going forward until these "lost" tax bases have been recovered through sustained growth. On the spending side, the 2009 budget was rather unique in that the vast majority of stimulus spending was time-limited, largely within two- to two-and-a-half-year deadlines to avoid structural spending, and it will be crucial to let this spending terminate as configured. The lesson learned from our previous experience with deficits is that they do not get better with age, or easier to deal with, and budgetary surpluses and a strong national balance sheet were an anchor that helped shield us from the worst of the global crisis.

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In the medium to longer term, the preponderance of analysis points to the importance of productivity, and the interconnection between productivity and innovation, for Canada's future growth, welfare and security. Why productivity, a topic that even few economists are willing to raise in polite company? Because productivity drives the sustainable wages of workers, the profits of companies, the competitiveness of countries and the standards of living of societies.

A few statistics illustrate the point. Over the quarter century from 1981 to 2007, Canadian living standards grew on average 2.2 percent per year, reasonably good but less than in the US. Of this, productivity growth accounted for 60 percent, terms of trade for 20 percent and the labour force for 20 percent. However, over the latter part of this period, 2000 to 2007, the contribution of productivity growth fell to 30 percent, labour force continued to account for 20 percent, and terms of trade soared to 50 percent. Over the same period, growth in US living standards was greater than in Canada and also relied more on productivity growth, with the worrying result that the Canada-US business sector labour productivity gap grew to over 20 percent by 2007 and the total economy productivity gap to 12 percent. To a real extent these productivity gaps vis-à-vis the US both underscore business concerns with a high Canada-US dollar and make the argument for the necessity of improving our productivity performance.

Looking ahead, it is a demographic fact that growing our living standards through the labour force will be constrained by aging. It is also close to a fact that the "rise of the rest" is beginning to erode the relative research advantage of Western countries. China and India, for example, are investing in world-class research capacity in very targeted areas, but their scope and ambition and results will rise quickly and, as they do, it will be more difficult to attract the best foreign students and researchers as they will have more choice. For these and other factors, faster productivity growth, rather than the slowing productivity growth we've experienced over the last decade, is the only answer unless we are willing to bet the farm on continual growth in our terms of trade.

Producing the needed improvements in our productivity performance is going to require fundamental changes in a number of basic areas: primarily innovation; quality of the workforce; and access to large and growing markets. Starting with markets: if the US is destined over time to be a less dominant market, we need a market enlargement strategy, one that gives us more focused access to the rapidly growing markets of China, India and Brazil and to the technology of Japan and Europe, as well as to capital, networks and entrepreneurship. The European Union and the "Asian triangle" of Japan-China-India stand out as strategic candidates. We should consider a new generation of customized economic partnership agreements as part of such an approach.

We underinvest in innovation as a country, particularly in private sector investments in R&D, which are well below the norms of our major competitors. We have to better focus our publicly funded research efforts more on objective-driven research tied to results; a good case in point is CCS (carbon capture and storage). We must develop better innovation partnership models between our business sector and our research universities, adopting best practices in the US and elsewhere.

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On an ongoing basis, brands matter, and this is true not only for companies, but also for sectors and countries. The negative branding of Canada in 1995 by the *Wall Street Journal*, which declared Canada an honorary member of the Third World, had a lasting impact on investors and international opinion. The positive branding of our financial sector last spring by commentators as diverse and influential as Paul Volcker and Fareed Zakaria, at a time of maximum global uncertainty, also had a real impact. But in too many markets, we have little or no clear brand, India being a case in point; while in some emerging countries like China and Brazil, there have been some dents in our brand, whether deserved or not. We also risk negative branding by others, in areas like the oil sands, unless we aggressively shape our energy brand. Positive brands reduce uncertainty, influence investment decisions and reduce risk spreads. Going forward, we need to invest in the Canada brand, one based on our strengths, our opportunities, our excellence and our values, and use a positive brand as part of our strategy to attract newly footloose capital, and the high-quality jobs it brings, to Canada.

To conclude, where does this all take us? First, the role of government is evolving, here and elsewhere, whether we always like it or not, and the key is to ensure it does so in an efficient and effective way for Canada. Second, and very much related, sound, forward-looking public policies will be key differentiators across countries, all of whom are facing similar structural drivers of change.

Third, public engagement by the private sector will be crucial to ensure that all perspectives on policy issues are understood, not just by governments but also by the public. To be effective, this will take sustained dialogue, with a focus on first establishing a common understanding of the challenge rather than rushing to policy prescriptions. Equally, sustained engagement between the private sector and government, both elected and public service, is particularly valuable in times of change and uncertainty. Business associations can play an important role in joining and helping to shape the public debate on the evolving role of government.

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