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#7

The Meltdown Chronicles

CANADA'S SLIDE TOWARD DEFLATION UNDERSCORES NEED FOR STIMULUS

By Kim Pollock



When Prime Minister Stephen Harper reluctantly tabled a “stimulus” budget in January, many Canadians feared the Prime Minister and his Conservative government were insincere.

It appears those concerns were well founded.

Remember: Harper and finance minister Jim Flaherty had to be forced *on pain of political death* to bring in a stimulus plan in the first place. Churlishly opting in November to stand pat in spite of the worst economic crisis since the 1930s, it took the threat of *removal from office* by a coalition of the three opposition parties

to change the Conservatives’ minds.

Saved by the Liberal Party’s leadership change, in January the Harper government finally introduced a relatively-tepid stimulus budget, neither enough nor the right stuff to stop the Canadian economy’s slide toward recession. The budget lacked substantial measures to improve public services, support the incomes of low-paid workers and the poor, set a positive new course for the economy or provide relief for legions of Canadians likely to lose their jobs.

The budget certainly included dozens of new

spending announcements targeted at every part of the country and many sectors of the economy, as well as over a dozen new *tax cuts*. There were also promises of increased funding for infrastructure, training and Aboriginal Canadians.

But the funding for almost all of these measures is *temporary* – only two years -- conditional on other funding and much less than what is required. That’s a major problem because the impact of the crisis on workers and communities will undoubtedly last longer than two years. Meanwhile many communities face severe budget pressures; under the

“The economic contraction in Canada intensified significantly in the first quarter of 2009. Exports of automotive products, forest product, and industrial materials posted further substantial declines. Firms have started to address their inventory problems, with widespread shutdowns in the automotive sector in particular. Business investment is expected to register another steep decline in response to rising unused capacity and weak terms of trade. Economy-wide, firms cut about 270,000 jobs in the first quarter and reduced the average work week.” -- Bank of Canada, April 2009

“Deflation does not reduce wages ‘automatically’. It reduces them by causing unemployment.” -- J.M. Keynes, 1925

“The amount of economic stimulus in Harper’s plan is less than that provided by most other industrialized countries”

Harper government’s “use it or lose it” rules, hardly any money will flow before the expiry date.

The budget proposed to extend benefits for those who qualify for Employment Insurance but it didn’t include any increase in access to EI or improved benefit levels. There is also nothing to strengthen public pensions, no national anti-poverty plan and no significant increase in investments for early learning and child care, social services or health care. And it seems new Liberal leader Michael Ignatieff is completely satisfied with that.

Worse, ignoring the advice of virtually every economist in the country, the Harper government is charging ahead with *broad-based personal income tax cuts* that will cost about \$2 billion a year and provide their greatest benefit to Canada’s *wealthiest* citizens.

“Hidden, but still included in this budget are the cuts to transfers, controls on program spending, weakening pay equity for federal employees and the privatization plans announced in Harper’s disastrous November Economic and Fiscal Update,” notes the Canadian Union of Public Employees. “This includes limiting growth of transfers under the Equalization program and selling off over \$10 billion in federal public assets over the next five years. These limits on the growth of equalization will mean reductions in transfers by about \$7 billion over the next two years, reducing the ability of provinces to provide and deliver public services across the country.” The budget also continues the government’s misguided policy of forcing municipalities into public-private partnerships and other roadblocks to public investment.



The amount of economic stimulus in Harper’s plan is less than that provided by most other industrialized countries; much of it is in areas that deliver little “bang for the buck”, do little to protect the vulnerable or create jobs and build a more productive economy. Already the Conservatives appear surprised at the sharp rise in unemployment numbers and EI claims.

The Meltdown Chronicles



United Steelworkers
District 3
Special Report

Economic research has shown that the best stimulus comes from measures that restore and increase the incomes of the unemployed and low-paid workers, since they are likely to *spend directly in their communities* any raise in income they receive. Tax cuts, on the other hand, are the poorest form of stimulus since they are most likely to benefit corporations and the wealthy; they’re slow to take effect, more likely saved than spent and disproportionately spent on imported luxury goods.

The Harper plan is not only half-hearted; it has also been extremely slow off the mark. *Globe and Mail* Ottawa bureau chief Brian Laghi wrote recently that Ottawa “has barely begun to trickle out cash as the country’s short construction season shifts into gear. More than three months after (Harper) unveiled measures designed to deal with the economic crisis, few mu-

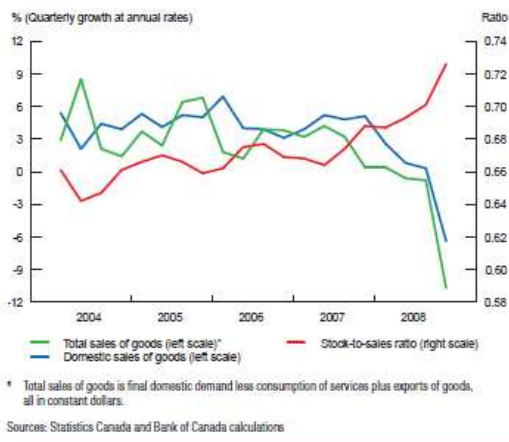
municipalities have broken ground on shovel-ready projects... Critics say the process has been slowed by negotiations over cost-sharing with some provinces and by Ottawa's insistence on vetting applications from municipalities rather than allowing projects to go ahead and having them accounted for later."

Flaherty promised *quick action* when he outlined the stimulus plan in January, even warning that errors would be inevitable in the rush to dole out spending. "There will be some mistakes made. But its worth that risk to help the majority of Canadians during what is a serious recession," he said at the time. And he added: "This isn't business as usual. This is an urgent, extraordinary situation."

So much for Flaherty's sense of urgency! Since then *nearly nothing has happened* except that the Canadian economy is slipping further into recession. Employment grew by 36,000 in April but only because of an increase in *self-employment*, says Statistics Canada's *April Labour Force Survey*. Overall employment has *fallen by 321,000* since October 2008. The unemployment rate was unchanged at 8.0 percent in April, its highest level in *seven years*.

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Chart 8: Sales plunged, and inventories grew



Since last October, in fact, employment in goods-producing sectors has dropped sharply (-6.3 percent). By contrast, employment in the services-producing sector, traditionally less sensitive to economic slowdowns, has decreased only slightly (-0.5 percent). Total employment has declined 1.9 percent, with the biggest losses in construction (-8.5 percent), manufacturing (-6.5 percent) and natural resources (-5.9 percent). But without quick stimulus, you can bet those service-sector numbers will be the next to jump.

Deflation is a real concern...

There is still a real danger that the Canadian economy might fall into a deflationary spiral. Bank of Canada governor Mark Carney told Parliament recently that: "Total inflation will temporarily fall below zero in 2009..." Only in the third quarter of 2011 will prices likely "return to the Bank's 2 per cent inflation target..."

Aggregate prices in fact *fell* by almost 2 percent from September to April, dropping by 0.3 percent in April alone. In response the central bank is desperately trying to stimulate at least some economic activity by slashing interest rates. On 21 April the Bank lowered the policy interest rate by *1/4 of a percentage* point to 1/4 per cent, which Carney said "is judged to be the effective lower bound of the policy rate. Conditional on the outlook for inflation, the Bank has committed to holding this rate at 1/4 per cent until the end of June 2010."

The Meltdown Chronicles



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In fact, since December 2007, the Bank of Canada has cut interest rates by 425 basis points to their *historic lows and lowest-possible* levels. Nonetheless, banks continue to sit on huge cash reserves: since September chartered banks' holdings of Canadian dollar assets have risen by 43.3 percent, indicating a reluctance to lend or an inability to lend profitably.

“The US, then as now Canada’s largest trading partner, was especially severely hit by the global economic downturn of 1929, especially with the dramatic collapse of US agriculture. ”

Deflation occurs when one or another sector of the economy experiences a sudden fall off in orders from other sectors or consumers; this leads to a rapid reduction in orders and falling profits. Firms respond by laying off workers and cutting output. Unfortunately, layoffs in one sector generally mean *further* lost orders and profits in another; companies in that sector therefore also cut output and lay off workers. Without some sort of intervention, the *whole economy* is soon in a downward spiral – fewer orders, falling profits, more layoffs, even fewer orders... and so on down. This makes things *even worse* because both working families and companies tend to put off purchases in hopes of *even lower* prices later on. That becomes a self-fulfilling prophecy that pushes a weak economy even *farther* down. This is what happened during the Great Depression of the 1930s.

... Just as it was in the 1930s.

The US, then as now Canada’s largest trading partner, was *especially severely* hit by the global economic downturn of 1929, especially with the dramatic collapse of US agriculture. By 1932 US manufacturing was down 48 percent from 1929; farm prices were down 44 percent. The stock market was down 80 percent and *25 percent* of the work force was unemployed.

Unsurprisingly, by 1932 *Canada’s* industrial production fell to only 58 percent of its 1929 level. Total national income fell to 56 percent of its 1929 level, worse than any nation apart from the United States. Unemployment reached *27 percent* during 1933. Exports shrank by 50 percent from 1929 to 1933.



Then as now, as well, the root problem was a sustained, long-term fall in the rate of profit. The graph below shows that just as they have in recent decades, in spite of determined efforts by corporations and governments in the advanced countries, profits – especially in manufacturing – fell almost steadily from about 1890 right through the end of the 1920s, when the economy collapsed suddenly and drastically. Economic historian Michael Barrett Brown actually traces the start of the drop in profits to the late 1870s with the exhaustion of the initial burst of economic growth began during the Industrial Revolution and carried on by Britain’s massive exports of railways and other capital goods.

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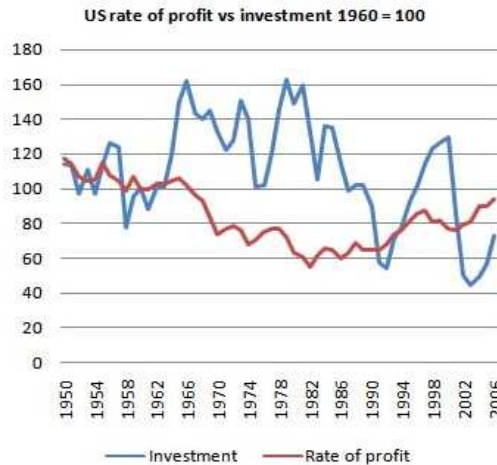
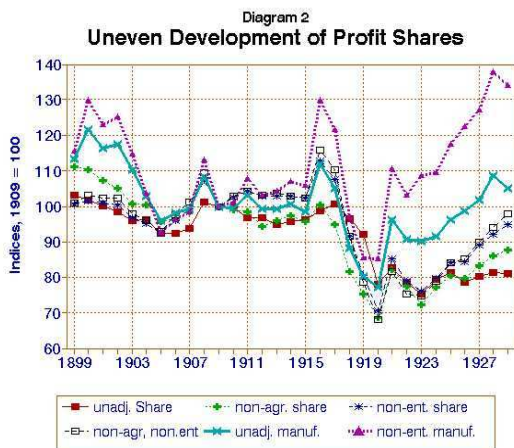
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Journalist John Judis wrote recently in the *New Republic* that “well before 1929 there were rumblings of trouble in the American economy--not only in the stock market bubble, but in

overcapacity in key industries like auto, and in the rise of technological unemployment.” In spite of massive offshore investments, attempts to curb trade unionism and efforts to lower real wages by importing cheap food and consumer goods, the rate of profit still tended downward over several decades.

Economist James Devine observed in a 1994 article in *Research in Political Economy* that: “the US economy as a whole suffered from declining profit rates during the first two decades of this century (1900-1920)... Most data also show a steep profit-rate fall immediately after the (First World) war.” Canada also saw declining profits; according to economic historians W.T. Easterbrook and Hugh Aitken: “For two brief spells, roughly from 1913 to 1915 and from 1921 to 1924, economic expansion *came to an abrupt halt* and in each of these periods there appeared the prospect of a lengthy and painful adjustment...”

“The Conservative Party government elected in Canada in 1930 made things worse.”



Then as now as well, falling profits translated into falling investment; that in turn meant a reduction in labour income and reduced purchasing power for working families. Unfortunately for corporations, falling purchasing power meant falling orders, layoffs – and again, so on down. Employers made things *even worse* by slavishly adopting free-market strategies: they cut wages and drastically reduced their workforces. This of course further reduced demand for their products. Governments *added* to the deflationary cycle, doggedly balancing their budgets even when it meant severe cuts in public-service payrolls.

The Conservative Party government elected in Canada in 1930 made things worse. Prime Minister R.B. Bennett’s hardline pro-business, pro-banking agenda provided little relief to millions of increasingly desperate and angry unemployed workers and hard-hit farmers. Despite the economic crisis, market economics remained Bennett’s guiding principle, just as it did for Herbert Hoover’s Republicans in the US. Government relief to the unemployed was seen as a disincentive to individual initiative, so it was only granted in minimal amounts, attached to insulting or demeaning work programs.

Fortunately for American workers, Hoover was defeated by the Franklin D. Roosevelt’s New Deal Democrats in 1932; unfortunately for Canadians, Bennett *remained* in office until 1935. Roosevelt’s efforts to generate economic activity through public spending and huge infrastructure projects slowed the growth of unemployment as this graph shows. But in Canada, the

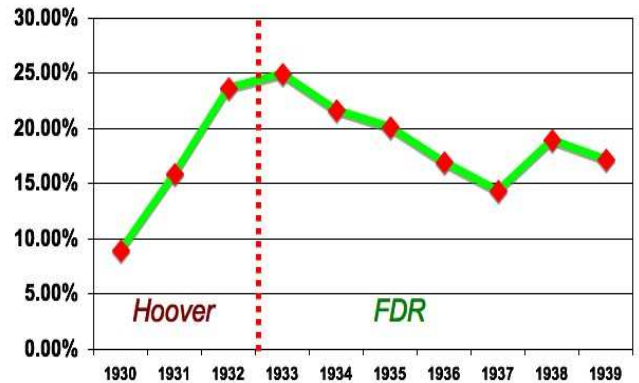
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District 3
Special Report

Conservatives gave way to *another* lukewarm figure, Liberal Mackenzie King. King was hardly more willing than Bennett to stimulate the economy.

Certainly prior to his defeat in 1930, King showed little urgency. The *Dictionary of Canadian Biography* reports that his massive diaries didn't even *mention* the market collapse of 1929; he "found the talk of unemployment exaggerated - in 1930 the Dominion Bureau of Statistics was only starting to register a drop - and surely next spring would bring higher prices and more jobs. It was, King believed, a temporary recession and just patience was needed."



"It was only with the onset of war in September 1939 that the Canadian economy began to recover."

Back in office in 1935, King again did little to improve the economy or help workers and farmers. Although the economic situation continued to be desperate – when the Democrats relaxed their stimulative measures in 1936, the economy actually appeared to *relapse* in 1937 after a weak recovery – King still only reluctantly agreed to modest government deficits in 1938 and 1939.



It was only with the onset of war in September 1939 that the Canadian economy began to recover. As former Saskatchewan premier and NDP leader Tommy Douglas said, the unemployed "rode boxcars across the country until the war came. And then (the government and corporations) found all the money and the clothes and everything they need to look after the boys in the way they hadn't done before the war."

The Meltdown Chronicles



United Steelworkers
District 3
Special Report

Surely We Can Do Things Better This Time...

Surely we needn't wait for war to stimulate Canada's economy today?

Yet here we find ourselves in much the same situation as in the 1930s. While a US president takes steps to reflate the economy and to create jobs, the government of Canada seems content to ride on America's coattails. And the same Liberal Party that a few months ago accused Harper of doing too little to stimulate employment now carps about the growing *deficit!* And while President Barack Obama reinforces the US's Buy American program, the Harper government *carps* about the US program instead of adopting a similar strategy for Canada.

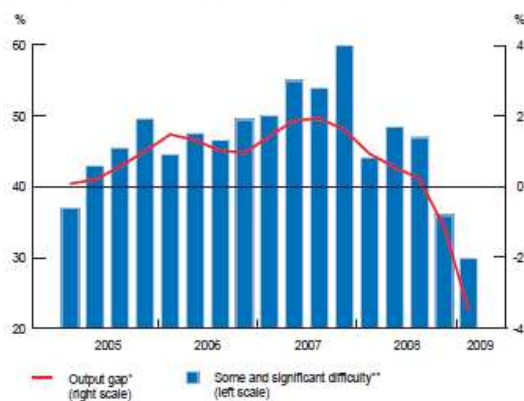
With Canada's response to the recession lagging behind that of the US, it's not really a surprise that Canada's gross domestic product declined 1.4 percent in the first quarter, its largest decrease since 1991. Lower corporate spending in Canada and the US—particularly investment in factories and equipment—led to a sharp decline in Canada's exports and imports. Business investment in Canada fell at the fastest rate since 1982, according to Statistics Canada. While resources lie idle and people are unemployed, they refrain from or delay needed and useful investments. While there is need, hunger, homelessness and unemployment, government and industry wait.

In the US by contrast, the economy is still slumping but the slide is already slowing down. The US economy fell at an annualized rate of 5.7 percent in the first quarter, representing a slight improvement from the 6.1 percent first-quarter decline predicted in April. The revision came from upward adjustments made to exports and inventories, while profits saw their first increase in seven quarters.

In the fourth quarter of 2008 as well, Canadian industries were already operating at just 74.7 percent of capacity, down from 78.1 percent in the third quarter, down almost 10 percent from a year before. Capacity utilization was already at its lowest rate since Stats Can began collecting the data in 1987. Canada Mortgage and Housing Corp recently lowered predictions for housing starts for this year: it now expects 141,900 starts in 2009, 11.4 percent below the forecast of 160,250 it made three months earlier and a 33 percent drop in new construction from 2008.

“As in any capitalist crisis, in other words, paper wealth has evaporated or is being hoarded while useful machinery, equipment, and raw materials ”

Chart 9: Economy operating well below potential



* Difference between actual output and estimated potential output. The estimate for the first quarter of 2009 is based on a projected decrease in output of 7.3 per cent (at annual rates) for the quarter.
 ** Response to Business Outlook Survey question on capacity pressures. Percentage of firms indicating that they would have either some or significant difficulty meeting an unanticipated increase in demand/sales
 Source: Bank of Canada

Business fixed investment is expected to contract sharply in 2009, reports the Bank of Canada, “reflecting a drop in corporate profits, tight credit conditions, weak commodity prices and the uncertain economic outlook.” And since 2007, reports the Bank of Canada, “the major banks have reported cumulative capital market write-downs of almost \$12 billion on a pre-tax basis.”

As in any capitalist crisis, in other words, paper wealth has evaporated or is being hoarded while useful machinery, equipment, and raw materials – not to mention, of course, workers themselves – are unused, underemployed or unemployed. They are not sitting idle because they are somehow suddenly useless; they aren't being used because it isn't *profitable* for corporations to employ them.

Corporations, however, are perfectly happy to allow this situation to continue. Wealthy individuals can live off their savings; companies and banks either cut output or reduce operations to match demand or live off their reserves.

The Meltdown Chronicles



United Steelworkers
 District 3
 Special Report

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Workers Can't Wait...

The situation is much different for working people, however. Most workers live virtually from paycheque to paycheque. A sustained fall in income or long-term unemployment represents a serious crisis for most working families. There were 10,578 personal bankruptcies filed during April, up 57 percent from 6,736 in March 2008, the federal Office of the Superintendent of Bankruptcy reported recently. On a monthly basis, consumer insolvencies were up 17.3 percent from 9,020 in February. Working families are not just losing their jobs; they're also becoming maxed out on credit cards, mortgages and other consumer debt. That's why economic stimulus matters.

It's about time, then, that the Harper government got its priorities straight. While Harper's supporters in the boardrooms sit back and wait for recovery, many average Canadians are hurting. An economic stimulus plan should include income support for the unemployed and the poor, not just to help people through tough times but to stimulate production and investment by increasing consumer demand. Ottawa should move immediately on a *beefed-up* program of investments in transportation, alternative energy, sustainability upgrades and industrial restructuring. And we should take this opportunity to improve human services like health care, education, training and child care.

Long ago British economist John Maynard Keynes suggested that: "If the Treasury were to fill old bottles with bank notes, bury them at suitable depths in disused coal mines which are then filled up with town rubbish, and leave them to private enterprise on the well-tried principles of laissez faire to dig them up again... there need be no more unemployment and with the help of the repercussions, the real income of the community and its capital wealth also would probably become a great deal greater than it actually is..."

Keynes also observed that more useful investments were certainly possible – home construction, for instance. "But if there are political or practical difficulties in the way of this, the above would be better than nothing." Canadians know there are *plenty* of urgent needs in our society and lots of *better* ways to stimulate the economy. It's really a question of political will. ♦

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United Steelworkers
District 3
Special Report