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RECENT CANADIAN BORROWING ABROAD
Its Nature and Implications

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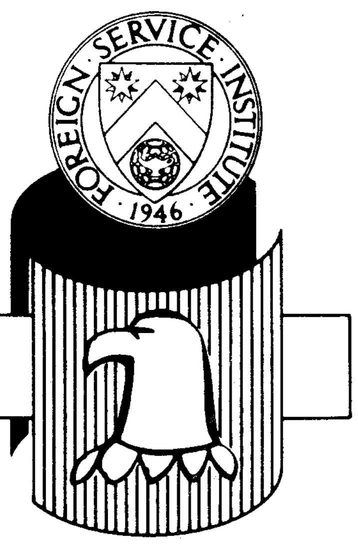

NINETEENTH SESSION

SENIOR SEMINAR IN FOREIGN POLICY

DEPARTMENT OF STATE

1976 - 1977

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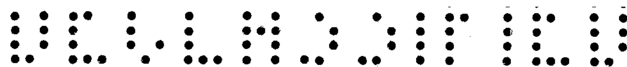

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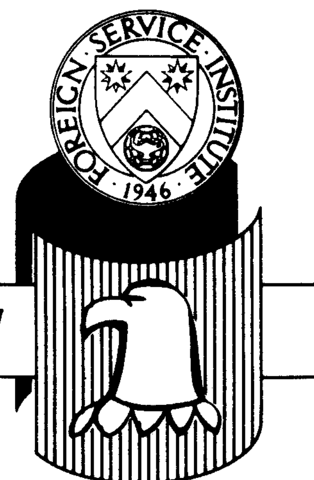
Case Study by GEORGE B. ROBERTS



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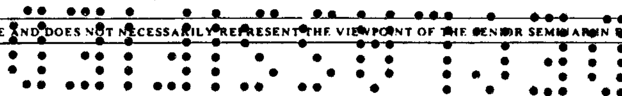

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RECENT CANADIAN BORROWING ABROAD
Its Nature and Implications

by

George B. Roberts

SUMMARY

Canada has borrowed money for decades, but in the past two years the amount has ballooned to levels which appear unsustainable and which will impose a heavy debt service burden in the future. Much of this burden will be thrown on the Canadian economy as a whole.

Removal of the withholding tax on foreign interest payments, lower interest rates in the United States, and a recession-induced good supply of lendable money in the U.S. have all combined to bring about the recent surge in foreign borrowing by Canada. At the same time, however, a shift into a deficit in the energy trade, a growing deficit in the travel and debt service accounts, and a large increase in Canadian manufacturing costs have all created doubt as to the viability of Canada's balance of payments.

Proposed remedies for this situation include depreciation of the Canadian dollar, continued price and wage controls, and encouragement of Canada's export-efficient natural resource and primary-processing sectors. All these remedies entail difficulties, however, particularly in the realms of inflation, governmental interference in the economy, and unemployment. Greater economic integration with the United States would create industrial dislocations and problems with Canadian nationalism.

Canada will have a difficult time coping with its balance of payments and debt service over the next few years. Since the United States much prefers to have a peaceful and self-confident northern neighbor, it will be to our interest if the Canadians find a way to do it.

Senior Seminar in Foreign Policy
April 1977

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This paper was prepared as a Case Study in connection with the Nineteenth Session of the Department of State's Senior Seminar in Foreign Policy. It grew out of a visit the Seminar made to Toronto in October of 1976, during which the author first became aware of Canada's recent heavy foreign borrowing.

The author is not an economist nor has he ever served in a developed, industrial country. Any mistakes or unwarranted biases evident in this paper are thus his responsibility alone and not that of the many people who so kindly shared their time and opinions with him in the course of researching the paper.

George B. Roberts
March 1977

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Canada has traditionally borrowed money from foreigners. In 20 out of the last 25 years, for example, Canada has borrowed more than it has lent outside the country.[1] Canada's railroads were built with borrowed British capital, and the great expansion of Canadian industry after World War II was the result of U.S. equity investment. Canadian capital imports are nothing new.

The ratio of Canada's foreign debt to Gross National Product (GNP) has been even higher in the past. During the period from 1955 to 1960, the foreign debt to GNP radio was above the current approximately 25%.[2] At the moment, Canada owes roughly $50 billion in foreign debts and has a GNP which is approaching $200 billion. The net foreign exchange outflow to service this debt is still only about one percent of GNP,[3] though the burden is growing.

With this in mind, the question naturally arises as to why anyone should be concerned about recent Canadian borrowing abroad. The answer is twofold: first, the borrowing in 1975 and 1976 was unsustainably large, and second, there have been basic structural shifts in the Canadian economy in the past few years which have made it and will continue to make it difficult for Canada to service its growing external debt.

The Amounts Recently Borrowed

During the 1960's, Canada's foreign borrowing averaged about $460 million a year.[4] In the early 1970's, U.S. balance of payments problems produced concern over capital exports, and the level fell off. It then ballooned to $4.3 billion in 1975 and $8.6 billion in 1976.[5] Most commentators think that the 1976 rate will not be sustained but that 1977 will still see inflows in the four to five billion dollar range.

The recent borrowing is not only unusually large, but it raises the question as to whether such inflows might be, to use the word of a prominent American investment banker, unsustainable.[6] Most countries, and not just Canada, have imported capital to finance their development, and as long as the imported capital adds to the nation's productive capacity. there is no cause for concern. The borrowed money increases the borrower's ability to service and ultimately to repay the debt. If, for example, we assume that over the next four or five years the Canadian economy will have an average GNP of about $200 billion and will grow at a rate of about five or six percent, then Canada could borrow $2.5 to $3 billion a year without increasing the current 25% ratio of debt to GNP. The size of Canada's external debt would grow but Canada's ability to bear the increasing burden would also grow.

It is evident, however, that Canada has been increasing her external debt faster than she has been increasing the GNP which services the debt. This fact becomes even clearer when we note that Wood Gundy, one of Canada's largest investment banking firms, estimates that the Canadian economy grew .6% in 1975, 4.9% in 1976, and will grow only 3.8% in 1977.[7] The Conference Board in Canada estimates that the Canadian econony will grow only 3% in 1977.[8] This latter figure would make $1.5 billion the foreign borrowing limit if Canada were to maintain a 25% debt to GNP ratio. (There is nothing sacred about this ratio. It is only used in this paper as a means of telling whether Canada's debt burden is growing or shrinking.)

There is also some doubt in the minds of those who watch the Canadian economy as to whether the money Canada has borrowed has really contributed to the country's ability to service its foreign debts. Borrowing which increases a nation's GNP should not increase its debt burden, but when the borrowing is from foreigners, when it is denominated in foreign

currency, and when it thus must be serviced in foreign currency, a simple increase in the GNP as a whole is not enough to keep the debt burden from increasing. That portion of the country's economy which produces foreign exchange must increase proportionate to the foreign borrowing if the debt burden is not to increase.

The most obvious example of foreign borrowing which has not increased Canadian productive capacity -- foreign exchange or otherwise -- is Quebec's borrowing to fund its Olympic debts. This expenditure undoubtedly increased tourist revenues in 1976, but the Olympics are now over, the tourists are gone, and Quebec and the City of Montreal are stuck with the bills. Paying them will be a net drag for some time to come. The same is true for the relatively small Canadian provincial and municipal borrowings to cover deficits and public facility capital costs.[9]

Less obvious burdens on the Canadian economy are the large borrowings by such huge provincial public utilities as Hydro Quebec and Ontario Hydro. There is no question that the money has gone to productive purposes and that it has been well spent. Hydro Quebec enjoys a generally accepted reputation as "the best managed utility in North America," and as a provincially-owned corporation it enjoys a coooperative rather than adversary relationship with the authority which sets its rates. Its James Bay hydroelectric project is the largest construction effort under way in the world at the present time. It will produce some 10,000 megawatts of power when complete, and the first 5,000 megawatt phase is due to come on line in 1981.[10] Ontario Hydro has long been a favorite of U.S. lenders and is a leader in the development of nuclear power.[11]

There is some question, however, as to whether these utilities will be able to make a direct contribution to Canada's ability to generate foreign exchange. Ontario Hydro, for example, estimates that the long-term demand for electricity in the Province will grow at a rate of about seven percent a year. Nevertheless, in order not to overstrain Ontario's credit status (the Provincial government guarantees all of Ontario Hydro's borrowings), the Province has told Hydro that it should plan on having only enough borrowed capital to increase load capacity at a rate of about five to six percent a year.[12] This means that any available surplus of electricity for export to the United States -- such export sales amounted to $101.1 million in 1974, $41.8 million in 1975, and $86.8 million in 1976[13] -- will probably shrink if not disappear. Ontario Hydro might even want to import power from the U.S.

Hydro Quebec faces a similar situation. Its load growth projections are also seven percent per year. The Treasurer of Hydro Quebec, Georges Lafond, thus expects only to be able to export "triangles and footballs." (Triangles are the short-lived power surpluses which become available immediately after new power sources come on line but before steadily-growing demand has caught up to the supply. Footballs are seasonal surpluses -- summer in Quebec and winter in the U.S.) Despite Brian McKenna's statement in the Canadian Sunday Supplement Magazine, Weekend, that "the power flows south to the money,"[14] Lafond does not expect that Hydro Quebec will be able to export James Bay power to the U.S. on any steady, dependable basis.[15] In fact, Lafond said that Hydro Quebec had had a very difficult time getting permission from the Canadian National Energy Board to build a 735 kilovolt transmission line to the New York state border to export Hydro's triangles and footballs. Ontario had fought the line on the basis that neighboring provinces should get first call on Quebec's surpluses, not the U.S.

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It is thus evident that although the money borrowed by Hydro Quebec and Ontario Hydro will undoubtedly increase the electricity available for consumption in Canada, it may not directly produce any increase in Canada's ability to earn foreign exchange. The foreign exchange load of servicing the Hydros' foreign debt will thus most likely be thrown on the Canadian economy as a whole. In recent years the Canadian economy has built up a poor record as a generator of exports and foreign exchange.

Reasons for the Recent Heavy Borrowing

Before discussing Canada's recent performance as a foreign exchange earner, it would be useful to look at the reasons for the surge in Canadian foreign borrowing during the last two years.

The first and most obvious reason was the removal of the 15% Canadian withholding tax on foreign bond interest payments in 1975. This was a conscious move by the Canadian Government to encourage foreign portfolio (debt) investment in Canada rather than direct (equity) investment. Direct investment was felt to have become politically less desirable to the extent it involved (and already had involved) the loss of Canadian ownership and control of important sectors of the Canadian economy. The problem with debt investment, however, is that interest has to be paid irrespective of how well or badly the enterprise is doing, and in the case of bonds denominated in foreign currency, the interest has to be paid in foreign exchange.

Another reason for the surge in Canadian borrowing was -- and still is -- the difference in interest rates between the United States and Canada. In an effort to damp down inflation in 1976, the Bank of Canada kept its bank rate at 9 1/2% for most of the year.[16] With the U.S. still struggling out of a recession, with U.S. housing activity still down, and with a realtively easy, anti-recession monetary policy by the U.S. Federal Reserve, American money was available for about two full percentage points less than Canadian. The big U.S. insurance companies -- "the Mets and the Prus" -- were literally bulging with cash. Premium money kept pouring in, but with construction and business activity down, there were few good places to invest it. There are stories of insurance company investment managers calling investment bankers begging them to take money off their hands. Usually the shoe is on the other foot.

It is no wonder, then, that such high-quality borrowers as Hydro Quebec and Ontario Hydro found a ready market in the U.S. for their paper and at far better interest rates than they could get in Canada. They also found the traditional advantages to borrowing in the U.S: sophisticated institutions with long experience in managing loans, a large market which could absorb billion-dollar issues easily, and an established willingness to finance reasonable risks over the long term. Despite Canada's high internal savings rate, Canadian capital markets tend to be small and thus have difficulty in absorbing such large borrowing lumps as Hydro Quebec's billion-dollar James Bay issues. They also tend to have relatively conservative lending policies. European capital markets are becoming more important -- Canada raised some $3 billion in them last year -- but they still prefer to lend for only five to seven years and have yet to come up with much of the twenty and thirty year money available in the United States.

As the U.S. economy picks up, the spread in interest rates between the United States and Canada should narrow. U.S. construction activity is still weak, however, and the nervousness created by Quebec separatism still exerts an upward influence on Canadian interest rates. The spread will still be there. Hydro Quebec still has money left over from its 1976

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borrowings, so it should be in the market for only $500 to $600 million in 1977.[17] Canadian borrowing in 1977 will thus be down from its very high 1976 levels, but it will still be well over a rate which would hold the overall amount of foreign debt at 25% of GNP.

Structural Shifts in the Canadian Economy

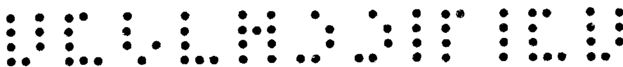
In a paper presented to the Liberal Party conference in Toronto in March of 1977, John Kettle, a futurist consultant, said, "Canada's international trade is in bad shape and almost certain to get worse. The reasons why it is ailing are many; most of the reasons will cause it to continue to deteriorate. By the end of the 1980's the trade situation is likely to have damaged the Canadian dollar severely, cut our standard of living, reduced our options in important areas, increased unemployment and probably inflation too, and put us more firmly at the beck and call of the United States."[18] Somewhat more temperately, Charles A. Barrett, in a study prepared for the Conference Board in Canada, says, "The medium-term outlook for the growth of Canada's international trade and for the balance of payments is not encouraging."[19] Why is this so? What has happened? Canada has often run payments deficits, but in 1970 it ran a nice $1.1 billion current account surplus, and as recently as 1973 its current account was slightly in the black.[20]

Judith Maxwell, in her Policy Review and Outlook, 1977: An Agenda for Change, prepared for the C. D. Howe Research Institute, gives four basic reasons for doubt as to the viability of Canada's current international payments. The first is in the realm of energy. Canada used to be a net energy exporter. The country's energy export earnings briefly peaked at well over a billion dollars just after the OPEC embargo, but the Canadian government quickly realized that its proved reserves would soon disappear if Canada continued to export oil. Canada should become a net oil importer by the end of this year, and by 1982 the energy trade deficit will be approaching $3 billion.[21] Gas may well be found in the Far North, but no one knows whether the discoveries will be exploitable and marketable.

There has also been a marked shift in the past few years in the Canadian travel account. The deficit this year is about a billion dollars. Canadians flock to the South Jersey Shore in summer and to Florida in winter, and vacation trips to Europe are becoming more and more common.[22]

Canadian interest obligations in foreign exchange have ballooned along with the borrowing they service. By 1975 total foreign debt stood at $43 billion, with service payments just under $2 billion.[23] Foreign debt is currently pushing toward $50 billion, and interest rates for new issues are currently in the eight to nine percent range.[24] This would indicate that the foreign exchange annual debt service burden will move toward $4 billion, or two percent of GNP. Maxwell comments as follows: "If interest payments ballooned from the current one percent of gross national product to, say two percent, the debt burden would create such a large current account deficit that there would be severe and continuing deterioration in that deficit as the country borrowed simply to pay interest on its debt."[25]

The energy, travel, and interest payment picture is depressing enough, but the real gloom comes when one looks at recent developments in Canada's manufacturing sector. Maxwell refers to the "maturation of the Canada-U.S. Automotive Agreement" -- the completion of the boom in rationalizing investment in Canadian automotive facilities just after the Agreement was signed. After several years in which Canada ran a surplus in its



international automobile trade, the account has now turned into a deficit. Canada is still assembling automobiles at a good pace, but more and more parts are being imported as the companies discover that they can be made more cheaply south of the border or even outside North America.[26]

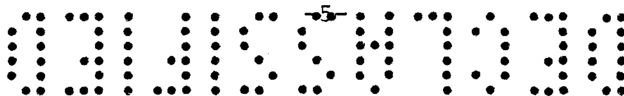
These changes in the automotive industry are symptomatic of a basic change which has affected the whole of the Canadian manufacturing sector. The lack of a recession as severe as the one suffered in the United States was a cause for self-congratulation in Canada, but the piper is now asking to be paid. Canada's wage level moved upward at a rate of about twelve percent a year from 1969 through 1976, with the result that Canada's labor costs rose more quickly than those in the United States. In fact, U.S. labor costs per unit of output went down in 1976.[27] With a three dollar minimum wage in Quebec, for example, more and more Canadian firms are finding it advantageous to invest and manufacture in the United States. While in Canada, I was told of a Canadian toy manufacturer which had decided to expand in Plattsburgh, New York, and I was half facetiously told by a banker in Toronto that if I were to quit the Foreign Service and set myself up as a salesman of small to medium-sized U.S. companies, I could make a million dollars in no time peddling these firms to Bay Street businessmen looking for places to put their money outside Canada.

Without exception, the people to whom I spoke in Canada[28] said that "We have to get our costs in line." Canada has always been a high-cost country in which to manufacture finished merchandise. As a matter of national policy, Canada set out many years ago to create a one-tenth size scale model of the U.S. economy, complete with a fully-developed, modern industrial sector. The vast distances, harsh climate, and smaller market made this effort very expensive. The lower productivity of this mini-America means that, according to one Toronto banker's rough estimate, Canadian wages ought to be about 85% of U.S. wages if the finished Canadian products are to be competitive with U.S. products in North American and world markets.[29] At the present time, however, Canadian wages in many industries are higher than in the U.S., hence the rush of Canadian firms to set up shop south of the border. Hence also the deterioration of Canada's trade in "end products" from a $2 billion deficit in 1962 to a $10 billion deficit in 1976.[30]

The result of this situation was put perhaps most eloquently by Prime Minister Trudeau in a speech in Toronto in March 1977. "The (Canadian) dollar fell about ten percent in the last year. Why? Because we're no longer as competitive as we should be, because we can't sell as much in foreign markets, because we're not as productive, because our cost is too high, because our labor is asking too much, because our entrepreneurs are not as bright." [31]

Options for Action

Despite the unanimity about getting costs in line, there is far less unanimity, as might be expected, about how to do it. One suggestion, and one that has been used by many other countries facing balance of payments problems, is to depreciate Canada's currency. The freely-floating Canadian dollar was pushed up to unusually high levels in 1976 by Canada's heavy foreign borrowing. The foreign currency proceeds of these loans were converted into Canadian currency in order to pay bills within Canada, thus creating a strong demand for Canadian dollars. With the Bank of Canada following a tight-money, anti-inflationary program, the price of Canadian dollars rose, thus creating, in the words of a Bank of Canada official, "the greatest levitation act since Houdini" [32] in the face of a huge balance of payments deficit.



A Canadian dollar at U.S. $1.03 or $1.04 was helpful from the anti-inflation point of view, since consumer demand could be met by cheaper foreign imports. It was hardly helpful, however, to the end products trade balance, and it also stimulated Canadian investment outside the country. Cheap U.S. dollars and low U.S. wages were too much for Canadian investors to resist.

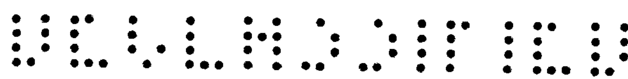
According to those who call for a cheaper Canadian dollar, a lower exchange rate would make Canadian manufactured exports cheaper and imports more expensive, thus bringing the trade figures back into balance. Britain has been seeking to do this for years. The problem is that in any country -- such as Canada -- in which consumers rely to any great extent on imports, the pressures for compensatory wage increases to make up for the greater cost of living become very difficult for managers and politicians to resist. Wage demands are usually granted, and the country is back where it started before the currency was depreciated.

In addition to the internal inflationary pressures, there is the perverse J-curve lag in the effects of a currency depreciation. The cheaper currency means that exports sell for less and thus export receipts are less until volume catches up -- assuming that demand for the exports is elastic enough to create bigger volume. Imports cost more, so until import volume falls off -- which again requires good elasticity of demand -- import expenditures go up. While these hoped-for elasticities are working themselves out, the country is worse off than it was before the currency was depreciated.

A lower exchange rate would create special problems in Canada. The best, most easily sold Canadian exports are natural resources and merchandise which has been through only primary processing. The prices of such items are set by world markets and are usually expressed in U.S. dollars. A cheaper Canadian dollar will increase the profits of Canadian natural resource producers and primary processors, thus strengthening an already strong sector of the economy. This sector tends to be capital rather than labor intensive. A cheaper Canadian dollar may thus help Canada's balance of payments in the long run by strengthening the export sectors, but it will not do much for Canada's unemployment problem. More about this later.

Another special problem with respect to a lower exchange rage for Canadian currency has to do with debt service. The great bulk of Canada's recent foreign borrowing has been denominated in foreign currency, usually U.S. dollars. When the Canadian dollar was at U.S. $1.03 and one of the big provincial utilities borrowed U.S. $1 billion, the utility received roughly $970 million in Canadian currency with which to pay its construction costs in Canada. When the Canadian dollar falls to U.S. $.95¢, as it now has, this means that the provincial utility will have to come up with service payments on a debt which is now worth roughly $1.05 billion in Canadian currency. This amounts to an extra interest charge on the loan and an extra burden on the Canadian economy. If the interest rate spread between Canada and the U.S. is still great, this extra interest charge can still leave the utility in a better position than if it had borrowed in Canada but still not as well off had the Canadian dollar stayed at or above par. The Treasurer of Ontario Hydro told me that his firm would still be protected with respect of its entire borrowing program if the Canadian dollar went as low as U.S. $.85¢, but he made it clear he would rather it didn't.[33]

The Honorable Walter Gordon, former federal Minister of Finance, is a particularly strong advocate of depreciating the Canadian dollar. When asked about the inflationary consequences of such a policy, Gordon called



for lower interest rates. Cheaper money, Gordon believed, would hold down the cost of housing and of consumer credit in the face of more expensive imports.[34] The problem with this policy package is that in order to keep interest rates low, the Bank of Canada would have to increase the money supply, thus creating what would probably be irresistible inflationary pressures. Prices and wages would move up and remove the temporary advantage of a cheaper Canadian dollar.

Canada's Ministry of Finance seems to favor continued price and wage controls as the best way of keeping the country's costs in line. This view is shared, understandably, by the staff of the Canadian Anti-Inflation Board. No one thinks that controls can be kept on forever -- they are too difficult to administer and they ultimately create serious distortions in the economy. Assistant Deputy Finance Minister Hood and Anti-Inflation Board Executive Director Johnstone both think, however, that a carefully phased lifting of controls followed up by a vigorous jawboning program would be the best way of maximizing the benefits of controls as long as possible while minimizing the costs.[35]

Arguments for and against controls will probably never end. Those for them point out that when vigorously and efficiently applied, they stop the rise in prices. Those against them point out that they only suppress symptoms of underlying forces in an economy, and when the controls are removed, even if done in a careful, phased manner, the forces are still there. Anti-controllers point to the increased government interference in people's lives, the delay or distortion of business decisions, and the ultimate flight of capital and talent to other sectors or even to other countries where there are fewer or no controls. Pro-controllers point to the relative success of U.S. price control during World War II; anti-controllers point to the horrors of rent control in New York. The general consensus seems to be that while controls may have a beneficial shock effect in getting poeple to abandon undesirable inflationary expectations, the longer they go on the worse they get and they have to be removed sooner or later.

Most of the bankers and brokers to whom I spoke agreed that the best way to attack Canada's debt service and balance of payments problems would be to encourage the export-efficient natural resource and primary processing economic sectors. Canada's rich earth will always be an excellent producer of mining income, and if energy demand in Quebec should grow more slowly and if nationalist sentiment should not get in the way, Quebec could export hydroelectric power to the U.S. There was somewhat less optimism with respect to Canada's forest industries. The U.S. Jones Act (no foreign ships can carry cargoes between U.S. ports) gives British Columbia forest producers an advantage over U.S. Pacific Northwest producers in American east coast markets, but high Canadian wages mean that Oregon foresters can beat Canadian competition when markets are accessible by truck or rail.[36] A new development is the growth of the pulp and lumber industry in the U.S. southeast. A tree grows much faster in Georgia's warmer weather and longer growing season than it does in Quebec, and new varieties of trees increase still further the rapid turnover advantage of U.S. southeastern forests.

The employment effects of stressing the natural resource and primary processing sectors are even more difficult to accept, especially when one realizes that stressing these sectors could mean putting less emphasis on the labor-intensive but export-inefficient manufacturing sector. About 2,500 workers were employed on the James Bay project in March of 1977, and during the coming summer the number will rise to four or five thousand. When the dams and powerhouses are built, however, it will only

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take a few hundred people to watch over the production of 10,000 megawatts of electricity. Mining, lumbering, and papermaking in Canada are highly mechanized, and stressing these industries will not do much for a Canadian unemployment rate which had hit 7.5% by the end of 1976.[37]

There are several reactions to this employment vs. balance of payments dilemma. Some point out that Canada has recently gone off the deep end on doles and unemployment benefits. Ontario, for example, is having second thoughts about an unemployment compensation law under which a person has only to work eight weeks to qualify for benefits. The possibilities for summer-job students are obvious. The Provincial Parliament session which began March 29 is to consider a proposal to raise the cutoff point to twelve weeks.[38] There are also stories of tourist industry seasonal workers in the Maritimes living through the winter on unemployment benefits. The burden of this line of argument is that the high Canadian unemployment rate is to some extent the product not of difficulty in finding work but of ease in drawing welfare.

Another line of argument with respect to the high unemployment rate is one based on demographic projections. Canada is currently subject to a rising rate of participation in the work force as more and more women seek jobs and those people born during the post-war baby boom come into the job market. The new, restrictive immigration laws have yet to have had time to make themselves felt. Current calculations are that these trends will have stabilized by 1982, at which time Canada will have a labor shortage. Accordingly, some observers believe, Canada should not worry about its current unemployment problem but simply hunker down, pay a heavy unemployment benefit bill for the next few years, and let the balance of payments problem work itself out.

Needless to say, this proposed course of action (or non-action) does not enjoy universal support. Objectors point out that there are pockets of unemployment far higher than 7.5%. Quebec's unemployment rate hovers around 10%, the Maritimes' is even higher, and there was a story in the March 21 Globe and Mail about a town in Newfoundland where the unemployment rate was 85%. A program which stresses natural resources and primary processing will not do much for such regions. And it is from such a region -- Quebec -- that Canada faces a challenge to its national existence based in good part on the claim that federation has done little or nothing for Quebec's economy and may even have hurt it.

The success of the U.S.-Canadian Automotive Agreement leads to questions whether there are other such areas where free trade, integration, and rationalization could lead to greater efficiency, lower costs, and increased Canadian manufactured exports. Without exception, I was told that there was no other industry where there were so few and such large firms and which was thus susceptible to Auto Agreement-ization. There are industries such as home appliances where Canadian producers could be combined and rationalized but not usefully integrated with the corresponding U.S. industry.

Without doing a thorough analysis of the Canadian industrial sector it is impossible to know whether there really are no other opportunities for arrangements similar to the Auto Agreement. It is interesting to note, however, that proposals by the Economic Council of Canada to increase Canadian industrial efficiency by instituting free trade in industrial products between Canada and the U.S. have received little if any popular support.[39] The first objection is based on the great dislocations which would occur in Canadian industry. Dozens of factories and thousands of jobs would disappear in the face of tariff-free competition from larger

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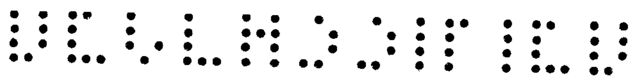


and more efficient U.S. firms. They would ultimately be replaced by converting Canadian industry to producing certain specialized products for the entire North American market, but the interim would be painful. It would be particularly difficult for a province like Ontario which has a large stake in tariff-protected industries.

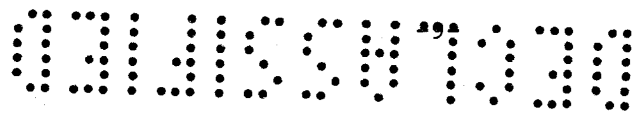
The other objection to free trade between the U.S. and Canada is a political and emotional one. Many Canadians fear that even though economic integration of this sort might increase Canadian manufacturing, efficiency and competitiveness, it would inevitably lead to political integration. The fear seems logical enough, but it is possible to argue that closer economic links do not necessarily have to lead to closer political links. The European Community, for example, seems to be having a difficult time passing from economic arrangements to political ones. The problem seems to be that if Canada is to have any voice in the control of an integrated North American economy, then there would have to be a North American government in which Canada would have a voice. Due to the difference in size of the two countries, such a government would be inevitably dominated by the United States. These possibilities have not been systematically examined, but as long as Canadians think they might lead to national extinction, they will not be examined. Canada, with its open economy, multiple ethnicity, and free society, is perhaps one of the most un-nationalist countries in the world, but when it believes its own existence is at stake, there is an understandable reaction. There is also the fact that most Americans, on the rare occasions when they think about such things, do not see any particular advantages for the United States in any such free trade or economic integration arrangements.

Conclusions

Canada is in for a thin time over the next few years. The debt service burden will grow, the balance of payments will continue to be in deficit, and most of the proposed remedies will be politically distasteful. Application of these remedies will be hampered by political weakness -- the federal government will be reluctant to take measures which might fuel feeling in Quebec that continued union with Canada was a bad idea. The government will also be understandably reluctant to take measures which might result in an increase in unemployment and/or a cut in the standard of living of those who still have jobs.

The plus side of this gloomy picture is that Canada is still fully competitive in natural resources and primary processing. In addition, the United States has no shortage of money to lend. Premiums will still come pouring into the Mets, the Prus, and the pension funds. With U.S. construction activity still far from boom conditions, the U.S. equity market going nowhere, and nine percent coupons on Hydro Quebec bonds, Canadian paper will find a ready market. The individual issuers of the paper have strong balance sheets even if the Canadian economy as a whole has its problems. In any event, the competition is in worse shape -- Canada is still a far better-looking place to invest money than most other foreign countries. So if the U.S. economy turns up enough to suck in some more Canadian exports but not enough to suck up too much lendable cash, and if the Canadian demand for money slacks off a bit, then perhaps Canada's foreign debt to GNP ratio may rise somewhat, but the debt will be serviced, rolled over, and ultimately brought back down by retirement and GNP growth to a more comfortable level.

The other end of the possibility spectrum is a situation in which Canada continues to borrow from ever-willing U.S. lenders, fails to get a grip on its costs, continues to run huge payments deficits, and gets



deeper and deeper into contracting new debts simply to service the old ones. Canada is already part of the way toward this end of the spectrum -- as Maxwell says, "In a number of ways Canadians have been living beyond their means for some years." [40] Stopping living beyond one's means is not easy. Living standards have to fall and more effort has to be made for less reward. Political weakness stemming from the Quebec problem is no help in dealing with the situation.

Canada's basic problem is that Canadians are paying themselves more than they are producing. They are paying themselves 100% and more of U.S. wages while choosing to burden themselves with a type of nationhood whose extra costs mean that they can only afford to pay themselves about 85% of U.S. wages. The reality of this situation is being obscured by a flood of foreign loans which cannot go on forever. Canada will not only have to learn to live with less foreign capital inflow, but will also have to learn to live with a heavy debt service burden. The cutback to a sustainable income and consumption level in Canada is going to be painful, but since a peaceful and self-confident Canada is very much to the interest of the United States, we can only hope that the Canadians will find a way to do it.

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FOOTNOTES

1. Statistics Canada, *The Canadian Balance of Payments* (Ottawa, Information Canada, various issues). Table reproduced in Judith Maxwell, *Policy Review and Outlook, 1977; an Agenda for Change*, C. D. Howe Research Institute, Montreal, pp 58 & 59.

2. M. Jacques DuMont, Banque Canadienne Nationale, interview in Montreal, March 25, 1977.

3. Statistics Canada, *The Canadian Balance of Payments*, op. cit. Quoted in Maxwell, op. cit., p. 67.

4. Statistics Canada, *The Canadian Balance of Payments*, op. cit. Quoted in Maxwell, op. cit., pp 58 & 59.

5. Table prepared by the Bank of Montreal Investment Department.

6. Speech in Canada by Mr. Alexander Tomlinson, the First Boston Corporation, 1976.

7. *Canadian Economy Forecast, 1976 through 1978*, Wood Gundy, Ltd., Toronto, January 1977.

8. Conference Board in Canada press release, March 21, 1977, Ottawa.

9. Table prepared by the Bank of Montreal Investment Department.

10. Brochure, *The La Grande Complex*, prepared by the Société d'Energie de la Baie James, Montreal, 1976.

11. Prospectus issued by the Province of Ontario, $300,000,000 in 30-year 8.40% debentures due January 15, 2007, New York, January 11, 1977.

12. Letter from W. Darcy McKeough, Treasurer of Ontario, to R. B. Taylor, Chairman, Ontario Hydro, Toronto, January 22, 1976.

13. Figures received from Mr. James Fullerton, Treasurer of Ontario Hydro, in an interview in Toronto, March 29, 1977.

14. *Weekend* magazine, Montreal, March 19, 1977.

15. M. Georges Lafond, C. A., interview at James Bay, March 23, 1977.

16. Bank of Canada, *Annual Report of the Governor to the Minister of Finance and Statement of Accounts for the Year 1976*, Ottawa, February 28, 1977.

17. Telephone Conference Statement by John E. Wiley, General Partner, Salomon Brothers, New York, February 4, 1977.

18. John Kettle, paper adapted from an article in *Executive* magazine, Toronto, February 1977.

19. *Canada's International Trade: Trends and Prospects*, a report from the Conference Board in Canada, Ottawa, July 1976.

20. Maxwell, op. cit. pp 58 & 59.

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21. Maxwell, op. cit. p 61.

22. The American Embassy Minister's driver, for example, is planning a holiday trip with his wife to Italy in the summer of 1977.

23. Maxwell, op. cit. p 67.

24. Telephone Conference Statement by Peter A. Gordon, Vice President, Canadian Sales, Salomon Brothers, New York, February 4, 1977.

25. Maxwell, op. cit. p 72.

26. Canada's International Trade, op. cit. p 40.

27. Maxwell, op. cit. p 65.

28. A list is given at the Appendix.

29. Dr. Gerald Angevine, Senior Economist, Canadian Imperial Bank of Commerce, interview in Toronto, March 29, 1977.

30. Maxwell, op. cit. p 63.

31. The Globe and Mail, Toronto, March 25, 1977.

32. Ms. Edith M. Whyte, Chief, International Division, Bank of Canada, interview in Ottawa, March 21, 1977.

33. Mr. James Fullerton, Treasurer, Ontario Hydro, interview in Toronto, March 29, 1977.

34. The Hon. Walter Gordon, Canadian Corporate Management Co., interview in Toronto, March 28, 1977.

35. Assistant Deputy Finance Minister W. Hood, interview in Washington, March 11, 1977. A.I.B. Executive Director R. Johnstone, interview in Ottawa, March 21, 1977.

36. Fred Sohn, President, Sun Studs, Inc., and Sun Veneer, Inc., interview in Roseburg, Oregon, December 4, 1976.

37. Maxwell, op. cit. p 16.

38. Mr. G. McIntyre, Executive Director, Treasury Division, Ontario Ministry of Treasury, Economics, and Intergovernmental Affairs, interview in Toronto, March 29, 1977.

39. Economic Council of Canada, Annual Reviews, Ottawa.

40. Maxwell, op. cit. p 90.

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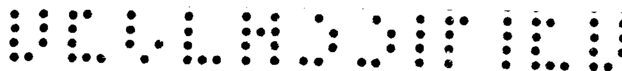


APPENDIX

List of persons interviewed in the course of preparing this paper:

Mr. J. T. Boehm, Canadian Embassy, 1746 Massachusetts Avenue, Washington, D. C. 20036

Mr. J. R. McKinney, Canadian Embassy, 1746 Massachusetts Avenue, Washington, D. C. 20036

Mr. W. Hood, Assistant Deputy Minister of Finance, Department of Finance, Ottawa, Ontario, Canada

Mr. Jerry Feldman, Canadian Desk, DIBA, Room 4824, Department of Commerce, 15th and Constitution Avenue, Washington, D. C. 20004

Mr. Richard Harding, Canadian Desk, BIEPR/OITP, Room 3059, Department of Commerce, Washington, D. C. 20004

Mr. Elliot Kalter, Canadian Desk, Federal Reserve, Room 525-A, 600 Watergate, Washington, D. C. 20037

Mr. Robert Harlow, Canadian Desk, Room 5048, Main Treasury, Department of The Treasury, Washington, D. C. 20004

Mr. David Blakemore, EUR/CAN, Department of State, Washington, D.C. 20520

Mr. Robert W. Duemling, 400 Acacia Avenue, Rockcliffe Park, Ottawa, Ontario K1M OM2

Mr. J. Duncan Edmonds, Public Affairs International, Ltd., Suite 805, 350 Sparks Street, Ottawa, Ontario K1R 7S8

Mr. Michael G. Kelly, Director, International Finance Division, Department of Finance, Ottawa, Ontario

Mr. Robert Johnstone, Executive Director, Anti-Inflation Board, Canadian Building, 219 Laurier Street West, Ottawa, Ontario

Mr. Charles Barrett, Economist, the Conference Board in Canada, Suite 1800, 333 River Road, Ottawa, Ontario K1L 8B9

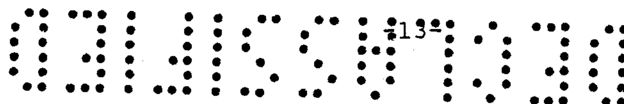
Ms. Edith M. Whyte, Chief, International Division, Bank of Canada, Wellington Street, Ottawa, Ontario

Mr. Jan Robertson, Capital Markets Division, Department of Finance, Bell Building, Ottawa, Ontario

Mr. Bruce D. Lister, Chief, Intergovernmental and Regional Unit, Fiscal Policy Division, Department of Finance, Bell Building, Ottawa, Ontario

Mr. Tom Scitovszky, Chief Economist, Standard Life Assurance Co., 1245 Sherbrooke Street West, Montreal, P.Q., Canada

Mr. Ian A. C. McCallum, Vice President, Money Management, International Banking, Bank of Montreal, 129 St. James Street, Montreal, P.Q., Canada



Mr. Michael Moffatt, International Banking Division, Bank of Montreal, 129 St. James Street, Montreal, P.Q., Canada

Mr. John McNeil, Vice President, Investments, International Banking, Bank of Montreal, 129 St. James Street, Montreal, P.Q., Canada

Mr. Olivier, Economist, Banque Canadienne Nationale, 500 Place d'Armes, Montreal, P.Q., Canada

Mr. Jacques DuMont, Economist, Banque Canadienne Nationale, 500 Place d'Armes, Montreal, P.Q., Canada

Ambassador Thomas O. Enders, American Embassy, Wellington Street, Ottawa, Ontario, Canada

Mr. Warren Clark, American Embassy, Wellington Street, Ottawa, Ontario, Canada

Mr. John C. Leary, American Embassy, Wellington Street, Ottawa, Ontario, Canada

Ms. Elizabeth J. Harper, American Consul General, Complexe Desjardins, Jeanne Mance Street and Dorchester Blvd., Montreal, P.Q., Canada

Mr. Steve Erickson, American Consulate General, Complexe Desjardins, Jeanne Mance Street and Dorchester Blvd., Montreal, P.Q., Canada

Mr. John Diggins, American Consul General, University Avenue, Toronto, Ontario, Canada

Mr. John A. Cantwell, American Consulate General, University Avenue, Toronto, Ontario, Canada

Mr. J. A. G. Grant, Director and Chief Economist, Wood Gundy Ltd., Royal Trust Tower, P.O. Box 274, Toronto-Dominion Centre, Toronto, Ontario M5K 1M7, Canada

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Mr. Ramsay Holmes, Deputy Economic Advisor, Bank of Nova Scotia, 44 King Street West, Toronto, Ontario, Canada

Mr. David L. Crane, Editorial Page Editor, The Toronto Star, One Yonge Street, Toronto, Ontario M5E 1E6, Canada

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Mr. Donald S. McColl, Director, Finance Management Branch, Ministry of Treasury, Economics, and Intergovernmental Affairs, Frost Building North, Queen's Park, Toronto, Ontario M7A 1Z2, Canada

Mr. James Fullerton, Treasurer, Ontario Hydro, 700 University Ave., Toronto, Ontario, Canada

Mr. Alexander Tomlinson, The First Boston Corporation, 20 Exchange Place, New York, N.Y.

Mr. Edward Townsend, The First Boston Corporation, 20 Exchange Place, New York, N.Y.

Mr. Richard J. Schmeelk, General Partner, Salomon Brothers, One New York Plaza, Battery Park, New York, N.Y.

Mr. Fred Ferber, Bond and Commercial Loan Dept., Prudential Life Insurance Co., Prudential Plaza, Broad Street, Newark, N.J.

Mr. Joseph Wilson, Merrill Lynch, Inc., One Liberty Plaza (165 Broadway - 28th Floor), New York, N.Y.

Mr. Roy Weinberger, Assistant Vice President, International Finance, Standard & Poor's Corporation, 345 Hudson Street, New York, N.Y. 10014

Mr. Jerome J. Corcoran, Rating Officer, International Finance, Standard & Poor's Corporation, 345 Hudson Street, New York, N.Y. 10014

Mr. Robert W. Bruce, Rating Officer, Municipal Bond Dept., Standard & Poor's Corporation, 345 Hudson Street, New York, N.Y. 10014

Dr. Jackson Phillips, Moody's Investors Service, Inc., 99 Church Street, New York, N.Y. 10007

Mr. George Leung, Moody's Investors Service, Inc., 99 Church Street, New York, N. Y. 10007

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