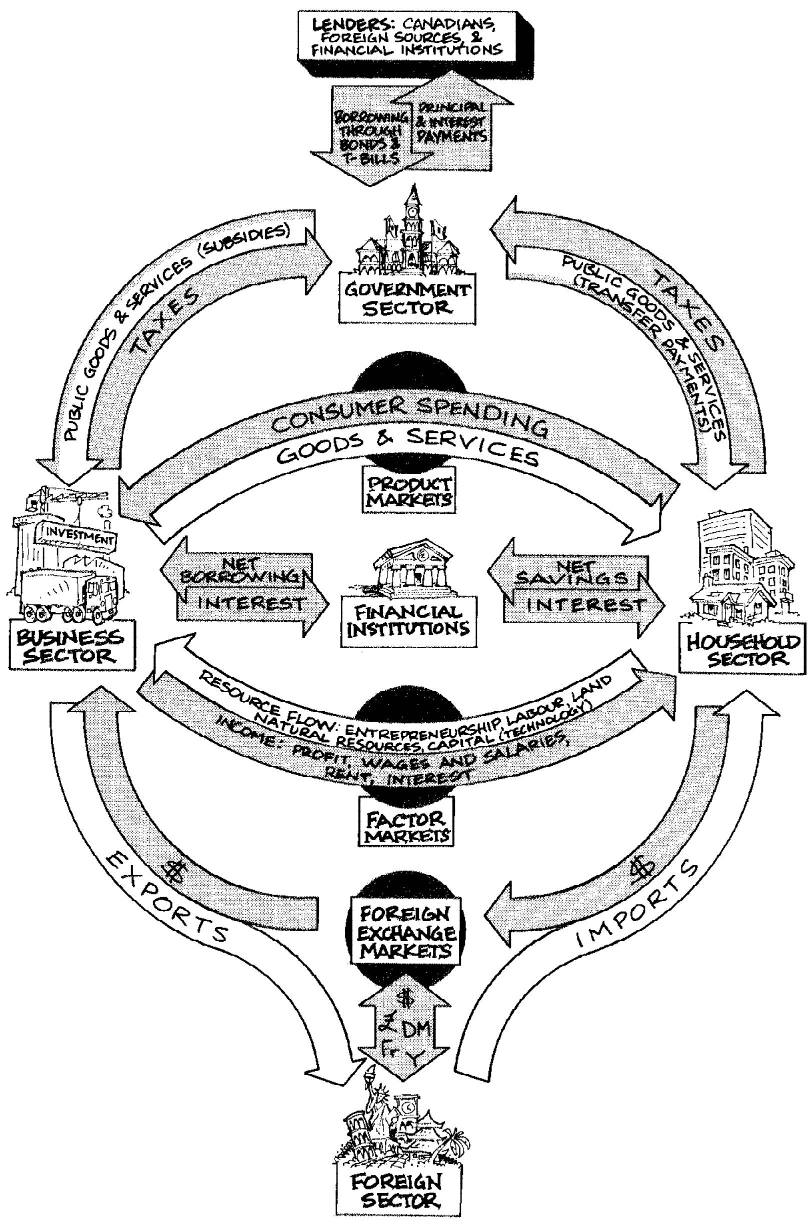
THE CANADIAN ECONOMY: THE BIG PICTURE

Revised Edition



CFEE CANADIAN FOUNDATION FOR ECONOMIC EDUCATION
FONDATION CANADIENNE D'ÉDUCATION ÉCONOMIQUE

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by Gary Rabbior

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The Canadian Economy: The Big Picture
Revised Edition

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THE CANADIAN ECONOMY: THE BIG PICTURE

Life: Where does an economy fit?

Life has many dimensions. Most of us spend a good portion of our lives seeking fulfillment in the more emotional and spiritual areas – happiness, friendship, love. In our day-to-day personal and family lives, we also tend to seek out ways to improve our standard of living and quality of life. One way to improve our quality of life is through acquiring material things. We find there are products and services that can make life more enjoyable, more pleasurable, or simpler. This is where our economy and economic system come into play.

Even some aspects of our emotional world are linked to the economy. Happiness, enjoyment, and so forth can come from a wonderful trip, a family cottage, a good meal, a nice car, an extremely comfortable pair of shoes, a good book, or a delightful movie. Our lives are complex and, in today's world, our economy is inextricably linked to our lives – in terms of our work and play.

Furthermore, people's lives are significantly linked to the economy of the particular country in which they live. Entire societies differ in some of the most fundamental ways based on the kind of economic system they have established. Every society has to decide what kind of system it will use to provide the products and services people are seeking. In traditional economic terms, every society has to decide (a) what to produce, (b) how production will be organized, and (c) how to distribute what is produced.

Some societies have made efforts to establish a system in which goods and services are produced by **public** enterprises, that is, business activity owned by government. They have concentrated production activity in the hands of the **state** rather than encouraging **private** ownership (where production activity is left to the actions and decisions of private producers). We know that in Russia, for example, individuals have only recently been given the opportunity to own a business to produce a good or service. In establishing these privately owned businesses, they will try to produce something people want and will buy. If an individual is successful, **profit** is the reward for effort.

Over time, the societies that have permitted and encouraged private ownership, and allowed the quest for profit to serve as an incentive for production activity, have done considerably better than government-dominated economies. All the leading economies in the world today rely heavily on private ownership of business activity. These economies leave more decision making to the **marketplace** – the interaction between buyers (consumers) and producers – and less to centralized decision making by government.

As is frequently the case when the topic comes around to peoples' livelihood, well-being, and "economic lot in life," personal values come into play. The previous paragraph notes that those economies that have encouraged and nurtured private ownership have done better than those that have depended on centralized government decision making. This can imply that one type of system is better than the other. That is not our intent here. It is simply a matter of fact that the standard of living, and economic well being, is higher in countries such as Canada, the United States, Western Europe, and Japan where private ownership is predominant.

Some may argue that the only consideration here is economic well being. And that is true since we are looking at how economic systems work. Some may say that a society where people are less well off materially but where there is more equality is preferable. Such discussions come down to personal values, views, and priorities.

In this document, our objective is to explain how the Canadian economy works, an economy that allows and encourages private ownership. Governments play a key role, and we will explore the interrelationship between the public (government) sector and private sector. Let's now focus our attention on the Canadian economy – how it has evolved and how it operates today.

Historically, Canadians have been encouraged to try to establish privately owned businesses to produce goods and services. In the early days, Canada's small population with relatively few buyers limited the opportunities for private enterprise. It's hard to run a profitable business if there aren't many buyers. As a result, the government tended to be more involved in the Canadian economy than it was in a country such as the U.S., which had a much larger population and many more buyers.

Over time, though, as our population grew, more and more private businesses were established and were able to earn a profit. The ability of some of our producers to sell to buyers in other countries through international trade also contributed to their successes.

A larger and larger Canadian population meant higher and higher demand for goods and services. Canada became a nation in which individuals were encouraged to become **entrepreneurs** and establish businesses to respond to these demands. In some cases, the government continued to play a role. In other cases, some demands were met by producers in other countries as we imported goods and services. In all cases, with goods and services provided by private Canadian producers, government, and foreign producers, the quantity and quality of goods and services available to Canadians increased.

In general, our economy has come to rely most heavily on privately owned production activity, with entrepreneurs identifying a need or want (demand) and establishing businesses to produce a good or service (supply) in response. If the entrepreneur is successful, profits are earned, jobs are created, and the business expands. If unsuccessful, the business fails and the entrepreneur and employees must seek alternative ways to earn an income to support themselves and their families.

Canada's entrepreneurs, complemented by government production activities, helped to build our economic system, producing more and better goods and services as our population grew and our needs and wants expanded. In this way, Canada has established an economic system similar to that of many other economically successful nations – largely market-based, encouraging effective and innovative private ownership while government maintains a strategic role particularly in the area of social services, broad economic policies, and the provision of essential services such as education and health care. Our system is often referred to as a **capitalist system** because we allow and encourage the private ownership of capital, that is, the plants, factories, equipment, and so forth that are used to produce and provide goods and services.

Our economic system is also referred to as a **mixed economy** because it involves both private and public ownership of resources, and goods and services are produced and provided by both governments and privately owned companies. This is the "economic system" we have built in Canada. But how does this system affect us as individuals?

Once again, we can note that life has many dimensions, and when we are young we are often predominantly interested in music, clothes, sports, movies, dances, and affairs of the heart. But even at a young age we begin to learn about the links between our economy, work, and well-being. To afford music, clothes, sporting events, movies, and entertaining those affairs of the heart, most young people need to work to earn an income. The income earned, we learn, is affected by a wide variety of factors, including where one lives and one's age, ability, education, experience, connections, and so on.

In the beginning, we tend to seek work as a means to an end. We enter the **labour market** and the economy to offer our services. In return for the labour services rendered, an employer pays a wage. And we then use all, or part, of that income to acquire things we want (we may choose to save a portion). Later, though, it usually starts to become apparent that our labour has a broader purpose than just to generate personal income. Our labour is also making a productive contribution to society. After all, if efforts were not made by many Canadians to produce and provide goods and services, the income earned wouldn't really matter – there would be nothing to buy.

We see, then, that once a society has put its economic system in place, that economy serves a number of key roles. First, it involves the efforts of all sorts of people doing all sorts of things to produce goods and services for people to buy. The need for an economy and production stems from people's desires for goods and services. In a market-based economy such as Canada's, this results in the establishment of business enterprises. These business enterprises are started by entrepreneurs to produce a good or service that people need and want and, most important to the entrepreneur, will buy. If the business produces what people want, the business will sell its output and, it is hoped, earn a profit for the entrepreneur (and perhaps other owners of the business). If the business continually loses money and is unable to earn a profit, the business will fail – the entrepreneur loses his or her income, employees lose their jobs, and our economy loses the goods and services that were produced.

Production: It's a job – for some

We have recognized that one role of our economy is to produce goods and services. A second key role of an economy is, through these production activities, to create jobs so that people can find employment. And third, through its efforts to produce goods and services and its employment of people's skills, the economy provides people with an opportunity to earn an income. In turn, those people who earn an income are then able to acquire the goods and services produced.

These, then, are the economy's key roles – to produce goods and services, to create employment, and, thereby, to provide the means for people to acquire the ability to purchase goods and services that are needed and wanted. In an ideal world, our economy would provide gainful, meaningful employment for everyone, thus enabling everyone to acquire most of what they need and want.

Alas, as we know, we don't live in an ideal world. Some people earn more than others. Some earn little, if any, income. Some are able to acquire almost everything they want. Some can't afford the things they need. Some have jobs. Some don't.

Canadians are actually pretty fortunate. In fact, since 1991, the United Nations has ranked Canada number one among all OECD countries in terms of a place to live and work.[1] The majority of those Canadians who wish to work are able to find work (even though we still have many people unemployed). Income levels are relatively high and the overall quality of life is pretty good. Most Canadians probably appreciate the benefits this country provides – even with its problems and shortcomings.

One of the reasons why we say Canada has done so well is because we have been successful in the past in our ability to compete with other nations. One way to measure how well an economy is doing is to compare the level of **output per person**, or Gross Domestic Product (GDP) per capita, in various economies. That is, you add up the total value of all that is produced in a country's economy and divide that total by the number of people. This provides one way of measuring a nation's **productivity**.

This means of measuring productivity can imply that output is determined solely by people and their labour. In fact, output will actually be determined by many factors, such as the quality of capital (equipment, machines, and so forth) and technology available to people.

The key point to remember is that Canada's "economic ability" compared with the "economic ability" of other nations is crucial to our well-being. As important as love, friendships, religion, and other things are to us, we need to eat, be clothed, be housed, and be healthy. And, let's be honest, most of us want more than that. Did I hear someone say cars, stereos, computers, boats, bicycles, leather jackets, rollerblades, trips south in winter....? Where do those things we want to buy come from? They come from our economy. If we want such things, we need our economy. And we need it to be an effective and

[1] The Human Development Index, compiled by the United Nations, measures three key indicators: national income, literacy, and longevity.

efficient economy, one that can compete effectively with others. If we cannot compete, other nations will produce the goods and services that people want. And other nations will benefit from the jobs created, the incomes earned, and the investment for growth that can take place.

To understand the challenges our economy faces, and the factors that will influence how well it does in terms of production, job creation, and income generation, we need to get a sense of the “big picture.” How does our economic system work? How does it fit together? How is Canada linked to the rest of the world? Let’s start to build a picture of what our economy looks like so we can understand it a little better.

We have noted that entrepreneurs set up businesses to produce the goods and services that we need and want. But they sure can’t do the job alone. They need resources – land, natural resources, capital resources (factories, machines, equipment and so on), and labour. Where do these other resources come from?

We have noted that, in Canada, the majority of resources are privately owned. That is, individuals, or groups of individuals, can own land, natural resources, factories, equipment, and, of course, their own labour.

Since resources are owned privately, they provide the means by which the people who own them can earn an income. By providing land, natural resources, capital equipment, or their labour, people are able to earn various kinds of income – rent, interest, wages and salaries. If the entrepreneur is able to use these resources together effectively and successfully, we have seen that the entrepreneur will earn a profit in return. Shortly, we’ll represent this in a diagram to help clarify the make-up of our economy. As we build the picture of our economy, you will see that two general kinds of things “flow” in the economy. There are **real** flows – flows of real, tangible things such as goods, services, and people. And there are **money** flows – flows of, well, money. There are money flows because, like most modern economies, our economy uses money as a **medium of exchange**. People use money to acquire, or acquire the use of, a good or service. Most exchanges or trades in our economy have two sides. On one side is the good or service provided. On the other side is the money provided to complete the transaction. The amount of money required is determined by the price of the good, service, or resource.

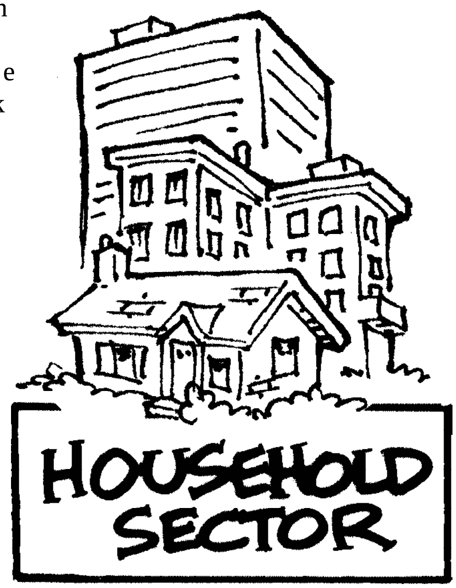
In simple economies, exchanges can take place largely through **barter**, trading one good or service directly for another. But in a modern, complex economy with millions of items and billions of exchanges, direct barter would be impossible. So economies use money as (1) a unit of account to establish prices, (2) a medium of exchange for transactions, and (3) a store of value to save for use at some time in the future.

In the diagram we will build, we will show how money flows through markets as exchanges are made and a good or service is provided in return for payment. We will also show how some funds are not spent today but saved for the future – postponed spending, if you will. We will see that this postponed consumption, and the flow of some of our money into savings, plays a key role in our economy. All that lies ahead. We’re going to build this picture one step at a time.

Putting the puzzle together: Let's start at home

First, let's begin with the fact that people live in households – all sorts of households. There is a wide variety of family structures, types of housing, and so on. But in our diagram, let's represent these households, in all their various forms, by the image below.

All the resources that are available to use in production activities and that are privately owned are owned by people who live in some kind of household. Now, as we begin to look at the structure of our economy, we find that we quickly confront a "chicken and egg" problem. People who live in households provide the resources to enable goods and services to be produced. People in households also buy the goods and services that are produced. Producers will produce what people want to buy. But people only get incomes to buy something after their resources are used and compensated. So, what comes first? Do we start with people's willingness to buy, or do we start with people earning incomes that enable them to buy? In putting the "economic puzzle" together, we need to know which piece comes next.



To get us started, let's say that, in the beginning, there were entrepreneurs. The entrepreneurs ventured out into what is called the **private sector** or **business sector**, which is where privately owned production activities take place to produce goods and services.

As they leave the households[2] and venture out to set up and operate their businesses to produce goods and services, the entrepreneurs look back to the household sector for two main reasons. The first, as any good producer knows, is to determine what people living in those households need and want – what they will be willing to buy. The second reason is to acquire the services of the additional resources that will be necessary for production. Once the entrepreneur has decided "what to produce," the decision must be made about "how to produce." This decision will determine what resources are needed and how they will be combined together in some production process. Once that is known, the entrepreneur will have to seek out those resources and provide the owner of the resources with some form of compensation. The resources represent a **cost** to the entrepreneur, but they represent **income** to the person who owns/provides the needed resources.

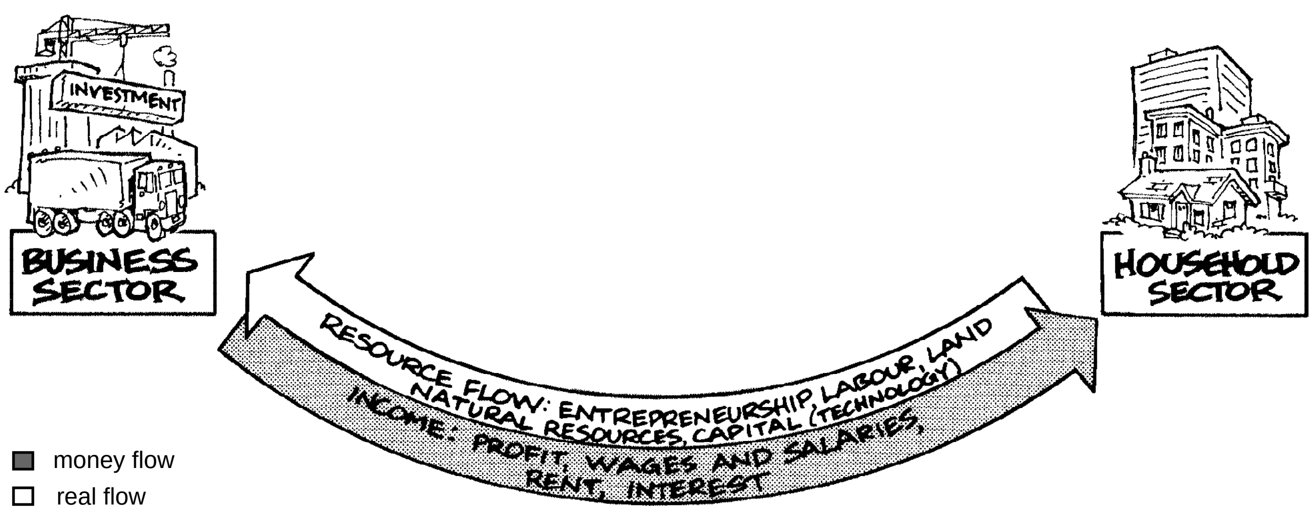
Some resources are used up right away in production, such as the wood used in a hockey stick. Some resources are used up more slowly, such as the saw used to cut out the stick. Some resources aren't used up at all but, instead,

[2] Note that, in our society, people increasingly do not even have to leave their households but can set up a business in their home.

are employed, such as the people involved in producing a hockey stick. Not only are people not used up, they often get better over time as they gain experience, insight, and more training. So, some resources become owned by the entrepreneur as costs are paid, whereas other resources are simply used/employed by the entrepreneur as rent, interest, salaries, or wages are paid to the owner who maintains ownership of the resource.

Follow that entrepreneur: The flow of resources to production

We can illustrate this provision of resources to private sector production activity in our diagram. Below we see an illustration on the left representing the private sector. We also have one arrow illustrating the provision of resources (including the talent and initiative of entrepreneurs) to the private sector. A second arrow shows the return of incomes to those who provide resources (includes the profits earned by the entrepreneurs). As mentioned earlier, the flow of resources is referred to as a real flow – real, tangible things are provided. The income flow is called a money flow since (unless you are paid in something else) it is a flow of money, which *represents* value rather than being valuable in and of itself. For example, a one hundred dollar bill has little value in and of itself. It is just a piece of paper. However, because it is widely accepted in our society, its value is in its **purchasing power**. It can acquire $100 worth of real, tangible things.



Why are real flows distinguished from money flows? There are a number of reasons, but a key reason is as follows. If you buy a CD player, that CD player is real – it stays the same. But money can change. It can change in terms of its purchasing power. If the CD player costs $100, there has to be an exchange of $100 to acquire it. However, if the price is $150, it takes more money to acquire it. In both cases, it may be the same CD player, but the flow of money to acquire it is different. Prices in the economy affect the purchasing power of money, and money flows change when prices change. This is one reason for drawing the distinction.

In our economy, it is often very important to know not only *real* information (for example, the number of CD players produced and sold) but also *money* information (the amount of money it took to acquire the item). Money information is also frequently referred to as nominal information. In today's economy, we often measure things in dollar terms, but it is important that we also look for real information when we want to know how the economy is doing.

Why is it important to distinguish between real and nominal information? Well, if I tell you that 100,000 CD players were produced in 1999 and 110,000 were produced in 2000, you know that more CD players were produced in the year 2000. That's straightforward, real information. However, if I tell you that $1-million worth of CD players were produced and sold in 1999 and $1.1-million worth were produced and sold in 2000, can you tell me whether or not more CD players were produced in 2000? No, you can't. That's because the higher dollar amount may simply reflect higher prices. It's even possible that fewer CD players were produced in 2000. That's one reason why we distinguish between real and money flows. Both provide important information.

To market, to market to buy a...resource?

When you have a situation in which there is a seller of something and a buyer of something, you have a **market**. There is a market for all our resources. There is a market for land, for timber, for oil, for wheat, for minerals, for computers, for engineers, for tool and die makers, for computer software creators, and so on. The interaction that takes place within each of these markets will determine the level of cost or **compensation** paid for the resource or use of the resource.

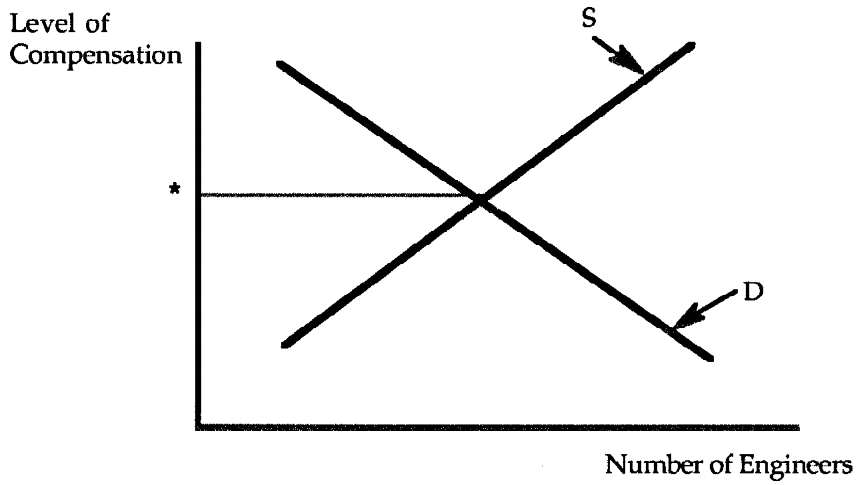
Consider, for a moment, the market for engineers. There are companies seeking to employ the services and talents of engineers. They represent the **demand** in the market for engineers. The different businesses will make decisions about the engineers they will employ based on the talent they need and the cost that will be required to gain such services.

On the other hand, there are people who have chosen to be trained as engineers and who offer their services in return for income. They represent the **supply** of engineers.

The coming together, and decisions, of those who want to employ engineers and those who are offering services as engineers will determine the market compensation for engineers. Such a market exists for all our resources, and these markets will determine the costs (from the business point of view) and the incomes (from the resource owner's point of view).

We can show this in a simplified form on the next page. Suppose line "D" represents the **demand curve** for engineers. The demand curve shows the number of engineers that would be sought by employers at various levels of compensation.

Note that as the level of compensation falls, more engineers would be sought. This makes sense when you think about it. Would you tend to seek more or less of something if its cost was lower?



Suppose line "S" represents the **supply curve** for engineers. The supply curve indicates the number of people who will offer their services as engineers at various levels of compensation. Note that usually more people will offer their services as engineers as compensation levels rise. This makes sense, too, since the higher potential compensation would likely attract more people to the profession.

These lines are a simple representation of market forces at work. They illustrate the employers' willingness to employ engineers at various levels of compensation. And it also illustrates the engineers' willingness to offer services at various levels of compensation.

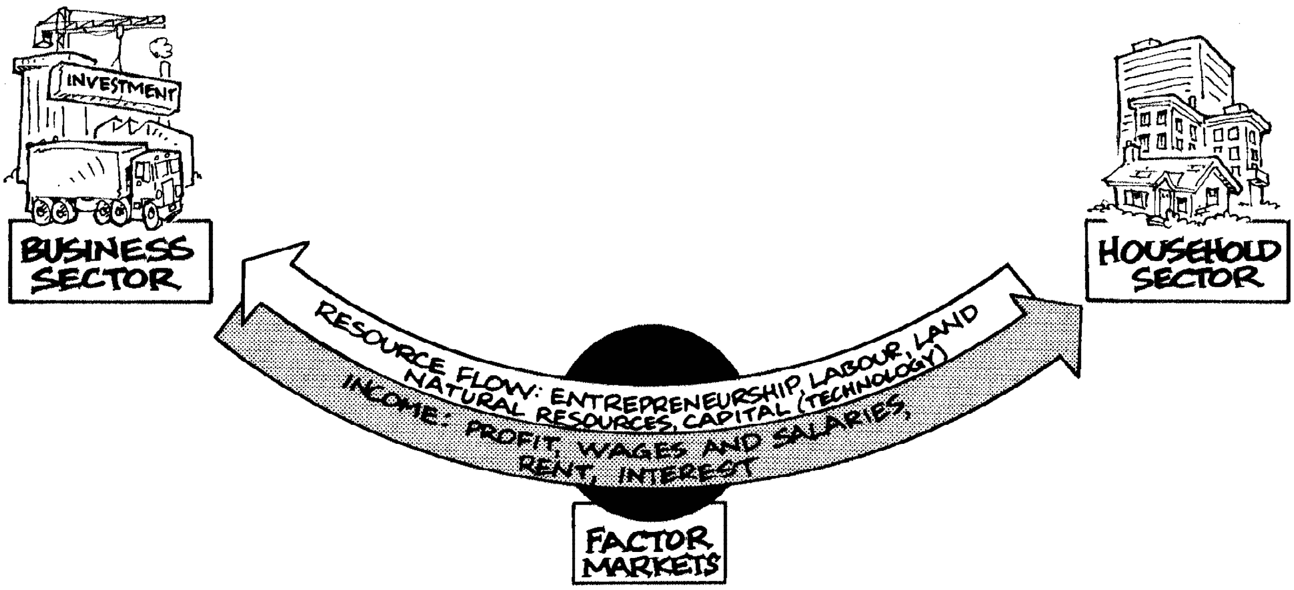
These market forces of **demand** and **supply** will put pressure on the level of compensation for engineers that results in the market. Above the compensation level shown as *, the quantity of engineers looking for work exceeds the number being sought by employers. The result is unemployed engineers. With more engineers looking for work than there are available positions, downward pressure will tend to be exerted on the level of compensation. For example, some engineers may be willing to work for less to get one of the relatively scarce positions.

Below the compensation level *, the number of engineers being sought exceeds the number seeking work. The result is a shortage of engineers. And, as companies find it harder and harder to employ the engineers they need, there is upward pressure on the level of compensation. Companies may be willing to pay more to attract the engineers they need.

At the level *, the number of engineers seeking work matches the number being sought by employers. It is sort of a balance point, a point of **equilibrium**. The market forces of demand and supply will push the market level of compensation toward that point. The market forces will seek out a point of balance. That's how markets work. And, in our economic system in Canada, there are a vast number of markets.

Another piece of the puzzle

We can add these **resource markets** to our diagram where they are given their more common name in economics books – **factor markets.** Resources are also called **factors of production**, hence the term "factor markets."



Who will buy?

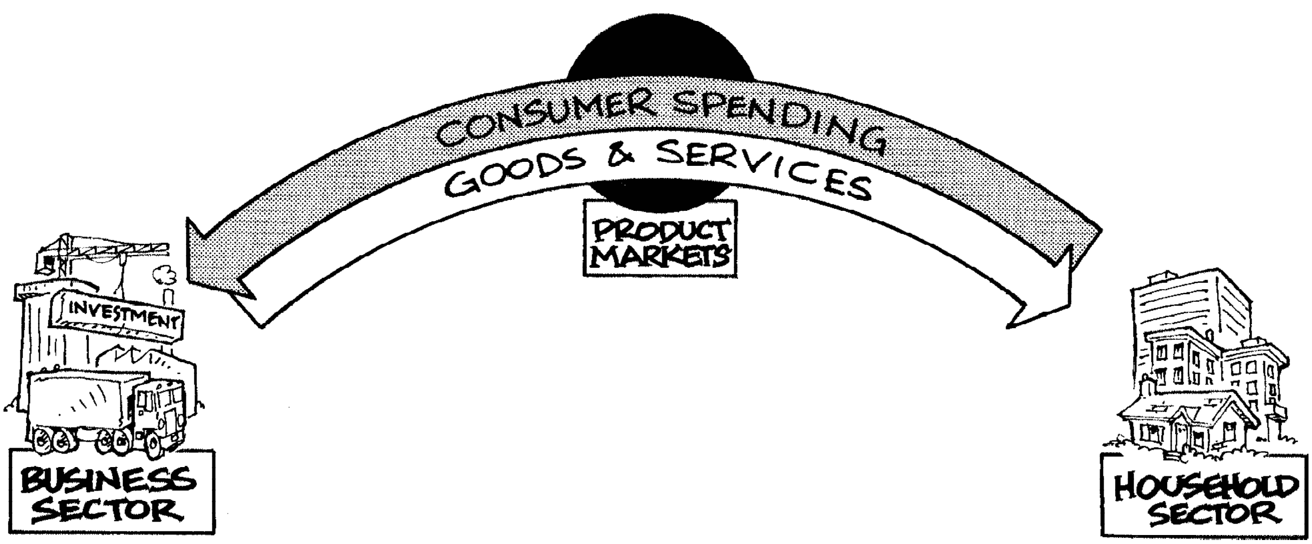
Thus far, our diagram represents the production side of the economy and the resource markets that exist for the **inputs** used to produce goods and services. But what use are goods and services if there are no users, no buyers? We now turn our attention to the other side of economic activity – **consumption**. Every dollar that comes into a household generally has one of four things happen to it. It is (a) spent to acquire goods and services, (b) saved, (c) paid to the government as tax, or (d) given away. (We won't consider those dollars that unfortunately are lost or stolen.)

Those dollars that are spent on goods and services invariably find their way back to the businesses in the private sector. Households spend part of their incomes to pay the prices to acquire the goods and services that are needed and wanted. This provides funds (revenues) to the private producers. As with households, different things happen to the revenues of private producers. The revenues are used to (a) cover the producers' costs and are paid out as incomes to the resource owners, including the owners of the enterprise, (b) pay taxes, (c) save, (d) invest back into the business to expand/improve production, or (e) give away.

Neither households nor businesses have total freedom of choice concerning what to do with each dollar. There are bills and costs and taxes that must be paid. Over time, though, both businesses and households should be managed in a way that enables more income to become discretionary. That is, the household or business can *choose* what to do with it. Businesses will try to manage affairs so that profits can rise and more productive investments can be made. Households will try to manage affairs so that income can be saved and investments can be made, with the result that **net worth** rises as the households' overall level of wealth improves.

The consumption decisions of households can be added to our diagram. When households spend on goods and services, revenues are provided to the private sector. The households receive goods and services in return. The flow of goods and services is a real flow. The flow of consumer spending is a money flow. This is shown below.

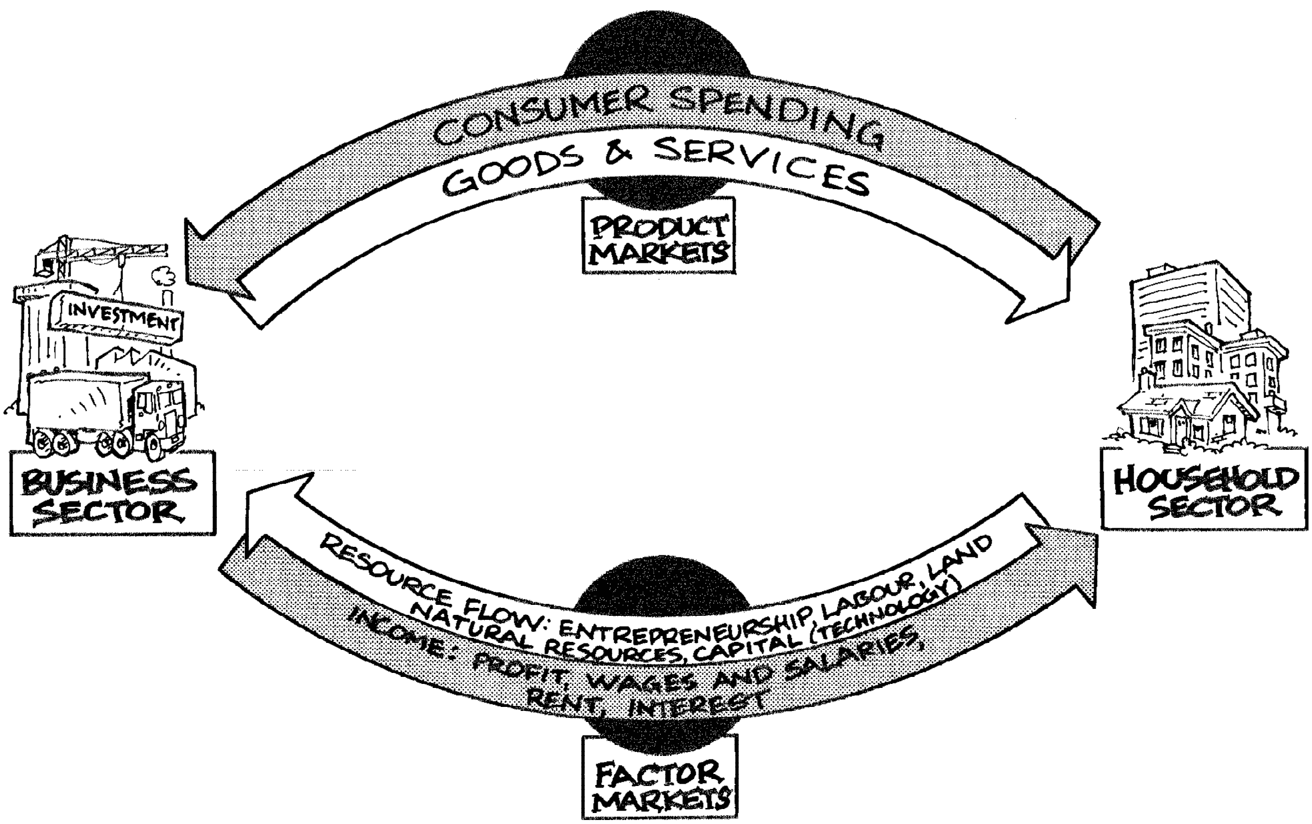
Just as resources are exchanged at costs determined by markets, goods and services are also exchanged at prices determined by markets. The willingness of households to buy goods and services represents the demand in the market. The willingness of producers to provide goods and services represents the supply in the market. The interaction of the producers and consumers, and their decisions to provide/purchase, determines the market price for each good or service that is produced. This, in turn, will determine the quantity of each good/service that is sold/purchased. These markets for goods and services, known as **product markets**, can also be shown on our diagram.



If we put together the pieces of our diagram so far, we essentially get a picture of our domestic private economy. Resources are provided by households for use in the business sector. Incomes are paid for the use of resources. The resources are then used to produce goods and services that are offered for sale. Households use the incomes they have earned to make decisions about the goods and services they will buy. As businesses sell goods and services, they earn revenue to produce more. This leads to businesses buying more resources – and the cycle continues.

Resources are exchanged in factor markets. Goods and services are exchanged in product markets. In both cases, the market forces of supply and demand will determine the price or cost.

A quick glance at the diagram will illustrate why this is often referred to as a "circular flow" diagram – both money and real flows keep the cycle moving. You might get the impression from this that things just keep going in circles and stay the same. But we know this isn't the case. That's because there are key pieces still missing from our diagram.



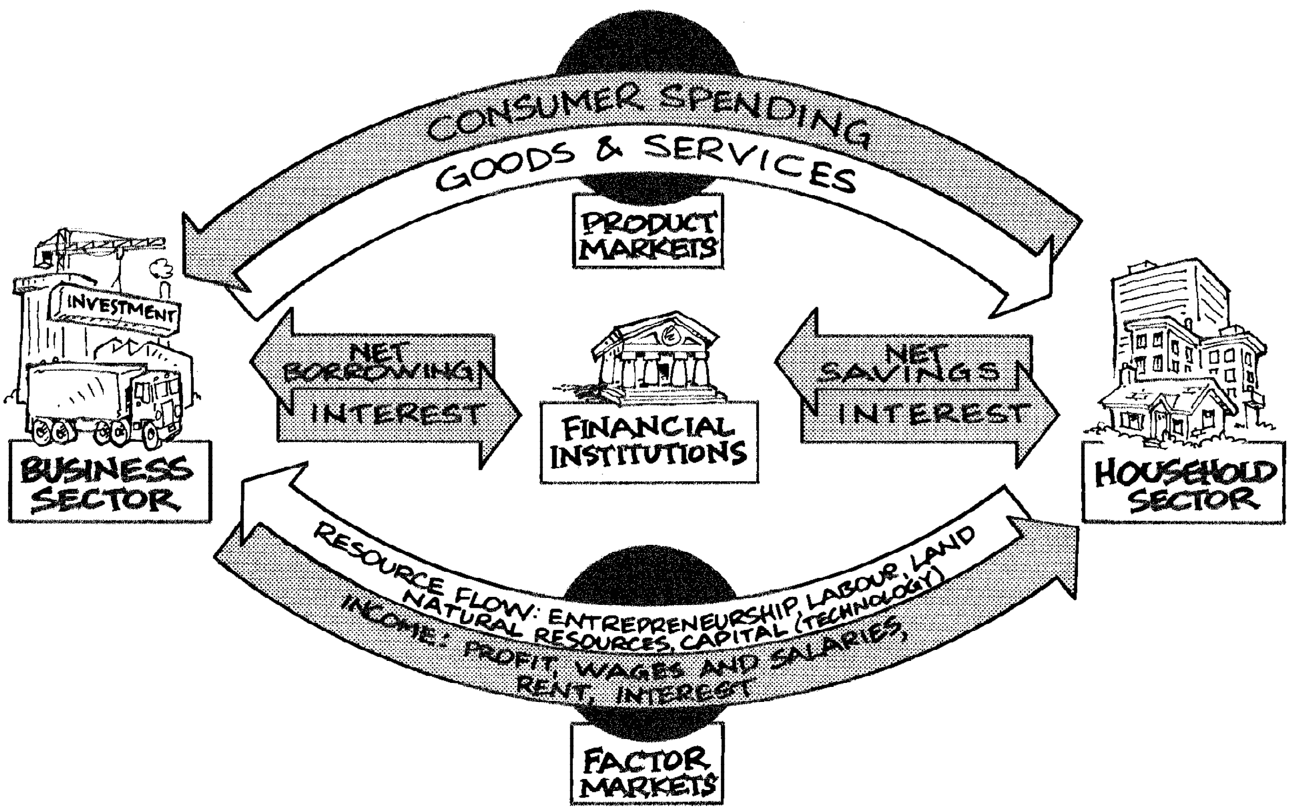
We're almost done – bank on it!

As we mentioned, households can save some of their income. When they do so, they usually deposit their savings in some type of financial institution. In return for depositing their savings, households earn interest. Naturally, households also borrow from these institutions and pay interest for the right to use the borrowed funds. However, overall, households in our economy save more than they borrow. We therefore say that households are **net savers.**

This can be shown on our diagram with savings flowing to financial institutions and interest flowing to households.

At the same time, businesses are, far and away, **net borrowers.** They borrow more than they save, often for the purposes of investment. Through investment, businesses expand or improve their production capabilities. This, too, is shown on the next diagram.

All the flows into and out of the financial institutions are money flows since no real things are being exchanged. Instead, money is moving in and out of both sides of the markets for funds that exist in our financial institutions.



We now see that funds can flow as spending or investment activities in our economy (which tend to generate production) or they can flow into areas that don't necessarily generate production. For example, funds that flow into savings don't generate production unless they are borrowed for spending and investment activities. Therefore, funds that flow in the economy tend to be classified in one of two ways. If they are used for spending or investment activity, they are called **injections** since they represent an injection into the economy that supports production activities. If, on the other hand, they flow so that they don't promote production in Canada, they are referred to as **leakages**. Leakages in our economy include funds that flow into (a) savings, (b) taxes, and (c) import purchases. These are leakages because (a) savings will sit with financial institutions and won't promote production as long as they stay there, (b) taxes will sit with government and won't promote production as long as they stay there, and (c) import purchases promote production activities in other countries, not in Canada.

Now, any of these leakages can be converted to an injection. For example, savings become injections if they are borrowed and spent or invested. Taxes can become injections if governments use taxes for spending purposes to provide "public" goods and services. And import purchases can become injections if other countries spend to buy Canadian exports.

The impact on production activities, then, comes down to which is higher – injections or leakages. For example, if there is more saving than borrowing, there will tend to be less production. Similarly, if there is more spending by Canadians on **imports** than spending by other countries on Canada's **exports**, the impact is to lower production levels in Canada.

Therefore, in terms of economic activity – and the production of goods, services, jobs, and incomes – the relationship between injections and leakages in the economy is very important. If injections are greater than leakages, production levels tend to rise. If leakages tend to be rising faster than injections, production levels will tend to fall.

As production levels rise in an economy, more jobs and incomes tend to be created. As production levels fall, there can be a loss of jobs and incomes. Therefore, as the economy moves through cycles – with production levels rising and falling – the lives of many people can be affected as their jobs and incomes are affected.

Let's turn our attention more closely to the "roles" the economy serves.

Whose job is it anyway?

An economy's job is to provide goods and services, jobs, and incomes for people in the society. It would be wonderful if our economy could always fill its roles perfectly and provide all people who wish to work with an adequate job and income. But that isn't the case. We have some people without jobs and some with low or little incomes. And, at the same time as our economy must respond to the challenge of providing jobs to those currently willing to work, it also has to address the needs of our growing population. Where do the new jobs come from for our growing population? Our economy faces a persistent challenge of providing jobs for those who want to work and providing additional jobs as our population grows through birth rates and immigration.

A key thing to note here is that, although we refer to the roles of the economy, we are really referring to ourselves. Canadians set up and run businesses. Canadians run our governments. Canadians provide the labour services – creativity, ingenuity, and so forth – that run our public and private production activities. Although our economy involves the use of capital and natural resources, it will only be as good as the people who run it and make the consumer, production, investment, saving, and public policy decisions. We all have economic responsibilities since we are all involved in making economic decisions.

In addition to the challenge of providing employment, there is another issue to consider. Over time, most of us seek to earn and acquire more of what? The answer to this question tends to be different for each of us. But, over the course of our working lives, the fact remains that most of us aim to do better over time – which can mean a better job, more income, more "things," more opportunity, and so on. Is that greed? Is it ambition? Is it a desire to be good providers? Is it some inner drive to do better? Who knows? But it's reality. If you are in school now, you are probably hoping to carve out a life that will enable you to progress, over time, in a material sense, as well as in other ways. How does our economy enable people to earn more and attain more wealth and an improved quality of life?

Well, if the economy stood still, we would be in trouble. If we have more people, and, at the same time, people aspire to acquire more, but the economy has nothing more to offer, we're in a spot. That is one factor that isn't indicated in a diagram such as the one we've drawn. The economy appears to be static and fixed. But the economy doesn't stand still. An economy is very dynamic and is constantly changing. New businesses are established. Existing businesses expand. Some businesses contract. Some close down. In reality, an economy is changing all the time. A key consideration is whether the economy is "growing" or "contracting." Actually, an economy can change even if the level of production stays the same. Consider, for example, the shift in some economic activity to the so-called new economy and the world of "e-commerce." But most of the time an economy is either in a period of **growth** or **contraction**.

If an economy is going to create more jobs, more opportunity, and more incomes, it will need to grow – there is no alternative. The concept of **economic growth** is, in itself, controversial. Although growth is needed for more jobs, opportunity, and incomes, some are concerned about the impact of growth on our resources and the environment. This is a justifiable concern. Over time, our economy – and we – will be challenged to find ways to achieve growth without harming the environment.

Fortunately, some changes in our economy are helping us to address this challenge. For example, many aspects of the "digital economy" put considerably less pressure on our resources than traditional production. The productions of new software can produce much in the way of jobs and incomes without placing demands on our natural resources or posing risks to our environment.

That said, economic growth will be important if we want our economy to continue to create more jobs, opportunity, and incomes. To show growth in our paper representation of the economy, we have added a box labelled "Investment" to the business sector. It is through investment (funds used to increase and improve the quantity and quality of our resources) that the **productive capacity** of our economy expands and improves over time and growth is achieved.

However, as we noted, all aspects of our economy don't simply move forward and ahead to bigger and better times. Unfortunately, some businesses close and some businesses decline. Whether our economy expands and grows is significantly determined by the degree to which business success and expansion exceeds business failure and decline. Businesses can fail or decline for a variety of reasons, and we will be examining some of these later. Similarly, there are many factors that contribute to business success. But what leads to business growth and expansion? The key ingredient here is **investment**. The creation of new businesses and the expansion of existing businesses come from investment.

Investment refers to the creation of a new business, the expansion of an existing business, or the improvement in the production capability of a business. This might mean a new factory, new equipment, better technology, better training for workers, new management techniques, and so on. But for such investments to take place, investment funding (also known as **financial capital)** is needed. After all, it takes money to build a new factory, to acquire new equipment, to provide training, to develop new technology, and so on. Once funds are used for a specific investment (for example, a new computer system), the financial capital becomes **physical capital.**

Investment, then, is the key to growth and expansion in the economy's ability to create wealth, and jobs, and incomes. But, for investment to occur, more than money is needed. Investors need a reason to invest. What is a good reason to invest? What would affect an investor's decision to invest? Well, most investors would be interested in:

(a) the potential pay back. What return can be earned on the investment? If the return is 3¢ on every dollar invested in a particular business, and a financial institution is paying more than 3 per cent, why not just put the money in the financial institution and earn the interest?
(b) the potential risk. What are the chances the investor will get the potential return? What are the chances the return will be higher? Or less? Or none at all?
(c) the options. If the potential return on an investment in a business is in the 3 per cent range, but represents some risk, why not buy a guaranteed investment certificate (GIC), which has a very low risk element. Alternatively, if one investment has a potential return of 7% and another has 12%, and the risk is the same for each, which would you choose? The 12% option!

So, funds flow into investment in search of a return while considering the risks involved and the other options that are available. An investment is made in a business when it is felt that the funds will contribute to the success of the business and provide a desirable return. If a business doesn't provide such a potential for investors, the business is unlikely to attract investment funds. Overall, if Canadian businesses don't offer potential success and attractive returns, investment funds won't flow and we won't get the economic expansion we need for new output, new jobs, new incomes, and new wealth creation.

Invest for growth – but where are the funds?

With that said, let's assume that there are businesses that are attractive to potential investors. Where do the funds for investment come from?

Funds for investment come from a number of sources. Some come from profits earned by a business. Rather than distributing all profits to owners, a business can decide to invest some profits to expand/improve the business.

Funds for investment can also come from people's savings. A person may decide to use his or her savings (and perhaps those of others) to establish a new business or invest in the expansion of an existing business. The investor hopes to earn a return that would provide more funds for the future. Some people may invest directly in businesses. Other people's savings, placed on deposit in financial institutions, create a pool of funds that may be loaned to businesses for investment purposes.

Funds for investment can also come to businesses as grants or loans from government.

And funds for investment can also come from foreign sources, that is, from people in other countries who wish to invest in the creation of a new business in Canada or the expansion or improvement of an existing one.

All of these represent potential sources of funds for investment. But it is important to note that savings by Canadians are the largest source of investment funds. Household savings, therefore, can play a key role in helping the economy expand and improve over time.

In Canada, the more new investment is attracted to create new or expanded businesses (over and above those that close or decline), the more our whole economy will grow and expand. **Economic growth** refers to an expansion in the total quantity of goods and services produced by an economy – measured by a statistic called **gross domestic product** or **GDP**. The key fuel for economic growth is investment.

Through investment, new growth, and expanded business activity, new jobs are created and new and higher incomes are earned. But there are things to think about as we seek to achieve economic expansion and growth – including, as we noted, the impact on the environment.

Wise investment – wise growth – think before you grow

It would be difficult to expand our economy without available resources. We need to think about how we use our resources, the rate at which we use our resources, and how we can renew and improve our resource wealth.

It doesn't do us much good to expand our economy and create new wealth if we pollute our air and water and diminish our quality of life by what we do to our environment. We have to think about that.

It isn't much of a goal, either, if our economy expands and creates new wealth only to have wider and wider disparity in our society. We have to think about that, too.

And there are other considerations. Creating an economy that grows and expands (and brings good things such as new goods and services, jobs, and incomes) also entails responsibilities. Growth for growth's sake is a pretty shallow ambition. Thoughtful, creative, considerate growth can bring great benefits – and we need them.

In summary, investment leads to an expansion of the private sector and business production activity. In turn, this should help create jobs and incomes as our population increases and our aspirations grow. Canada will compete with other nations in terms of its ability to attract investment. It will compete in terms of the quality of investments that are made. Investment in Canada will have a significant effect on our economy – its production ability and capacity – and, as such, it will affect the lives of Canadians.

But, before we examine how well our economy is doing in comparison with other nations, we need to complete the picture of our economy. There are a couple of pieces of the puzzle still to go.

The final pieces

We referred earlier to government, and we know that governments play a significant role in our society and in our economy.

Governments do a number of things including:

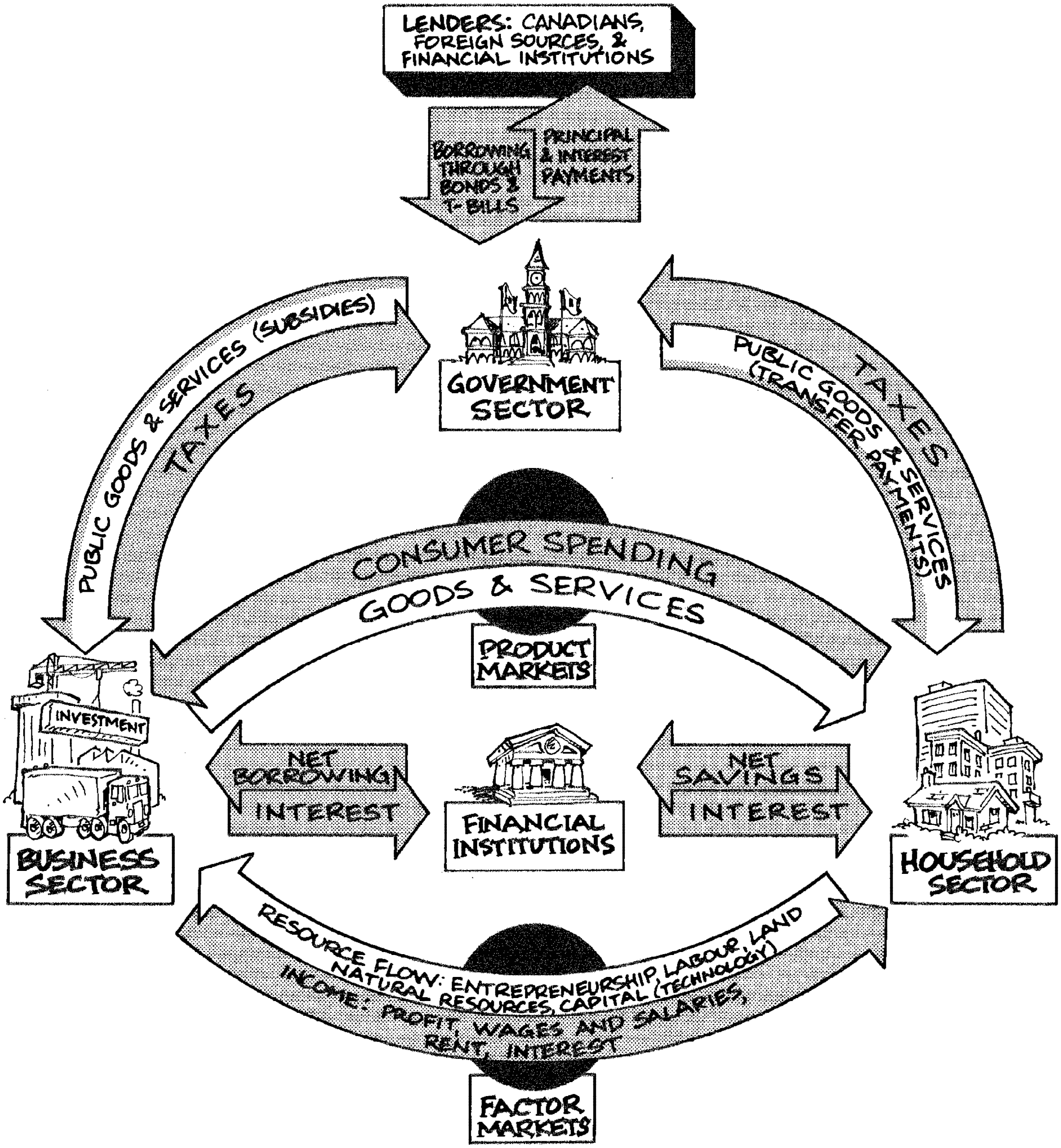
a) providing public goods and services such as roads, sidewalks, bridges, schools, and hospitals,
b) establishing regulations to protect workers and consumers,
c) providing grants, loans, and subsidies to some businesses and households (including welfare, old age security, and so on),
d) restricting the production of certain things (for example, illegal drugs), and
e) employing people to produce the goods and services governments provide.

To do these things, governments require funds. They obtain these funds through taxes. We can now add this to our diagram. Both households and businesses pay taxes. In return, both sectors obtain the right to use roads, bridges, schools, hospitals, and so on. Governments provide transfer payments (welfare, old age security, and so on) to households and some subsidies to businesses. And governments make payments to the private sector to produce certain things that governments want to provide but don’t produce themselves (for example, a new road, hospital, school, coastal patrol ship, rail line, canal, or airport).

So, funds flow to governments as taxes. And, in turn, governments provide a variety of goods and services (and, in some cases, funds) either directly or indirectly by contracting private sector producers. These flows are shown on the diagram on the next page.

Note that tax flows are money flows. The flow of public goods and services is a real flow. But part of what flows from governments to businesses or households is a money flow as funds are transferred not for goods or services but as direct grants, subsidies, welfare payments, and so on.

You will note that our diagram also indicates another key component of our economy – government borrowing. If, over the course of one year, government spends more than it receives in revenue, it runs a **deficit**. If government takes in more in revenue than it spends, it runs a **surplus**. From the 1970s to the



late 1990s, governments (in particular, the federal government) have spent more funds than they received in revenue. As a result, governments have accumulated significant **debt** (the cumulation of annual deficits). In recent years, recognizing the problems created by continuous deficits and mounting debt, governments have started to have surpluses.

Where do governments get funds when their spending exceeds revenue? Like us, they borrow. They borrow by issuing bonds and treasury bills. Bonds represent longer-term borrowing. For example, you might acquire a Canada Savings Bond for one, two, or more years. A bond is like an IOU. You lend the government money, you are paid interest, and, at a set time, you receive your money back. A treasury bill is a short-term loan, for example, 30 days, 60 days, 90 days, 120 days.

These bonds and treasury bills can be acquired by Canadians (individuals or organizations) or by non-Canadians. In either case, they represent borrowing by governments to cover shortfalls in revenue. As with any debt, interest must be paid. The extent of government debt in Canada makes this a key part of the diagram.

But there is one more piece to the puzzle, one more key sector to show. Canada does not produce everything Canadians want to buy. Furthermore, Canadians do not buy everything our businesses produce. The fact is, nations engage in international trade. Our producers sell goods and services to buyers in other countries (our exports), and Canadians buy goods and services from producers in other countries (our imports). Canada has a very open economy, that is, we depend on trade for a significant portion of our total national income.

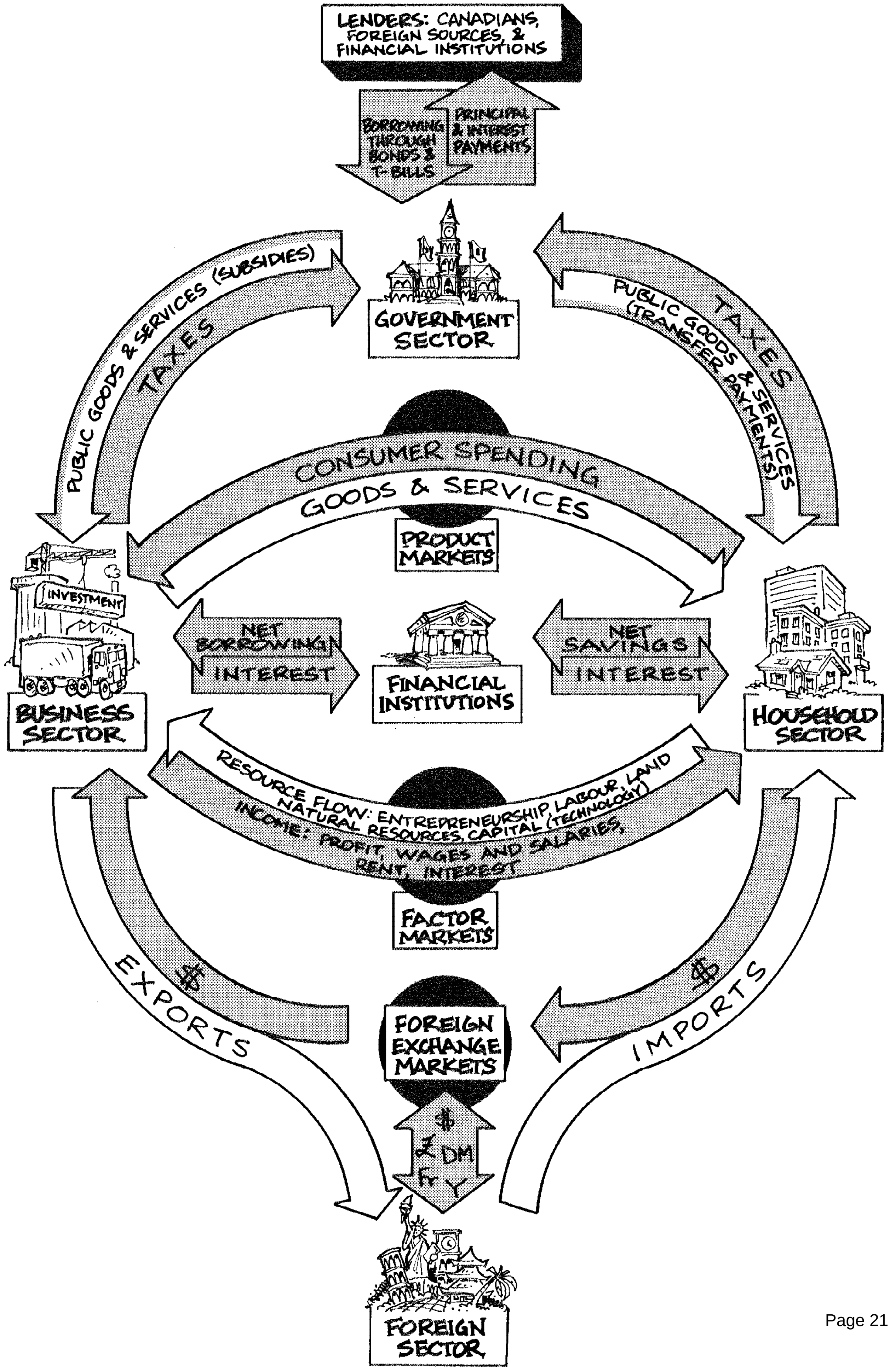
Again, there are money flows out (as payments for imports) and money flows in (as payments for our exports). But, although Canada uses money and the U.S. uses money and Japan uses money, we all use different money. Canadians use Canadian dollars, Americans use U.S. dollars, the Japanese use yen, Germans use marks, the French use francs, the British use pounds, and so on. This means funds don't usually flow directly from buyer to seller; they go through a transition stage. When a Canadian producer sells something to a buyer in France, the Canadian seller usually wants Canadian dollars. Therefore, the French buyer uses **foreign exchange markets** to buy the Canadian dollars needed with French francs.

Currencies from virtually all nations of the world can be bought and sold through these foreign exchange markets. And the funds of one country will have to be exchanged for the funds of another before they can flow into that country's economy as spending, saving, investment, or lending.

This flow of funds and goods and services into and out of Canada through the foreign exchange markets is shown on the diagram on the next page.

The complete picture – but not the complete story

That piece of the puzzle completes the "big picture." The diagram on the next page gives you a pretty good overview of how our economy works. At any given moment, the economy will be producing a certain level of goods and services. Total output may rise (economic growth) or total output may decline (economic recession/contraction). The capacity of the economy to produce output will be determined largely by the production capacity available through the private sector and how capable our producers are. Over time, then, the capacity of our economy to produce output, our productive capacity, will be affected by investment.


LENDERS: CANADIANS, FOREIGN SOURCES, & FINANCIAL INSTITUTIONS
BORROWING THROUGH BONDS & T-BILLS
PRINCIPAL & INTEREST PAYMENTS
GOVERNMENT SECTOR
PUBLIC GOODS & SERVICES (SUBSIDIES)
TAXES
PUBLIC GOODS & SERVICES (TRANSFER PAYMENTS)
TAXES
CONSUMER SPENDING
GOODS & SERVICES
PRODUCT MARKETS
INVESTMENT
BUSINESS SECTOR
NET BORROWING
INTEREST
FINANCIAL INSTITUTIONS
NET SAVINGS
INTEREST
HOUSEHOLD SECTOR
RESOURCE FLOW: ENTREPRENEURSHIP, LABOUR, LAND NATURAL RESOURCES, CAPITAL (TECHNOLOGY)
INCOME: PROFIT, WAGES AND SALARIES, RENT, INTEREST
FACTOR MARKETS
EXPORTS
$
IMPORTS
$
FOREIGN EXCHANGE MARKETS
$
£
DM
Fr
Y
FOREIGN SECTOR

But, given the capacity of an economy to produce goods and services, to what extent will that capacity be utilized? This is largely affected by the various flows shown in our diagram – the “injections” and the “leakages.”

Spending tells a tale

One way to get a sense of whether production levels in our economy will be high or low, expanding or contracting, is to take a look at the level of total spending in the economy. Total spending can be calculated by adding up all the various sources of spending that help generate production in Canada. At the same time, though, one has to subtract the spending in Canada that generates production in other countries, that is, our spending on imports.

Total spending, then, is equal to:

Spending by Consumers (C)	+	Spending by Businesses (Investment) (I)	+	Spending by Governments (G)	+	[Spending by other countries on our Exports (X)	–	Spending by Canadians on Imports from other countries (M)]

Therefore, TOTAL SPENDING = C + I + G + (X - M)

The total spending in the economy will determine the extent to which the existing productive capacity of the economy is being utilized. Spending levels may be relatively low, and, as a result, we may have idle, unemployed resources. On the other hand, spending levels may be relatively high and may be exerting pressure on our economy’s ability to produce. Resources may be quite scarce or even unavailable. Spending, therefore, affects resource utilization and the extent to which the economy is using its capacity.

Over time, though, we hope the economy’s productive capacity, in both quantity and quality, will improve. As we have noted, that is the key role that investment will play. On that point, it is important to note a key factor. Although we have identified one source of spending as G (government spending), it can really be broken down into two components. There is actually a “C” part of G and an “I” part of G. That is, some of what government spends goes for consumable items. The money flows and goes. The money, or what it acquires, is used up right away. But some government spending goes to things like roads, hospitals, and schools. So government really engages in investment activities, too. When we look at factors that will influence the productive capacity of the economy over time, we have to consider both **private investment** (shown as “I” in the equation) and **public investment** (which is part of “G”).

If one of our major goals is to have our economy expand so that it can create jobs and incomes for Canadians, as well as produce the high quality goods and services we need and want, the decisions made by these spenders, and most particularly the private and public investors, will be very important.

Our changing world – our challenging world

Canada, as well as other nations in the world, is becoming more and more linked and interrelated with other nations throughout the world. The economic welfare of our nation is significantly affected by the degree to which those in other nations buy our goods and services, invest in our country, and lend us funds as we require them. When we sell goods and services to other nations, jobs are created and incomes are earned. When investment comes to Canada, businesses expand and improve, technology is developed and applied, and jobs can be created. When we need to borrow, as many of our governments do, our ability to do so and the interest rate we have to pay will depend on the confidence foreign lenders have in our economy.

But other nations produce goods and services. Other nations provide attractive investment opportunities. And other nations have borrowing needs and seek to attract lenders. Canada must compete for sales. We must compete for investment. We must compete for lending.

There's the word – compete. If we need to compete, we are involved in competition. And if we are involved in competition, our **competitiveness** will determine our success.

Now, some people don't like the idea of competition. But what do we do about the high proportion of our national output that we can't sell internationally if we can't compete? Who will buy that output? If it isn't sold, what about the lost jobs and incomes? What do we do when we need to borrow if we can't compete and can't attract funds? What do we do if we can't attract investment? What do we do if our own businesses can't compete with other nations' producers in providing what Canadians need and want?

The answer is that we wouldn't be ranked as the number one country in the world. The reality is, our country is involved in markets – markets for resources, goods, services, and money. And we have been competitive. We have done well. But other countries are continuously improving. It's getting harder to compete. There are more "players" producing well and competing effectively with us.

And most Canadians can feel it. We feel the pressure and the challenges. We might not like it, but it's there. And Canadians have to respond. If we don't, we will have to accept the inevitability of a lower standard of living and quality of life. Like it or not, Canadians' ability to respond to global challenges is being tested. The question is: how well will we respond?

What are your thoughts and suggestions? We encourage you to think about it. And, more important, consider what *you* can do about it. How can we continue to make Canada the #1 ranked country in the world in which to live? We will all play a role in our future – and how that future will unfold.

This brings us to the end of our introduction to the "big picture" – Canada's economy – and how it fits together.

We hope you will think about the opportunities and challenges facing Canada and the potential impact these can have on you, your family, and your community. Once you have identified the challenges, we hope you will seek out the opportunities and get involved in initiatives that you believe are important – to your future and to the future of Canada.□