

# au courant

Economic Council of Canada

Volume 8, No. 2, 1987

## The Council's Annual Review of the economy



- Free trade with the United States?
- A new project on international finance

# PUBLICATIONS

## Twenty-Fourth Annual Review

**Reaching Outward** (EC21-1/1987E; \$6.95 in Canada, \$8.35 elsewhere).

In its 1987 review of the economy, the Council looks at some of the important structural changes that will influence Canada's long-term economic performance, including the globalization of markets and the potential impact of a Canada-U.S. free-trade deal. The Council's medium-term outlook for the economy is featured as well.

## Annual Report

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**No. 323** "Fiscalité et l'endettement des entreprises canadiennes," by J.-M. Gagnon, J.-M. Suret, and J. St-Pierre.

**No. 324** "Taxation and the financial policy of firms: Theory and empirical applications to Canada," by Jan Bartholdy, Gordon Fisher, and Jack Mintz.

**No. 325** "L'inférence des taux marginaux d'impôt à partir des cours boursiers," by J.-M. Gagnon, J.-M. Suret, and D. Morissette.

**No. 326** "Identifying and measuring the impact of government ownership and regulation on airline performance," by D. W. Gillen, T. H. Oum, and M. W. Tretheway.

**No. 327** "Cost-effectiveness of after-tax financing: Flow-through shares in Canada," by Glenn P. Jenkins.

**No. 328** "The formation and dissolution of the Canadian rail cartel," by A. Ellison.

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Editor: Jonathan Massey-Smith

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# Reaching Outward

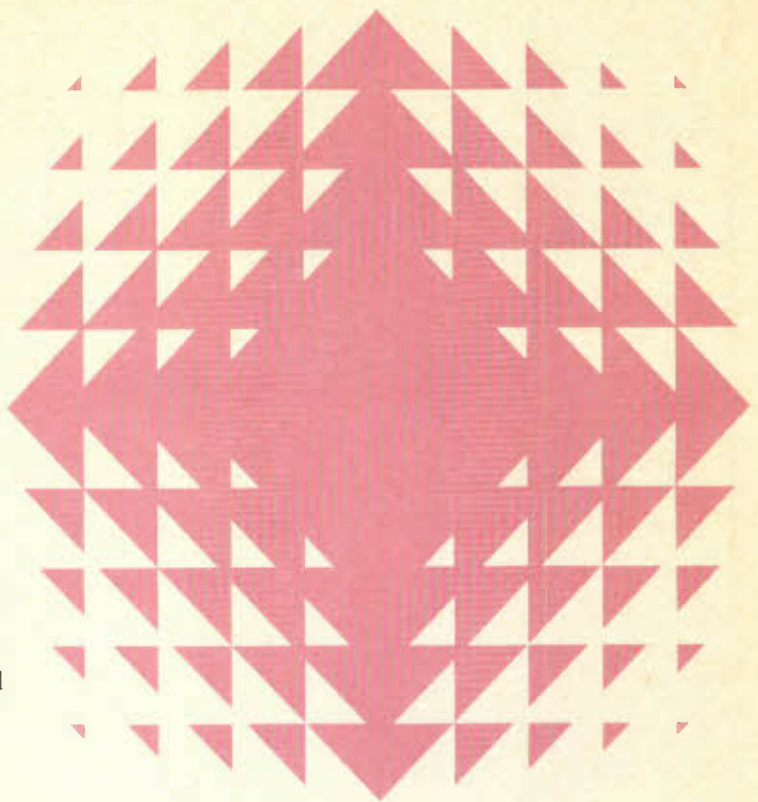
Canada has legitimate grounds for pursuing its own cultural and social policies, as well as regional and industrial development, under a free-trade deal with the United States, the Economic Council says in its Twenty-Fourth Annual Review of the economy.

The Council says that any pressure to harmonize these policies as a result of either the trade talks or protectionist U.S. trade legislation must be resisted. Given the importance of cultural development to Canadian identity and nationhood, the Council observes that government intervention to ensure some minimum level of Canadian content "may be deemed essential." As for Canada's social programs, it says there is "no legitimate basis . . . for the United States to attempt to force them to the negotiating table," since those programs "do not involve trade-diverting subsidies." Similarly, regional support initiatives that are intended to redistribute jobs and incomes within Canada are not "legitimate targets" for U.S. trade actions, it argues.

One way or another, the next year will be a major turning point in Canadian history, the Council says. If a Canada-U.S. trade accord is implemented, it will require major adjustments. But it also promises sustained benefits. If no trade deal occurs, Canadians will have to rethink seriously their approach to commercial policy and to international diplomacy.

The Council is struck by the degree to which national economies are becoming increasingly integrated and by the relative decline in the economic leadership of the United States. The first development includes growing pressure on governments to harmonize their laws governing commercial transactions. In the second instance, U.S.-led economic growth is showing signs of faltering because of the huge trade imbalance and massive government debt in that country. The Council warns, in fact, that the prospects of the U.S. rectifying its trade imbalance without resorting to protectionism are not "especially strong," unless the industrialized world can sustain growth of about 3 per cent annually over the next few years. But such growth may require strong fiscal initiatives on the part of major surplus nations such as Japan and West Germany. So far, neither country has shown sufficient willingness to respond in this regard.

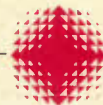
In contrast to the growing protectionism on the trade front, there is widespread liberalization taking place in most of the world's major financial centres. Investment capital is increas-



ingly mobile internationally. Governments have been forced to recognize that autonomy over economic policy is clearly limited, the Council says. It suggests that, at a minimum, leading industrialized nations "explore systematically the options that exist between the two extremes of fixed and floating exchange rates." Similarly, coordination and action are required to help the less developed nations work off their debt burdens in ways that will not destabilize the international financial system. The price of limited action to date has been a deterioration in the financial health of debtor countries and a major constraint on world trade.

In this environment, one of the key objectives for economic policy, in the Council's view, is to make the economy resilient enough to withstand unfavourable shocks from abroad – such as low commodity prices, for example. At the same time, the Council believes that Canada is well placed to seek out and compete in new markets. In fact, it has already demonstrated its capacity to trade with Japan and the newly industrialized nations. Moreover, the realignment of the Canadian dollar in relation to the Japanese yen and to European currencies has enabled Canada to increase exports to those markets. Even though Canada lags behind other countries in the use of robots, computers, and process technologies, it is ahead of most others in its application of satellite communications, remote sensing, optic-fibre networks, and other basic technologies. Canadian businesses now attract capital from around the world; with it comes new technologies and expertise that enhance competitiveness. The Council also notes that Canada is "a young and informed society." Proportionately, for example, it has more young adults in full-time postsecondary programs than any other industrialized nation except the United States.

On subsequent pages the Council describes its medium-term economic outlook against this background. It also examines the growing pressure to harmonize policies across the Canada-U.S. border, with special attention to subsidies, health care, and cultural industries.



# Outlook for the economy

The Council's main projection of the key economic indicators – which it calls the “base case” – is founded on certain specific assumptions (on the past performance of the economy, for example, as well as its present position; on current information about its future course; on the outlook for foreign economies; and so on). Using this basic projection, the Council then tries out various scenarios or alternative cases to see how the economy would be affected.

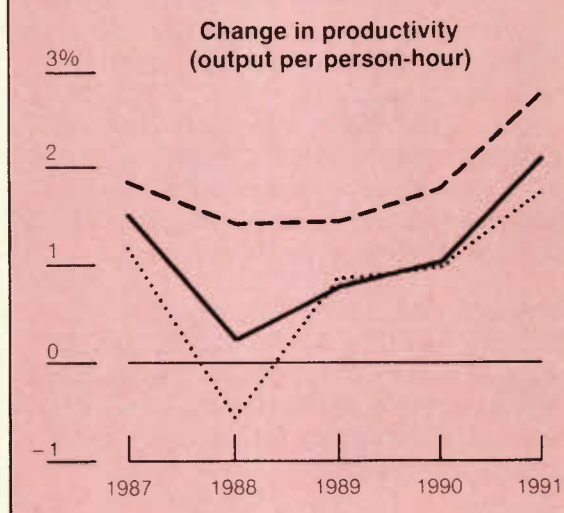
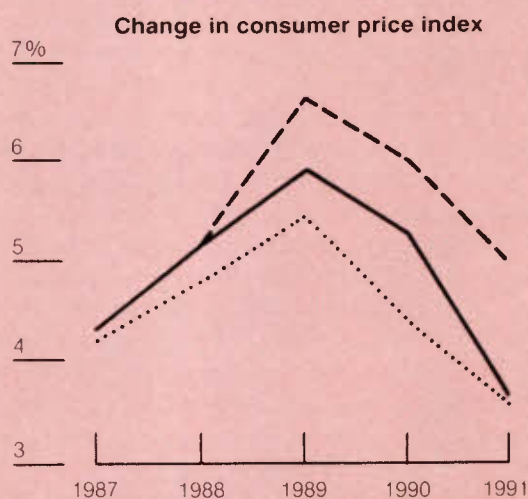
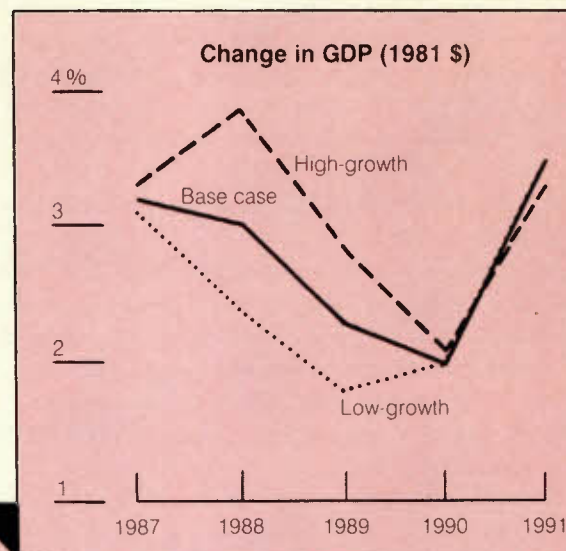
At the moment, central Canada is enjoying an economic boom, triggered primarily by last year's fall in oil prices and interest rates, as well as the exchange-rate realignments that have made Canadian products more competitive in Europe and Asia. Increased exports to the United States have contributed to the recovery as well. The result has been a sharp drop in unemployment in the industrial centres of southern Ontario and Quebec, and a decline in the personal savings rate as Canadians have become more confident about the future. As well, government revenues (especially in Ontario) have increased in response to higher incomes and sales.

But the recovery has been slow to work its way through to other provinces. A revival in the oil sector will help western Canada and possibly parts of the Atlantic region; but the glut in agriculture, depressed metal prices, and the uncertain availability of adequate fish stocks, among other things, will affect the future prosperity of those regions.

The Council singles out three problems that deserve special attention over the next while: unemployment; debt burdens; and productivity growth. Unemployment remains unacceptably high in the resource-producing regions of the country, it says. The federal government's fiscal position is still tenuous, despite several years of rigorous spending restraint. The widening gap in manufacturing productivity between Canada and the United States is worrisome as well, because this sector is the most exposed to international competition.

The Council recognizes that the choice of policies used to tackle regional imbalances is limited by fiscal constraint. The Bank of Canada faces a dilemma, too, because there is no mechanism to differentiate monetary policy among regions where economic performance diverges. In this sense there could be the risk, for example, of precipitating inflation in central Canada while the rest of the country is still struggling to get out of the recession.

In the Council's view, the medium-term outlook is plagued by uncertainties, depending to a considerable extent on the way the industrialized countries work out the current imbalances in trade and capital flows. By far the most important factor to watch is interest rates, followed by the outlook for the U.S. economy, the possibility of a Canada-U.S. trade deal, and the impact of recent tax-reform proposals in Canada. The Council's base case calls for the continuation of steady growth for Canada as a whole until 1989, but wide disparities in regional growth rates will still exist. By the end of the decade, Canada will still have some distance to go



before a reduction in unemployment and deficits, as well as growth in productivity, will enable it to deal undeniably from a position of strength.

Real growth is estimated to average 2.8 per cent during the 1987-91 period. The year 1988 will be a bit stronger, with growth at 3 per cent. In the following two years, however, economic performance is expected to be below average, reflecting, among other things, a weakening of the external sector and a tail-off in the investment cycle. In the Council's high-growth scenario, real growth is expected to average 3.1 per cent over the next five years. Both the unemployment rate and the government deficit as a percentage of gross domestic product (GDP) show modest improvement, as do other indicators. In the low-growth scenario, real growth averages just over 2 per cent; in this case, the growth is weak enough during the 1988-90 period to cause new damage to deficits and unemployment rates.

Inflation is expected to average just below 5 per cent in the base case, peaking at 5.9 per cent in 1989. Its level will be affected by the recovery in oil prices, the expectation of a U.S. inflation bubble, a tightening of labour markets, a bottoming-out of commodity prices, below-average productivity performance, and some upward pressure on the growth of nominal wages.

Employment growth in 1987-88 should be strong, following the pattern of real growth; but it will slip below 2 per cent in the 1988-90 period, when real growth weakens.

Productivity growth (output per person) is expected to advance at a rate slightly above 1 per cent annually. The Council expects strong productivity performance in 1987 and that it will strengthen again as the economy recovers from the 1990 growth pause. A poorer performance during the intervening years contributes to upward pressure on unit labour costs, adding to the inflationary strains in 1988-90.

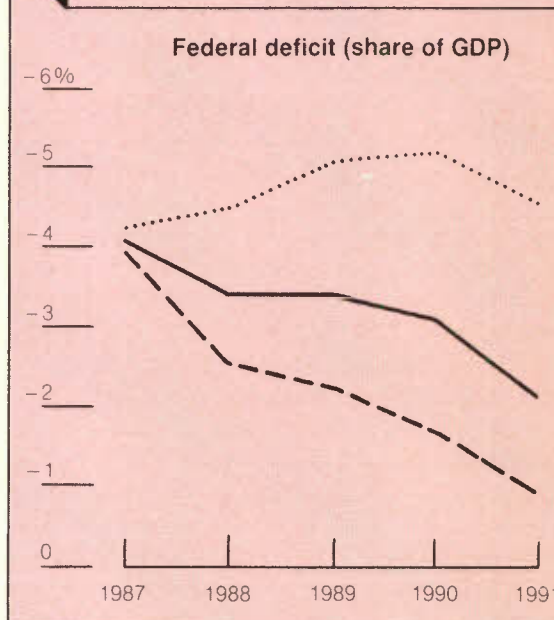
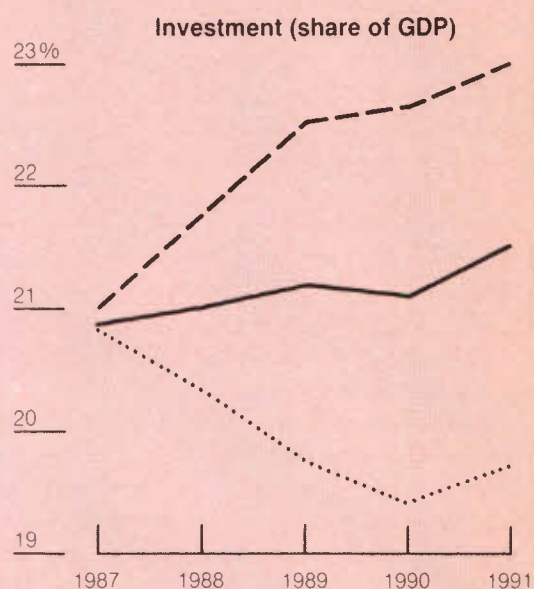
After a long drought, growth in real wages recovers during the 1989-91 period. Nominal wage growth will average about 5.3 per cent but exceed the 6-per-cent mark in 1989-90.

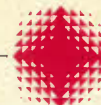
By the end of the decade the unemployment rate declines to just above 8 per cent, while averaging 8.5 per cent over the 1987-91 period. The decline is interrupted by the period of slow growth in 1990, after which a strong recovery nudges the unemployment rate downward again.

Investment is expected to be one of the engines of growth during the 1987-91 period. The origin of this strength will be the current surge in new housing construction, sustained growth in machinery and equipment purchases, and more spending in the energy sector.

Canada's current-account balance of payments remains in deficit throughout the projection period. A weakening of external demand, a bubbling-up of domestic inflationary pressures relative to external market conditions, and a weak automobile market all contribute to the deterioration in 1987-89.

No substantial improvement in the ratio of the federal deficit to GDP occurs until 1991, despite assuming sustained expenditure restraint. After the growth pause, a strong performance pushes it down to 2.1 per cent. If there are unforeseen expenditure increases or revenue shortfalls, however, little or no improvement can be expected.





# External pressures on domestic policy

Many of Canada's unique institutions and programs will be potential trade irritants unless there is an easing of protectionist sentiment in the United States, the Council warns.

It looks at three areas in particular: subsidies, social programs, and cultural industries.

On many occasions the Council has questioned the proliferation of subsidies and other government interventions in the economy. While agreement among governments as to the definition of "fair subsidies" will be difficult, the Council suggests retaining the definition applicable under the countervailing provisions of the General Agreement on Tariffs and Trade (GATT). It distinguishes between government support that is available on a universal basis and that which is applied selectively to shore up specific industries or firms. Under GATT rules only the latter are considered "countervailable subsidies" (where a country can, for example, impose import duties to offset the effects of the subsidy). The Council also says that it is not unreasonable for U.S. authorities to exert pressure in instances where, for example, Canadian public policy is aimed principally at shifting production and jobs from the United States. But when public policy has as its principal focus other national objectives – social concerns, cultural development, and the alleviation of regional disparities, for example – "these items are not cards that need to be played in a trade negotiation," it argues.

Even with an agreement on the definition of "fair subsidies," however, the U.S. Congress may retaliate in other ways. For example, it could argue that most of Canada's major social programs (health care and social security) lead to unfair competition. That's because they are funded largely from general tax revenues, while in the United States the funding comes primarily from payroll taxes or premiums levied directly on employers and employees. The result is that Canadian employers have much smaller payroll costs. Corporate taxes, as

well as personal taxes, are higher in Canada, however, in order to finance its social programs.

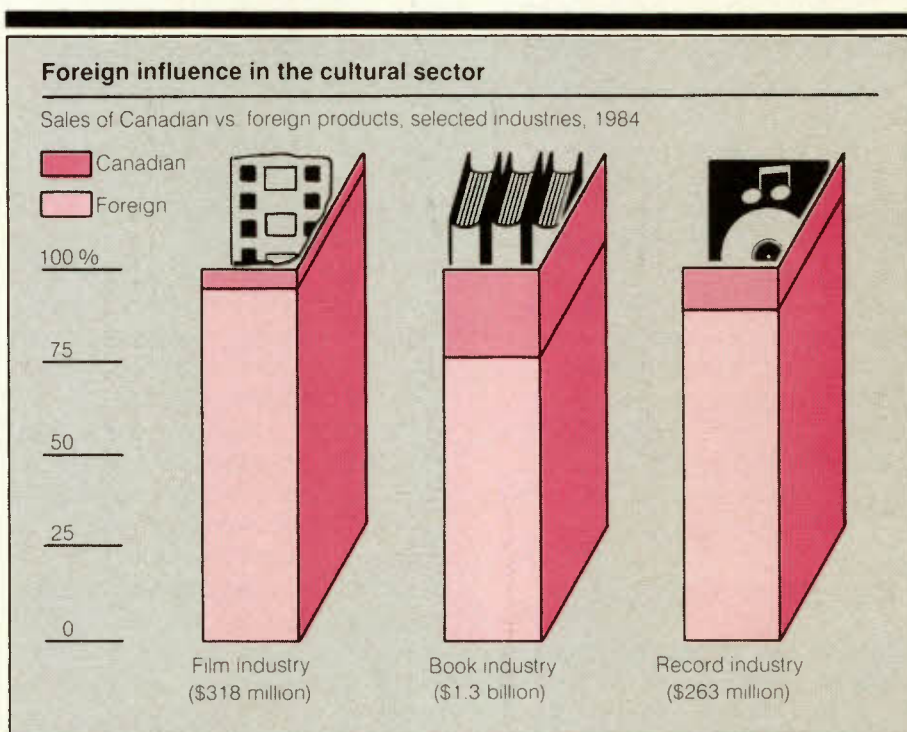
## Regional and industrial incentives

Canada has had a long tradition of using federal government programs to encourage growth in its less advantaged regions, to reduce income and employment disparities among regions, and to make available a basic level of services that is relatively uniform across the country. In general, the Council is "not much enamoured" with many of them. In a forthcoming document it will report on three trade-related adjustment programs in particular: the Pulp and Paper Modernization Program; the Shipbuilding Industry Assistance Program; and the Canadian Industrial Renewal Board. In each instance the Council finds that government intervention is "largely unwarranted," with the possible exception of labour-adjustment assistance.

Generally speaking, should these types of programs be aimed at relocating investment and employment in order to reduce regional disparities in Canada, they need not be subject to international negotiation. Should they be aimed at attracting investment that would not otherwise be economic in the longer term, however, they become a legitimate item for international negotiation.

## Unemployment insurance

A chronic complaint of the U.S. fishing industry has been the existence of special unemployment insurance provisions that assist Canadian fishermen. But the worry here has less to do with the possibility of countervailing action than with the broader pressures that might be applied to harmonize the two countries' systems. In the Council's view, "Canadians are not willing to see the program gutted or to give up regional or other portions of it unless there is a viable alternative put in place." It notes that



85 per cent of the jobless in Canada receive benefits, while in the United States roughly 75 per cent do not. (Because they are out of work, the U.S. jobless have no medical coverage either.)

## Health care

Through its 10 provincial governments, Canada has a comprehensive

commercial culture industries are at issue, including publishing, radio and television production, film making, and sound recording.) While Canadians are ardent consumers of cultural products and services, many of these are imported. The accompanying chart shows the degree of foreign influence in the film, book, and record industries, for example.

Because foreign-owned subsidiaries

**Canadians are clearly not prepared to give up the health care advantages they enjoy.**

health care system that is much admired internationally, the Council asserts. On a per-capita basis, taking all public and private spending into account, health care in the United States costs about one-third more than in Canada. In some cases the same operation costs three to five times more in the United States than in Canada. Irrespective of hospital costs, the largely privatized U.S. health care system is more expensive partly because of the higher number of physicians per capita and their generally higher salaries. Liability insurance is much more expensive there as well. Meanwhile, the U.S. Institute of Medicine reports that some 35 million Americans do not have medical insurance, and the disparities in access to health care are getting worse. While private U.S. institutions devote considerably more resources to research and are at the forefront of medical skills, Canadians "clearly are not prepared to give up the health care advantages they now enjoy," the Council believes.

In general, publicly funded programs that are directed at redistributing income and economic activity across regions or at insuring against illness, accident, or job loss are common to most industrialized nations, the Council notes. For that reason they have been excluded from the GATT definition of countervailable subsidies. "In short, there is no case to be made for countervailing action against Canada," it concludes.

## Cultural issues

The Canada-U.S. free-trade talks have intensified concerns about Canadian cultural sovereignty with respect to content, production, and ownership. (Only the

handle the sale and distribution of most imported cultural products, Canadian-owned enterprises are chronically underfunded. As a result, commercial lenders are wary of lending them capital. Moreover, with the trend to major corporate takeovers and mergers in the United States and Europe, the competitive environment is changing, to the disadvantage of Canadian producers. The fear is that in an unregulated free-trade situation the financial power and sophisticated marketing and distribution strategies of these multinationals "could well marginalize Canadian cultural products within the Canadian marketplace," the Council says.

Because of the size of markets in the United States and the United Kingdom, they are able to command products that reflect their unique cultural experiences, regardless of the ownership of the enterprises that operate there. "The same is not true when foreign-controlled firms operate in Canada," the Council maintains. Still, in the current trade negotiations, ownership should be of concern only when it limits Canadian content and competitiveness, it says.

Canadian governments have erected several trade barriers to further Canada's cultural development. These include legislation that prohibits foreign ownership of Canadian television, radio, and cable-vision stations; Canadian-content regulations; and postal subsidies that provide a cost advantage to Canadian periodicals. Such intervention may imply an economic cost to Canadians. "Given the central importance of cultural products to Canadian identity and nationhood, however, we can accept that such decisions may be deemed essential," the Council concludes.

At the same time, policies to support

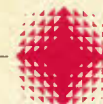
domestic content and sales are a matter for case-by-case consideration. In fact, says the Council, "Canada may find it necessary to seek out forms of support for culture that minimize distortions to trade."

## Trade adjustment

To illustrate the effects of Canada-U.S. free trade on the Council's base-case projections for the Canadian economy, the Council developed two scenarios. The results of these simulations were initially published in a separate discussion paper (see page 9 of this issue). In the Review, the Council provides additional information on trade adjustment.

For example, it finds that workers initially laid off as the result of a free-trade deal would generally have little difficulty finding work. That's because the job losses from free trade would be concentrated in the same occupations in which job gains would be the greatest — clerical, product fabrication, processing, service, sales, and management. The high degree of labour mobility between occupations and industries in Canada would make the adjustment process easier as well. But a significant number of women now working in textile and knitting mills in some of the small towns of Ontario and Quebec could be forced to find new jobs, the Council warns. At the same time, though, female workers generally would benefit more from trade liberalization than males.

Each year under bilateral free trade about 66,000 jobs would be created and 23,000 lost. But the job losses would represent less than 2 per cent of normal permanent displacements in any given year, the Council points out. Similarly, the adjustment pressures that firms and industries would face in adapting to the larger North American market would be modest compared with normal competitive pressures. In the Council's view, Canada would not need special programs to help displaced workers adjust to trade liberalization. But it calls on governments to focus on the training needs of individuals and on the smooth functioning of labour-market information systems to ensure that placement services work efficiently. The Council's recommendations in its recent study of the impact of technological change on labour markets (see *Au Courant*, vol. 8, no. 1) should apply to workers displaced by trade as well.



# Options for the future

A free-trade deal with the United States must satisfy Canadians on a number of fronts, the Council says.

In providing freer access to U.S. markets, it must take account of state and local, as well as federal, barriers. It must clearly identify areas of policy, trade, and investment that are non-negotiable, as well as the domestic institutions, laws, and regulations that are beyond the reach of countervailing action. It must contain clear definitions of subsidies that are countervailable and those that are not. These definitions should be in keeping with the spirit of the current definitions under the General Agreement on Tariffs and Trade (GATT). And, finally, the accord should contain a dispute-settlement mechanism that would deal with trade irritants quickly and impartially.

## *Failed negotiations*

Failure of the negotiations would be unfortunate, the Council says, but it need not be catastrophic. Almost 80 per cent of Canadian exports to the United States already enter duty-free, while the remainder bear average duties of less than 7 per cent, it notes. Should the negotiations fail and should the United States pursue its own unilateral trade policy more or less independently of GATT, two options are possible. One is to take a defensive stance, countering restrictive trade action with restrictive trade action, in a series of mutually self-defeating disputes and rounds of nationalistic posturing. The other is to turn outward, using aggressive marketing and a combination of lobbying and proactive diplomacy to strengthen the multilateral commitment to trade liberalization.

The defensive option would involve a period of severe economic stress and would probably result in substantial losses for Canada. The outward option would require a much more far-sighted

and aggressive commercial policy, with Canada sounding the alarm about the risks of protectionism; encouraging Japan, West Germany, and the United States to make a more serious commitment to the current round of multilateral negotiations; and pressing hard for an agreement to stop the addition of new trade barriers during the GATT negotiations. If relations with the United States are not seriously impaired by the failure of the talks, Canada should also form a common front on such issues as agricul-

tural subsidies, trade in services, and possibly intellectual property.

## *Increased lobbying*

Canada should push forward on two other fronts as well: increased lobbying in Washington, in order to forestall as many protectionist actions against Canada as possible; and more aggressive promotion of Canadian exports, especially in countries on the Pacific Rim. "In short, the alternative to Canada-U.S. free trade will not be the status quo but a tough and combative international marketplace," the Council says.

The spectre of protectionism aside, the Council sees much on the horizon that gives cause for optimism. Canada has survived the worst recession since the 1930s, along with a severe drop in commodity prices that now seems to be bottoming out. The commercial sector is leaner; financial institutions, more solvent. Business investment is picking up. Unemployment is falling, even in the most severely affected regions. Recent government initiatives appear to be strongly supportive of economic growth, including changes in the financial sector, tax reform, regional initiatives, and the trade talks.

Over the past few years the Canadian economy has been moving closer to the targets set for it by the Council in the past (see box). But it is unlikely that the targets for productivity growth and reduced unemployment will be met by 1990. For its part, the federal government has been pursuing a policy of spending restraint without engaging in vigorous slashing of social policies and entitlement programs. "In our view, that is the right course," the Council says. But the vulnerability of the federal fiscal position to an early downturn in the economy underlines the need to make as much progress as possible on deficit

## TARGETS

- 1 — Employment growth of 2 to 3 per cent a year in order to lower unemployment to a range of 6 to 8 per cent by 1990.
- 2 — Productivity growth of 1.5 to 2.0 per cent a year.
- 3 — Annual inflation of 5 per cent or less.
- 4 — Net capital inflows of about 2 per cent of GNE or less.
- 5 — The maintenance and improvement of existing social policies.
- 6 — A gradual reduction of the federal deficit to an easily manageable level.
- 7 — Regionally balanced growth, employment opportunities, and social infrastructures.

reduction while the economy is still relatively healthy.

## *Regional balance*

Moreover, Canada's major problem over the next few years will remain that of achieving regionally balanced growth

Some commentators talk about a post-industrial society in which advanced nations specialize in services that are then traded for manufactured goods produced in the industrializing countries. But the Council does not share this view. Recent studies have shown that about 60 per cent of commercial activity

remain a keystone activity of any medium-sized nation," it says.

At the same time, the Council reiterates its concern that if Canada is to sustain economic growth in a globalizing economy, it "has no choice but to reach outward to new markets." The possibility of a trade accord with the United States is one route. Should that fail, however, Canada must define a role for its medium-sized economy in a world of larger trading blocs. Canadian industry must therefore gear up to compete in markets outside North America.

(In commenting on the Annual Review, four members of the Economic Council questioned the validity of the assumptions used to model the impact of free trade, as well as the results of that process. They also felt the Review should have given more attention to the problem of unemployment, the need for labour adjustment policies, and the impact of Ottawa's recent tax-reform proposals.)

***The alternative to Canada-U.S. free trade will not be the status quo but a tough and combative international marketplace.***

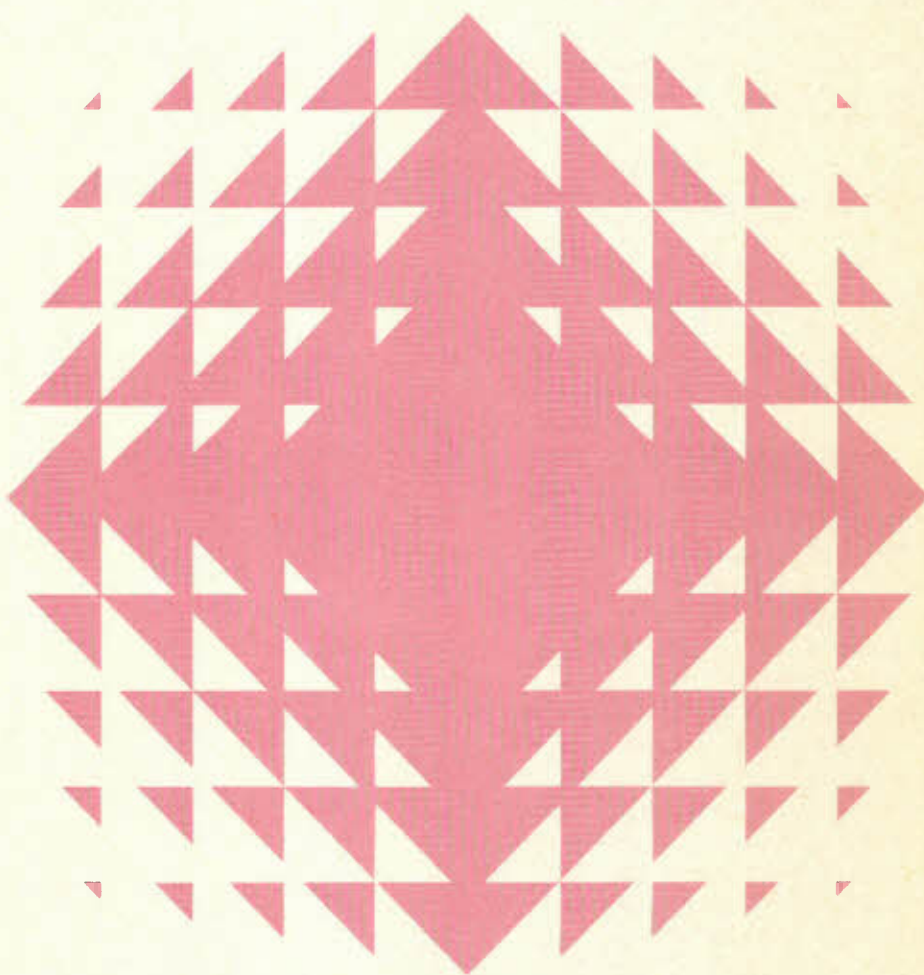
and employment. Since monetary policy is relatively impotent in addressing this issue, "there will be continuing pressure for federal fiscal initiatives," the Council says, at least until commodity prices recover. In this regard the creation of regionally based federal-provincial coordinating agencies should help in the design of sensitive policies to ensure that support programs are targeted at the most deserving groups and sectors.

Developments in agriculture have been particularly worrisome worldwide, setting in train a vicious cycle whereby subsidies encourage surpluses that are often dumped in developing countries, where they undercut domestic agriculture. The Council is addressing the question of the future market prospects for grain in its research on the future of the grain economy in the Prairie region, to be completed in 1988.

(including wholesale, retail, financial, and other commercial services) is related to the production, transportation, and distribution of manufactured goods. "We have little doubt that manufacturing will

## *Reaching outward*

Whether or not the lowering of trade barriers worldwide is possible, the reality is that high-income developed countries cannot compete in the manufacture of labour-intensive manufactured goods. These products are more expertly produced at lower costs in developing countries. "Increasingly, our competitive advantage will be in areas that involve a high degree of scientific and engineering skill and in which labour costs are a small proportion of total costs," the Council concludes.



# The impact of a trade accord

Free trade with the United States could create as many as 350,000 new jobs in Canada by 1995, while causing only relatively few job losses in a handful of declining industries, according to new Council research.

Moreover, the gains in employment and net output from a bilateral trade deal would be distributed "fairly uniformly across all regions," says a new discussion paper by Council economists Sunder Magun, Bimal Lodh, and Someshwar Rao. Free trade would also hasten the necessary structural adjustments in the economy – the shift away from labour-intensive to high-technology industries – in order for Canada to compete "much more vigorously in the world economy in the 1990s and beyond," the authors conclude.

The Council researchers undertook two simulations to illustrate the effects of a bilateral free-trade pact on the Council's base-case outlook for the Canadian economy. In the first, all tariff and nontariff barriers between the two countries are removed (excluding agricultural and other subsidies, and trade in services). In the second, free trade is supplemented by specific productivity improvements in manufacturing industries (which result from greater economies of scale, product specialization, and so on). The work was carried out as part of the Council's Trade Policy Options and Structural Change project.

In both scenarios the impact of free trade improves real wages, increases output and employment, stimulates business investment and productivity, lowers prices, reduces government budget deficits, and strengthens the Canadian dollar in relation to its U.S. counterpart. Most of the stimulus to the economy comes from growth in consumer expenditures and investment, as a result of lower

prices and production costs, and higher real incomes. The accompanying chart summarizes the major impacts of free trade on the Canadian economy.

## Impact, by sector

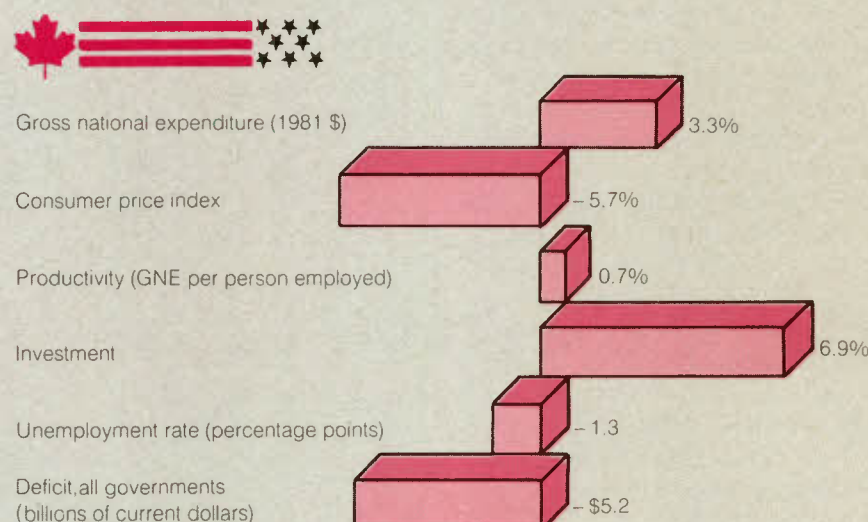
While the direct effects of trade liberalization adversely affect Canadian industries that are highly protected – chiefly in the manufacturing sector – all industries benefit indirectly from the overall increase in consumer expenditures and investment. In the first scenario, the total net impact (direct plus indirect) of bilateral free trade is positive and significant in 29 of the 36 industries examined; in the second, 30 industries record gains in output and employment.

The impact of free trade on employment, by sector, is summarized in the

accompanying chart. Primary industries such as forestry, agriculture, and fishing would benefit greatly from the removal of nontariff barriers. In the service sector, four industries – retail trade; wholesale trade; business services; and personal services – would account for close to 65 per cent of all the new jobs created. The substantial gains in service-sector output and employment reflect the growing importance of services in the Canadian economy, the authors point out. All seven industries that would experience a decline in output and employment are in the manufacturing sector: rubber and plastic products; leather products; textiles; knitting mills; electrical products; chemicals and chemical products; and miscellaneous manufacturing. These industries are highly protected and already face stiff competition from low-wage

### The free trade impact by 1995

Percentage and level changes over the Council's base-case projections



developing countries. The net employment reduction in those industries is about 16,000 in the first scenario, and less than 7,000 in the second. Overall, the manufacturing sector would benefit significantly from trade liberalization, with more than 42,000 jobs being created therein.

### Regional impacts

To the extent that employment losses are concentrated in depressed regions and single-industry towns, free trade would exacerbate the adjustment problems in those areas, the authors explain. At the same time, by increasing overall incomes, as well as employment, in Canada, free trade would strengthen the fiscal ability of governments to provide adjustment assistance. Moreover, the gains from free trade would be fairly evenly distributed across all provinces (see chart). The Atlantic provinces, Alberta, and British Columbia would experience slightly above-average gains in output and employment, reflecting the importance of primary industries and construction in those provinces.

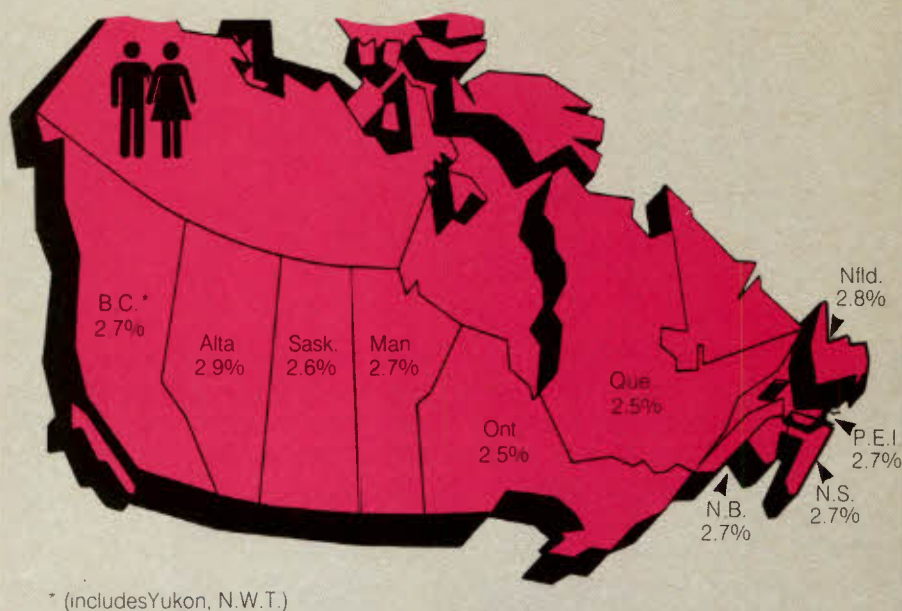
The authors caution that the size of the impacts in their scenarios depends upon the nature of free trade implicit in the assumptions and upon the structure and properties of the models used to simulate free trade. They also note that the paper's projected impacts fall within the range of all other available estimates.

As part of their free-trade simulations, the researchers provide new and more up-to-date estimates of the cost of trade protection (including both tariff and nontariff barriers) between the two countries. They find that average tariff rates (on dutiable goods only) in Canada are generally higher than those in the United States (11.2 per cent of the total value of dutiable Canadian imports from the United States, compared with 6.5 per cent for dutiable Canadian exports to that country). Nontariff barriers, on the other hand, are generally higher in the United States (1.8 per cent, compared with 1.0 per cent). The authors also develop specific estimates of the potential gains in manufacturing productivity that would likely result from a bilateral trade pact; these gains average 6.1 per cent for the manufacturing sector as a whole.

"Impact of Canada-U.S. free trade on the Canadian economy," by S. Magun, S. Rao, and B. Lodh. Discussion Paper No. 331.

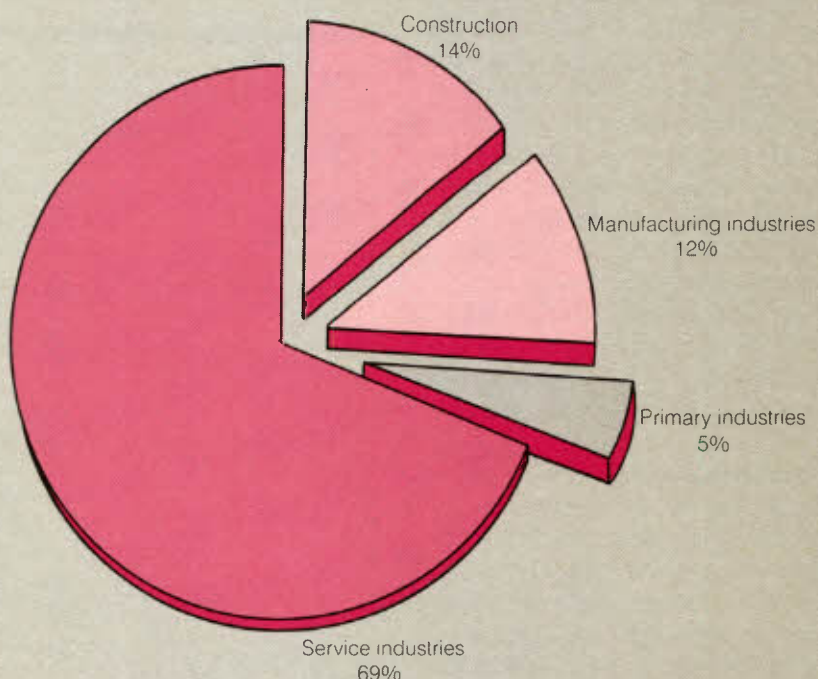
### The outlook for employment by province, 1995

Percentage change over the Council's base-case projections (simulation 2)



### The outlook for employment by sector, 1995

Number of jobs created (simulation 2)



# S·P·E·A·K·I·N·G·O·U·T

**F**inancial markets are becoming increasingly global in scope as investors and borrowers conduct a worldwide search for the most profitable opportunities.

International capital flows over the past decade or so have increased dramatically. In 1970, for example, Canadian residents sold \$1.3 billion of Canadian bonds and purchased \$196 million of foreign bonds. In 1985 they sold \$63 billion and purchased \$32 billion. Between 1982 and 1985, issues on international bond markets more than doubled. Foreign-exchange trading is now a U.S.\$200-billion-a-day business around the world.

In this environment, Canadian banks and other financial institutions face growing competition. Moreover, the rapid increase in cross-border capital flows among nations has allowed serious debt and exchange-rate imbalances to grow unchecked. In addition, the changing role of financial institutions and the development of new financial instruments and practices are affecting the ways in which economic activities are financed. While these changes create opportunities for Canadian investors, Canada is also at risk as national financial markets become increasingly interdependent.

In order to attain a clearer picture of how developments in this area affect Canada, the Council launched a new project on international finance last April. To find out more about it, *Au Courant* spoke with project director André Ryba.

**Au Courant:** Where does Canada stand in terms of its competitiveness in international financial markets?

**Ryba:** Canada has always had world-class financial institutions. We have some very strong banks, life insurance companies, and emerging financial holding companies. Canadian banks are leaders in providing syndicated loans (where two or more banks join forces to finance a major project). But international financial markets are evolving rapidly. We are seeing a shift away



André Ryba

from traditional banking to securities trading. For example, instead of taking out a loan, a borrower issues bonds or notes to raise capital, using a bank as a broker to sell, and possibly to underwrite, a certain portion of them. Another form of "securitization" that has grown rapidly is the bundling of loans into securities pools, units of which are sold to investors. It appears, however, that this innovative process has not spread as quickly among Canadian banks as it has among U.S. institutions. Part of our study will look at why Canadian firms are less innovative in the financial area – is it because of regulation or taxation, for instance?

**Au Courant:** At the international level, what other changes are taking place that affect Canada?

**Ryba:** Perhaps the most significant development occurring at the moment is what we call the "globalization" of financial markets. What this means, taking the U.S. government bond market as an example, is that despite the existence of separate bond markets in New York, Tokyo, and London, in reality these are part of a single worldwide market. Indeed, many investment dealers operate in all three markets, passing their trading operations from

London to New York to Tokyo and then back again as one market closes and another opens. We may even see the end of the traditional exchange floor, since computers can replace it on a 24-hour basis. The globalization of financial markets raises some very serious policy implications for Canada. For example, are we going to see Toronto downgraded to a regional securities market? Will it be more difficult to finance industry as a result? Moreover, as markets become more and more interdependent, it becomes increasingly difficult to conduct independent macroeconomic policy.

**Au Courant:** How can we conduct effective domestic policy in view of the world's growing economic interdependence?

**Ryba:** Basically, there are two issues that arise in this regard. The first is whether or not we view Canada as a catalyst in bringing countries together to solve mutual problems and to coordinate national policies for mutual benefit. Clearly, the growing interdependence of national economies underlines the need for some form of international cooperation. The U.S. balance-of-payments deficit has to be resolved one way or another, for instance. Discussions among central bankers, finance ministers, and supervisors of financial institutions are already under way, with the objective of achieving greater coordination in financial activities. There are many opportunities for Canada to make a contribution. I think we can play an important role in the discussions on trade in financial services under the framework of the General Agreement on Tariffs and Trade, for example. The second issue that we have to consider is what policy options are available to enable Canada to gain from new opportunities and to shield itself as much as possible from the negative effects of world events. In this sense it's important to understand the factors that have contributed to recent developments on international financial markets. This

will give us some sense of what Canada's approach should be in world forums, and some idea of what types of domestic policy would promote our best interests.

**Au Courant:** What will the project be looking at specifically?

**Ryba:** It will be broken down into four areas of study. First, we shall be looking at recent developments on international financial markets, such as changes in capital flows; balance-of-payment positions; financial innovation; the growth of international financing; and the emergence of London, Tokyo, and New York as international financial centres. Different scenarios will be developed with respect to the future pace of globalization. Second, we shall examine trade in financial services, including barriers to trade and the consequences for Canada of moving to freer trade in this area. Third, we shall look at the fragility, or stability, of the international financial system by examining the impact of recent developments such as the increase in cross-border capital flows. Finally, we shall study how all of these developments affect Canada. Will these changes give Canadians better access to investment opportunities abroad? How will the Canadian financial industry fare in the future? Are Canadians going to be better served? What policies are needed to ensure that Canada will be able to take advantage of new opportunities?

**Au Courant:** How will freer trade in financial services affect Canada?

**Ryba:** First, we have to agree on what we mean by freer trade. There is already

free movement of capital between countries. So in that sense free trade already exists. In Canada, however, the right of establishment (to set up a subsidiary of a foreign bank, for instance) is regulated by government. If freer trade means opening up our borders to foreigners, then we may see a greater number of financial failures because of

do not regulate the activities of Canadian institutions outside Canada. In fact, they are involved in activities abroad that they are prevented from engaging in domestically. If, however, we have too strict a regulatory framework in Canada, many of our institutions will operate out of London instead of Toronto, for example. The

***There is a real fear that Toronto's position will deteriorate rapidly unless we match the regulatory climate of the London and New York markets.***

the increased competition. But competition is healthy, as long as we maintain a proper balance between competition and solvency. Moreover, foreign firms are likely to bring with them innovative instruments. Another likely benefit of opening our borders to foreign competition is that Canadian firms will have access to new foreign markets. In fact, the entry of foreign financial firms into Canada should be based on reciprocity, so that Canadian firms will have equal access to the foreign markets concerned. The Council made this recommendation in its recent Statement on financial institutions (*Competition and Solvency: A Framework for Financial Regulation*; see *Au Courant*, vol. 7, no. 3).

**Au Courant:** Is too much government regulation making our financial sector less competitive than that of other countries?

**Ryba:** A lack of regulation doesn't necessarily enable you to be more competitive. Financial activity moves away from overregulated countries, but it does not move to places where there is no regulation. You need some rules of the game to have confidence in the institution and in the financial system. You cannot operate in a jungle as far as finance is concerned. What is important is to have the proper dose of regulation – the minimum amount required to ensure stability and confidence. At the same time, you must remember that we

recent accord between the Ontario and federal governments, which allows banks and life insurance companies to operate securities subsidiaries, is a step in the right direction.

**Au Courant:** But aren't Canadian firms taking more and more of their business to London, where there is less regulation?

**Ryba:** Yes, this was true in the past – not only for banks but for investment dealers as well. There is a real fear that Toronto's position as a major financial centre will deteriorate rapidly unless we match the regulatory climate of the London and New York markets, although London is increasing the regulation of international markets. In Europe, a number of major financial centres lost out to London as a result of the regulatory reform in that city. Now Paris is trying to gain back lost business by reregulating also. But it may be too late; London may have taken an insurmountable lead.

**Au Courant:** How soon do we have to act to prevent a similar decline in Toronto?

**Ryba:** Yesterday was already late. We have to act very soon. Actually, one of the issues we'll be considering in this project is what can be done to maintain the strength of Toronto, since London and New York have already taken a huge lead.



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## *New members appointed to the Economic Council*



Jacques Bougie is president of Alcan Extrusions. A graduate of the Université de Montréal and the École des hautes études commerciales, he is also a member of the Quebec bar. He has served as a school board administrator and as director general of the Société québécoise d'information juridique.



Alix Granger is vice-president of Pemberton, Houston, Willoughby, Inc. A graduate of the University of Toronto and Simon Fraser University, she has written numerous articles and publications on financial matters, and frequently appears as a guest commentator on radio and television.



William Mackness is senior vice-president and chief economist of the Bank of Nova Scotia. He is also a member of the board of trustees of the Fraser Institute and a past member of the Ontario Economic Council, and he has served as a special policy advisor to the Minister of Finance. He is a graduate of the Université de Montréal and the University of Western Ontario.



Bartlett B. Rombough is president and chief executive officer of PanCanadian Petroleum Ltd. He serves on the board of governors of the Canadian Petroleum Association and is chairman of its natural gas committee. He is also a member of the Institute of Chartered Accountants of Alberta and Manitoba.



Ken Stickland is president of both KenAgra Management Services Ltd. and Cen Alta Grain, as well as a director of Stickland Farms. He is a member of the Canadian Association of Agricultural Economists and the Agricultural Institute of Canada. He has served as a special advisor on agricultural transportation to the Alberta government and as an officer of the Alberta Export Agency. He is a graduate of the University of Alberta.



Norman E. Wale is general manager, planning, of Canadian Pacific Ltd. He was formerly a research director at the Economic Council and has taught economics at the Université de Montréal, of which he is a graduate. He has also served as director general of the university branch at the Ministry of State for Science and Technology.

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