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Remarks by Dr. Andrew Sharpe to the Senate Committee on Banking, Commerce and the Economy on the State of the Economy and Inflation, October 25, 2022

I would like to thank the committee for the invitation to appear before you today.

I am Executive Director of the Centre for the Study of Living Standards (CSLS), an Ottawa-based, not-for-profit economic research organization I founded in 1995.

The focus of our research is the living standards of Canadians, and in particular trends in productivity, the labour market, and economic well-being.

Our flagship publication is the peer-reviewed journal the *International Productivity Monitor*, co-published with the UK Productivity Centre at the University of Manchester.

In my opening five minutes I will make remarks in five areas: inflation, the labour market, potential growth, productivity, and economic well-being. I can elaborate on these remarks during the discussion.

Inflation

Inflation is a major problem for the Canadian economy. It needs to be brought back to the 1-3 per cent range within a reasonable period.

Yet I am cautiously optimistic on this front.

- The year-over-year headline rate of increase in the CPI has fallen from 8.1 per cent in June to 6.9 per cent in September.

- The year-over-year measure of the CPI reflects what happened to prices 12 months ago and as large past increases fall out, the rate of increase subsidizes. Recent month-to-month rates of inflation are much lower than the year-over-year rates
- With higher interest rates, weaker demand is putting downward pressure on price increases. It is unlikely that energy prices will continue to increase and housing prices are falling
- Inflation is a problem because it can result in falling living standards or real income. This happens when the rate of increase in wages and other sources of income falls behind that of consumer prices. This has indeed been the case for most Canadians in 2022. What is important is that the living standards of Canadians at the bottom of the income distribution be protected. Recent federal government policies have correctly focused on this.
- The risk with the current high inflation is that inflationary expectations will be ratcheted up based on these rates of increase and become entrenched in wage demands and price behaviour, leading to an upward wage-price spiral. The evidence is still out on whether this is happening.

The Labour Market

The labour market is the success story of the Canadian economy.

Back in the 1960s the Economic Council of Canada defined full employment as a situation where the number of job vacancies equaled the number of unemployed.

According to this definition we have been at full employment in Canada as there have been one million job vacancies in this country compared to around the same number of unemployed.

This is a wonderful situation for an economy to be in as the societal benefits of full employment are many.

- There is no loss of potential output due to underutilized labour.
- There is more employment income for the population, reducing poverty.
- The level of happiness and quality of life of a person with a job is much greater than an unemployed person, especially the long-term unemployed.
- Workers, especially those in the bottom half of the wage distribution, have greater bargaining power and can obtain real wages, allowing median wages which progress in line with labour productivity growth.

- Government revenues benefit enormously from a full employed economy, as recently seen in Ontario and at the federal level for fiscal 2021-2022.

A top priority for the Canadian economy is to maintain this situation of full employment or maximum employment. This was recognized in the agreement between Finance Canada and the Bank of Canada in the December 2021 renewal of the inflation target.

Labour shortages, which can characterize a situation of full employment, are often considered the equivalent, from the other side of the coin, of job shortages, or unemployment. But in my view a lack of jobs is a much greater social evil than a shortage of workers. Unemployment results in a loss of potential output for the economy that will never be regained. A labour shortage means less sales and profit for an employer, but this is not wasted resources.

Potential Economic Growth

A healthy economy should grow at its potential. The potential growth rate of an economy is determined by potential labour supply, both the number of potential workers and the average hours workers wish to work, and potential or trend labour productivity growth (output per hour).

In 2021, the CSLS published a report on potential growth for the Canadian economy for the 2018-2042 period. Economic growth was projected at 1.7 per cent per year with 1.0 per cent from labour productivity and 0.7 per cent from labour input. Labour input growth is from immigration, not natural increase.

A key priority for government policy must be to enhance the potential growth of the economy.

Productivity

Productivity growth is the only sustainable source of increases in the standard of living of Canadians. Aggregate labour productivity growth in Canada since 2000 has been around 1 per cent. In the three decades after WWII, it averaged over 3 per cent. Living standards now take 70 years to double, compared to 23 years in the immediate postwar period.

Productivity growth is largely driven by technology so our current weak productivity growth suggests the pace of technological change is less than in the golden age of growth during the third quarter of the 20th century, despite the computer revolution. I would be happy to follow up.

The economic policy environment in Canada is already largely favourable to productivity advance. It is very unlikely that changes in public policy in this country could boost annual labour productivity growth from 1 to 2 per cent. Yet we should continue to strive to implement policies that are productivity-enhancing.

Economic Well-being

A focus on GDP growth can lead to the neglect of what is more important for Canadians, namely their economic well-being. Indeed, the Bank of Canada states that its objective is to maximize economic well-being, not GDP.

The Centre for the Study of Living Standards argues that there are four key dimensions of economic well-being: consumption, stocks of wealth, inequality and economic security. We have developed the Index of Economic Well-being for Canada and the provinces and for OECD countries to track the progress of economic well-being. I would be happy to elaborate on this in the discussion period.