What's Wrong With The Canadian Economy

A rapid sequence of developments dating from late October announced to the world that the Canadian economy is bankrupt. In the week of Oct. 22, the official unemployment figures for the third financial quarter were announced at 8.3 percent, the highest level since the 1930s; Inco Ltd., one of the world's largest nickel producers, announced a production cutback of 20 percent; and the Canadian dollar hit a 40-year low, diving below a 90-cent exchange rate for the U.S. dollar for the first time since 1935.

CANADIAN ECONOMIC SURVEY

The accelerating Canadian collapse points up the progressive decline of the North American continental economy, throughout the post-World War II period, which has made the present crisis inevitable — short of a total international financial policy reorganization. The earlier deterioration of the Canadian economy relative to the U.S., has not been primarily due to "local mismanagement" on the part of Canadians (nor to maliciousness on the part of the U.S. shareholders in Canadian industry), but to Canada's unique place as an area for sound capital investment.

Canadian economic surveys commonly explain the deterioration of Canada's overall balance-of-payments position as the result of a "dichotomy" between Canada's characteristic merchandise-based trade surplus and spiraling capital outflow, when there is in fact no such dichotomy. On the contrary, this present analysis will demonstrate that it is the rapid decline in Canada's trade and production in recent years that has led to the present emergency. This decline is a more specific reflection of the increased inability of the entire North American economy to generate sufficient rates of surplus for further development. That surplus, translated into capital investment, is the life's blood of Canada; without it, the Canadian economy is becoming incapable of supporting national financial and monetary requirements under conditions of general world inflation.

The Gravity of the Current Crisis

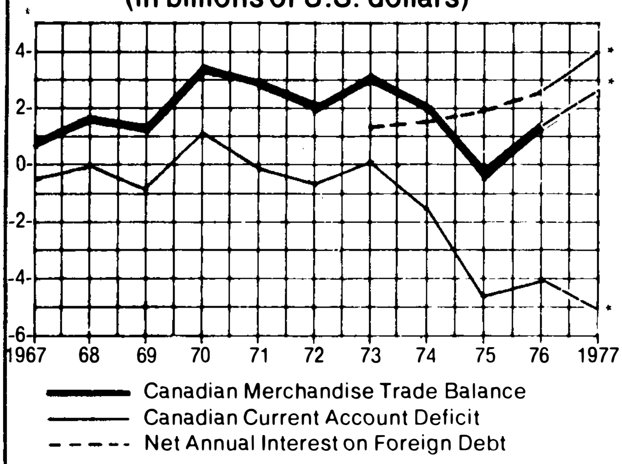
A glance at the indices summarized in Graphs 1 and 2 will convince even the most optimistic that extension of current trends on even a near-term basis will only lead to full-scale collapse of the Canadian economy. Starting with the close of 1973, Canada's current-account balance plummeted from a surplus to a $4 billion deficit with a deficit of $5 billion minimally projected for 1977.

Over the same period the merchandise-trade balance has faltered, going into the red in 1975 with only a partial recovery the following year. Although this year's trade (surplus) is expected to rise above 1976 value, it will still be below the 1973 surplus of about $3 billion. Filling the gap between the trade and current-account balances, foreign borrowings over the same period doubled total Canadian international indebtedness. The additional interest and dividend obligations contributed an additional $1.5 billion to the annual current-account deficit by 1976. As a result, Canada has become one of the world's most indebted nations, with an outstanding foreign debt burden of about $54.5 billion.

The collapse of production is illustrated in Graph 2 by the decline in utilization of Canadian industrial capacity from near full capacity in 1974 to only 85 percent capacity by 1976. Many indicators, including recent announcements of mining cutbacks make clear that the industrial used capacity is already significantly lower. Government reports on industry show, for example, that in January 1977 for the first time on record 12 of Canada's

Graph 1

Annual Current Account Deficit Plunges as Trade Surplus Sags, Debt Service Soars (in billions of U.S. dollars)

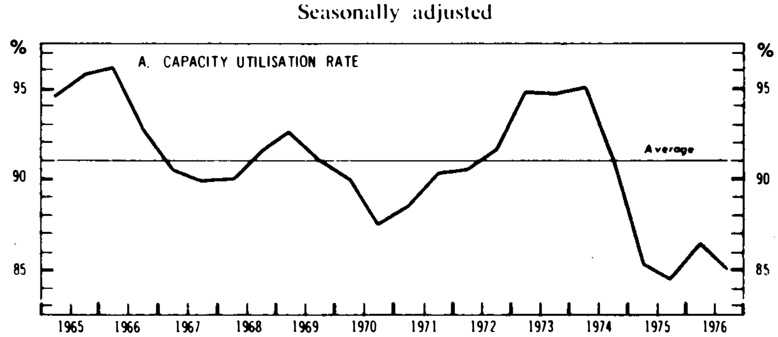


Source: OECD Economic Survey Canada 7/77

Graph 2

Canadian Industry at Standstill: Capacity Utilization 1965-76

Seasonally adjusted



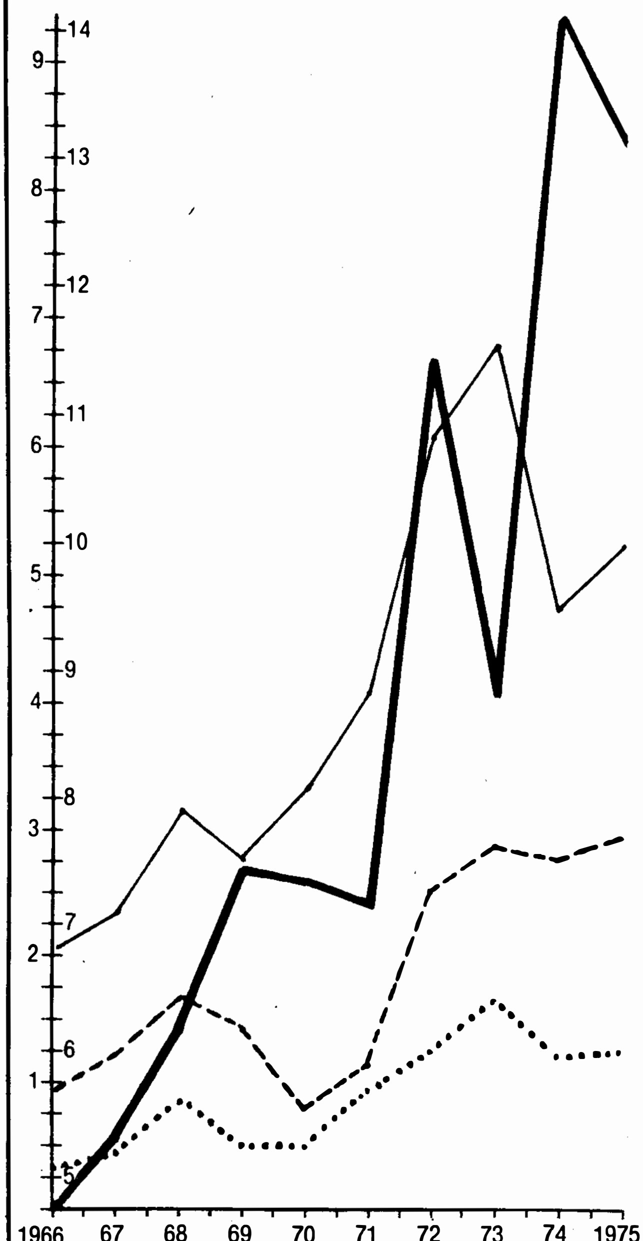
Sources: Canadian National Accounts Stastistics, Bank of Canada.

26 pig iron furnaces — representing 10 percent total productive capacity — lay idle. Previous years' reports show at most only 2 to 3 smaller furnaces idle at any one time. The rate of cannibalization of production is also reflected in the official unemployment tally, which jumped 0.2 percent during August to a total of 8.3 percent, a national rate not seen since the Great Depression of the 1930s.

Graph 3

U.S. Direct Investment, Lifeline To Canadian Economy,

(Billions of Current U.S. Dollars)



Annual Increment of Total U.S. Direct Investment Abroad (Right hand scale)

Annual Increment of Manufacturing U.S. Direct Investment Abroad (Left hand scale)

Annual Increment of Total U.S. Direct Investment in Canada (Left hand scale)

Annual Increment of Total U.S. Direct Investment in Canadian Manufacturing Industry (Left scale)

Source: **Survey of Current Business**

Canadian financial and monetary parameters only complement the above picture. A current projected rate of real economic growth for 1977 of at best two percent is being overwhelmed by an annual inflation rate (as of September) of 8.4 percent, according to the Consumer Price Index. Following the late October nosedive of the Canadian dollar to below the 90 cent "psychological threshold," Finance Minister Jean Chrétien announced the creation of a $1.5 billion standby (i.e., bailout) loan fund, arranged for the Canadian government by major Canadian commmercial banks operating on the European markets. The move was necessitated by the depletion of Bank of Canada (BOC) foreign-reserve holdings following support operations for the Canadian dollar in September.

The collapse of the Canadian dollar by over 10 percent relative to its U.S. counterpart and by an average of 25 percent relative to other major currencies since the end of 1976 has created multiple strains on national finances. In addition to raising the price of imports, the devaluation has multiplied the pressure of the debt burden. Since many major Canadian borrowings, including those of the large Provincial power utilities like Hydro Ontario are denominated in U.S. dollars, the collapse of the Canadian collar effects a significant increase in overall indebtedness.

The U.S. — Canada's Economic Parent

The breakdown shown in Table 1 of total earnings on U.S. direct investment abroad between the years 1966 and 1976, as well as the percentage of those earnings reinvested in different national sectors and subsectors, demonstrates the precise relationship between the U.S. and Canadian productive economies. The percentage of the total U.S. earnings credited to Canada is the smallest in absolute terms as compared to less-developed countries (LDCs), but in terms of the percentage of total U.S. earnings reinvested abroad, a proportionately higher, and in many cases absolutely higher, proportion of earnings are reinvested *in Canada* as compared to other sectors. Sixty-one percent of total earnings on U.S. direct investment in Canada is reinvested into the Canadian real economy, as opposed to only 50 percent for Europe and 23 percent for the LDCs. Since 70 percent or more of *all* foreign direct investment in Canada originates from the U.S., it is obvious that the motor forces of the Canadian industrial economy is its role as a surplus investment of U.S. industry, in a sense not true of any other nation in the world.

This relationship is reflected in a number of ways. Seventy percent of total Canadian merchandise exports go to the U.S., a flow supported until now by numerous tariff concessions favoring the marketing of Canadian goods in the U.S. under GATT agreement.

U.S. ownership by equity of 32 percent of Canadian non-financial industry versus only 10 percent equity ownership by other foreign countries further underscores the relationship. U.S. ownership extends to 62 percent of Canadian petroleum and natural gas industries and 46 percent of Canadian manufacturing industry.

However, it is not U.S. and other foreign ownership of Canadian industry that defines the dependence of Canada on the U.S. economy, but rather Canada's dynamic role as an industrial R and D sector with respect to the U.S. Canada is notably advanced in the high-technology areas of nuclear energy development, telecommunications and other research and development areas. Canada's CANDU (nuclear reactor) program, widely considered to be superior to its U.S. fission counterpart, exemplifies the point.

Canada: Early Casualty of North American Recession

Graphs 4 and 5 demonstrate the process underlying Canada's current economic woes. As the recession began with an inflationary spiral after 1973, the manufacturing component of the U.S. direct investment abroad slackened, while inflation artificially drove the total investment figure to new heights (Graph 3). At the same time, total U.S. direct investment in Canadian manufacturing industry began a marked decline. Since the Canadian productive economy represents the generation of a U.S. surplus, *no* component of direct investment on the Canadian side reflects the inflationary side of the process, hence *total* U.S. direct investment in Canada leveled off as did investment in specific productive subsectors.

The same principle operates on the earnings side, as seen in Graph 4. Both the total U.S. and Canadian sector earnings on U.S. direct investments rose relative to the proportion of earnings reinvested following 1973, the relative cannibalization with respect to reinvestment served only to antagonize the inflationary component of the earnings figures. Again, earnings credited to actual investment in Canadian manufacturing slipped relative to total earnings, while reinvestment of earnings in Canadian industry began a sharp decline.

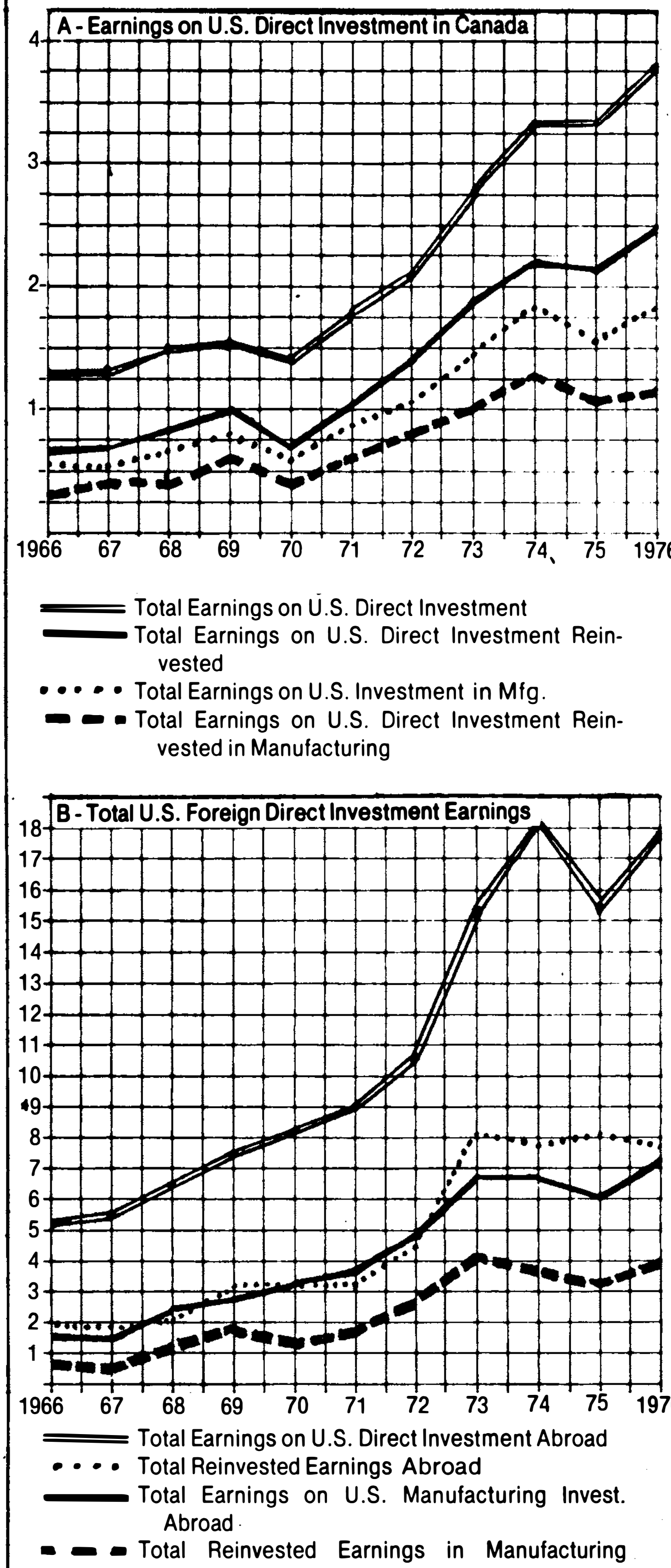
Graph 5 illustrates the operative principle most strikingly. Capital outflow figures from the U.S. soared on the whole after 1970, while outflows going into industry plummeted. For Canada, both total capital outflows and outflows in industry fall sharply whenever the U.S. economy experiences a recessionary binge as in 1968, 1971 and following 1974.

The Balance-of-Payments Crisis

Clearly there is no dichotomy between Canada's emergence since 1973 as one of the world's most indebted nations and the decline of her productive economy. The monetarist terms under which the free world economy has functioned since the 1944 Bretton Woods monetary agreement led to a situation by 1974 in which the total value of dollar-denominated international credit obligations, including outstanding international debt on the account of the International Monetary Fund, World Bank and Eurodollar pools, far exceeded the capacity of the world's productive economy to support it. The monetary bubble was in effect developed through the effective cannibalization of potential investment in the real economy during the entire period.

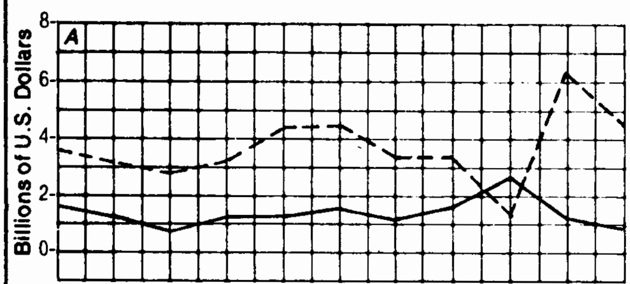
As inroads into the productive account were continued to maintain the debt bubble following the post-1973

Graph 4
Reinvestment Sags As Depression Deepens (in billions of U.S. dollars)

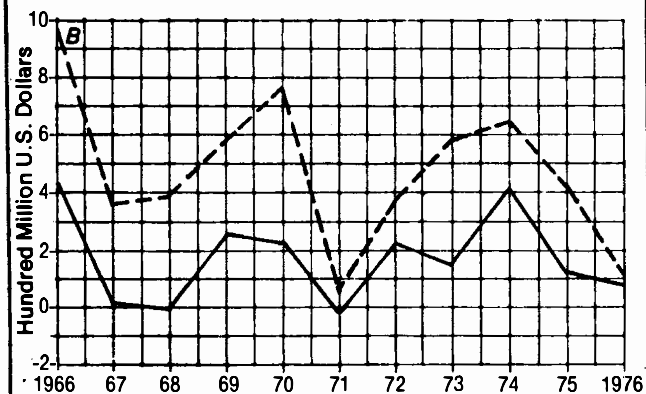


Source: Survey of Current Business

Graph 5
Capital Outflows to Canadian Manufacturing Dive As Depression Hits



- - - Total U.S. Direct Capital Outflow
— U.S. Direct Capital Outflow To Manufacturing



- - - Total U.S. Direct Capital Outflow to Canada
— Total U.S. Direct Capital Outflow to Canadian Manufacturing

Source: *Survey Of Current Business*

collapse of the speculative raw-material market, those sectors (i.e. Canada) that represented outlets for investment of surplus in manufacturing and real production were overwhelmed by the cancerous debt burden. As the investment lifeline to Canadian industry was cut off from abroad, the latter became a bad credit risk overnight.

Canadian commercial banks then began to channel financial investments away from Canada and into the Eurodollar market and other foreign ventures. The Canadian dollar became in short supply and BOC interest rates were raised, which in turn forced faltering Canadian industry, both government and private-owned, and local and provincial governments to turn to the cheaper foreign markets for their annual borrowings. From 1974 until very recently, the Bank of Canada maintained its short-term lending rate at several percent higher than the U.S. rates, a situation only recently reversed by an abrupt rise in the U.S. rates.

With the collapse of the speculative bubble in raw materials and commodities following 1973, the last inflationary "stimulus" to Canadian production — with the single exception of the auto industry — evaporated. Table 2 demonstrates the decline and leveling off of production of Canada's key raw-material exports following the 1972-74 peak. Raw materials account for 30 percent of Canada's annual merchandise export market. With only the agricultural sector and the auto subsector of manufacturing sustaining net increases in annual production levels after 1974, almost 70 percent of Canada's total productive capacity in terms of export-market value, is in an accelerating state of collapse.

Canadian Politics Effects Rate, Not Form of Collapse

Canadian political developments, as well as foreign poltiical initiatives impinging upon Canada, have only served to accelerate certain aspects of Canada's mounting crisis but have not significantly shaped the course of developments per se. The foregoing analysis effectively demonstrates that every element of Canada's current predicament follows lawfully from its unique role in the North American economy as a whole. A number of specific political factors affecting the immediate course of developments are worth mentioning however.

The decision of Quebec to secede from the Canadian union under the direction of proclaimed British mimic René Levesque, leader of the Parti Quebecois (PQ) provincial government, has antagonized the pressures of the foreign debt burden and has undermined confidence in the security of foreign investment in Canada's second most industrialized province.

Since the provincial takeover of the Quebec Hydro utility industry in the early 1960s, a move which anticipated the 1976 PQ victory, the Quebec provincial and local governments as well as the major public utilities, including Hydro-Quebec, have been barred from the domestic credit market and have been forced to rely

Table 1
Earnings and Reinvested Earnings On U.S. Direct Investment Abroad
(cumulative % 1966-1976)

	Canada			Europe			Developing Nations		
	Total	Mfg	Petrol	Total	Mfg	Petrol	Total	Mfg	Petrol
% Total Earnings on U.S. Foreign Direct Investment	20.0	25.0	13.9	29.6	48.1	5.0	39.2	17.2	70.4
% Total U.S. Reinvested Earnings on Direct Investment	29.0	30.0	39.3	40	43.7	10.7	21.9	18.0	24.9
RIE as % Earnings Credited to Each Sector & Subsector	61	67	63	50	51	47	23	59	8

completely on foreign borrowing to meet annual budget requirements beyond internally generated funds. (This does not give credence to recent PQ claims that Quebec is "exploited" economically through its relationship to the Canadian confederation but only points out the extra burden which the Quebec political situation has placed on the growth of the Canadian deficit. Quebec annual foreign borrowings currently total over $1 billion.

The secessionist Parti Quebecois government is also planning to take over the U.S. owned Asbestos Corporation Ltd. as the first step to provincial "nationalization" of the entire asbestos industry. Quebec accounts for 25 percent of current world production of raw asbestos processed at construction sites in the U.S. and Europe. Although Levesque presented the takeover as part of a provincial employment program, requiring reprocessing of raw ore inside the province, all parties to the affair, including top level PQ advisors, admit "off the record" that the scheme is economically unfeasible. Provincial reprocessing would, for example, mean that thousands of tons of heavy cement pipe would have to be shipped long distances to the U.S. and overseas instead of the current, much cheaper practice of reprocessing at or near the site of utilization.

This action has set the tone for a number of analogous "provincial rights" in other provinces. The environmentalist New Democratic Party Premier of Saskatchewan, Alan Blakeney, last year secured the right to enforce a provincial government takeover of the otherwise privately owned potash industry. Blakeney won a Supreme Court battle against federal government attempts to protect the private owners against the "nationalization" with arguments of federal constitutional authority to set raw materials policy.

Not to be outdone, Prime Minister Trudeau has announced that he would support the formation of an international nickel cartel to "stabilize the world market" and soften the impact of mass layoffs just announced by Canada's largest nickel producer, Inco Ltd. The Inco production cutback, effective in 1978, amount to a 5 percent cut in world nickel output, since Canada accounts for over one third of world production.

The cartel initiative was seconded by External Affairs Minister Donald Jamieson's annoucement that Canada will likely file formal charges against the U.S. firm Amax Inc., for dumping nickel below the production costs on the European market. The charge will be heard before the General Agreement on Trade and Tariffs (GATT) hearings in Europe.

Table 2

Recent Production Trends of Major Canadian Raw Materials (million units)

	1972	1973	1974	1975	1976
Asbestos (tons)	1.69	1.86	1.81	1.16	1.69
Nickel (tons)	0.26	0.27	0.29	0.27	0.27
Copper (tons)	0.79	0.91	0.91	0.81	0.80
Nat. Gas (th.Cu.Ft)	2,913	3,119	3,023	3,080	3,086
Petroleum (bl)	560	655	613	575	527

Financial Sabotage

Closely related to the "provincial rights" and cartelization are the activities of Walter Gordon, Mel Watkins, and other associates of the London-based International Institute for Strategic Studies. Charging that Canada has been "exploited" by U.S. based "imperialist" industrial owners, Gordon and Watkins succeeded in forcing the 1974 creation of the Foreign Investment Review Act to monitor all bids on Canadian firms. The FIRA has the authority to overrule any such bids not deemed primarily beneficial to the "Canadian" economy. Although FIRA rulings to date have approved more proposals than it has rejected, its creation has served to generate extra tension and uncertainty for industrial investment in Canada.

By helping to undermine confidence in the security of the foreign investment in Canadian *production*, the existence of the FIRA tends to ensure that an even larger portion of foreign investment in recent years takes the form of cheap buying-up of relatively weak Canadian firms for speculative purposes rather than investment designed to directly stimulate production. Thus the rate of approved foreign takeovers increased rapidly from 63 to 153 in the three years since the FIRA went into operation, a rate approaching that of a period of intense conglomeration of Canadian firms during the 1968-70 recessionary period.

From the standpoint of the mutual interests of the U.S. and canada, it is the *weakening* of the real production-based relationship of the Canadian economy to the U.S. and the productive needs of the world economy as a whole that is the cause of Canada's present depression skid.

— *Peter Wyer*