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Canada's Economic Independence: Fact vs. Myth

"FEW economists and almost no politicians realized that the titanic growth of the Canadian economy had been bought at the high price of an inflated currency, exchange deficits, capital imports, a towering foreign debt and the wholesale alienation of Canadian resources to foreign investors. Canada, fortune's fool, was living wildly beyond its means." [1]

This quotation from a book by a distinguished Canadian writer and commentator on the national political scene puts in two succinct sentences a popular view of Canada's position in the world economy. Now it is my contention that the wide popularity of this view, here and abroad, is roughly proportional to the shakiness of its foundation in fact and analysis.

To get the true picture, we must exercise a measure of historical judgement; and historical judgement is impossible without the facts. Even in so short a period as the five years that separate us from the exchange crisis of 1962, contemporary Canadian history has been distorted, "rewritten" if you like, to conform not to the facts of 1962, but to the myth that fits into the recurring Canadian nightmare of utter vulnerability and abject dependence on support from abroad.

The rewriting of history is not, as we like to think, confined to iron-curtain or bamboo-curtain countries. There is a compulsiveness in the reaction of Canadians to the economic facts of life that drives them to a complete rejection of the real world and to the acceptance of a mythical world of unrelieved darkness consistent with their baseless feelings of national inferiority. Here at last they can revel together in universal misery!

At the risk of depriving many of my fellow citizens of their inalienable right to the continued pursuit of unhappiness, I shall take this made-to-order opportunity, in appearing before a distinguished audience of Professors of Business History, to marshall facts and analysis which, I believe, can be useful in putting Canada's recent economic history in a true perspective.

[1]Bruce Hutchison, *Mr. Prime Minister, 1867-1964,* Toronto, Longmans Canada Limited, 1964, p. 310.

I

THE MYTHOLOGY OF CANADA'S "BALANCE OF PAYMENTS DEFICIT"

Ask any Canadian man-in-the-street: "What is Canada's major economic problem?" The chances are good that he will reply: "Our balance-of-payments deficit."

This is the myth. In fact, our so-called "balance-of-payments deficit" is one of the biggest non-problems that Canadians have so far been able to invent as a source of chronic national anxiety.

In spite of the apparent effort of our statisticians to obscure the fact in their published figures, and in spite of the propensity of commentators to misinterpret all statistical material, the international balance of payments always balances. The two major components of the balance of payments, the current-account balance and the capital-account balance, must precisely offset one another.[2]

The only way that any nation can get so-called "deficits" or "surpluses" in its balance of payments is to make an arbitrary selection of certain items from the over-all balance. What is selected defines, for that nation, the balance-of-payments surplus or deficit. Canada has a deficit on current account, and this has been selected also to represent our "balance-of-payments deficit." The United States has a large surplus on current account. Nevertheless, through a similar selection process, the United States also achieves a balance-of-payments deficit.

Thus, though one might naively think that the algebraic sum of all deficits and surpluses throughout the world should be zero, this is not in fact the case. Indeed, with the variety of definitions now in vogue, it would be theoretically possible to reach the ultimate absurdity in which all nations are running balance-of payments "deficits" at the same time! This possibility is all the more believable since each nation defines its balance-of-payments "deficit" or "surplus" in such a way as to maximize pessimism, condone protectionism, and in general to emphasize the dreariness of the human condition.

As I have said, in Canada, the whole deficit on current account is identified in the popular view with "our balance-of-payments deficit." It is this deficit, or so it would appear, that makes economic independence impossible for Canada. The reason, the argument goes, is that a profligate Canada must cover her trade

[2] "The current-account balance is the net surplus or deficit in trade in goods and services. The capital-account balance is the net surplus or deficit in short and long-run capital flows, and can most conveniently be considered as the net export or import of bonds, stocks, and claims including movements of monetary gold and changes in official reserves." (W. E. McLaughlin, *Canada, the United States, and the Balance of Payments—a Different View,* address to the Economic Club of New York; published under title "Balance of Payment, Canada and the United States," *Vital Speeches,* June 15, 1966, pp. 521-524.)

and service deficit by borrowing abroad, thereby amassing an enormous burden of debt which, on some dread day of reckoning, will become due and payable. We shall then, and all too late, discover through national ruin the cost of "living beyond our means."

This Day of Judgement theory of foreign investment is deflated a bit when we look at the figures. In 1963, the latest date available with a complete breakdown of the figures, Canada's Balance of International Indebtedness shows a net liabilities item of $19.3 billions.[3] But, of this figure, almost two-thirds represents net direct investment, largely in Canadian subsidiaries of foreign corporations, which will never have to be paid back. This is one advantage of direct investment that is sometimes overlooked. If we eliminate net direct investment, we have $7 billions still to be accounted for. Since short-term and miscellaneous items almost precisely cancel out, this $7 billions is also the amount of net long-term fixed-interest foreign investment in Canada.

It may help us to achieve a perspective on this "towering foreign debt" if we compare it with certain Canadian asset items. For example, Canada's net long-term bonded debt to foreigners is only slightly more than the total assets of the financial institution which I represent: The Royal Bank of Canada.[4] The debt is, of course, insignificant when compared with the total assets of the nation as a whole.

This is an important qualification on the statistical side; but, in the whole mythology of Canada's payments deficit, the most important departure from reality lies in the assumption that Canada first indulges in an orgy of spending on imports and is then forced to scrounge around in foreign capital markets to get the money to pay for it. This personification of nations as borrowers and lenders is completely misleading. We are presented with a little Morality Play in which Canada is cast as an international pauper standing hat in hand pitifully begging for money to pay for her profligate spending on imports. Yet Canada is perhaps the second richest country in the world. What is wrong?

What is wrong is simply that this is not at all a true picture of what goes on in the real world.

In the real world, decisions to invest in Canada are taken, not by foreign governments, and not for the purpose of supporting the Canadian dollar or "covering" the Canadian deficit on current account: these decisions to invest are taken by private investors for private gain.

In fact, neither Canadian borrowers nor foreign lenders and investors borrow, lend, or invest for balance-of-payments purposes. Canadian private corporations and public bodies borrow abroad because "the price is right" and

[3]Bank of Canada, *Statistical Summary, 1965 Supplement,* p. 147.

[4]Total assets at end of year 1966, $6,957,619,972.

the funds are available. Foreign individuals and corporations lend or invest in Canada because they feel assured of a safe and adequate return on their loan or expect a profit on their equity capital that is attractive relative to the risk involved.

In other words, we get a net inflow of capital, or a surplus on capital account in the balance of payments, because foreign investors take a favourable view of Canada. The inflow of capital is an indication of Canada's economic strength, not weakness. Moreover, the resulting capital-account surplus, in simple balance-of-payments arithmetic, *must* be accompanied by a current-account deficit. Indeed, the resulting current-account deficit is the vehicle by which the initial flow of money capital is transferred into a flow of real capital in the form of goods, services, and technology. Canadian trade in goods and services is, therefore, especially sensitive to movements and trends in capital flows, and a large part of Canada's imports is the direct or indirect result of a previous inflow of foreign capital. Thus the capital-account surplus and the current-account deficit go hand-in-hand: in the words of a sometime popular song, "You can't have one without the other!"

Elimination of the current-account deficit should not, therefore, become a goal of policy. There is nothing especially attractive about a current-account surplus as such. Of course, if we impose special handicaps on foreign capital or scare it away, imports induced by capital flows will stop and we shall achieve a current-account surplus. But we shall also sacrifice both our current prosperity and our future growth.

We had current-account surpluses in the 1930's during a period of depression and declining trade. We had current-account surpluses during the war years reflecting corresponding capital-account deficits largely due to outflows of funds to finance mutual aid programmes. And we had current-account surpluses in the immediate post-war years reflecting capital-account deficits largely due to outflows of funds to finance reconstruction loans in Europe. The myth that a current-account surplus should be considered either an end in itself or a prerequisite to independence was exploded in 1947 when, in spite of a small current-account surplus, we managed to have an exchange crisis which was met by import restrictions and exchange controls.

The fact is that current-account surpluses or deficits are neither good nor bad in themselves: they can only be appropriate or inappropriate. So long as Canada remains a large net importer of capital, a current-account deficit is appropriate. When Canada becomes a net exporter of capital, as she will undoubtedly be in time, a current-account surplus will be appropriate. Within this framework, of course, increased productivity and over-all efficiency is always a worthy goal of policy: this is the way to improve our terms of trade

in international markets and to improve our standard of living at home. But there is no point in creating unnecessary problems by tinkering directly with the current-account balance through restrictions on capital flows and imports of goods and services, or through open or disguised export subsidies. These devices can have only a deleterious effect on the economic welfare of the Canadian people.

Indeed, if this "current-account myth" would conveniently disappear, the nation would reap immediate rewards in the freeing of the manhours wasted on this false problem for useful work on the real problems that beset us

II

THE MYTHOLOGY OF CANADA'S FLOATING RATE AS CAUSE OF THE EXCHANGE CRISIS IN 1962

An excellent example of the "rewriting" of Canadian history for the comfort of the conventionally minded is found in the popular explanation of the exchange crisis of May-June, 1962.

The popular view is that the floating exchange rate worked well from the beginning of its career in the fall of 1950 until the recession that began in March-April, 1957. Then, for some mysterious reason, it ceased to work well and indeed, by stubbornly remaining at a so-called "premium" over the U.S. dollar, the floating Canadian dollar sabotaged the government's best efforts to increase business activity and employment. Finally, so the story goes, Canada's "over-valued" dollar became subject to speculative downward pressure and, in the resulting exchange crisis, had to be abandoned and a fixed rate established.

This popular story of the rise and fall of Canada's floating-rate system ignores some key facts and, partly as a result, is completely misleading as an analysis of the events of 1961-62. I shall not at this time go into the arguments for or against a floating exchange rate—although I have long been an advocate of its advantages to Canada. However, part of the argument against my position is based on what I believe to be a misinterpretation of the "floating-rate period" of Canadian history. Again, with or without conscious intent, history is quietly being rewritten to fit a cliché that will give comfort to the complacent rather than to show the potentially disturbing pattern of events unfolding in the real world: the world of myth transcends and obscures the world of reality

The *reason* the floating exchange rate worked well in the period 1950-57 was that, during most of that period, monetary policy was, quite properly, restrictive. The inflationary pressure caused by the Korean War was followed by inflationary pressure from the investment boom of 1955-57. Since monetary policy was appropriate to the problem, the floating rate adjusted automatically

to give the fiscal and monetary authorities the freedom of action necessary to achieve their goals without any disturbing repercussions in the balance of payments or in the exchange market

The reason the floating rate did *not* work well in the period 1957-61 was that money remained generally tight even though there was slack in the economy with over-capacity and unemployment. Interest rates remained high enough to attract interest-sensitive capital and this in turn caused the floating exchange rate to rise when the needs of the economy would have been better served by a lower rate.

Unfortunately, the true culprit, inappropriately tight money, was linked in the public mind with the high-riding floating exchange rate—a case of guilt by association. As a result, when a change in monetary management and in the direction of monetary policy occurred in June, 1961, it was accompanied by a policy of deliberately forcing the exchange rate to a lower level. This, of course, was the end of a true floating exchange rate and the substitution of a rate manipulated by the government. Indeed, the floating rate in its pure form really came to an end with the "baby budget" of December, 1960, which imposed handicaps in the form of special withholding taxes on foreign capital (to reduce upward pressure on the rate)[5] and was accompanied by an unannounced programme of intervention in the market by the Exchange Fund Account with the object of buying U.S. (selling Canadian) to bring the external value of the Canadian dollar to a lower level.

The lack of confidence in the Canadian dollar that occurred after June, 1961, and especially after October 31, 1961, is no mystery. It was the inevitable result of "talking down" the Canadian dollar to what was vaguely described in the budget speech of June, 1961, as a "significant discount."[5a] Even then resistance to a further fall in the Canadian dollar developed at about 97 cents U.S. and, in October, the Exchange Fund Account had to buy $186 millions U.S. to keep the Canadian dollar from strengthening. When an official pronouncement made it clear that the Canadian dollar was to be forced down still further, such a lack of confidence developed that the authorities soon found it impossible even to hold a 95 cent U.S. rate without a large loss in reserves. An official 92½ cents U.S. parity rate filed with the IMF on May 2, 1962, became tenable only through the imposition of an austerity programme. This programme, dangerously delayed by a general election, was finally announced on a Sunday: June 24, 1962.

Of course the authorities should have reversed monetary policy much

[5]Canada, Department of Finance, *Budget Speech*, December 20, 1960, Ottawa, Queen's Printer, 1961, pp. 13-15.

[5a]Canada, Department of Finance, *Budget Speech*, June 20, 1961, Ottawa, Queen's Printer, 1961, p. 13. See also pp. 7, 8, and 12-14.

earlier than mid-1961; nevertheless, had they at that time been content with a policy of monetary ease, monetary and fiscal policy would have been appropriate to an economy in which there was over-capacity and unemployment. There was no need to do anything about the exchange rate. Left to itself, the floating exchange rate would have adjusted smoothly to the level appropriate to a policy of ease, just as it did to the opposite type of policy in 1950-57. In both cases, the rôle of the floating rate was simply to give the authorities the freedom of action needed to achieve their goals without giving rise to disturbing repercussions in the balance of payments or in the exchange market.

The floating rate was allowed to play this rôle in 1950-57. It is a tragedy that it was not allowed to do so in 1957-62. If the floating rate had been allowed to play its rôle in the period 1957-62, and especially in 1961-62, we should have avoided the exchange crisis of 1962, the humiliating dependence on official foreign aid which brought it to an end, and, most important of all, the chain of events since 1962 which has progressively limited our freedom of action to pursue a Canadian policy without the ever-present fear that the concessions we now live by[6] will be withdrawn as punishment for trying to run our own show. We're hooked, and the fixed-exchange rate, the bait we took so eagerly in 1962, is what has hooked us!

This, in my opinion, is a true account of that tortured period from mid-1961 to mid-1962, when, through our own official policy, we set in motion the forces that pushed us finally into the exchange crisis of 1962. The final analogy I believe to be a true picture of our present condition. We *are* hooked. Nevertheless, the current myth seems to have it the other way round — with Canada somehow in charge of the rod and reel!

All this has a bearing on the effect of foreign investment on the economy, to which I now turn.

III

THE MYTHOLOGY OF THE "FOREIGN INVESTMENT EFFECT" ON CANADA'S ECONOMIC INDEPENDENCE

I have already pointed out that foreign investment is not a creature of the current-account deficit to be fattened or starved depending on the profligacy or parsimony of Canadian importers of goods and services, or on the efficiency or inefficiency of Canadian exporters. Foreign investment has a life of its own. In Canada's case especially, it is more likely to influence, than to be influenced

[6] I refer here especially to the Exchange Reserve Agreement with the United States. In July, 1963, this limited our exchange reserves to $2.7 billions in return for exemption from the U.S. Interest Equalization Tax. In December, 1965, the limit on reserves was reduced to $2.6 billions and exemption extended as applied as well as under new or extended guidelines. Under a floating rate, reserves are automatically stable and this problem would not arise.

by, the size of the current-account deficit It is fundamental to an understanding of the problem that we do not personify nations as "Borrowers", "Lenders", "Exporters", or "Importers." Canada does not borrow, the United States (for example) does not lend or invest: Canadians borrow, Americans lend or invest; and the final result of these thousands of unconnected, but, through the market, interdependent transactions is reflected in the balance of payments.

Nevertheless, there is a sense in which Canada "needs" foreign investment. Canada has one of the highest rates of saving in the world; but opportunities for investment are greater still, and outrun our high rate of saving. This means that rates of return are high enough to attract foreign investors.

It is the operation of the international capital market, in so far as it is free, and not the incidence of deficits that makes Canada a net importer of capital This is fortunate for Canada, because foreign capital is essential to Canada's prosperity and growth. It is for this reason, and not for balance-of-payments reasons, that capital should be welcomed into Canada

I do not for a moment deny that there are problems associated with foreign investment in Canada But it is most important that we define these problems correctly.

Here again I believe we have built up a mythology over the years

It is often assumed that a foreign-owned Canadian subsidiary corporation will act differently from a Canadian-owned corporation, and in such a way as to be detrimental to Canada. In the past, I have referred to this as the "business-behaviour problem" of foreign investment. Yet there is no reason to believe that a foreign-owned Canadian corporation is necessarily inferior to a Canadian-owned corporation as a Canadian corporate citizen: indeed it may well be the other way round. Foreign-owned Canadian corporations are, if anything, likely to be especially careful to "behave like Canadians" because they feel the need to achieve ready acceptance in the Canadian community. The "business-behaviour problem" is in my view a false problem. In any case, foreign-owned subsidiaries in Canada are Canadian corporations, and, like all Canadian corporations, they are subject to Canadian law and regulation.

There is, however, a political problem associated with foreign direct investment which, when it appears, can be solved neither by the foreign parent nor by the Canadian subsidiary corporation. I refer here to the "incidents", disturbingly on the increase, in which foreign laws or regulations reach into Canada, to affect Canadian corporations—especially corporations owned by U.S. parent companies.

For example, a foreign government may, quite appropriately, forbid its citizens to export certain goods, or any goods at all, to a designated country. The problem arises when the foreign government puts pressure on corporations

with subsidiaries in Canada to forbid those Canadian subsidiaries from exporting to a designated country even though exports to that country are perfectly legal, even encouraged, under Canadian law or policy

I do not, I think, need to give more specific examples affecting Canadian exports The problem is a recurring one The disturbing thing is that it should occur at all

In recent years, and even in recent months, there has been an apparent proliferation of incidents outside the export field

For example, the S E.C has sought to extend its financial regulation of U S companies to certain Canadian corporations, even though their shares are unlisted on any American stock exchange You don't have to be a xenophobe to rage at this kind of legalistic border-hopping, however innocent of such intent the foreign authorities may be. Unfortunately, all this leads to increased sensitivity, and irritability, with the likelihood of a further rash of offsides committed by both countries

IV

THE MYTHOLOGY OF FINDING A 'REALISTIC SOLUTION

Perhaps the most disheartening aspect of Canada's problems today is that an entrenched mythology discards as unthinkable any realistic solution

It is unrealistic for example to regard a current-account surplus as a key goal of policy Yet it is a major item in almost all popular agenda for policy. The current-account balance is merely a resultant of other policies: if these policies are right, the current-account, whether deficit or surplus, will also be right

Stability at a high level of employment and business activity is a key goal of policy So is long-run economic growth. So is increased productivity and over-all efficiency So is equity and incentive in taxation and the distribution of income. Neither the current-account balance nor, for that matter, the level of the exchange rate, is in itself a key goal of policy Both should be resultants, and both should be flexible in response to market forces within the climate provided by over-all economic policy

To carry this argument a step further, it seems to me to be the essence of realism to build on the experience of recent history and to recognize that inflexibility of exchange rates, and, since 1963, of exchange reserves as well, should be regarded as a central area of research into Canada's problems and a central theme for high-level policy recommendations

Instead, the Economic Council for Canada, in its *Third Annual Review*, talks at great length (and very well indeed!) on almost everything else There are two or three cryptic references to the exchange rate in the Council's *Third*

Annual Review For example: "There must be, too, an approximately correct setting of the Canadian dollar exchange rate: if this were again to become clearly inappropriate, as it did in the late 1950 s, it would have to be put right before much else could be accomplished"[7]

Nothing has been learned! True, the present fixed rate *could* get out of line, and it *would* have to be "put right." But the floating rate of the late 1950's was merely reflecting, and very accurately at that, the existence of an inappropriate monetary policy Nevertheless, the Council perpetuates the myth that it was the floating exchange rate, not monetary policy, that was "out of line" in the late 1950 s; and from this it draws the policy conclusion that we must somehow, within the present rigid IMF system, manipulate our exchange rate.

Surely the lesson taught by our experience in 1961-62 is that a so-called "fixed" rate that is, or can, be manipulated gives us the worst of all possible worlds

It is unrealistic, finally, to assume an anti-foreign-investment posture on the assumption that foreign investment must necessarily lead to foreign domination of the economy. There is no point in inveighing against the foreign investor, hobbling him with tax and other handicaps, or scaring him out of the country or out of the market for funds. The plain fact is that we *need* foreign investment if we are to be a prosperous, progressive, and growing country. And if we are not a prosperous, progressive, and growing country, we shall not for long be an independent one.

Surely the real problem of foreign investment is the threat to sovereignty caused by border-hopping laws and regulations of other countries What we should do is to worry less about the behaviour of foreign-owned Canadian corporations and put all our energies into the creation of higher invisible legal defences at our border to stop the continued infiltration of foreign law and regulation into our country

This is the real problem of foreign investment Moreover, it is a problem that must be solved if we are to maintain prosperity, growth, *and* independence as the dominant characteristics of Canada's second century.

Let's get rid of the myths and get on with the job!

[7]Economic Council for Canada, *Third Annual Review,* Ottawa, Queen s Printer, 1966, p. 167