



HIGHLIGHTS

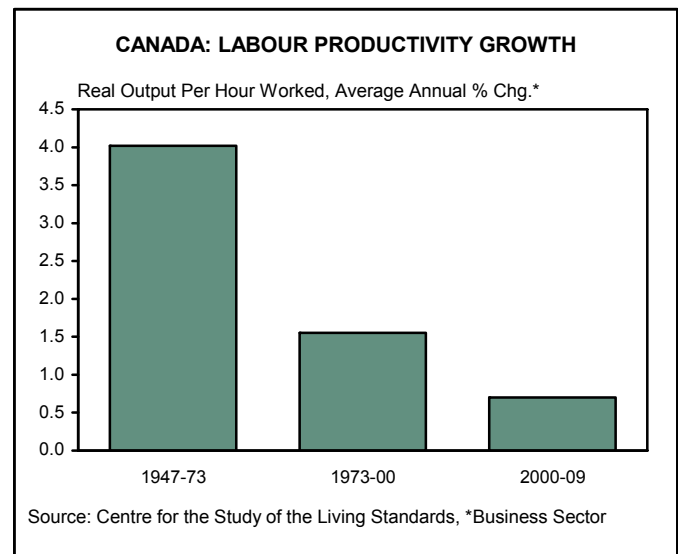
- Productivity is the main driver of a rising standard of living
- Labour productivity growth has stagnated in Canada, causing a decline in the country's international economic clout
- An important factor contributing to this slow productivity growth has been weak business investment in key capital goods
- Between 2002 and 2007, businesses failed to take advantage of an exceptionally favourable investment climate
- Currently, the public policy setting and a strong Canadian dollar have created another excellent environment for capital investment
- In the face of an increasingly competitive global economy and pressing demographic challenges, Canadian businesses must seize this opportunity and invest in new innovative productivity enhancing technologies

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INNOVATE OR PERISH

Canadian businesses can take heart that an economic recovery has taken hold and is likely to become more firmly entrenched over the time. This will naturally bring solid earnings growth. However, this positive cyclical backdrop belies a deep structural problem in the Canadian economy – namely the nation's abysmal productivity performance. While better economic times are ahead, foreign competition is intensifying at a furious pace. For example, American companies slashed payrolls during the recession and investment in equipment and software surged as a U.S. economic recovery took hold. Meanwhile, the global economic recovery is being fuelled by rapid growth in emerging market economies – such as China and India. The traditional Canadian response to increased competition by developing nations has been to gradually move up the value added production chain. However, a new era of global competition is emerging and developing nations are rapidly moving into more sophisticated manufacturing. One only needs to observe the number of engineers graduating every year in Asia for a sign of things to come. The bottom line is that Canadian firms must innovate or perish.



Canada's dismal track record

Although the word productivity has a negative connotation to most Canadians, the ability of an economy to generate higher output for each hour worked is the main driver for a rising standard of living. Over the past sixty years, labour productivity has been responsible for roughly 75% of all income growth per person. For businesses, productivity is the ultimate source of higher profits while meeting increased wage demands.

From the end of the Second World War until the early 70s, Canadian business sector labour productivity rose at over 4% per annum. From the early 70s to 2000, productivity growth moderated to a meager average annual pace of 1.6%. From 2000 to 2009, labour productivity growth dropped further to a shockingly low 0.7%. This truly dismal performance means that Canada has gone from the 5th most efficient economy in the industrialized world in 1970 to 15th position in

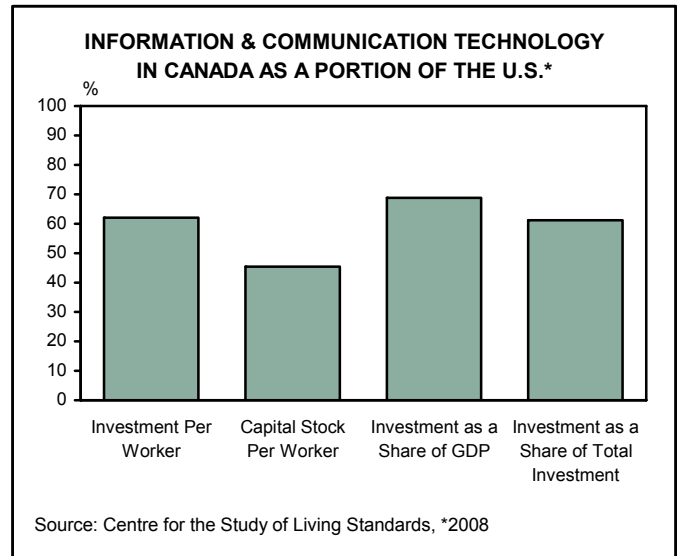
2009. It also led to Canada dropping from the 5th highest income per person to the 10th slot over the last two decades. Based on these recent trends, Canada will continue to decline in ranking over the coming years. These comparisons with other industrial countries mask the deterioration happening relative to developing nations that are leapfrogging up the international rankings each year.

There are many explanations for Canada’s depressing performance, and these will be delved into at length in a forthcoming TD Economics Special Report entitled “The Productivity Puzzle: Why Is The Canadian Record So Poor & What Can Be Done About It”, but in this note we will focus on addressing business investment and innovation.

The role played by weak business investment

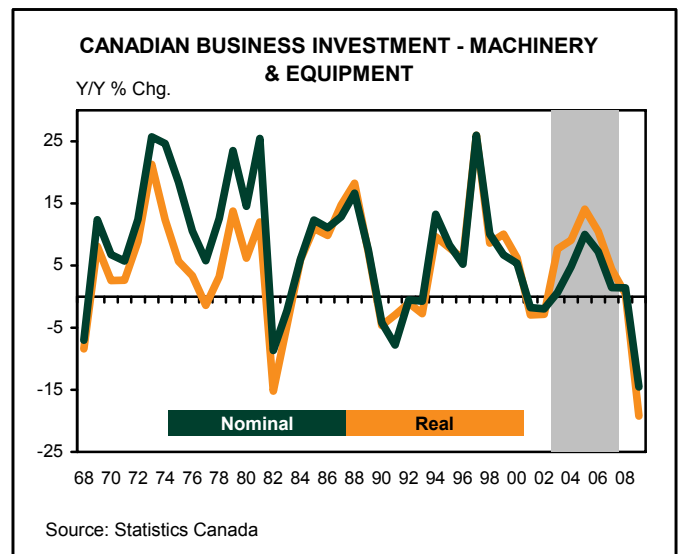
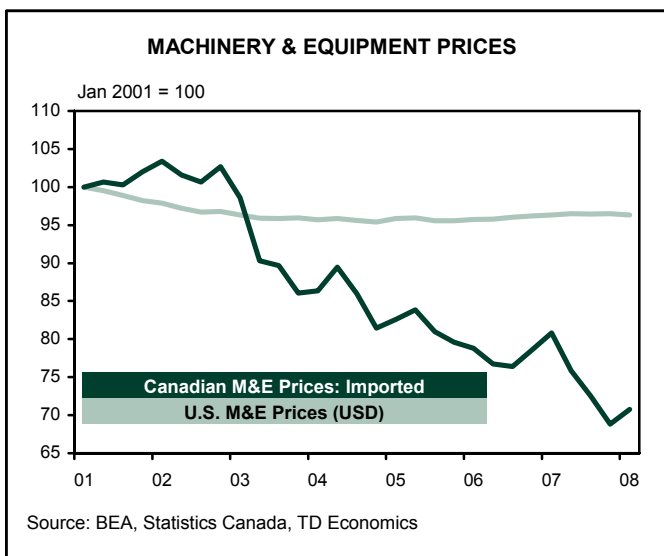
A major contributing factor to Canada’s poor productivity track record is weaker business investment and a resulting lower stock of capital. In 2008, machinery and equipment per worker in Canada was a mere 49.1% of that in the United States. The ratio of capital per unit of labour – capital intensity – grew at an average annual pace of 0.5% per annum between 1984 and 2008, compared to 2.8% over the preceding two decades. Canadian firms are also severely underutilizing information and communication technologies (ICT). ICT is revolutionizing business and peoples’ lives, but the stock of ICT capital per worker in Canada in 2008 was only 45% of that in the United States.

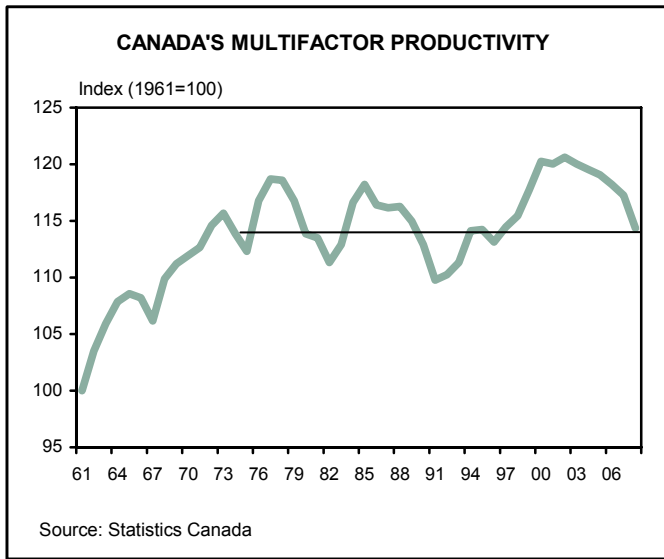
This weak investment performance is a major conundrum, particularly when one considers the economic backdrop before the recent recession. Between 2002 and 2007, the economy was growing at a solid pace. Retained earnings were piling up. Corporate taxes were falling. Interest rates



were not high. The Canadian dollar appreciated by nearly 40% materially lowering the cost of imported machinery and equipment. We should have seen a dramatic business investment boom. What actually occurred in terms of investment in machinery and equipment was simply unimpressive. Despite robust profits and retained earnings growth, nominal business investment in machinery and equipment rose at only 5% per annum. Economists will often talk about the strength of real business investment in this period, but that only came about because of falling prices.

Why did businesses not respond? The data suggest that firms were not being innovative and did not take advantage of the favourable environment. This can best be illustrated by a metric called multi-factor productivity. It is a benchmark for business innovation and the skill with which firms are taking advantage of new technologies and more skilled





workers. On this front, the shocking reality is that the level of multifactor productivity in Canada in 2008 stood at the same level as existed in 1970. This must change.

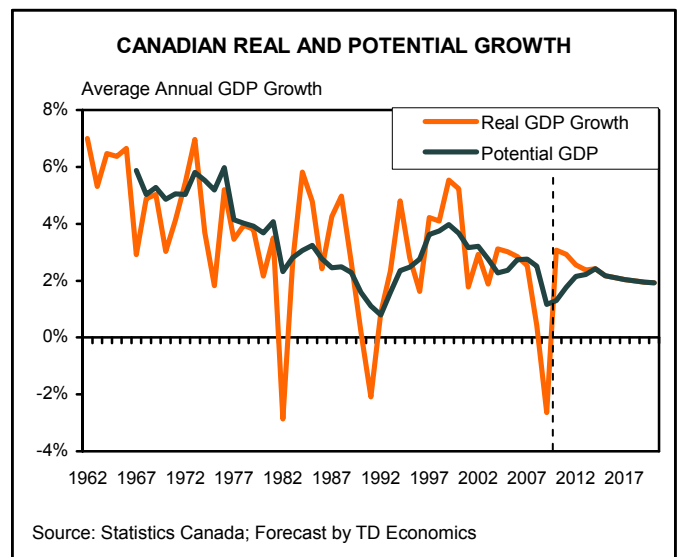
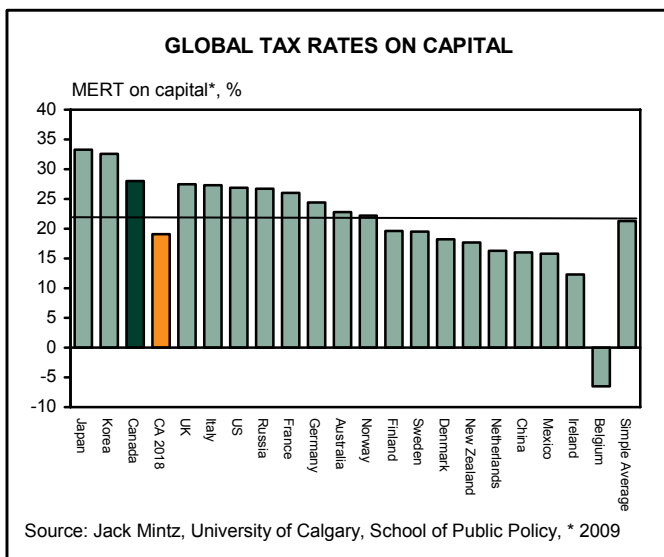
The time to invest is now

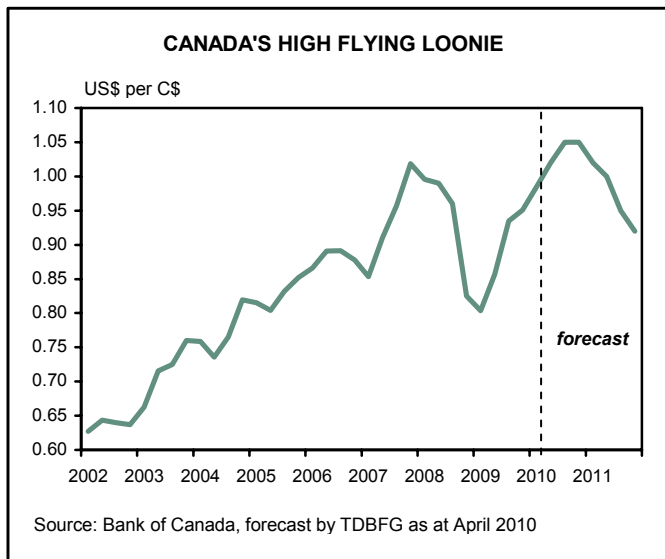
The good news is that an extremely favourable environment for business investment and innovation is upon us once again. Governments have been instrumental in setting a favourable backdrop. The effective marginal tax rate on capital has been declining and will continue to do so in the near term. Indeed, Canada is poised to become one of the most competitive jurisdictions for capital investment in the industrialized world. This has been facilitated by lower corporate income tax rates, the elimination of capital taxes,

and the harmonization of sales taxes in some provinces. Although interest rates will likely rise over the coming years, the level of borrowing costs will remain low for some time. The economic recovery is supporting solid earnings growth. The Canadian financial system is open for business and credit is flowing. The Canadian dollar is also likely to hover at close to parity over the next couple of years. The question is whether businesses will respond this time around or whether yet another opportunity will be lost?

There have been many voices raising concerns about Canada's dismal productivity record. Bank of Canada Governor Carney suggested that, after the economic recovery has matured, the medium-term trend growth rate in the Canadian economy would be around 2%, materially slower than the traditional assumption of 2.8%. The Parliamentary Budget Office has cautioned that federal deficit reduction could be challenged by the likelihood of only 2% growth per annum. These views echo the warnings made by TD Economics in a report last November entitled "A New Normal: Canada's Potential Growth During Recovery and Beyond."

It should be noted, however, that there is a downside risk to the above projections. Getting to 2% real GDP growth on a sustained basis requires an improvement in productivity. Without any increase in output per hour worked, Canada's aging population will only support a trend economic growth rate of close to 1.3% in the years ahead. Indeed, while foreign competition should be a powerful motivator for increased capital investment and innovation, demographics should also be pushing firms to find better ways to employ labour. It is only a matter of time before the aging population leads to renewed labour shortages.





Business must step up to the plate

Our forthcoming productivity study will strive to diagnose Canada's productivity problem and outline some policy recommendations, but in the final analysis businesses must step up to the plate. The economic and policy environment is right. The time to invest in new innovative and productivity enhancing technology is now to meet the competitive pressures of the future and address the looming challenge from demographics. Moreover, increased investment and innovation would not only be in the interests of businesses – it would also materially benefit workers and governments.

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