ECONOMIC CLIMATE *for* BARGAINING

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Frontline Summary

Economic Outlook Summary

The economic outlook for 2011 continues to weaken, with growth now expected to average only 2.3%, down almost a full percentage point from last spring's forecast.

With Washington set to embark on a second round of stimulus, Canadian politicians should also get the message that it is too soon to reduce their support for the economy.

The outlook for economic growth is down in all provinces, but rising energy prices continue to widen Canada's regional economic and fiscal divide. Canadian provinces have an advantage over U.S. states bound by balanced budget rules—and they should continue to use it.

Private economic forecasts now expect:

- Economic growth will increase by an average of only 3.0% in 2010 and 2.3% in 2011.
- Unemployment rates will only gradually decline from 8.1% this year to 7.8% in 2011.
- Consumer prices will rise by an average of 1.7% in 2010 and 2.0% in 2011.

The pain refrain: why austerity won't make the economy better there's a perverse policy being peddled these days: that spending cuts and fiscal austerity will immediately boost economic growth. This idea is a myth and has been thoroughly discredited by the IMF among others. Instead, there's evidence that growing inequality helped cause the crisis: more progressive taxes and higher wages can both reduce deficits and also reduce economic instability.

Benefits of public spending for the economy. It is widely accepted that public spending prevented a much deeper economic crisis, but less widely understood how important public spending has been for ongoing economic growth and development. In addition to the direct benefits provided, public spending plays a major role in generating stronger and more stable economic growth.

Fairer taxes could net federal government over $20 billion. Canadian governments are at an extreme in focusing almost entirely on spending cuts to reduce their deficits. A few fair tax measures could not only net the federal government over $20 billion; they would also enhance equality and economic stability.

Slow job growth clouds recovery. Job growth has slowed to a crawl, increasing by an average of only 8,000 a month since July and far below the rate of population growth. Normally this would lead to rising unemployment, but instead more young people are dropping out of the labour force. At the same time, older workers are delaying retirement and staying in the workforce longer.

Inflation: the great divide. Inflation continues to be driven higher by sales tax and energy prices increases, with very little impact from the ups and downs in the economy.

Public sector wage adjustments slide again. Average wage adjustments for public sector workers declined further in the third quarter, below the private sector average. While there is some divergence between public and private wage increases, they tend to closely track each other over time. This means cuts to public sector wages are also likely to suppress private sector wages.

The *Economic Climate for Bargaining* is published four times a year by the Canadian Union of Public Employees. Please contact Toby Sanger (tsanger@cupe.ca) with corrections, questions, suggestions or contributions.

ECONOMIC CLIMATE for BARGAINING

The pain refrain: why austerity won't make the economy better

There's a perverse economic policy refrain that has gained support recently: the idea that cuts to public spending and fiscal austerity will boost economic growth. It's especially popular in Anglo-American countries with Conservative politicians eager to play the strict and responsible father figure.

Prime Minister Harper strongly pushed the austerity agenda at the G20 summit in Toronto, getting world leaders to agree on reducing deficits instead of agreeing to make finance pay for the costs of the crisis with a bank tax.

U.K. Prime Minister David Cameron is following Canada's approach and focusing heavily on cuts to public spending rather than tax increases to reduce deficits. Canada's experience during the 1990s is being taken to show that if governments focus on deep cuts to public spending to reduce deficits, they can grow the economy at the same time.

But this supposed lesson ignores two major factors. Canada's economy grew during this period because of a booming U.S. economy and plummeting interest rates that compensated for the negative impact of the budget cuts. Neither of these positive factors are there now to provide a needed boost. The U.S. and European economies are in the doldrums and interest rates are heading up, not down.

Canadians know that their government's deficit cutting in the 1990s certainly wasn't without pain. Much of the federal government's spending cuts came from cutting transfers to the provinces. Most of them in turn downloaded these costs onto the public and municipalities. This simply converted the federal deficit into growing social and community deficits, with increased poverty and a municipal infrastructure deficit that grew to over $120 billion.

The ultimate costs of providing important public services weren't so much reduced; instead they were shifted onto others and deferred—and we are still paying for the costs of this deficit cutting more than a decade later.

A number of academic economic studies have also been extremely influential in convincing governments and policy-makers that they can significantly cut spending, grow their economies, and then subsequently get re-elected. Ontario employers have even cited some of these studies in an attempt to persuade arbitrators to freeze wages.

"No pain, no gain" may work as a mantra for some to achieving greater physical and emotional fitness, but it is the wrong prescription for an economy still in the recovery room. And, as usual, those peddling this philosophy want to keep the gains for themselves and distribute the pain to others.

In a perverse way, this approach may make good politics, but it adds up to lousy economics. Even the International Monetary Fund (IMF) recently demonstrated that these studies were seriously flawed. Not only did they ignore the impact of lower interest rates, which usually accompanied spending cuts, but their selection of deficit-cutting episodes was biased.

The IMF study convincingly shows that reducing deficits, whether through spending cuts or tax hikes, will lead to economic pain, with slower economic growth and higher unemployment.[1] Spending cuts have historically caused less damage, but that's because they were combined with interest rate cuts as well.

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[1] *Will it Hurt? Macroeconomic Effects of Fiscal Consolidation,* International Monetary Fund, October 2010. www.imf.org/external/pubs/ft/weo/2010/02/pdf/c3.pdf The study says there are longer-term economic benefits to cutting government debt, but this is based on a theoretical model and happens because of lower interest rates.

The IMF study actually used Canada in its model to show that cutting deficits when interest rates are close to zero and other countries are also cutting their deficits (as is the case now) will be particularly damaging. In this situation, a one percentage point cut to the deficit as a share of GDP through spending cuts will lead to twice this loss for the economy.

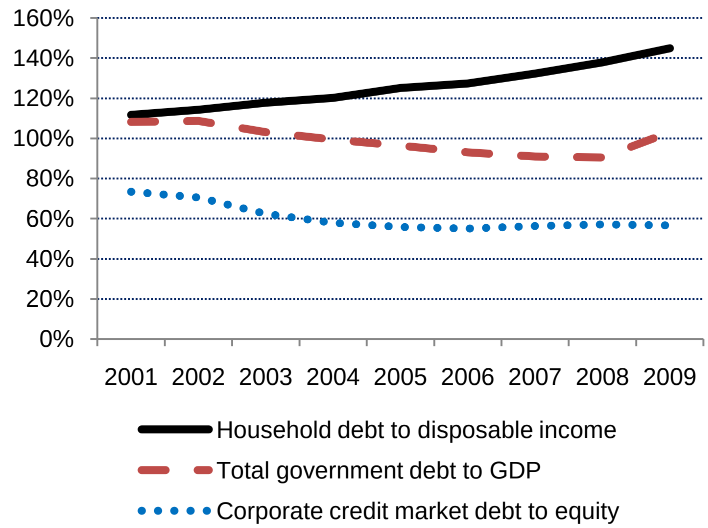
This degree of cutting would also translate to an increase in the unemployment rate by slightly more than one percentage point—equivalent to an increase in unemployment levels by about 200,000 for Canada.

That's the same number of jobs that the federal government estimates was created by all its stimulus spending. The IMF study also found that the most damaging tax hikes at these times are sales tax increases.

Goldman Sachs, the investment bank dubbed the "giant vampire squid" by Rolling Stone writer Matt Taibbi, also produced a study that purports to show that fiscal austerity can boost economic growth in the short run. This analysis was also thoroughly discredited by U.S. economist Dean Baker.[2]

While government deficits have increased in the past two years, the more disturbing trend is the increase in household debt ratios. These reached a record level of almost 150% of personal disposable income earlier this year. Meanwhile the total gross debt of all Canadian governments is just above 108% of our economy and corporate debt levels have steadily declined.

Households, Government and Corporate Debt Ratios 2001 to 2009



Source: Statistics Canada National Economic Accounts Financial Indicators.

Between households there is even greater inequality of wealth and of debts. Stagnant wages for the working people, escalating incomes at the top, and lower tax rates for the top 1% have led to Canada now having the greatest inequalities of income and wealth since the 1920s and the Great Depression.[3] It's this rising inequality, stagnant and declining wages for the rest of the population that leads to rising household debts, instability and ultimately economic crises.

As another recent IMF study has shown, what's needed are policies to redistribute income, with higher taxes on top incomes and higher real wages for workers.[4]

Public spending cuts and wage freezes not only lead to lower wages for public sector workers; they also lead to reduced services, reduced bargaining power and lower wage increases for all workers.

2 Dean Baker, *The Myth of Expansionary Fiscal Austerity*, Center for Economic Policy and Research, October 2010.

3 Armine Yalnizyan, *The Rise of Canada's Richest 1%,* Canadian Centre for Policy Alternatives.

4 Michael Kumhof and Romain Rancière, *Inequality, Leverage and Crises,* IMF Working Paper, November 2010.

Slowing economy sends message to maintain public support for economy

Prospects for economic growth took a further slide following Statistics Canada's latest release of the national economic accounts. These show Canada's economy grew at an annual rate of only 1% in the third quarter, below the 2.3% growth of the second quarter.

Despite consumer spending remaining strong, Canada's economy was dragged down by a decline in net exports, a drop in residential construction and a slowdown in government spending. Business is finally kicking in with increased investments, but at a rate considerably below their growing profits.

Economic growth forecasts for 2011 have been demoted even further and are now almost a full percentage point lower than the federal budget's forecasts last March. With high household debts and lower wage increases, consumer spending is bound to slow. This should add to concerns about the high dollar and weakened prospects for the U.S. economy following the mid-term elections.

Our previous reports warned that the economy was bound to slow considerably. With these latest numbers from Statistics Canada, the federal government seems to have got the message. The Bank of Canada held off on a hike in its interest rate at its December announcement date while federal Finance minister Flaherty extended deadlines for stimulus spending and suggested more flexibility in reaching its deficits targets.

With government spending expected to slow across the board next year, provincial governments also need to get the message to maintain support for the economy and suspend plans for cuts to public spending.

Canadian Economic Outlook- Average of Private Sector Forecasts

Annual growth rates unless indicated	**2008**	**2009**	**2010**	**2011**
	Actual		Forecast	
Growth in the Economy				
Real GDP	0.5%	-2.5%	3.0%	2.3%
- Consumer Spending	2.9%	0.4%	3.4%	2.9%
- Business Investment	3.4%	-19.9%	3.2%	8.3%
- Government Spending	4.1%	5.1%	4.5%	1.4%
Labour Market				
Employment growth	1.5%	-1.6%	1.6%	1.4%
Unemployment rate	6.1%	8.3%	8.1%	7.8%
Productivity growth	-0.5%	0.9%	1.0%	1.0%
Inflation - Consumer Price Index	2.4%	0.3%	1.7%	2.0%
Corporate Profits before tax	8.0%	-32.3%	18.2%	8.4%
Real Personal Disposable Income	3.7%	1.2%	3.4%	2.6%
Personal Savings Rate	3.6%	4.4%	4.6%	4.6%
Housing Starts (000s)	212	149	190	176
Interest Rates and Exchange Rate				
Short-term 3 Month T-Bill	2.33%	0.33%	0.65%	1.52%
Long-term 10 Year Bond	3.61%	3.23%	3.11%	3.26%
Exchange rate C$ in U.S. cents	$ 93.81	$ 95.97	$ 96.99	$101.75

Averages based on latest forecasts from seven different Canadian forecasters as of 6 December 2010.

Provincial economic prospects down across the country

Next year's economic growth outlook for all provinces has been further degraded by an almost equal degree in recent forecasts.

With the exception of Manitoba, Saskatchewan and Alberta, all provinces are expected to record slower economic growth in 2011 than the already sub-par recovery rates of 2010.

Thanks to rising energy prices, the economies of both Saskatchewan and Alberta are forecast to expand by more than 3% this year and next. With weakened U.S. economic prospects, growth in most of central and eastern Canada next year is now expected to be closer to 2%.

The pace of job creation is also expected to slow down in most provinces, with the expanding resource sectors and strong finances of Alberta and Saskatchewan helping those provinces buck this slowing trend.

With slower job growth, the unemployment rate in all provinces is expected to improve more gradually.

Forecasts for price increases are not much changed: inflation is expected to meet or surpass the national average of 2% in those provinces where harmonized sales taxes were introduced or increased. Consumer price increases are also expected to accelerate in faster expanding western provinces.

The table below presents an average of the recent publicly-available forecasts of main economic indicators at the provincial level, calculated from the five major commercial banks. It should be noted that their forecasts of inflation have often tended to be lower than actuals in recent years.

Provincial Economic Outlook

% annual growth except where noted

	Real GDP		Employment		Unemployment Rate		Inflation	
	2010	2011	2010	2011	2010	2011	2010	2011
Canada	3.1	2.4	1.6	1.5	8.1	7.8	1.7	2.0
Newfoundland & Labrador	3.7	2.7	3.1	1.4	14.7	14.2	2.3	1.8
Prince Edward Island	2.2	1.9	3.4	0.8	10.8	10.6	1.9	1.6
Nova Scotia	2.1	1.7	0.6	1.0	9.1	9.0	2.2	2.0
New Brunswick	2.3	1.9	-0.2	1.0	9.0	8.9	2.1	1.7
Québec	2.9	2.1	1.9	1.3	8.0	7.9	1.3	1.9
Ontario	3.4	2.2	1.8	1.5	8.8	8.5	2.3	2.1
Manitoba	2.5	2.7	2.0	1.4	5.4	5.4	0.9	1.7
Saskatchewan	3.1	3.6	1.4	1.7	5.0	4.9	1.3	2.1
Alberta	3.1	3.4	0.6	2.1	6.6	6.2	1.2	1.9
British Columbia	3.3	2.7	2.0	1.5	7.5	7.3	1.6	2.1

Based on the average forecasts from five different bank forecasters as of 6 December 2010.
National averages may differ from those reported in the Canadian Outlook table because they are from a smaller group.

Benefits of public spending for the economy

The critical importance of public spending in rescuing the financial sector and preventing a deep economic depression is now widely accepted.

However, what is less widely understood is just how important public spending and services are for ongoing economic growth and development. In fact, there's a long-term and powerful relationship between increasing shares of public spending and continued economic growth, called *Wagner's Law*, first identified in the 1880s.

David Hall from the University of Greenwich has documented the broader economic and social benefits of public spending in a recently published report ***Why we need public spending***.[5] The following summarizes many of his points together with examples from Canada.

Public spending and investment has been the major driving force of economic and social development for more than a century. It has been particularly crucial in the following areas:

- ***Physical infrastructure,*** including railways, roads, bridges, ports, electric, communications, water utilities, etc. Many of these have been nation-building projects and led to major increases in economic growth and productivity. In fact, Statistics Canada has confirmed that every dollar invested in public infrastructure yields a 17% annual return for business alone—not even accounting for the individual and social benefits. This rate of return far exceeds average private rates of return.

- **Education and health care.** Much-improved public health and education has not just directly improved human wellbeing, it has also had enormous economic benefits. Improvements in health have been responsible for about 25% of the increases in labour productivity in industrialized countries over the past 30 years. Investments in education provide an average 10-15% rate of return. Public services such as these are more efficiently, equitably and effectively delivered by the public sector.

- **Other community and public services**. Community and public services from libraries to recreation facilities and other community services are much more equitably and efficiently provided by the public sector.

- **More equal distribution of income.** The public sector and public services redistribute income and promote greater equality in a number of different ways: through progressive income taxes, social assistance and transfers, and through provision of public services available to all irrespective of ability to pay. In addition, public sector wages and salary scales are much more equitable than those in the private sector. More equitable distributions of income are better not just for social reasons, but also for the economy because lower income people spend a higher share of their income, stimulating economic growth. In addition, more equitable countries are more stable socially, politically and economically. As the recent bestselling book *The Spirit Level* has shown, more equitable societies work better for *everyone* in terms of health, education, and many social factors.

- **Social security and insurance.** Many public services (particularly health care, unemployment insurance, public pensions, etc.) function as an efficient collective form of insurance. These allow everyone to work more productively without the fear and risk of becoming impoverished or bankrupt if some misfortune occurs, and without the cost of more expensive private insurance.

- **Strong regulations enhance wellbeing and stability.** Following the tainted meat scandal, Canadians are more aware of the problems with industry self-regulation and the importance of strong public regulations for human health and safety. The financial crisis also demonstrated the importance and need for stronger regulations over banks and financial products to prevent individuals from losing their savings and to prevent damaging financial crises from developing. Stronger financial and mortgage market regulations in Canada, as well as a national public system of mortgage insurance has helped prevent the same type of real estate market meltdown and bank failures that occurred in other countries.

[5] David Hall, *Why we need public spending*, PSIRU Business School, University of Greenwich, October 2010. www.world-psi.org/publicspending

Unfortunately, cuts to public spending have led to de-regulation or privatization of these important functions of government.

- **Counter-cyclical spending.** A significant amount of public spending and tax revenues naturally operates as an automatic stabilizer for the economy to counteract private sector booms and busts. Employment insurance, social assistance and income tax revenues are prime examples of this. However, the effectiveness of public sector spending as an automatic stabilizer has been diminished as a result of cuts to employment insurance and social assistance, balanced budget and fiscal rules, and as a result of a shift away from income taxes.

Statistics Canada figures show that over 3.6 million Canadians are directly employed by the public sector across Canada: including by governments at all different levels, by hospitals, schools, universities and colleges and other public sector and community organizations.

However, this is just a portion of the number of jobs that are supported by public sector spending across Canada. Spending by these public sector workers helps support an additional over 1.5 million jobs in communities where these public sector workers work and live.

Spending on the wages and salaries of public sector employees accounts for less than 30% of all government spending. Public sector spending in other areas—including on other goods and services, transfers, and investments in infrastructure—adds up to twice the amount that goes directly to the wages and salaries of public sector workers. This amount—approximately $350 billion a year—itself supports approximately 5 million jobs in the private sector.

In total, public sector spending directly and indirectly supports approximately 9 million jobs all across Canada, or more than 50% of total employment. Only 40% of these are direct public sector workers.

Cuts to public spending will cause job losses in communities all across Canada, including many among those working for private sector employers. People outside of major centers are often well aware of these economic linkages and how important public sector spending is for maintaining employment and economic stability in their communities. While the linkages may be less evident in larger cities, they are still strong: the recent economic crisis showed that countries and regions where the public sector is more developed and stable generally suffered far less than other regions.

A few fairer taxes could net federal government over $20 billion annually

Canadian governments are at an extreme in focusing almost entirely on spending cuts to reduce their deficits.

Many other countries are introducing more balanced "fiscal consolidation" packages with a combination of spending increases and targeted tax increases. These include tax increases on high incomes and the financial sector in an attempt to have those who caused the crisis and benefited from the bailouts to also pay for the costs. In addition, many of these tax measures are designed to reduce the unbalanced incentives for risk and leverage that contributed to the financial crisis.

In contrast, a number of Canadian governments are doing the opposite: further reducing corporate income taxes and reducing tax rates on high income individuals. Some provinces have of course increased or shifted sales taxes onto consumers, but in most cases these are offset by lower income taxes, tax credits and reduced taxes on business.

The end result will be a more regressive tax system and increased inequality. This compounds growing inequalities in the tax system and in the distribution of income over the last half century.[6]

A period of weak economic growth may not seem like the best time to increase taxes, but progressive tax hikes on high incomes and business are likely to have a less negative economic impact than spending cuts and sales tax increases. Old arguments that taxes should be shifted from income and business and onto consumption to stimulate investment have lost credibility in the wake of the financial crisis.

Instead, a more progressive tax system that closes loopholes and taxes different sources of income more fairly would not only raise revenue for badly-needed public investments, but it would also enhance economic equality, stability and growth.

Some key fair tax measures include:

- ***New Tax Bracket on Higher Incomes.*** A 32% federal tax bracket on incomes of over $250,000, still below the existing U.S. federal rate, would generate over $1.6 billion annually for the federal government.
- ***Eliminate Stock Option Loophole.*** The federal government's stock option deduction allows Canada's wealthiest executives to pay tax at half the rate that working Canadians pay on their employment income. Eliminating this loophole would increase revenues by $1 billion a year for the federal government and by another $500 million for provincial governments.
- ***Fully tax capital gains.*** Income from capital gains and speculative investments are also taxed at half the rate of employment income. If this income was taxed at the normal rate while adjusting for inflation, it would raise at least $7 billion for the federal government and another $3.5 billion for provincial governments.
- ***Financial Activities Tax.*** Most financial activities are exempt from value-added taxes such as the GST and Harmonized Sales Taxes. This results in undertaxation of the financial sector and has contributed to the industry's out-sized profits. A 5% tax on profits and remuneration of the financial sector, as suggested by the IMF, would generate about $5 billion a year in Canada.
- ***Freeze or restore corporate income tax rates.*** Canada now has the lowest corporate income tax rates in the G7: further cuts are not needed. Freezing the federal rate at 18% instead of cutting it to 15% would save the federal government $4.9 billion annually; restoring the rate to 21% would generate $9.7 billion.
- ***Eliminate meals and entertainment deduction.*** The federal *Income Tax Act* has become increasingly complicated and filled with special deductions and loopholes. Eliminating the personal and corporate meals and entertainment expense deduction would save the federal government $450 million a year.

[6] Marc Lee, *Eroding Tax Fairness*, CCPA, November 2007; Armine Yalnizyan, *The Rise of Canada's Richest 1%,* CCPA, December 2010.

Slow job growth clouds recovery

It is now more than two years since the Canadian economy entered a sharp recession in October 2008 and almost a year and a half since the recession officially ended in July 2009.

Total employment is back to the level it was at the start of the recession, but there are still 290,000 more people unemployed and unemployment levels are higher in every province.

The national unemployment rate fell to 7.6% in November, down from 8.6% in July 2009, but it is still considerably higher than the 6.2% rate it was at the start of the recession.

Job growth was relatively strong during the first year of economic recovery for Canada, with an average of 37,000 additional jobs added every month. As this rate of job growth was higher than the monthly growth in the working age population, it succeeded in reducing unemployment levels and rates.

However, since July, employment growth has been much slower, averaging only 8,000 new jobs per month, far below the rate of population growth. We've had a decline in the national unemployment rate, but only because people have dropped out of the labour force and stopped looking for work.

Labour force participation rates have dropped particularly among youth aged 15-24 and in the provinces of Alberta and Ontario. If labour force participation was at the same rate it was at the start of the recession, we would have 240,000 more people unemployed, with 120,000 more jobless in Ontario and an additional 80,000 unemployed in Alberta. Most of the increase in unemployment would be among youth.

At the same time, there has been a steep *increase* in the labour force participation of older workers as more people put off retirement and work, often past the normal retirement age of 60 to 65. Some of these are likely working longer in order to earn income to compensate for losses in retirement savings.

As the latest *Recession Watch Bulletin* from the Canadian Labour Congress mentions, "it is ironic that the decision of so many baby boomers to stay in the workforce is part of the reason why their children are having such a hard time finding jobs."

Also troubling is the fact that there are still 114,000 fewer full-time jobs than there were at the start of the recession. All of the increase in employment from two years ago has been in part-time and temporary jobs: there are 90,000 fewer permanent employees than there were in October 2008.

Employment in construction has increased, but there are 240,000 fewer manufacturing jobs than there were two years ago. There are now fewer manufacturing jobs in Canada than at any time during the 34 years from 1976 to 2009.

Employment levels in CUPE's main sectors have generally continued to grow through the recession:

- Employment in **health care and social services** continues to grow strongly with 158,000 more workers in this sector than at the start of the recession (a growth rate of over 3% a year).
- Overall employment in **educational services** has increased slightly, but the composition has changed considerably. Together with declining school age populations, employment by school boards was falling. This trend has recently reversed, thanks mostly to increased employment by school boards in Alberta and Ontario.
- In direct government **public administration,** virtually all the employment growth in the past two years was in local government and the federal government, with very little increase in direct provincial government employment. More recently employment by both federal and local government has declined, possibly reflecting job losses through attrition and the phasing-out of stimulus spending.

Employment is expected to grow slowly over the next year, increasing by just 1.5%, compared to an average of almost 2% during the past decade. As a result, unemployment rates are expected to improve more gradually.

Inflation: the great divide

Canada's inflation rate has continued to rise, reaching 2.4% in October: its highest level in two years. The rise in Canada's inflation rate is not only defying most forecasts; it's also defying the gravity of a slack and slowing economy. Meanwhile south of the border, the U.S. Consumer Price Index increased by only 1.2%—half the rate of Canada—with fears of deflation outweighing inflation as a concern.

What's the story? In Canada, there's a clear divide: inflation is uniformly higher among provinces that increased or shifted their sales taxes onto consumers during the past year.

Ontario's inflation reached 3.4% in October, the highest rate for more than two years. This followed three months of 2.9% increases after the province shifted taxes from business to households by adopting a Harmonized Sales Tax (HST). The new sales tax isn't the only thing causing increases in Ontario: the cost of electricity has risen by 17% over the past year, natural gas has increased by 15% and fuel oil is up by 19%.

Consumer price inflation in Nova Scotia also exceeded the national average with a rate of 2.9% in October, pushed up by the province's 2 percentage point increase in its HST. The impact of the B.C. government's bedside conversion to the HST was also apparent in the province's inflation rate of 2.4% in October.

In every other province, with the exception of Newfoundland, inflation increased at less than the national average. In fact, the weighted average inflation rate for the provinces that didn't increase their sales taxes works out to 1.4%—a full percentage below the national average.

The uniquely higher increase in the cost of living in Newfoundland is due to two factors. House prices increases haven't let up yet and the cost of energy has increased at a faster rate than in other provinces.

The rising cost of gasoline—up by 8.8% since last year—has increased the cost of living in all provinces. The prices of other fuels have also increased steeply, with the price of fuel oil up by 16.6% nation-wide and natural gas up by 10.6%. The rising cost of fuel oil falls far more heavily on household budgets in Atlantic provinces where there is no natural gas distribution network.

Canada's underlying "core inflation rate" (which excludes the impact of sales taxes and the most volatile components of the price index) remains moderate and astonishingly stable despite all the turbulence in the economy over the last three years. It was up by 1.8% in October, the same rate it has been for the year-to-date and virtually the same as it has been for the past two years.

What this means is the Bank of Canada can't and shouldn't use price pressures as an excuse for increasing interest rates to cool the economy. In fact, Canada's core inflation rate seems to have become almost completely unhinged from what the Bank of Canada sees as the primary cause of inflation. According to the Bank of Canada, core inflation should fall when the unemployment rate rises and increase when the unemployment rate falls and the "output gap" narrows.

Instead, Canada's underlying inflation rate has remained very stable despite big changes in our economy, not only during the last three years, but pretty much since 1991 when Canada first adopted a 2% target rate. Our underlying inflation rate has become much more affected by expectations anchored to the 2% rate than by cyclical changes in the economy, as those at the bargaining table can also attest to.[7]

The Bank of Canada is now reviewing its 2% inflation price target and considering whether it should be changed when its current five year agreement with the federal government expires at the end of 2011. However, this narrow focus on tightly controlling *consumer* price inflation is misplaced.

In recent years it is *asset* price inflation and deflation—booms and busts in the stock market and in housing prices—that has caused far more damage to the economy than changes in *consumer* price inflation. The Bank of Canada may claim it doesn't have the mandate or adequate tools to control asset prices, but it has some of these tools and the federal government has many others. Changes here should include eliminating the tax loopholes for stock options and capital gains that overwhelmingly benefit the wealthy, encourage speculation and helped to fuel asset price booms.

[7] *Shifting Drivers of Inflation—Canada versus the U.S.* RBC Economics May 2010.

Inflation Outlook

While expectations of inflation remain well-anchored to 2% across the country, those in Ontario, British Columbia and Nova Scotia can expect inflation in their provinces to stay higher than average until the middle of next year. A 1% increase in Québec's sales tax on January 1, 2011, will also increase inflation next year.

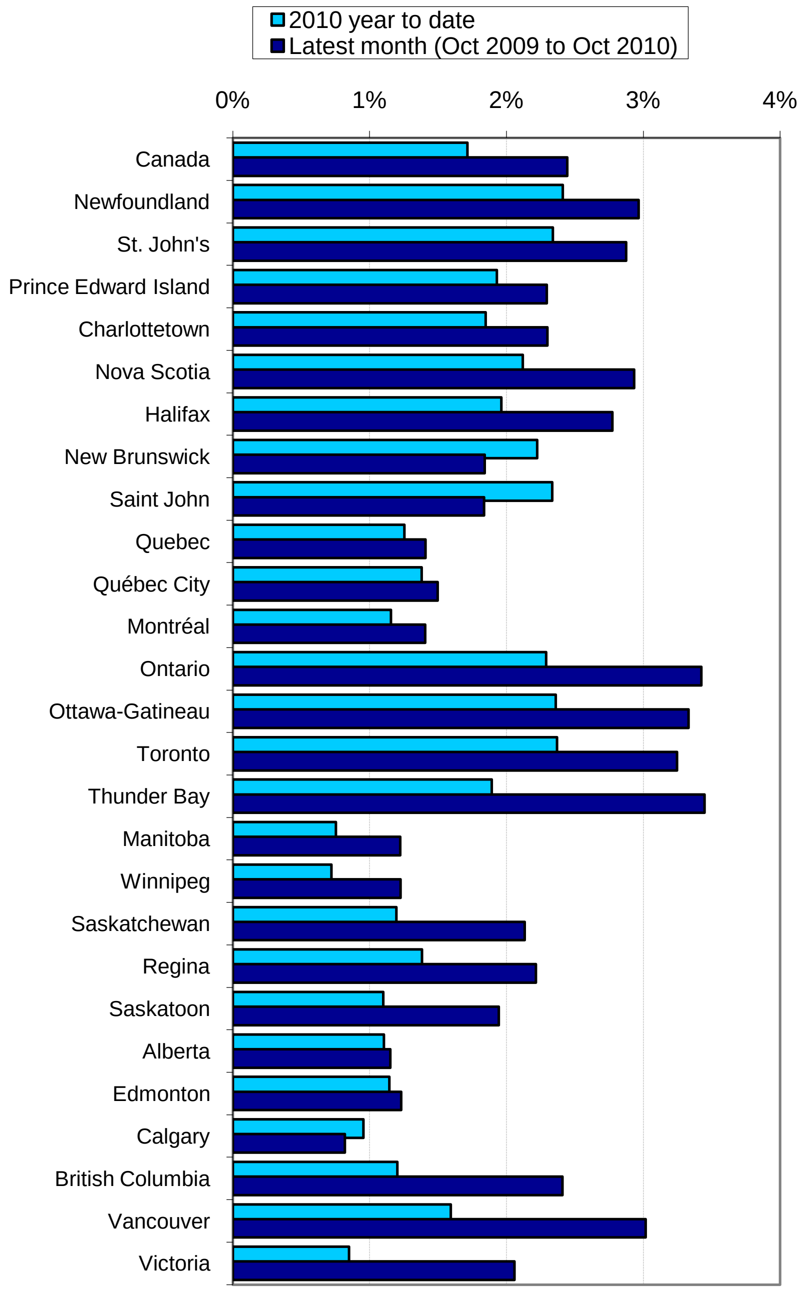
And if oil prices continue to climb, inflation pressures are likely to rise both in the oil producing provinces, and through oil price hikes heating up the cost of living in those provinces more dependent on fuel oil.

On average, private bank forecasters expect inflation to average 1.7% in 2010, rising to an average of 2.0% in 2011. Inflation is expected to be highest in those provinces that introduced or increased sales taxes:

- Ontario's inflation rate is expected to rise by an average of 2.3% in 2010 and by 2.1% in 2011.
- Nova Scotia's inflation rate is expected to increase by an average of 2.2% in 2010 and by 2.0% in 2011.
- British Columbia's inflation rate had been lower than average earlier this year, but it is expected to increase by an average of 2.1% in 2011.

As their economies grow faster next year, inflation rates in Saskatchewan and Alberta are also expected to pick up in 2011. Forecasts for different provinces are shown in the *Provincial Outlook Table* on page 4.

CPI Inflation by Province and City



Data from Statscan Cat # 326-0001

Public sector wage adjustments slide again

Despite rising inflation, average wage settlements continued to decline in the third quarter of 2010, pulled down by falling wage increases for public sector workers.

Base wage increases negotiated in large collective agreements signed in the months of July to September averaged just 1.8% a year. This matched the average rate of inflation reported during this period, but is likely to fall behind price increases for the duration of these settlements.

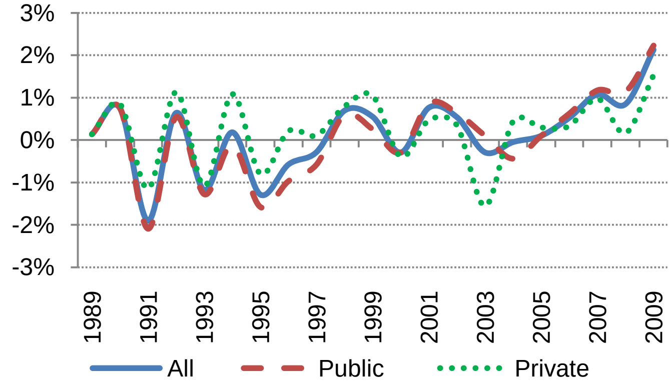
Annual wage adjustments for public sector workers averaged just 1.3% in the third quarter, while private sector workers gained average increases of 2.2%

Wage increases lagged further behind inflation in those provinces where harmonized sales taxes were introduced or increased, including British Columbia, Ontario and Nova Scotia. While the Ontario government announced it is seeking a two-year wage freeze on provincial public sector workers, settlements in the third quarter yielded annual average increases of 2% a year for public sector workers in the province.

Arbitration awards dismissed employers' arguments for a wage freeze and provided average increases of 1.5% to 2.3%. While certainly welcomed, these wage adjustments were below the 2.9% average rate of inflation during this quarter and are likely to lag behind inflation during the agreements. In contrast to previous years, a large majority of the workers covered by settlements reached in Ontario were in the private sector. Many public settlements remain open, adding to the uncertainty.

Wage adjustments in British Columbia have averaged just 0.1% in the first nine months of this year as a result of the two-year compensation freeze imposed by the provincial government. In contrast, workers in Saskatchewan and Alberta achieved average wage increases of 2.9% from settlements in the third quarter. This was about 2% higher than inflation during that time and likely to be higher than price increases for the duration of these agreements.

Real wage increases from collective agreements
All average, public and private sectors



Source: HRSDC average wage adjustments deflated by the consumer price index

Wage increases remain relatively higher for workers in the largely private sector primary industries, construction and finance and professional services. Workers in wholesale and retail trade are finally getting better settlements after two years of sub-par increases, but average wage adjustments for manufacturing workers remain meager.

Declining wage increases for public sector workers are also reflected in downward trending wage increases for workers in public administration and the largely public sector area of education, health and social services.

While much is made about differences between public and private sector wage increases, in fact they closely track each other over time, as the above chart shows. In addition, average increases for both private and public sector workers also positively reflect changes in overall public spending. This suggests that public spending cuts and wage freezes will suppress the wages of all workers, and not just those in the public sector.

This pattern of wage increases is partly reflected in the results of the Conference Board of Canada's *Compensation Planning Outlook* survey of non-unionized employees. Wage increases for these employees are expected to average a "moderate" 2.8% in 2011, with private sector increases of 2.9% exceeding an average of 2.3% for the public sector. Less than 3% of employers—all public sector organizations—are planning to freeze wages.

This survey also shows that workers in Alberta and Saskatchewan can expect the largest wage increases. A number of school board agreements in Alberta have their wage increases pegged to the increase in the province's annual average weekly earnings. This indicator increased by an average of slightly over 4% in the first nine months of 2010. If this trend continues for the rest of the year, then workers with wages based on this indicator can expect a similar increase in their wages next September.

Major CUPE Agreements reported in third quarter of 2010

Employer	Average Increase	Duration (months)
BC Assessment Authority	0.0	24
Gov't of Saskatchewan (non-medical, technical)	1.8	36
Powerstream (municipal utility Ontario)	2.9	36
City of Vaughan (clerical, technical)	3.0	36
York Regional Municipality (inside, outside, paramedics)	2.6	36
Extendicare Ontario	2.3	24
Group TVA Québec	1.7*	36
Telus Québec	1.9*	60
Maritime Employers Association Montreal	2.0	48
Gov't of New Brunswick (health and social care professionals)	1.0	48
Dalhousie University	2.3	36
* Includes COLA clause.		

Major Collective Bargaining Average Wage Settlements by Year and Quarter						
	2008	***2009***	***2010YTD***	***2010Q1***	***2010Q2***	***2010Q3***
All Average	3.2	*2.4*	*2.0*	*2.1*	*2.0*	*1.8*
Public Sector	3.5	*2.5*	*1.7*	*2.2*	*1.8*	*1.3*
Private Sector	2.5	*1.8*	*2.2*	*1.9*	*2.5*	*2.2*
CPI Inflation:	***2.3***	***0.3***	***1.6***	***1.7***	***1.4***	***1.8***

Average Wage Settlements by Province – Major Agreements												
	NL	**PEI**	**NS**	**NB**	**QC**	**ON**	**MB**	**SK**	**AB**	**BC**	**Multi Prov**	**Federal**
2008	*5.0*	*3.0*	*4.0*	*3.7*	*2.4*	*2.6*	*3.4*	*5.1*	*4.8*	*2.5*	*-*	*2.9*
2009	*5.0*	*3.6*	*2.9*	*6.0*	*2.2*	*2.4*	*2.9*	*5.0*	*4.5*	*3.0*	*2.1*	*1.6*
2010YTD	*1.3*	*1.9*	*1.5*	*2.3*	*1.8*	*2.2*	*2.1*	*2.4*	*3.7*	*0.1*	*2.5*	*1.8*
2010Q1	*1.1*	*-*	*2.1*	*2.6*	*1.9*	*2.0*	*3.3*	*-*	*5.6*	*0.2*	*-*	*1.7*
2010Q2	*1.7*	*1.9*	*-*	*-*	*1.7*	*2.4*	*-*	*2.3*	*2.7*	*0.0*	*-*	*2.1*
2010Q3	*-*	*-*	*1.1*	*1.8*	*1.8*	*2.2*	*1.2*	*2.9*	*2.9*	*0.5*	*2.5*	*1.6*
2010CPIQ3	***2.3***	***1.0***	***1.7***	***1.5***	***0.7***	***2.9***	***0.2***	***0.8***	***1.0***	***1.7***	***1.8***	***1.8***

Average Wage Settlements by Industry – Major Agreements						
Industry	**2008**	***2009***	***2010YTD***	***2010Q1***	***2010Q2***	***2010Q3***
Primary	*4.3*	*2.5*	*3.3*	*0.8*	*5.7*	*3.5*
Utilities	*2.3*	*3.0*	*0.6*	*2.9*	*0.0*	*0.0*
Construction	*5.4*	*3.7*	*2.3*	*2.1*	*2.4*	*2.3*
Manufacturing	*1.1*	*1.6*	*1.4*	*1.2*	*1.3*	*1.6*
Wholesale and Retail	*2.8*	*1.8*	*2.9*	*1.9*	*3.9*	*1.8*
Transportation	*3.1*	*1.1*	*2.2*	*3.7*	*1.9*	*2.0*
Information and Culture	*2.0*	*2.1*	*0.8*	*0.0*	*-*	*0.9*
Finance and Professional Services	*2.8*	*2.6*	*3.1*	*-*	*3.1*	*-*
Education, Health, Social Services	*3.8*	*3.0*	*1.8*	*2.1*	*2.4*	*1.3*
Entertainment and Hospitality	*1.9*	*2.0*	*2.2*	*2.4*	*1.2*	*-*
Public Administration	*2.7*	*2.1*	*1.3*	*2.8*	*1.1*	*1.6*

Source: Human Resources and Skills Development Canada, Major Wage Settlements, [latest information as of December 1, 2010] http://www.hrsdc.gc.ca/eng/labour/labour_relations/info_analysis/index.shtml , Consumer Price Index (Statistics Canada 326-0001). Q1 = 1st quarter (e.g. January to March), YTD = Year to Date.

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