THE CANADIAN ECONOMY: THE BIG PICTURE

Revised Edition

by Gary Rabbior
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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.

Money Can’t Buy, But Can Influence, Happiness

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.

Where We Live Matters

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.

Public vs. Private Production

Some societies have made efforts to establish a system in which goods and services are primarily produced or controlled by public enterprises, that is, production activity owned or influenced 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, in recent times, been given more opportunity to own a business to produce a good or service. In establishing these privately owned businesses, owners will try to produce something people want and will buy. If an individual is successful, profit is the reward for effort.

One of the most prominent and oldest debates in the world focuses on the question. What type of economic system is best? What is the best balance between “private” and “public” ownership of resources? Our intent in the publication is not to argue that one type of system is better than the other. It is to try and explain how an economy – like Canada’s economy – operates. It can be debated as to whether it is the best way – or could be improved and so forth. But that is not our focus here. Our focus is on helping you understand how it does function.
Our Goal – Help Explain How Canada’s Economy Works – Not How It Should Work

Therefore, our objective here is to explain how the “Canadian” economy works. Canada’s economy is one 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 later. But it is important to emphasize that our focus is on helping explain how an economy like Canada’s works – not to offer opinion on how we think it should work.

Canada’s Geographic Size, and Relatively Small Population, Has Had an Impact

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 for what you produce. As a result, 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.

A Market-based Economy Needs “Buyers” to Work

Over time, though, as our population grew, it became possible for more and more private businesses to earn a profit – so more were created. As the world became more inter-connected, this also helped. Some of our producers were able to sell to buyers in other countries through international trade. This also helped to expand the marketplace and contribute to their success.

Entrepreneurs Respond to Demand – Along with Governments and Foreign Producers

A growing Canadian population meant higher demand for goods and services. Canada became a nation in which it was increasingly possible to take initiative, become an entrepreneur and establish a business to respond to these growing demands. Government continued to play a role in providing some goods and services – particularly those that were needed but for which it was hard to earn a profit – such as roads, schools, hospitals, sewer systems, and bridges. In addition to Canadian producers and governments responding to the growing demands from Canadians, some demands were met by producers in other countries through goods and services that we imported. 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.

Canada Relies Most Heavily on Private Producers for Goods and Services

In general, our economy has come to rely most heavily on privately owned businesses. That is where most of our goods and services come from. Entrepreneurs identify a need, want, or problem and establish businesses to produce a good or service in response. If the entrepreneur, or group of entrepreneurs, is successful, profits are earned, jobs are created, and the business expands. If unsuccessful, the business has to adjust and respond or fail and, if that happens, the entrepreneur and the company’s employees must seek alternative ways to earn an income to support themselves and their families.

Canada’s Choice for an Economic System

Canada, therefore, has established an economic system that is similar to that of many other nations around the world. It is a system that is largely market-based, encourages innovation and private ownership, and, at the same time, looks to governments to play
a strategic role - particularly in the area of social services, broad economic policies, and the provision of essential services such as defence, education, and health care.

**A “Capitalist” System**

Our system is often referred to as a **capitalist system**. Why? Because in our system we allow and encourage the private ownership of capital. Capital refers to the plants, factories, equipment, and so forth that are used to produce and provide goods and services. If you wanted to, and had the resources to do so, you can own capital, operate a business, produce a good or service, and try to earn a profit. A non-capitalist system would keep the ownership of capital in the hands of the state – that is, government.

**A “Mixed Economy”**

Our economic system is also often referred to as a **mixed economy** because it involves both private and public ownership of capital and resources. Goods and services are produced and provided by both governments and privately owned companies.

**So What? How Does the Economy Affect Us?**

So there you go. That is the type of economy we have in Canada – in a nutshell. But what does it matter. And how does this system affect us as individuals?

Money, as I am sure you know – even at a young age – does not buy happiness. But it matters in life – and can affect our happiness and well-being.

**An Income Comes in Handy**

Life certainly has many dimensions and when we are young we are often predominantly interested in things such as music, clothes, sports, movies and media, parties, affairs of the heart – and education of course. 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, iPods/iPads, and entertaining those affairs of the heart, a person needs to have an income of some sort. At first, income may come from parents or other family members. Eventually, though, most young people need to work to earn an income. And, at that time, we quickly learn that our ability to earn an income is affected by a wide variety of factors. These can include where one lives, one’s age, abilities acquired/developed, education, experience, connections, and so on.

**Who’s in the Labour Market?**

When a person decides to look for work to earn an income, he/she is said to enter the **labour market**. If you aren’t working or looking for work, you are not considered as part of the labour market. You are part of what they call the **labour force population** if you are of legal age to work (15 or over). But you are only a member of the labour force if you decide to seek employment.

**What’s In It For Me? An Income?**

Some people will offer their services for free for certain causes or reasons and “volunteer” their services. Others, though, will enter the labour market to look for a job to earn an income. In return for the labour services a person provides to a business or government, the employer pays a wage (hourly) or salary (yearly). And that income is then used to acquire things we want, save for the future, help others, and oh yes, pay taxes. Our labour also has a broader purpose than generating personal income. Our labour also makes a productive contribution to society.
We see, then, that once a society has put its economic system in place, that economic system 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 and use. The need for an economy and production stems from people’s desires for goods and services. The needs and desires are so important in our economy that it is often said that “the consumer is sovereign.” That is, in the end, consumers determine what will be produced by what they need and want – and are willing to buy.

**Production: It’s a Job – For Some**

A second key role of an economy is to create jobs through production activity so that people can find employment. 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.

**The Roles for Our Economy**

These, then, are the economy’s key roles – to produce goods and services, to create employment, and, thereby, provide the means for people to acquire income to purchase goods and services produced. In this way, it is hoped that people are able to achieve a desirable level of individual and family well-being. In an ideal world, our economy would provide gainful, meaningful employment for everyone, thus enabling everyone to achieve a healthy, happy, and comfortable life.

**But the World is Not Fair**

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 basic things in life they need. Some have jobs. Some don’t. Some are able to work. Others are not. Some are born into a world of opportunity. Others face considerable challenges and barriers.

**But, Compared to Most, Canada Does Pretty Well**

In terms of global comparisons, Canadians are actually pretty fortunate. The United Nations has frequently ranked Canada number one or very high among countries in terms of a place to live and work.¹ The majority of 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.

**Productivity is SO Important**

One reason why Canada has done so well in the past is because we have been successful 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. To do that, 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 – which is a key factor affecting a country’s success.

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

However, this means of measuring productivity can imply that output is determined solely by people and their labour. Not so. Output will actually be determined by many factors, such as the quality of capital (equipment, machines, and so forth) and technology that are made available to people to work with.

How We Compare Matters!

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, iPads, smartphones, boats, bicycles, leather jackets, 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 to be an effective and efficient economy – one that can compete effectively with others. If we cannot compete, other nations will produce the goods and services that people around the world want. And other nations will benefit from the jobs created, the incomes earned, and the investment for growth that can take place.

Time for “The Big Picture”

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.

First Thing We Need – Resources

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), technology, and labour. Where do these other resources come from?

You, Too, Can Own Resources

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.

Two Kinds of Flows

In our economy, two general kinds of things “flow.” 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.

**Barter is an Option – But Can Face Challenges**

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 becomes very difficult. Some bartering still takes place, but, by and large, using money is easier. 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 are about to 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 of that lies ahead. We’re going to build this picture one step at a time.

**Putting the picture 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 image #1.

**The Old Chicken and Egg Dilemma**

All the resources that are privately owned are owned by people who live in some kind of household. Now, as we begin to look at the Big Picture 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 picture” together, we have to have some place to start.

**The Beginning: A Good Place to Start**

To get us started, let’s say that, in the beginning, before there was an economy, people fended for themselves. There was no exchange. No organized production. No interdependence. That takes us a long way back in time.

Then let’s say the “economy” was born when people started to see the opportunity to produce for others – not just themselves, that is, say the economy was born with the beginning efforts of entrepreneurs. Entrepreneurs venture 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 did so, people became more interdependent and economies evolved. Rather than producing everything for themselves, people started getting things they needed and wanted from others.

As entrepreneurs venture out of their households 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 – and 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” (looking at what people need and want), the decision must be made about “how to produce.” This decision will determine what resources are needed and how the resources 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.

**Decisions, Decisions! Which Resources to Use?**

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 the wood to make the stick. Some resources aren’t used up at all but, instead, are employed, such as the people involved in producing, marketing, and selling 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 into Production**

We can illustrate this provision of resources to private sector production activity in our diagram (see Image #2). Below we see an illustration on the left representing the private sector. We also have one arrow illustrating resources (including the talent and initiative of entrepreneurs) flowing to the private sector. A second arrow shows the return of incomes to those who provide resources (including the profits earned by the entrepreneurs). As mentioned earlier, the flow of resources is referred to as a real flow – that is, 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 having value 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.
Real Flows versus Money Flows

Why are real flows distinguished from money flows? There are a number of reasons, but a key reason is as follows. If you buy an iPad, that iPad is real – it stays the same over time. Once an iPad, always an iPad. But money can change. It can change in terms of its purchasing power. If the iPad costs $200, there has to be an exchange of $200 to acquire it. However, if the price falls to $150, it takes less money to acquire it. In both cases, it may be the same iPad, 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 between real flows (that stay the same) and monthly flows (that can change.)

Both Real and Money (Nominal) Information is Important

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

But Why Are They Important?

Why is it important to distinguish between “real” and “nominal” information? Well, if I tell you that 2,000,000 iPads were produced in 2013 and 2,100,000 were produced in 2014, you know that 100,000 more iPads were produced in the year 2014. That’s straightforward, real information. However, if I tell you that $400 million worth of iPads were produced and sold in 2013 and $420 million worth were produced and sold in 2014, can you tell me whether or not more iPads were produced in 2014? No, you can’t. Why? Because the higher dollar amount may simply reflect higher prices. It’s even possible that fewer iPads were produced in 2014. That’s one reason why we distinguish between real and money flows. Both provide important information but “real” information gives us a different story – and different insights – than nominal 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, price, or compensation paid for the resource or use of the resource.

The “Demand” Side

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.

The “Supply” Side

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.

Together You Have a Market

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).

Oh No! Math! Yes – A Demand Curve!

We can show this in a simplified form on the next diagram. 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?

**More Math! A Supply Curve**

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 engineering services 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.

**Forces of Demand and Supply Interact**

These market forces of demand and supply will interact and put pressure on the level of actual compensation for engineers that will occur in the market. Note that if the compensation level is above the compensation level shown as *, the quantity of engineers looking for work is greater than the number being sought by employers. The result is unemployed engineers.

What happens next? Well, with more engineers looking for work than there are available positions, the level of compensation will tend to be pushed down to a lower level by the market. 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 is greater than the number of engineers 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.
In Search of Equilibrium

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 equilibrium 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 pushing on price levels for resources and for the goods and services that the resources produce.

Another Piece of the Picture

We can add these resource markets to our diagram where they are given their more common name in economics textbooks – factor markets. That’s because resources are also called factors of production, hence the term “factor markets.”

Who will buy?

So far, our diagram represents the production side of the economy and the resource markets that exist for the inputs used by businesses 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.)
Spending Puts Money Back into the Economy

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.

Something to Aim For: Discretionary Income

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 will try to manage their money in a way that enables more income to become “discretionary” – that is, money that doesn’t have to be used for fixed and required expenses – money that you can use as you wish. 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 over time, well-being improves, goals are achieved, and financial futures are more secure.

Part of Our Picture – Consumer Spending

The consumption decisions of households can now be added to our diagram. When households spend on goods and services, money is provided to the private sector (“revenue” for a business.) 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.
At What Price?

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 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.
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. In addition, 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 (see Image #7).

At the same time, businesses are, 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 Image #7.
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.

**Injections versus Leakages**

Therefore, funds that flow in the economy tend to be classified in one of two ways. If they are used for spending on goods and services, or investment activity, they are called *injections* since they represent an injection of money 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.
Leakages Can Become Injections

Now, any of these leakages can be converted to an injection. For example, savings become injections if they are borrowed by a business or household and spent or invested. Taxes can become injections if governments use taxes for spending purposes to provide “public” goods and services (e.g. a road, hospital, school). And import purchases can be offset by injections of money into Canada if other countries spend to buy Canadian exports.

Which is Greater – Injections or Leakages? It Matters!

The impact at any point in time on production activities in our economy, 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.

Injections vs. Leakages? Jobs and Incomes Can Depend on the Balance

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 and our economy expands creating more jobs, incomes, and opportunity. If leakages tend to be rising faster than injections, production levels will tend to fall in the economy and this can lower employment incomes, and opportunity.

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 now 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 new births and immigration.

Our Economy Is Us!

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.
A Future Goal? To Do Better!

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?

The Need for a Growing Economy

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.” 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 – and hopefully improving the environment for future generations.

The World Has Changed and Is Changing

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 production of new software can produce many jobs and incomes without placing demands on our natural resources or posing risks to our environment.

Economic growth will be important though if we want our economy to continue to create more jobs, opportunity, and incomes. To show growth in our diagram of the economy, we have added a box labeled “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, productivity is improved, and growth is achieved.

Investment Plays a Very Key Role

The key ingredient to a better future for an economy – and the people who work in that economy and depend on it – is investment – the creation of new businesses and the expansion and improvement of existing businesses.
Investment therefore 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 and Growth Go Hand in Hand**

Investment, then, is the key to growth, and expansion, and improvement in the economy’s ability to create wealth, jobs, income, and opportunity. But, for investment to occur, investors need a reason to put available money into investments. What is a good reason to invest? What would affect an investor’s decision to put money into an investment? 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% on deposits, why not just put the money in the financial institution and earn the interest? If the potential return from the investment is 6% - that may lead to an investor deciding to make that investment.

(b) **The potential risk.** What are the chances the investor will get the potential return? What are the chances the return will be higher – for example, 8 or 9%? Or less – possibly 3-4%? Or perhaps no return at all and maybe even a loss – or a loss of all the money invested?

(c) **The options.** If the potential return on an investment in a business is in the 6% range, but another has a potential return of 7% and another has 12%, and the risk is the same for each, which would you choose?

So, investors and investments will be influenced by 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 and improvement we need for new output, new jobs, new incomes, new wealth creation, and a healthy and improved environment.

**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 by the institutions 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.

**Our Savings Create a Pool of Funds for Investing**

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 improve. **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, new and higher incomes are earned, and new opportunities are generated. But there are some important things to think about as we seek to achieve economic 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. The benefits of economic growth and improvement should flow fairly. 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. To that end, a country and a society should have goals that help guide decisions. It helps to have a vision for the type of economy – and country – you want to have in the future.

Today, change happens quickly – and it can happen without much thought and planning. Consequences can sneak up on us and we may find in the end things didn’t turn out as we liked or hoped. Having and running an economy is a big responsibility. It is important that all Canadians, including policy makers, think about the kind of future outcomes we want – and act, and make decisions accordingly.
Now, before we conclude, there are a couple of final pieces of the picture to add to our diagram.

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 Image #8.

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, a government spends more than it receives in revenue, it runs a deficit. If a government takes in more in revenue than it spends, it runs a surplus. A deficit or surplus refers to a government’s financial situation over a one year period. From the 1970s to the late 1990s, governments (in particular, the federal government) spent more funds than they received in revenue. As a result, governments accumulated significant debt (the accumulation of annual deficits and the total amount a government owes). In the late 1990s and up to the financial crisis that hit, and recognizing the problems created by continuous deficits and mounting debt, many governments, including the federal government, ran surpluses.
Then, when the financial crisis and recession hit, the federal government had to boost "injections" into the economy to help stabilize things. As it increased spending to help stabilize the economy, the federal government has had a series of deficits. The deficits have been declining and, very soon, the government hopes to be back in a surplus position.
Governments Borrow Money Too

Now here’s a good question. Where do governments get funds when their spending exceeds revenue? Like us, they borrow. They borrow by issuing bonds and treasury bills. Bonds are one way of raising money. An investor buys a bond and thereby lends the bond issuer money. The bond issuer agrees to pay a certain amount of interest to the buyer of the bond (e.g., 3% a year) for a certain period of time (e.g., 10 years). Some bonds are riskier than others – that is, there is always a chance that the bond buyer may not get some, or all, of his/her money back. Canadian government bonds are very low risk. There is very little chance that the bond buyer won’t get all the money back. So the government can sell bonds to borrow money. Bonds are usually used for longer-term borrowing. For example, you might acquire a Canada Savings Bond for one, two, or more years. Essentially, it is like an IOU. You lend the government money, you are paid interest, and, at a set time, you receive your money back. Treasury bills are sold by the government to cover shorter-term borrowing, for example, 30 days, 60 days, 90 days, or 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.

One Final Piece of Our Picture

So governments play a key role in the economy. But there is one final piece to the picture, 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.

The Need for “Foreign Exchange” Markets

Again, there are money flows out (payments for imports) and money flows in (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 and the French use Euros, and so on. This means funds don’t usually flow directly from buyer to seller in global markets; the funds 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 Euros.

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 (see Image #9).
The Complete Picture – But Not The Complete Story

That piece of the picture completes the “big picture.” The diagram on the next page gives you a pretty good overview of how our overall 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 (productive) our producers are. Over time, then, the capacity of our economy to produce output, our productive capacity, will be affected by investment.
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 in our economy, then, is equal to:

\[
\text{Spending by Consumers} + \text{Spending by Businesses} + \text{Spending by Governments} + \text{Spending by other countries} - \text{Spending by Canadians on Imports from other countries} = \text{TOTAL SPENDING}
\]

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

**Spending and Production Affect the Use of Our Economy’s Capacity**

The total spending in the economy will determine the extent to which the existing productive capacity of the economy is being used. 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 Infrastructure Is Important

You may have heard or read about “infrastructure” but what is it? Infrastructure is what enables goods, services, people, water, energy, etc. to move – to move from where they are to where they are needed or want to go.

To move goods and services, for example, we need roads, bridges, airports, dockyards, and so on. If we don’t have good quality infrastructure, it takes more time, and money, to move people and things around. Canada, like many other countries, needs to invest in its infrastructure to make sure our economic activity is well supported, efficient, and able to compete. We have been making infrastructure investments – and you may have experienced some of the challenges that arise when we need to build or repair road, bridges, transit systems, sewers, power lines, and so forth. These can cause delays and frustration – but they are important investments. The quality of our infrastructure will have a very major effect on our economic activity, competitiveness, growth, and the ability of our economy to generate and sustain jobs and incomes.

Our Changing World – Our Challenging World

Canada, as well as other nations in the world, are becoming more and more linked and interrelated. 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 here in Canada. 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 too of course. 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.

Canada Exists in a Very Competitive World...

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.

And Canada can compete. We wouldn’t be ranked as one of the top countries in the world if we couldn’t. The reality is, our country is involved in markets – markets for resources (including labour), 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 the Competition is Getting Together

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 may well find that we have to accept 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? How can we continue to make Canada one of the top countries in the world in which to live? We will all play a role in our future – and how that future will unfold.
Some people thrive on competition. Some people don’t like it at all. But it is a reality in today’s world. And competition means a constant challenge to improve. We need to develop and apply new technology; provide high quality education and training; build high quality infrastructure; have able and creative leaders in place in business and government; and so on.

There is no doubt that there would be less pressure, change, uncertainty, and stress in a world where one could relax, be happy with the status quo, rest on one’s laurels to enjoy past success. But the world isn’t like that these days. If we want to maintain and improve our quality of life and level of well-being, we have to face up to the competition – and aim to be the best we can.

At the beginning, we noted that this publication would try to help you understand the economy the way it is – not explore or debate the way it should be. There are those who like it and those who don’t – but as educators, our challenge is to try and ensure, as best we can, that people have a fair chance to achieve success – however success may be defined for them.

Take a look at the following and what it says:

Opportunity is nowhere.

You will notice that, read one way, it says opportunity is now here. Read another, it says opportunity is no where. That is a challenge for us today. We live in an opportunity-filled world – for some – for those who are equipped, prepared, and able to identify opportunities and act on them.

For others, who are less prepared, equipped, and able, it is a very stress-filled world. The challenge is to make sure that as many Canadians as possible – ideally all – are provided with the knowledge, skills, and tools to have a fair chance of achieving personal success.

We hope, in some small way, this publication helps make a contribution to a greater understanding of how the economy works and some of the economic forces and factors that can influence jobs, incomes, and the level of well-being of Canadians.