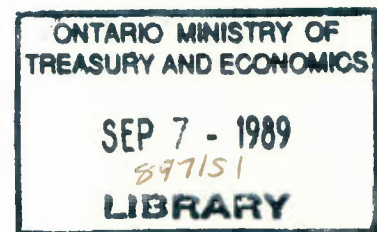


# AU COURANT

Economic Council of Canada

Volume 10, No.1, 1989

## INTERNATIONAL FINANCE A New Frontier



- Research and the "power of ideas"
- Grain exports: Canada's vulnerability
- Immigration: Cost and benefits

# PUBLICATIONS

## Council Report

**A New Frontier** (EC22-160/1989E; \$5.95 in Canada, US\$7.15 elsewhere).

The world of finance is changing at unprecedented speed. New technology, new services, and new approaches to regulation have created a climate for explosive growth in international financial markets. How are Canadian borrowers and lenders faring in these competitive financial markets? This policy statement by the Economic Council of Canada gives some answers and proposes policies to improve the Canadian financial system. The document describes how international financial markets have been transformed in recent years. It discusses new financial services and notes that new technology is binding the financial world into a single global marketplace. Turning to the domestic scene, it deals with such issues as the competitiveness of Canadian financial institutions internationally and the impact of new services on Canadian markets. The Council's policy proposals are designed to strengthen competitiveness and to

improve supervision of financial firms.

## Research Studies

Research studies are published by the Economic Council in both official languages. A list of titles is available on request, and ordering instructions appear below. Each study clearly attributes the findings and conclusions to the individual author, or authors, rather than to the Council.

**Canadian Agricultural Policy and Prairie Agriculture**, by Murray Fulton, Ken Rosaasen and Andrew Schmitz (EC22-159/1988E; \$11.95 in Canada, US\$14.35 elsewhere).

This study examines the crisis of Prairie agriculture in the 1980s with particular attention to the build-up of farm debt which has been one of the distinguishing features of the recent crisis. It identifies the volatility of land values as a key element in the transition from the booming years of the late 1970s to the bust in the mid-1980s.

The authors then review the major programs the federal government has used in recent years to support Prairie grain farmers. Programs

examined include: subsidies under the Western Grain Transportation Act, the Western Grain Stabilization Program, crop insurance, agricultural credit, the Special Canadian Grains Program, and the two-price wheat system. The study investigates the role these programs played in aggravating and in alleviating the crises and looks at their overall effects on the Prairie farm sector.

## Discussion Papers

Discussion papers are typically of a technical nature and are intended for distribution in limited numbers to individuals who may have a particular interest in these or related fields of research. Of varying length and complexity, these papers are reproduced only in the language in which they are written. Each paper is the sole responsibility of the author, or authors, and distribution under the auspices of the Council does not, of course, imply that the conclusions of the paper have been endorsed by the Council.

**No. 361** "General equilibrium models in the development of social policy," by A. Pierre Cloutier and Bernard Fortin.

## How to order

Research studies, Council reports, and technical papers are available across Canada from bookstores where government publications are sold. (A list is available from the Council on request.) These publications can also be ordered by mail from the Canadian Government Publishing Centre, Supply and Services Canada, Ottawa, Canada, K1A 0S9. (Please be sure to include a cheque or money order made payable to the Receiver General for Canada.)

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## FEATURE

<b>A new frontier to conquer .....</b>	<b>4</b>
Canadian institutions: Losing ground.....	5
Putting Canada's regulatory house in order .....	5
Links between financial institutions and nonfinancial corporations.....	6
Securitization .....	6
Swaps .....	7
Investment abroad by pension plans .....	7
Entry to foreign institutions into Canadian markets .....	7
International banking centres .....	7
Reducing the risks .....	8
<b>Securities: Harmonization is necessary.....</b>	<b>9</b>
<b>Research and the "power of ideas" .....</b>	<b>10</b>
<b>Grain exports: Canada is vulnerable in world markets.....</b>	<b>12</b>

## DIALOGUE

<b>Immigration: Measuring costs and benefits.....</b>	<b>14</b>
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**Editor: Jean-Guy Bruneau**

# Globalization and financial innovation

## A new frontier to conquer

Since the early 1980s, international financial markets have experienced an unprecedented expansion which, through its magnitude and scope, will permanently transform the way business is conducted domestically and internationally.

Governments, regulatory authorities, financial institutions, and businesses of all kinds are scrambling to adapt to the new financial frontier where national boundaries no longer stand in the way. This is the phenomenon known as internationalization of financial markets.

Fuelled by telecommunications high technology, financial internationalization has given rise to, among other things, a wide array of new financial instruments.

Those able to adapt rapidly to the new financial environment and to take advantage of its opportunities and avoid its pitfalls will quickly move to the head of the pack. Those reluctant to do so will inevitably find their markets slipping into the hands of bolder competitors.

These profound changes offer a wealth of possibilities for making business gains and tapping new financing sources. There is no doubt, however, that internationalization and innovation necessarily involve risks. Market "transparency" has, in fact, been reduced.

The challenge is thus to discover and learn how to use the new financial instruments while minimizing their inherent risks. A balance must be struck between, on the one hand, the competition and accessibility offered by the new financial environment and, on the other, the guarantees of solvency and reliability offered by appropriate solvency standards in law and sound corporate management. There is no denying, however, that increased competition inevitably entails greater risks.

Canada cannot ignore the recent evolution. This is the challenge laid out by the Economic Council of Canada in its Statement on international finance, the fruit of some two years of research. Convinced that internationalization offers exciting opportunities for the country, the Council's document begins by retracing in detail the transformations of the last few years and ends with a series of recommendations designed to help Canada take advantage of the new



opportunities while avoiding the inherent risks.

One thing is certain, stresses the Council: the worldwide trend in favour of integrated financial markets is now irreversible.

The Council notes that Canadian financial institutions have been losing ground internationally. And this loss of ground – a potential source of concern – comes just as the European Economic Community is poised to achieve full market integration. In 1992, the 320 million residents of the EEC will become members of a single market within which individuals, goods, services, and capital will be able to move almost as freely as they do within their respective nations today.

Competitiveness is the order of the day. To retain a foothold in this difficult environment, the Council asserts, Canada must opt for competition over protectionism.

Among other topics, the Council's Statement focuses on the following areas:

- *Harmonization of Canadian regulation* — According to the Council, one of the first steps has to be to put Canada's own regulatory house in order. Both greater harmonization and closer cooperation between the various regulatory authorities are required.

- *Investment abroad by pension plans* — The Council recommends that the Income Tax Act be amended to gradually remove the limits on investment abroad by pension funds.

- *Opening up Canadian markets to foreign institutions* — The Council comes out in favour of abolishing the

barriers that now prevent Canadians from participating fully in international markets, and it proposes continued action to facilitate foreign institutions' access to Canadian markets.

- *New financial instruments* — The Council recommends amending the provincial and federal legislation governing financial institutions to explicitly allow for the use of new financial instruments – futures, options, swaps – within the "prudent investor" framework. It also suggests "securitization" as a possible means of assisting the development of regions and small and medium business in Canada.

- *Links between financial institutions and nonfinancial corporations* — The Council Statement discusses the kind of links that should be allowed between financial institutions and nonfinancial corporations, already a subject of lively debate. The Council argues in favour of fairly tight restrictions, with a view toward enhancing the institutions' solvency and market stability.

- *International cooperation* — To harness the forces unleashed by globalization of financial markets, greater cooperation at the international level will be required. The Council thus urges the Canadian government to actively promote greater cooperation within the international community so that the obstacles standing in the way of orderly progress towards globalization may be eliminated.

- The efficiency of financial markets should, in the view of the Council, be everyone's concern – consumers, homeowners, fledgling entrepreneurs, and chief executives of large corporations. The financial system, it notes, is the machinery through which funds are channelled from investors to borrowers and risks are transferred to those firms best able or most willing to take them on. The efficiency of the financial system affects the cost and use of money; as a result, it also affects the pace of industrial development, the value of the Canadian dollar, and, ultimately, the length of the "Help Wanted" section in our daily newspapers.

Thus, asserts the Council, an efficient financial system is the driving force behind a country's economic well-being.

### **Canadian institutions: Losing ground**

Canadian institutions have operated in international financial markets since before Confederation. The Bank of Montreal opened for business in New York in 1859, in Chicago two years later, and in London nine years after that.

Canadians have also long been major investors and borrowers abroad. Many large nation-building projects, including the Canadian Pacific Railroad, were financed by foreign capital.

Today, however, Canadian institutions play a relatively small role on international markets. Worse, they are losing ground. Several indicators can be used to measure this phenomenon, including market share and asset size.

Globally, the share of Canadian institutions as managers of issues on the Eurobond market has declined from 6 per cent in 1976 to 2 per cent in 1988.

In terms of assets, the relative position of Canadian banks has weakened significantly. For example, the Royal Bank, ranked 16th in the world in 1981, had slipped to 57th position by 1987. Displacing it in the rankings over the past eight years were competitors from the United States, the United Kingdom, Japan, Switzerland, France, West Germany, Hong Kong, Italy, the Netherlands, Brazil and China.

While Canadian borrowers are very active on international markets, they make little use of domestic institutions to manage their foreign issues. The federal government itself has not called upon a Canadian institution to manage its foreign issues.

The Economic Council expresses surprise and concern about the decline of Canadian banks on international markets. From its many interviews with Canadian customers of Canadian banks and securities firms, as well as an extensive survey, a number of explanatory factors emerged: a certain lack of aggressiveness in pricing policy, less extensive worldwide networks than those built up by foreign rivals, insufficient access to investors, and strategies focused inward and oriented toward the short term.

Lying behind these explanations, notes the Council, is certainly the smaller size and capital of Canadian institutions

compared to their major foreign competitors. But there are other factors that go beyond the size and efficiency of the Canadian institutions. One is that the pool of capital directly available to Canadian financial institutions in the form of domestic savings has shrunk

Canada's loss of ground on international markets is worrisome. If Canadian institutions continue to lose market share and to reduce their international operations, they may eventually find it difficult to retain their traditional Canadian customers in the face of competition from better-capitalized and more internationalized institutions.

### **Putting Canada's regulatory house in order**

In Canada, the evolution of financial regulation reflects our divided constitutional power. The multiplicity of regulatory authorities has acted, at times, as a catalyst for change and has provided Canadians with an enriched system that serves their many different financial needs.

Canada's fragmented regulatory framework, however, creates problems in today's environment. Regulatory systems

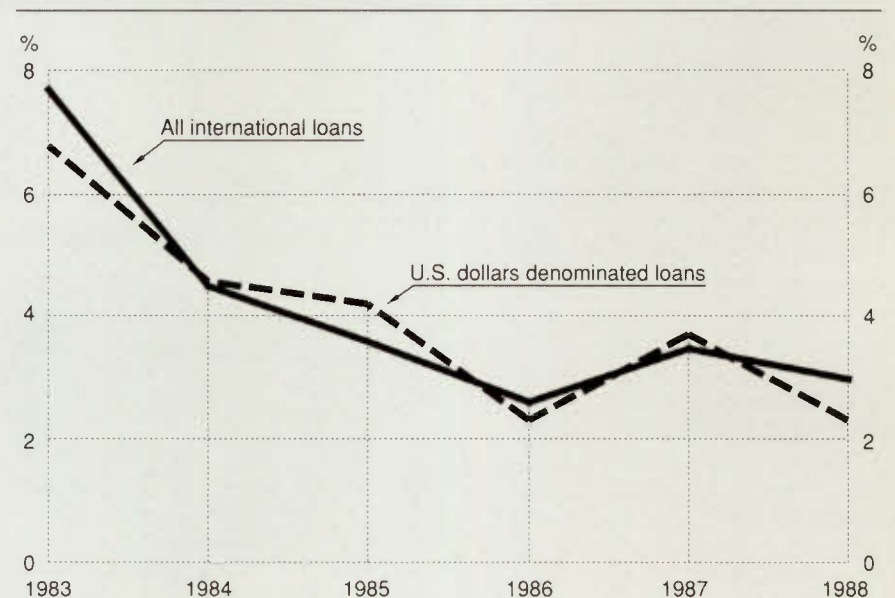
that compete across jurisdictional boundaries impose extra costs on financial institutions.

The number of foreign participants in the Canadian market has increased in recent years; Canadian-controlled firms have expanded their international activities; new financial instruments have proliferated. All of these developments have combined to reduce the transparency of the financial sector. To deal with these issues, the Council sees an urgent need to act quickly to harmonize regulation across the land and coordinate prudential supervision.

The lack of information-sharing between regulatory authorities and inadequate coordination of prudential supervision are, says the Council, major impediments to improving the efficiency of Canada's financial system. In delaying action on this front, Canadians are running counter to world trends. Regional economic blocks, especially Europe, are attuning themselves to the globalization of financial markets by harmonizing national regulatory and supervisory systems in the financial sector.

The Council puts forward two recommendations for the two key areas where

**Share of Canadian Banks and Securities Firms as  
Managers of International Loans, 1983-88**



increased compatibility is needed: regulation and prudential supervision. It urges the federal and provincial governments to work together on harmonizing such issues as investment powers, capital requirements, related-party transactions, and the distribution of financial products.

Secondly, the Council recommends that the federal and provincial governments coordinate the prudential supervision of Canadian financial institutions. It sees the simple sharing of information as only the first step in this process. Coordination must also extend to the standardization of norms for financial solvency, the development of early-warning systems, the level of capitalization, and the examination of financial firms. To facilitate the implementation of these two recommendations, the Council advocates the creation of a formal organization of independent provincial and federal regulators, to include, amongst others, the federal Office of the Superintendent of Financial Institutions, the provincial securities commissions, and provincial regulators of financial institutions. This organization would have a permanent secretariat and possibly be assisted by specialized committees. It would remain the responsibility of the 11 governments to translate the agreement into law, and the responsibility of regulatory authorities to enforce the law within their own jurisdiction.

## Links between financial institutions and nonfinancial corporations

By considering the issue of the ownership of financial institutions by nonfinancial corporations, the Council steps right into an ongoing controversy. Some are wholeheartedly in favour of commercial/financial links, while others are adamantly opposed.

Federal proposals put forward in 1987 would have the effect of tightening ownership restrictions for loan, trust, and insurance companies with capital in excess of \$50 million. At the same time, the governments of Ontario and Quebec have been moving in the opposite direction – towards allowing the establishment of commercial/financial links. The government of British Columbia adopted a similar position in 1988.

Because there are strong arguments and counterarguments on both sides of this issue, notes the Council, it is not an easy matter to decide where the public interest lies. From the simple perspective of promoting competition and opening up markets, nonfinancial firms should be allowed to own financial institutions without any reservations. From the simple solvency perspective, commercial/financial links should be banned outright. The former approach would enhance the competitiveness of various financial institutions but would, at the same time, serve to weaken the long-term stability of the financial system. The latter would buttress solvency but stifle competition. A middle-of-the-road solution is needed.

While stressing that many of its other recommendations are aimed at increasing competition, the Council judges that, on the question of links between nonfinancial corporations and deposit-taking institutions (which enjoy the benefits of deposit insurance), it is preferable to give priority to the solvency of institutions and the stability of financial markets. The benefits of commercial/financial links can be obtained in other ways.

The Council recognizes that a number of provincial jurisdictions have indicated their support for commercial ownership of financial institutions. The Council feels, however, that a more long-term

vision and a serious examination of the risks involved in such an approach are called for.

Realizing that links of this kind already exist between some institutions, the Council believes that such arrangements should be "grandfathered." Nevertheless, it feels that the commercial owners of financial firms should be required to gradually reduce their involvement to less-than-majority ownership.

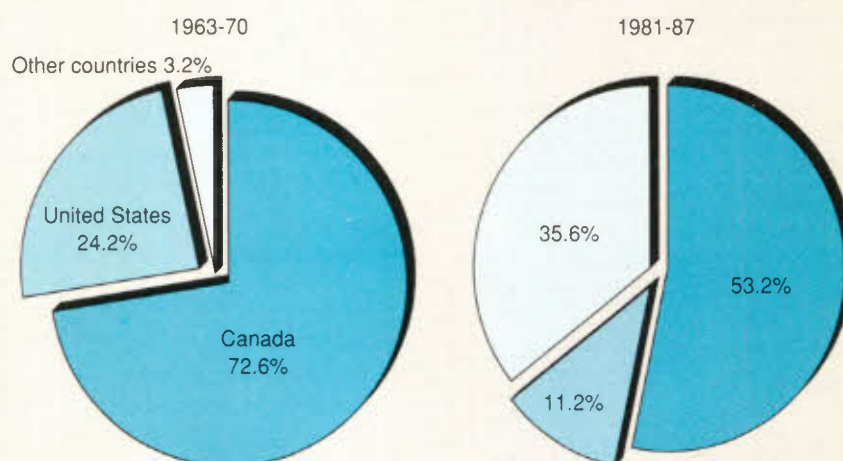
## Securitization

Among the list of new financial instruments, the Council singles out the conversion of loans into securities. This involves pooling mortgage loans, automobile loans, commercial loans, and so on into a pool created especially for this purpose and the selling to investors of participation certificates (or shares) in the pool. This process is called "securitization."

In 1987, 30 per cent of outstanding residential mortgages in the United States were pooled into funds of this kind. In fact, the concept had first appeared in the United States in 1970, with the assistance of the U.S. government.

The Council regards this financial instrument as a potentially important tool for the development of regions, particularly for small and medium-sized business. It also can serve to bring together

Placement of Canadian Bonds, 1963-70 and 1981-87



international and retail markets. Securitization of business loans, should it prove feasible, would benefit the development of regions and businesses and would strengthen Canada's financial institutions by enabling them to use their capital base more efficiently.

There are several components to the securitization process: origination of loans, packaging in a pool, establishment of a trust, selling of shares in the pool, credit enhancement, monitoring, and development of a secondary market.

The Council recognizes the inherent difficulties in the securitization of business loans given their heterogeneity. It therefore believes that the government must play the role of a catalyst in order to get a securitization program off the ground. Because the Federal Business Development Bank already plays an important role in the business financing area, it is likely in the best position to undertake the development of a securitized business loans market.

## Swaps

Financial innovation has spawned another instrument of efficiency that is particularly attractive to Canadians – swaps.

Swaps are essentially arbitraging instruments that allow market participants to take advantage of price differences between markets in order to make a profit or to lower their costs. Swapping is not only widely used, it is also, despite appearances to the contrary, a surprisingly simple technique. It is analogous to young boys and girls swapping cards depicting their favourite athletes. When they want a particular card, they do not check every box of cereal where such cards are found, but buy the first they find and then swap whatever card is inside with a friend who has the card they want.

Interest-rate and currency swaps operate in a similar fashion. A borrower or lender who wants an asset or liability with a particular interest-rate structure makes the best deal possible and then swaps the payments on his debt or investment with another borrower or lender. For example, a corporation that has obtained a fixed-term loan may assume the interest payment on a

floating-rate loan secured by another firm while the latter takes responsibility for the payments on the fixed-term loan.

Interest-rate and currency swaps, which did not exist in 1980, exceeded \$889 billion and \$210 billion, respectively, by the end of 1987.

## Investment abroad by pension plans

To facilitate the participation of all Canadians in the globalization of financial markets, the Council recommends the elimination of restrictions on Canadian financial institutions, and particularly the elimination of the tax disincentive for pension funds to investment abroad.

Under the Income Tax Act, trustee pension plans and registered retirement savings plans face a punitive tax penalty if their investments in foreign securities exceed 10-per-cent of the book value of the investing firms' assets.

Pension plans are large and are important investors in corporate securities. At the end of 1986, trustee pension plans altogether held shares worth a total of \$25 billion – some 10 per cent of all shares held by Canadians and about 37 per cent of all shares held by Canadian corporations and institutional investors.

Canadian pension funds often experience difficulty in diversifying their equity portfolios with Canadian securities alone. The 10 per cent limit also imposes a cost on pension funds inasmuch as it makes it harder to obtain the highest possible rate of return. The restriction does relatively little to improve the financing of Canadian business, since corporations (and governments) likely to have dealings with pension funds already have access to international markets. The Council acknowledges that, in the short run, some borrowers, including the federal government, might be adversely affected by the removal of this provision.

In any event, notes the Council, the removal of the present restriction should be implemented in successive stages and be subject to regular review.

Thus it suggests that the limit be raised by 2 or 3 percentage points annually, that the impact of the change be assessed every year, and that a comprehensive review should be conducted by the

Department of Finance when the ceiling has reached 20-25 per cent.

## Entry of foreign institutions into Canadian markets

In order to maximize the benefits of internationalization, argues the Council, foreign institutions must be given access to Canadian markets. Their presence in Canada may add to the stability of the domestic financial system and provide a stimulus to competition and financial innovation.

The Council's Statement recommends that the right of establishment be granted to all foreign institutions in all segments of the financial industry and that they benefit from the same privileges and be subjected to the same obligations (national treatment) as Canadian-controlled firms, on the condition that Canadian institutions be given "national treatment" in the markets of the country of origin of the foreign institutions.

The Council also addresses the question of how foreign institutions should be allowed to operate in Canada – by branch or by subsidiary. This is another issue with important ramifications for the stability of the financial sector. While acknowledging that opinion on this topic is divided and that branches are less costly to set up and operate, the Council nevertheless opts for the subsidiary option for foreign financial institutions wishing to establish in Canada.

In the Council's view, until such time as supervision of the various kinds of financial institutions is better coordinated and regulation at the international level is harmonized, prudence would argue for the subsidiary option.

## International banking centres

Another feature of the internationalization process that offers potential benefits for Canada is the booking of the international business of Canadian companies in Canada rather than abroad.

The Council notes that the place an international transaction is booked is often dictated by the taxation systems in place in the various countries (including, naturally, both taxes and exemptions). It is thus understandable that Canada has been attempting to match the financial

subsidies accorded by other countries in a bid to attract, or keep, this sort of activity. International Banking Centres (IBCs), which exempt the income from international operations from taxation, constitute just such a subsidy.

Parliament changed the Income Tax Act in 1987 in order to allow the designation of Vancouver and Montreal as International Banking Centres. As defined by the government, institutions in those two cities can accept deposits from, and make loans to, non-residents without paying federal tax on the profits from these transactions. Profits from investment dealing, letters of credit, and currency transactions, however, are still taxable. But the provincial governments have added their own concessions. For example, the Quebec government has gone one better than federal concessions by eliminating provincial taxes on capital gains, corporate profits, and employee income associated with international financial transactions taking place in Montreal.

The fact that IBCs are restricted to Vancouver and Montreal, notes the Council, may well result in business opportunities being lost. So far, little additional activity has been generated in Montreal or Vancouver. In the United States, on the other hand, there are no federal constraints on the location of international banking services.

Those who favour allowing these facilities to be established anywhere in the country argue that banks would set up IBCs where they would operate most efficiently; Canada would thus derive the greatest possible benefit. Since the international activities of Canadian banks are centred in Toronto, efficiency considerations would likely lead to IBCs being located in that city. In the United States, 80 per cent of banking centre assets are booked in New York City.

However, the Council recognizes that the establishment of IBCs in Montreal and Vancouver has a symbolic value in strengthening financial activities in those cities. Since we are dealing with a relatively recent phenomenon, concludes the Council, more time will be required before an adequate assessment of the efficiency of International Banking Centres is possible.

## Reducing the risks

The Council sees closer international cooperation among the supervisors of financial institutions as an important way the risk of a financial accident may be reduced.

It notes that the securities industry in general has lagged behind the banking system in this regard. International coordination of prudential supervision of securities dealing is still in infancy. The banking sector started work in this area in 1970. The major landmark of this movement is the 1975 Basle Concordat on the sharing of prudential supervision, designed to maintain the solvency of institutions and to protect their clients. In 1988, an agreement was reached on risk-weighted capital requirements.

The International Organization of Securities Commissions (IOSCO) was set up in its present form in 1984. It has created a number of technical committees to work towards finding solutions to some of these problems. Although some progress has clearly been made, the Council sees a long road ahead.

A number of problems beg for closer international cooperation, failing which the world's financial system may be vulnerable to accidents in the securities area. The Council cites such issues as the transfer of information between regulatory institutions, the control of fraud, self-dealing and abuses of conflict-of-interest situations, as well as capital-adequacy standards.

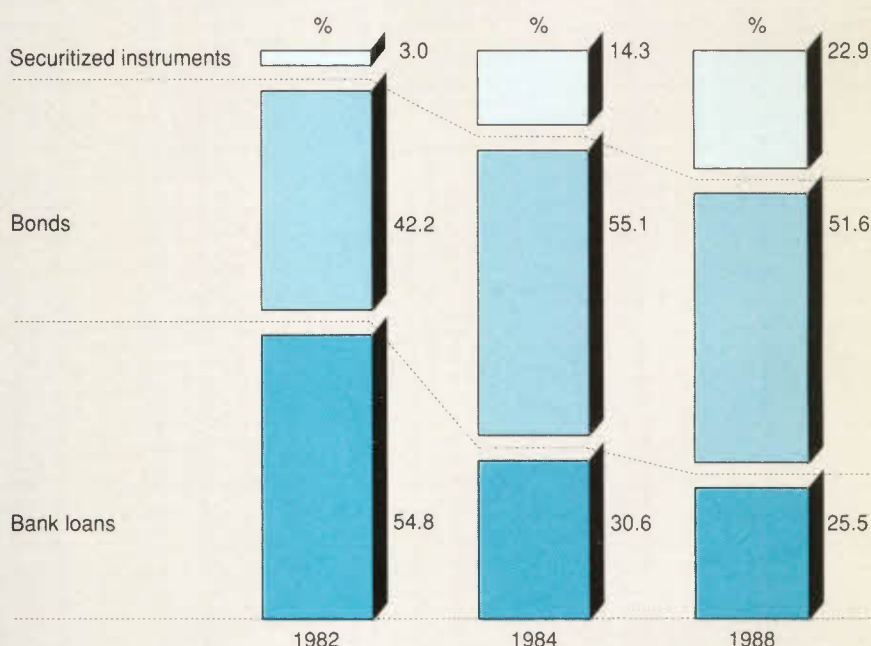
The Council also discusses the importance of achieving greater harmonization of accounting and auditing standards.

## Summary

Despite a number of remaining barriers, the drive to globalization and financial innovation is now unstoppable. These forces, stress the Council, *embody a compelling combination of economic logic and ever-more-sophisticated technologies.*

The world of finance has already been fundamentally transformed by the influence of these forces – and there is no looking back.

**Distribution of Funds Raised on International Markets, by Category of Instrument, 1982, 1984, and 1988**



# Securities

## Harmonization is necessary

One of the major economic developments of the 1980s has been the internationalization of financial markets.

This new global economy raises some important concerns: notably, differences in regulation systems, accounting standards, and compensation systems; the prudential supervision of multinational financial institutions; and the stability of financial systems throughout the world. Solving these problems will require international cooperation among the various supervisory authorities. It was with this goal in mind that the recently formed International Organization of Securities Commissions (IOSCO), with its secretariat in Montreal, has undertaken to promote better coordination of international regulations.

Mr. Paul Guy, the President of Quebec's *Commission des valeurs mobilières* and the General Secretary of IOSCO, was recently invited by the Economic Council of Canada to present a seminar on the problems involved in the growing internationalization of securities trading and on the urgent need for international cooperation in this area. *Au Courant* is pleased to present a summary of Mr. Guy's remarks.

### Internationalization of the securities industry

In light of the increasing internationalization of the securities industry, there is an urgent need for better coordination of regulations governing these activities, as well as sustained cooperation among various countries in order to ensure adequate prudential supervision.

This was the driving force behind the creation, in 1986, of the International Organization of Securities Commissions (IOSCO) in its present form. IOSCO now includes representatives from some 50 different countries. It has formed a technical committee to study some of the problems related to the internationalization of markets, which in turn has set up a number of expert task forces to study these problems and propose solutions. In his presentation at a seminar organized by the Economic Council of Canada, Mr. Paul Guy, the General Secretary of IOSCO, listed the main mandates of these groups: multinational security issues, the capital structure of securities firms,

offshore markets, accounting and auditing standards, compensation and international regulations, and fraudulent activities.

Barriers to international security issues hamper the internationalization of financial markets. As Mr. Guy noted, the stipulations governing such issues and the requirements for regulation publication of information on companies once stock has been issued vary greatly from one country to another.

Thus the first step in achieving better coordination of regulations, according to Mr. Guy, is to determine exactly what these differences are.

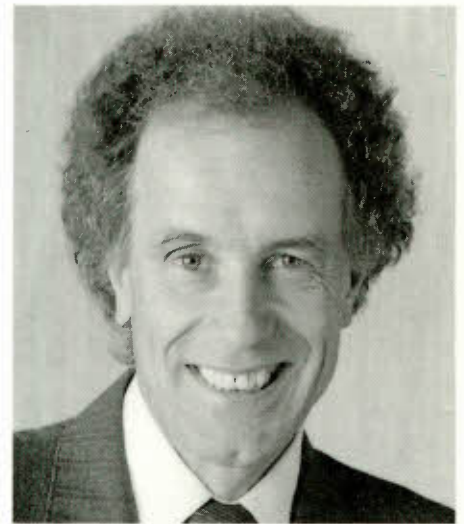
The difficulties involved in international issues are aggravated by the use of about 20 different sets of accounting standards worldwide.

For a number of years now, international organizations have been struggling with the task of developing a set of international accounting rules for corporate balance sheets and income-expenditure statements.

The imposition of minimum capitalization standards will serve to reduce the risks assumed by institutions and will come to be an important component of the supervisory process. Agreement has already been reached among a number of industrialized countries on minimum standards of risk in the banking sector. No such international consensus has yet emerged for the securities industry, however. Therefore, according to the IOSCO General Secretary, it is essential to develop standards not only for securities firms, but also for the other institutions, such as banks, that are becoming increasingly active in securities markets.

According to Mr. Guy, the fight against fraudulent transactions has been singled out for special attention by one of the IOSCO Technical Committee task forces. How to handle insider trading is becoming an increasingly important issue internationally. Mr. Guy believes that the best way to combat potential fraud is to set up special mechanisms to deal with cases of cross-border fraud.

Compensation and regulatory systems are also a source of concern to those involved in investment dealing. In North America, for instance, stock-market transactions are carried out within five



Paul Guy

business days. In other countries, they may take much longer to complete. Thanks to new technologies, it will soon be possible to finalize such transactions in less than a day. Until a transaction is completed, there is always a risk that the parties to a transaction might renege on their commitments; thus the time factor is crucial. The first step is for all countries to set up efficient compensation and regulation systems. Once this is done, the links between the various systems can then be established.

Mr. Guy pointed out that the agenda on international cooperation in securities dealing is very crowded, and so (as is usually the case when extensive international negotiations are involved) progress tends to be slow. He stressed that, despite the urgency of the situation, one cannot expect miracles. While the stock-market crash of October 1987 has so far not had any catastrophic repercussions, it still forcefully underlines the new risks inherent in a global economy and the benefits that will come from greater international cooperation.

Europe is rapidly moving towards unification of its financial markets. Thus it is extremely important, according to Mr. Guy, to make sure that the direction taken by this block in terms of investment dealing does not conflict with the rest of the international community.

Mr. Guy's conclusion? The members of the International Organization of Securities Commissions have quite a job ahead of them.

# Research and the "power of ideas"

As Judith Maxwell begins the second half of her term as Chairman of the Economic Council of Canada, she has agreed to review the first three and one-half years as well as to map out the Council's future directions as it prepares to enter the 1990s. As economic issues increasingly spill over into other areas, the Chairman sees many challenges ahead for the Council. She notes the important contribution that the Council can make through its research activities and emphasis on consensus – an approach that is helping decision makers and the public at large to rebuild the economic and social cohesion that has been so sorely tested during the 1980s. Mrs. Maxwell also stresses the quality of the "message" that the Economic Council must deliver to those responsible for charting the course of Canada's economic and social policy.

## The Economic Council of Canada: Directions and Perspectives

Somewhat like an air traffic controller at a large metropolitan airport, the Council must look as far ahead as possible in order to anticipate the difficulties and challenges that lie over Canada's economic horizon. It must weigh all the factors involved in order to determine the best flight plan for the well-being of Canadians.

For Judith Maxwell, now beginning the second half of her term as Economic Council Chairman, that is as far as the analogy goes, however. Unlike an air traffic controller, the Council does not have the final say (or even a privileged say) in the dialogue with those responsible for setting the course of Canada's economic policies.

"In this context, the form of the Council's message becomes almost as crucial as the content," the Chairman observes, "all the more so because of the large number of parties simultaneously clamouring for the attention of today's policy makers."

Mrs. Maxwell points out that basic research remains the cornerstone of the Council's work. While the complexities of the modern economic environment demand that research projects be as

exhaustive and rigorous as ever, she intends to focus on improving the quality of the message while maintaining the high standard of the Council's primary research during the second half of her term. The message, she says, "must be easily recognized and understood."

When it was established 25 years ago, the Council enjoyed a virtual monopoly on economic policy research. Today, decision makers are inundated with information and must be able to grasp rapidly and accurately the essence of economic policy advice and its relevance to their preoccupations.

## The Power of Ideas

Looking back on her three and one-half years as Council Chairman, Mrs. Maxwell notes one phenomenon that stands out: the "power of ideas."

"It is fascinating to follow the development of an idea and to realize the contribution it can eventually make to policy making, perhaps even to shaping public opinion. In essence, the Council is a generator of ideas." For example, the Council's emphasis on the importance of consultation and training in making successful use of new technologies has altered the way many Canadians think about technological change.

The Council, notes Mrs. Maxwell, has two major roles: creating a body of "economic know-how" through the work of specialized research teams and, equally important, using this knowledge to achieve a consensus that can help guide Canadians as they choose among the options available to them.

Canada's economic environment has changed radically since the Council was formed in 1963. Mrs. Maxwell singles out as an example the turbulence of the 1980s, produced by the combined effects of an unexpectedly severe recession, the shift from a resource- to a service-based economy, the rapid expansion of urban centres at the expense of rural areas, the polarization of opinion among economic advisers, changes in the ethnic mix and age profile of the population, and the growing importance of issues (such as social programs, health and education) where provinces have, or share with the federal government, a controlling jurisdictional interest.



Judith Maxwell  
Chairman

In addition to these contentious issues, Mrs. Maxwell notes important international factors: the increasing globalization of the economy and of financial markets (a question addressed in a recently released Statement by the Council, discussed elsewhere in this issue); and the emergence of new economic powers, such as the Pacific Rim countries.

The combined result of all of these factors is that governments must make increasingly difficult choices at a time when the country is most in need of coherent policy approaches to a multitude of issues.

"The Economic Council can never claim to have all the answers to this extraordinarily complex jigsaw puzzle, but it is certainly in a position to make a valuable contribution to the process through its ability to generate new ideas," the Chairman believes. And that is exactly the challenge that Mrs. Maxwell and her team will attempt to meet in the final years of her term.

Specifically, the Council will bring its expertise to bear upon projects that squarely address some of the problems that tend to create divisions within Canadian society. The ultimate aim of this effort is to stake out the common ground where governments can make judicious policy decisions that citizens can understand and support.

## A Unique Aspect

The Council certainly devotes a great deal of effort to basic research, especially data collection, sorting, and analysis. But, adds Mrs. Maxwell, "we must also

cil's "message" is being received loud and clear. Its advice is now being sought out by both federal and provincial agencies – a sure sign of its pertinence. On a number of issues, Mrs. Maxwell notes,

researched, tested, and communicated by the Council, can make a contribution to the development of public policy.

## Projects

The agenda for Mrs. Maxwell's next half-term is particularly full. The Council will be looking at a number of issues where Canadians have some difficult choices to make. Several of these issues range beyond purely economic considerations and so will require multidisciplinary teams.

In the fall, the Council will publish its *Annual Review*, this year focusing on intergenerational equity. Mrs. Maxwell notes that this theme will draw upon the Council's research into the economy's potential for long-term growth, Canada's aging population, and the growing concern for the environment – "all issues that will form part of our legacy to the next generation," she points out.

The Council will also focus on labour market policy. A Statement on employment in the service economy will be

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*"It is fascinating to follow the development of an idea and to realize the contribution it can eventually make to policy making, perhaps even to shaping public opinion."*

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endeavour to understand how governments work, how the regulatory system and our various institutions operate, and how our industries and communities have organized themselves to deal with their problems." This extra dimension of policy analysis is essential if the Council's work is going to be both pertinent and well-understood.

The Chairman finds the contribution of the Council's members to this process extremely valuable. The task of these individuals, who represent the various regions and economic interests of the country, is to review and discuss the results of the economists' work in order to arrive at a consensus position on the Council's recommendations before the final product is delivered to decision makers and the public at large. The quest for consensus is one of the Council's outstanding features and ensures the uniqueness of its contribution to government program development.

## "Message Received!"

Mrs. Maxwell is particularly proud of the performance of the Council as a whole in the last few years. It has succeeded in carving a place for itself in an extremely competitive environment, despite budget cutbacks that have led to a 10-per-cent reduction in its research staff and its operating budget.

Experience has shown that the Coun-

the Council's approach has become a benchmark. She points to the Council's findings on the impact of technology on labour markets, which have been adopted

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*"The Economic Council can never claim to have all the answers to this extraordinarily complex jigsaw puzzle, but it is certainly in a position to make a valuable contribution to the process through its ability to generate new ideas."*

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as basic analytical tools by both the federal and provincial governments. The same is true of the Council's thorough examination of the potential impact of the free-trade agreement. Even more recently, the Council's Statement on Prairie agriculture has helped to influence public opinion in that area, with its advocacy of assistance based on income rather than on production. In fact, Mrs. Maxwell considers this an excellent example of how an existing idea,

published, assessing the impact in such areas as income distribution and job quality. In addition, Council experts will complete two other major studies – one on poverty and social policy in Canada, and the other on immigration (see interview, pages 14-15). Finally, the Council is considering a new research initiative on economic relations between Canada and the Pacific Rim countries.

# Canada is vulnerable in world markets

Canada is one of the most vulnerable countries in the world to developments in the extremely volatile world grain market.

With 75 per cent of its production destined for export, Canada is more dependent on foreign trade than its major competitors, and so has more to lose from the chronic instability and uncertainty that currently plague the world grain market. Consequently, the nature and structure of this market has a major impact on the prosperity of Prairie grain farmers.

In recent years, national policies have become increasingly interdependent around the globe. The effectiveness of farm programs in one country now depends more than ever on the prevailing policies of others. A desire to protect themselves against the see-saw fluctuations of world markets has led a number of countries to institute programs and policies to subsidize production and exports. The result has often been that price instability is simply exported from one country to another. Retaining one's market share has become a matter of national pride; what seems to have been forgotten is that it is impossible for all players to increase their market shares simultaneously.

The tendency to resort to unilateral policies in perpetual reaction and counter-reaction to the actions of other countries can only strengthen protectionism and generate a more hostile business climate. In 1984, existing trade barriers throughout the world cost Canadian farmers about US\$300 million.

In a study carried out for the Economic Council of Canada, Colin Carter, Alex F. McCalla (University of California, Davis), and Andrew Schmitz (University of California, Berkeley) stress how important it is for decision makers to understand that demand for grain in international markets is not elastic; i.e., it does not react strongly to price changes. At the most, changing prices may lead to a repartitioning of the market among the various producing countries. The three researchers state categorically that market instability is on the rise, not because of such traditional factors as climate and natural disasters, but because of shocks produced by particular policies.

The study's three authors believe that Canada has little to gain from a price war (which can only benefit importing countries), but much to gain from a worldwide reduction in tariff barriers. They acknowledge, however, that freer trade will produce both winners and losers. Eastern Canada's farm industry, for instance, is unlikely to champion trade liberalization. But, for Canadian Prairie farmers, far fewer options are available than for their counterparts in competing countries.

It is for good reason, according to the authors, that Canada feels caught in a situation not of its own making and about which it can do little without the cooperation of others.

Recent moves towards trade liberalization, including the Canada-U.S. Free-Trade Agreement, give some reason for hope, but the authors are quick to put a damper on unwarranted optimism. According to present indications, they say, both optimistic and pessimistic scenarios regarding future developments in grain markets remain equally plausible.

If liberalization falters, Canada could still pursue long-term bilateral agreements. This would not solve the price-war problem, however, since Canada

would still have to compete with the United States, whose exports are subsidized.

In short, Canada has little choice but to support cooperative and multilateral approaches, and so must adopt farm strategies that are flexible and that keep its options open.

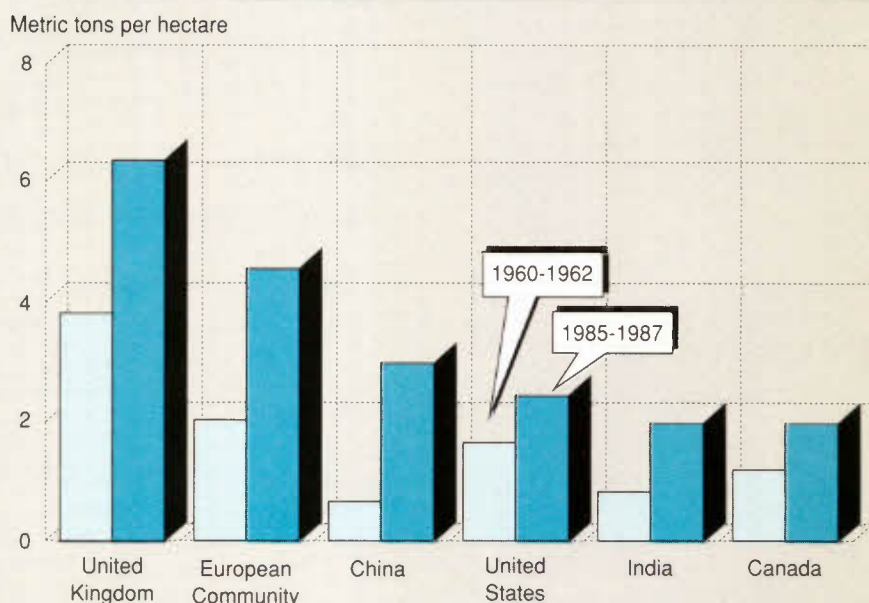
As far as government policies are concerned, the authors urge governments to strive to create an economic environment conducive to development while safeguarding their capacity to come to the aid of farmers should events take a turn for the worse.

## Major structural change

The phenomenal increase in grain production in the European Economic Community is without a doubt the most striking structural change in world grain markets of the last 30 years.

Even though its cultivated area of 35 million hectares has hardly changed, the EEC has managed to double its grain production. From the largest grain importer and Canada's main customer during the 1950s and 1960s, the EEC has moved to become the third largest grain exporter in the world.

Wheat Yields in Selected Countries, 1960-62 and 1985-87



China and India have also made spectacular gains in yields. In 1960, these countries produced 0.77 and 0.78 tonne of wheat per hectare, respectively. By 1985, India's output had more than doubled and China's more than tripled to 1.81 and 2.93 t/ha, respectively. The authors point out that if it is possible for India to attain self-sufficiency through appropriate support policies and modernization programs, a number of other developing countries should be in a position to do likewise.

The United States, for its part, succeeded in increasing production by 55 per cent over the same period.

Between 1960 and 1985, Canadian grain production increased 25 per cent, from 1.42 tonne per hectare to 1.74. Fourth in terms of yield per hectare in 1960, Canada slipped to sixth place by 1985 – actually ranking below the world average. Output, it must be remembered, can vary a great deal from one year to the next. Canada's share of world production has generally remained around 20 per cent.

Particularly because of the EEC's excellent performance, Canada's exports to developed countries have fallen sharply, from 48 per cent in 1969 to 27 per cent in 1983. Canada recouped some of these losses through increased sales to countries with centrally planned economies, which jumped from 33 to 49 per cent over the same period.

The EEC has been steadily increasing its share of the world export market. In 1985, it accounted for 15 per cent, just 3 per cent lower than Canada. The extent of this turnaround is illustrated by the fact that the EEC managed to transform itself from an importer of 10.3 million tonnes of wheat in 1960 to an exporter of 14.2 million tonnes in 1985. It now has a major impact on international markets.

### Japan

The import-demand prospects for the Chinese and Soviet markets present an enigma for the Canadian Prairie economy. The Soviet Union has always represented an unstable market, while China, at once the world's largest grain producer and one of Canada's most important customers, has set its sights on grain self-sufficiency.

Clearly, then, Japan, the world's largest net importer of food, represents an extremely attractive market for Canadian grain.

While Canada is already one of Japan's most important suppliers, it has to cope with a remarkably stringent system of tariff barriers that serves to restrict transaction volumes.

The retail prices of food in Japan are much higher than world prices. The retail price of rice, for instance, is double that in the United States. Beef is eight times more expensive and pork three times more expensive than in the United States.

Japanese government agencies buy food products at prevailing world prices, but then put them on the domestic market at much higher prices. The profits from this arrangement are channelled into farm subsidy programs.

In 1987, the Japanese government realized profits of approximately \$1.6 billion on wheat imports alone. Japanese farmers thus enjoy a strong protective umbrella, probably the most extensive in the world. The fact that the world wheat price is set by the United States, point out the authors, explains

why the 1985 U.S. *Farm Bill*, which has allowed the authorities to set target domestic prices and loan rates for farm commodities, has had such an important impact.

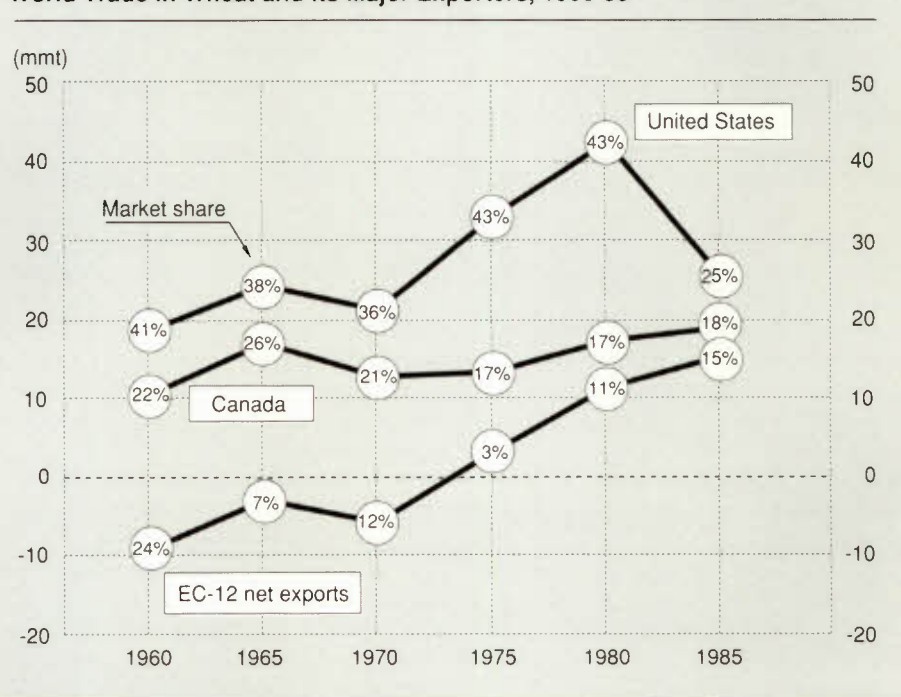
In order to remain competitive, Canada, too, must lower its export prices. The big winner in this game, of course, is Japan.

For every \$1 per bushel reduction in prices, the Japanese Food Agency pockets about US\$200 million, and Canada loses approximately \$45 million.

It goes without saying that freer trade with Japan, whether through a bilateral agreement or under the terms of GATT, will be of greater benefit to Canadian than to U.S. producers. The way things now stand – with the quota system for beef imports, the preferential treatment for corn feed over barley, and the JFA's wheat import system – is to the advantage of U.S. producers.

The conclusion of the Carter, McCalla and Schmitz study? Freer trade with Japan is what Canada needs in order to increase its market shares for these three products.

World Trade in Wheat and Its Major Exporters, 1960-85



# Measuring costs and benefits

Canada's birthrate is falling and its population growing older. According to demographic experts, the country's population will peak around the year 2030, then start to decline. Should we revise our immigration policy to compensate for this trend? That is the crucial question we must address.

Public pressure is growing for Canada to adopt a more open attitude towards immigration, particularly for immigrants from the Third World. Many Canadians are calling for more of an open-door policy, not just for refugees but also for ordinary people seeking better lives for themselves and their families.

The question of whether, in response to either of these trends, the pace of immigration should be allowed to rise in the next 10 or 20 years has become urgent. It is a complex issue, however. Immigration has a ripple effect that spreads to all corners of Canadian society. Not only are the questions many and complicated, they are often emotionally charged. Does immigration have an effect on the Canadian economy? If so, to what extent and in what way? What is the impact of the arrival of new immigrants on employment, urban development, social programs, governmental jurisdiction, cultural identity, or the economy as a whole?

In an attempt to find answers to these important questions, the Economic Council of Canada has undertaken a research project on immigration. The results, which should be available towards the end of 1990, are expected to be controversial. The Council believes, however, that to ignore an issue of this importance would be a far worse mistake.

A multidisciplinary team of experts will attempt to measure the impact of immigration on Canadian society as a whole. The team will try to debunk some of the myths that abound on this subject, in order to draw useful conclusions and formulate pertinent recommendations.

The task is a challenging one, for not all dimensions of this sensitive issue can be reduced to simple terms. To find out more about the Council's project, *Au Courant* interviewed its research director, Senior Economist Neil Swan.

**Au Courant:** Will you be working exclusively from data already available or will you be undertaking some basic research of your own?

**Swan:** We will make use of existing data, certainly, but we will also be doing some research ourselves. We will be using immigration data from the 1981 and 1986 censuses, and we will also be performing a number of special tabulations on these data. We will work closely with Employment and Immigration Canada and the Institute for Research on Public Policy in order to develop a longitudinal data base. This will enable us, among other things, to follow immigrants from the moment of their arrival in Canada, in order to find out how well they do out in terms of income and jobs, of their involvement in the business world, and so on. Ideally, the research could also be carried out for a small group of Canadian-born residents with similar profiles for comparison purposes.

**Au Courant:** Will studies of immigration done in other countries be useful to your work?

**Swan:** Naturally, we don't want to reinvent the wheel. There have been many studies on the topic of immigration elsewhere, and we will want to see whether their conclusions are in line with ours. In certain cases, we would like to pursue research in more depth. There have been some Canadian studies on the economic impact of immigration. While some of the foreign studies are certainly relevant to our project, we must take into account the many differences from one country to another. The United States, for instance, receives many immigrants from Mexico and Latin America. Some of these individuals enter the country illegally. Within the American population itself, there is a large black minority, as well as a sizable Hispanic minority. The position of the United States, therefore, is very different from our own, making it difficult to make comparisons. These same is true, to varying extents, for Great Britain and Europe in general. They are all distinct societies, with immigration traditions that differ from our own. One study that should prove



Neil Swan  
Research director

useful, however, is the one recently completed on immigration into Australia.

Other foreign studies on the social character of immigration may also prove helpful.

**Au Courant:** Does immigration have any impact on the standard of living of Canadians? If so, in what way?

**Swan:** This important question will be explored in a sub-project of the main study. It is quite possible, of course, that the level of immigration does affect our living standards, although opinion on this subject is clearly divided. Some claim that higher immigration bolsters the standard of living; other claim the opposite. It may be that immigration levels affect not only our standard of living but also the rate at which it changes. We hope to be able to measure changes in the standard of living, but measuring the pace of change may prove impossible.

**Au Courant:** Part of the controversy surrounding immigration involves the question of jobs. Will you be looking at this issue?

**Swan:** Yes, we hope to determine whether higher immigration has an effect, either temporarily or permanently, on employment. Does immigra-

tion create jobs, eliminate jobs, or is it employment-neutral? We will also try to find out whether certain groups are put at a disadvantage by immigration, in terms of jobs or income.

**Au Courant:** *How do you intend to differentiate between the economic and social aspects of immigration?*

**Swan:** Immigration clearly has an economic dimension, but its scope goes far beyond economics. The economic dimension may not even be the most important. The existing literature suggests that the effect of immigration on the economic welfare of Canadians themselves is probably not very significant, certainly not enough to warrant it being a major factor in determining how many immigrants Canada will eventually decide to accept.

The social dimension of immigration is much more important but lends itself much less readily to measurement, as it involves relationships between various groups in Canadian society. It is much more difficult to measure the advantages, disadvantages, or even the lack of change involved in various scenarios, such as those created by fixing immigration ceiling at 100,000, 200,000 or even 300,000 persons.

Because the social dimension is crucial, we will be calling upon the services of a group of experts from many different disciplines. We have already secured the services of a sociologist who will be coordinating research in the non-economic areas of our project.

**Au Courant:** *Is it possible to predict what changes will take place in immigration patterns?*

**Swan:** In the years to come, the traditional make-up of immigration will change a great deal. Because of the growing desire of people in Asia, India and Africa to emigrate, the face of immigration into this country will become much more visible. Again, the advantages and disadvantages of this phenomenon, as well as the possible reaction of Canadians to various immigration volumes, must all be explored.

**Au Courant:** *Will you be concentrating on certain specific immigration issues?*

**Swan:** The economic component of the project will attempt to focus on the consequences of immigration for Canadian-born residents, although we will also be looking at the situation of the immigrants themselves. We will attempt to determine how immigrants

**Au Courant:** *Will the aging of the population and the declining birthrate be important research topics in your project?*

**Swan:** The question of the "greying" population is important, in the sense that some people believe that immigration will alleviate the dependency problem that is normally associated

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## *"Quebec's policy in this regard differs from that of English Canada, in that it strives to integrate immigrants into the Québécois culture."*

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are integrated into Canadian society and to gauge the extent and nature of their contribution.

**Au Courant:** *What effect does immigration have on urban and regional development?*

**Swan:** As is well known, immigrants tend to settle primarily in the major metropolitan centres – Toronto, Vancouver, and Montreal. This means they favour just three provinces. This could become a significant factor if, as some authors advocate, immigration were to be seen as a way to compensate for Canada's declining birthrate. From this perspective, immigration in its current form might be viewed as contributing mainly to population increase in those three metropolitan areas.

**Au Courant:** *Will you be making a distinction between ordinary immigrants and refugees?*

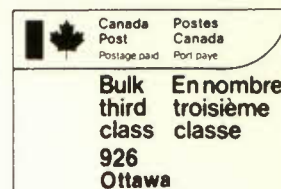
**Swan:** I don't think we can ignore that aspect. How can we, as Canadians, decide how a given immigration quota should be allotted between ordinary immigrants and refugees? Is there a fair way to do it? Naturally, the Council doesn't want to become embroiled in the delicate issue of trying to judge who is a refugee; still, we cannot avoid the issue altogether.

with an aging population. Others disagree. We will take a look at both of these views. As for the declining birthrate, many people believe, of course, that it is one more good reason to investigate the implications of immigration.

**Au Courant:** *Do you intend to single out the province of Quebec for special attention in your project?*

**Swan:** The integration of immigrants into society is one of the major issues raised in the context of immigration. There are two opposing points of view. Should immigrants be allowed to maintain and promote their native cultures while adapting to Canadian society, contributing to the country's vast cultural mosaic? Or should immigration policy aim at integrating new Canadians into the dominant culture? Quebec's policy in this regard differs from that of English Canada, in that it strives to integrate immigrants into the Québécois culture. Assuming a substantial increase in immigration, it would be interesting to study the advantages and disadvantages of the two schools of thought. Such an exercise should prove enlightening. I don't know what the right answer is, but this is certainly the kind of question that the sociologists on our team will be studying.

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# **WORKING TO IMPROVE CANADA'S POLICY PERFORMANCE**

... that has been the chief concern of the Economic Council of Canada since its creation as an independent advisory body in 1963.

Over the past two decades, the Council has focused on public policy issues of key importance to Canadians — including economic growth, the role of new technology, the impact of government regulation and the changing job market, to name only a few.

The Council pursues its goal of improving Canada's economic performance in three ways:

## **Consultation**

Members of the Council, representing a wide cross-section of Canadian society, meet regularly with governments and groups to study, analyse, and make

recommendations on significant economic issues.

## **Research**

An expert staff originates research and provides background information on a variety of topics, with particular stress on the medium- and longer-term problems of the Canadian economy.

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The need for better information on economic issues has led the Council to place strong emphasis on its contact with the public, through the use of topical publications, speeches, conferences, workshops and media relations.



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