External Affairs
Supplementary Paper

No. 56/8 **Some External Aspects of Canada's Expansion**

Address by Louis Rasminsky, Deputy Governor of the Bank of Canada, at National Foreign Trade Convention, New York, November 26, 1956.

I am very glad that I was able to accept the invitation to address this International Finance Session of the National Foreign Trade Convention. I know something of the serious and thoughtful work done by your Council, and of the important part that this association has played, both through these Annual Meetings and in other ways, in influencing public opinion in this country to look realistically at your foreign economic policies. I know that this influence, while always at furthering the interests of the United States (and properly so for an American group) has recognized that your interests will best be served by policies which also increase the economic strength of other countries and encourage the growth of mutually beneficial trade.

I intend to focus my remarks today on Canada's recent economic expansion, and to refer particularly to some of the external aspects of recent developments in my country. I am encouraged to do this because the central theme of this gathering is that foreign trade and investment promote security and prosperity, and this theme is applicable to Canada in no small degree.

I should perhaps warn you at the outset that I am not going to make any sweeping and memorable statements. In fact I shall try to be as dull as my subject permits. Not all Canadians are dull. Certain aspects of Canada's expansion are, from time to time, discussed with a good deal of vigour in Canada. This applies especially to the recent increase in our current account deficit, caused by a sharp rise in our imports (particularly from the United States) and to the large participation of foreign capital (again particularly American capital) in our growth. Where discussion is vigorous it is a safe bet that opinions are not unanimous. And in this situation it is a safe bet that the prudent central banker will be dull.

The growth of the Canadian economy in the last few years has attracted a great deal of attention outside Canada, as well as at home. Canadians have been both flattered and occasionally embarrassed to find themselves and their country suddenly re-discovered by your metropolitan and business press. A new Canadian sage has showed signs of growing up, based on dramatic and outstanding achievements which have greatly increased our output and potential output of certain basic resources -- iron ore, petroleum, aluminium, uranium, water-power and so on. It is no wonder that these resource developments have attracted great attention, for not only are they important in themselves, but they provide the very stuff of which romance (at least economic romance) is made -- daring magnitude, difficult pioneering in remote and forbidding country, wonderful engineering accomplishments.

The discoveries and developments I have been referring to have had a leavening effect on Canadian expansion. In some cases they have involved the opening up of remote areas and provided the opportunity to exploit other resources which would not have been able to stand on their own feet. They have brought along with them secondary developments of great importance: for example, oil and natural gas have contributed to the development of a sizable petrochemical industry. Perhaps most important of all, the uncovering of important basic resources has created, in the minds of Canadians and non-Canadians alike, a favourable attitude towards Canada's long-run prospects. This favourable attitude, and the willingness to back it up with hard cash, is reflected in the high level of investment which has been taking place in our country since the end of the war.

However, resource development can be exaggerated as a factor in our development. Growth in Canada during the last few years can, perhaps not inappropriately, be compared to the proverbial iceberg: the parts that one sees are most impressive, but the great bulk is below the surface and if not unknown at least invisible. In actual fact, aggregate investment in our secondary industries, in communications, in distributive and service facilities, in non-residential construction and in housing has been several times as large as investment in the exploitation of primary resources. What we have had is a general expansion, in which basic resources have played an important dynamic role, which has broadened and deepened the structure of the Canadian economy. Relatively undeveloped countries sometimes act as though the development of the primary products in which they have a natural economic advantage is incompatible with the development of secondary industry. Our own experience has been that the two can well go hand in hand, and that the broadening of the internal market produced in part by basic resource development brings in its train the development of secondary manufacturing industries and service industries as well.

The recent Canadian expansion is, of course, by no means an isolated case. In fact, one of the most striking economic facts of the past few years is the great increase in the demand for capital to finance expansion in virtually all parts of the world. One of the manifestations of this has been the universal rise in interest rates as the supply of savings has had difficulties in keeping pace with the demand for loanable funds. Though the Canadian case is by no means unique, there are, perhaps, two or three special features in our position. One is that the Canadian economy has been expanding almost without interruption since the end of the war. At first it seemed to be a question of making up for the depression and the war, during which civilian progress was at a standstill and even maintenance reduced; during the 1950's there has been continuous and, in the last year or two, accelerating new expansion. Usually in Canada and elsewhere sharp bursts of expansion have been moderated or temporarily halted by cyclical down-turns. This has been true since the war in most other countries. In Canada, though we have not been completely insulated from the cyclical disturbances that have been experienced elsewhere, these have for the most part taken the form of a pause in the growth of output, as in 1954, rather than a down-turn.

A second remarkable characteristic of our growth has been its magnitude. In real terms, gross national product is currently running some 40 per cent higher than it was at the end of the 1940's. This in itself, though impressive, does not seem much different from the growth of output in the United States.

But the rate of investment in Canada has been considerably higher than it has been in the United States and most other countries. Ever since 1948 the proportion of our gross national product devoted to investment has exceeded 20 per cent; this year it will amount to the very high figure of 25 per cent. These rates are considerably higher than the corresponding figures for the United States. There appears to be this difference between the recent character of investment in Canada and the United States -- that in our case a higher proportion of investment has gone into activities that either do not result directly in industrial output, such as pipelines and transportation, or into very long range projects which still are to be reflected in our production statictics such as oil, hydro-electric development, and so forth. It follows of course that a considerable share of the fruits of Canadian investment are still to be plucked.

Since the pause of 1954 the increase in output and investment in Canada has been very marked. Gross national product in value terms was 10 per cent higher in 1955 than 1954 and is currently running at a rate about 10 per cent higher than 1955. The increase in 1955 took up most of the slack which developed during the 1954 pause. The increase this year has absorbed more than the regular annual increase in the labour force resulting from population growth and immigration: good jobs have attracted more people into the labour force who would not be there under less buoyant conditions. The increase in gross national product this year includes a larger element of price increase than previously, and the current account deficit in our international payments has increased very sbustantially. Both of these developments reflect the growing pressure on our resources.

The current account deficits which have persisted with the exception of one year since 1950 are the focal point in our balance of payments. They represent the extent to which we have drawn on the rest of the world for goods and services to enable us to maintain levels of investment and consumption which are beyond our own immediate capacity.

The current account deficits ranged from $400-$500 million a year until 1955, but the deficit is now running at a rate in excess of one billion dollars a year. These are big figures by any standards, but it is worth remembering that as a percentage of total trade turn-over they are smaller than they have usually been in past periods of rapid expansion.

Current account deficits are no novelty in new countries. Frequently they arise because the pressure on resources is so great that goods and services are diverted from export markets to domestic expansion, with the result that exports fall or at least fail to achieve a normal growth. I should like to stress that this has not been the case in Canada. Exports are actually running at a rate nearly 50 per cent higher than in 1950. Indeed, to some extent the large increase in foreign demand for our exports has been the direct cause of internal expansion. The fact that we have been able to increase our exports so much while the expansion was going on must be attributed in part to a run of good luck for which we can claim no particular credit other than taking advantage of our opportunities. Since 1950 we have had the equivalent of between 8 or 9 normal wheat crops in seven years, with firm prices and good demand in all but a couple of years. Forest products have been almost continually in good demand -- newsprint has been at capacity demand or better since 1947.

Since the Korean war there has been an apparently insatiable demand with generally high prices for nickel and aluminium and more recently copper. Nor is this all; when agricultural markets began to sag off a few years ago we began to enjoy the first fruits of some of our long-period resource development. From a few million dollars a year, iron ore exports have grown to over $100 million. In spite of the exceptional rise in oil consumption in Canada, the prairie discoveries have enabled us to hold fuel imports at a level only a little over 1950 levels, and at the same time provide exports -- which were negligible before 1955 -- at a current rate of over $100 million per annum. And uranium production is only on the verge of assuming important proportions.

Our rising current account deficits are therefore wholly due to a greater rise in imports than in exports. Our imports are running 70 per cent higher than in 1950, with practically all the increase due to increased volume rather than price. The basic cause of the rise in imports is the intensity of demand for investment and other purposes. The physical limits of productive capacity are quickly reached in a small and relatively new economy, and when this happens the whole weight of demand is thrown on external sources.

The principal increases in our imports can be directly traced to the investment boom. A commodity classification of imports by purpose which has recently become available shows that between the first half of 1955 and the first half of 1956, when our total imports went up by almost 30 per cent, imports of investment goods rose by as much as 43 per cent while consumer goods were up only 18 per cent. This distribution of imports is gratifying, of course, because it means that the bulk of the large increase in imports has gone to broaden the structure of the Canadian economy and provide for increased output in the future.

I would now like to comment briefly on the other side of the medal, i.e. the financial counterpart to these deficits, our net capital imports. There is an unavoidable tendency to think of the balance of payments in personal terms. If a person runs a deficit and goes into debt presumably he has arranged for this in advance or has to scrounge up cash along the route. At all events, he has to make some formal provision for his indebtedness. The balance of payments in a free economy like the Canadian has no such planned programme. It is the aggregate of individual decisions independently arrived at day by day. The net capital borrowings which accompany a current account deficit occur side by side with the current transactions.

In the case of Canada a very large share of the capital inflow takes the form of direct investment. Since 1950 this has amounted to over $2,300 million or about two thirds of the total net long-term inflow. Direct investment is not a debt settling operation, but a dynamic independent development. The initiative is taken abroad rather than in Canada, and it often carries with it skill, technical know-how, market connections and access to the very large pools of money required to finance major projects under modern conditions. Capital investment of this type frequently takes the form of imports of capital equipment, machinery, etc., to be used in a Canadian project. Direct investment should therefore be regarded, in a sense, as a cause of the current account deficit rather than as a means of covering it.

The other main channel of capital investment in Canada has been the purchase by non-residents of Canadian securities. The largest element in this has been the net sale of new issues by Canadians to investors outside Canada. On balance from 1950 to mid-1956, sales of new issues have exceeded retirements by over $1,400 million, exclusive of large retirements of Government of Canada issues to which I shall refer in a moment. Most of the new issues sold by Canadians abroad have been provincial and municipal securities, though recently a number of large new corporate issues have also been sold in outside markets.

The ready access enjoyed by many Canadian borrowers to the capital market of the United States makes them quite sensitive to relatively small changes in the spread between long-term interest rates in the two countries. When this spread is relatively narrow, as it was for example in 1954 and the first part of 1955, Canadian borrowers are loath to assume the exchange risk involved in issuing bonds payable in U.S. dollars. In periods such as the past year, however, when the demand for capital in Canada in relation to the supply of loanable funds has been such that long-term interest rates have risen even more than they have in the United States, considerable borrowing by Canadians takes place on the American capital market. The sheer size of some of the recent corporate issues has probably been a factor dictating recourse by Canadians to outside capital markets. In this respect there is an analogy with the situation I referred to regarding direct investments in resource industries where very large sums of money have been required to finance particular projects.

Non-residents of Canada have also increased their holdings of common and preferred stocks in Canadian corporations. The very large two-way trade in outstanding Canadian securities has resulted in a net capital inflow between 1950 and mid-1956 of over $500 million, excluding the trade in Government of Canada securities. An increasing number of Canadian equities have been listed on stock exchanges outside Canada. Growth potential rather than yield appear to have been the important consideration influencing foreign investors in Canadian equities, and this is exemplified by the formation of diversified investment funds incorporated in Canada but designed to give American investors an opportunity to share in capital appreciation.

Although the inward movement of capital has been preponderant, one should not conclude that capital movements between Canada and the rest of the world are a one-way street. For example, Canadians have since the beginning of 1950 repatriated from abroad Government of Canada obligations to the amount of about $700 million. We have also added to our foreign assets abroad in various ways. Our investment in Canadian controlled companies operating abroad has been increased by over $300 million (not including retained earnings). We have provided funds to the I.B.R.D. for its lending operations by paying up our entire capital subscription (and becoming the only country other than the U.S. to do so) and by the Canadian public subscribing to several World Bank bond issues in Canada. We have also added substantially to our official holdings of gold and U.S. dollar balances. Our investments abroad are small in relation to foreign assets in Canada, but it may come as a surprise to you to learn that even excluding official reserves and bank balances, Canadians are heavier investors abroad on a per capita basis than are Americans.

I propose now to say a few words about the behaviour of the Canadian dollar since official fixed rates of exchange were suspended in 1950. Since then, the policy has been to allow the rate to be determined by market forces, including of course the effects of fiscal and monetary policies, with official interventions limited to the maintenance of orderly conditions in the exchange market. Since 1952 the Canadian dollar has been quoted within a relatively narrow range -- from equality with the American dollar to 3 or 4 per cent higher. Perhaps the most conspicuous feature has been the rather paradoxical behaviour of fairly persistent strength in the face of substantial current account deficits. In fact, there have been several occasions when a rise in the Canadian dollar has coincided with an increasing current account deficit. This of course goes to demonstrate the important part that capital inflows have played all through the piece.

Nevertheless for a free rate the Canadian dollar has been remarkably stable. There is reason to believe that at most times short-term capital movements, such as changes in balances held in Canada and abroad and commercial payables and receivables, have contributed to this stability. These short-term capital movements have shown a tendency to be inward and so support the Canadian dollar when it was tending to fall and outward when it was tending to rise, thus limiting the rise. This is in marked contrast to our experience with a fixed rate of exchange under exchange control when short-term capital movements were a factor of instability. During the present year, however, there appears to have been an inward movement of short-term funds notwithstanding a rise in the value of the Canadian dollar. The need for liquidity and the rise in the volume of imports -- as reflected in an increase in outstanding payables -- seem to be the factors mainly responsible.

The Canadian exchange arrangements since 1950 have not been fully in accord with the provisions of the International Monetary Fund, of which Canada is a member and to whose work we continue to attach great importance. The Fund provisions provide for a fixed exchange rate with fluctuations limited to 1 per cent on either side of the par value. I would like to take this opportunity of saying that the attitude which the Fund has adopted towards the Canadian case has not been in the slightest degree doctrinaire or rigid. On the contrary it has been helpful and understanding. Without for a moment suggesting that what works well in Canada is necessarily suitable for other countries, the Fund has fully recognized the special aspects of the Canadian situation which have led to the present exchange arrangements.

In the conditions under which it has operated, the free rate has been a helpful factor in the efforts made to maintain monetary stability in Canada. Since 1950 Canada has offered many attractive fields for investment. Under fixed rate conditions, the government is required to buy all exchange offered, and if the inflow is large and rapid it is difficult to take offsetting action to prevent this leading to an increase in the domestic money supply. Sums which seem quite small in American terms may be extremely large for Canada, and large capital inflows in an economy at full stretch under fixed rate conditions have therefore a great inflationary potential.

The free rate provides some assurance that capital inflows will take place in real terms rather than in the form of money. Perhaps I might expand this latter point a little for it is an important one. Under fixed exchange rates a person can acquire a title to assets in Canada simply by selling foreign exchange at the pegged price. The central authorities are required to buy all exchange that is offered in order to maintain the fixed rate, and they must find the Canadian dollars with which to purchase the exchange. Under the free rate system, on the other hand, the person who wants to buy Canadian dollars has to compete in the exchange market with other purchasers for a supply which is provided not by the central authorities but by corporations and individuals who wish for one reason or another to sell Canadian dollars and acquire foreign exchange. The pressure of market forces on the rate has the effect of bringing supply and demand into balance without, as I have already indicated, official intervention except as a contribution to orderly conditions. One effect of this mechanism is to ensure, in conditions of large capital inflow accompanied by pressure on domestic resources, that the inflow of capital either forces other capital out, through its effect on the rate, or takes the form of goods and services introduced into the Canadian economy from abroad as a supplement to Canadian savings.

The inflow of capital which has been such an important factor in post-war development in Canada has inevitably caused Canadians to think about its long run consequences, and some of its implications have caused a good deal of soul searching. One very natural concern is whether we have accepted capital from abroad in excess of our capacity to service it. The present burden of foreign debt, as measured by comparing it with gross national product or total exports, is less than it has been at many periods in our history. The increase in foreign debt has been much more than matched by an increase in national assets. Much of the investment has gone into things like petroleum and iron ore which either displace imports or result in exports.

Another question which is sometimes raised is whether the rate of development -- in which foreign capital has played an important role -- has been excessive, and whether progress at a somewhat slower pace -- and with a greater admixture of local capital -- might be preferable. I do not pretend to know the answer to this question. To a considerable extent the rate of progress is determined by the availability of resources, and the terms on which the public authorities or other owners are prepared to see them developed and used.

Another related subject of discussion is the extent to which American investment has tended to concentrate in certain resource and industrial sectors to the exclusion of Canadian participation. Since it is mainly direct investments which are referred to there is some fear that the exclusion of Canadian participation may be permanent in character. The increase in the foreign ownership of Canadian business has occurred in spite of a very high rate of Canadian savings and the fact that, unlike previous periods, Canadians no longer now invest to any considerable extent in U.S. equities. A number of steps have recently been taken which should have the effect of encouraging greater participation by Canadians in equity investment in Canada. For example, for some years now, Canadians have been permitted to claim as an abatement of their income tax liability an amount equal to 20 per cent of the dividends received from tax-paying Canadian corporations. Also, there has been some discussion as to whether the Canadian institutions which are the chief mobilizers of Canadian savings are playing as large a role as they might in providing equity capital to Canadian business. Finally, steps have been taken to revise certain of our arrangements regarding the taxation of dividends paid abroad in order to remove any possible tax disincentive that American companies owning subsidiaries in Canada might have to offering some of the stock in such subsidiaries for public subscription in Canada.

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I should like to conclude these remarks by referring again to foreign trade. In spite of the great development of our internal market, foreign trade remains of great importance to us. With a total trade turnover exceeding $10 billion, Canada has become the fourth largest trading country in the world. With a population less than 10 per cent of yours, our imports are over 40 per cent of those of the United States.

Our great interest in foreign trade is reflected in our policies. We have done away, as you know, with all exchange controls and import restrictions and maintain a relatively open economy with only a moderate degree of tariff protection. We have pressed other countries to remove the obstacles to trade. We have been encouraged by the progress made in removing quantitative trade restrictions, particularly by certain European countries, during the past few years, though we think that this progress did not altogether keep pace with the improvement which occurred, at any rate until very recently, in the world payments position. We are also aware of the forward steps taken by the United States in increasing the opportunities of other countries to compete in this market, though here too the rate of progress has at times been disappointing. Continued leadership on the part of the United States is essential on account of your position in world affairs. Any evidence of backsliding or of failure on your part to accept the same degree of competition that you urge upon others, is seized upon in foreign countries as a reason for continuing old restrictions on imports or imposing new ones. The American stake in world prosperity, as represented by your trade interests, your extensive investment interests and above all perhaps by your over-all political and security interests, cannot be exaggerated. I have every confidence that, with the help of groups such as this, your policies will further and not frustrate your interests.