CONSEQUENCES OF
AMERICAN INVESTMENT IN CANADA

by

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I INTRODUCTION

The subject of American investment in Canada is a topic on the mind of many Canadians. Insofar as it is a major part of the overall pattern of American investment abroad it is also a serious concern to the United States. For the latter the main problem it poses is the strain placed on its balance of payments.[1] For the Canadian, however, the problem is not so transient. It is the long-run effects rather than the short-run which worries him. The short-run effects of American investment in Canada have been beneficial; the stimulant of increased demand has spread to other sectors of the economy and prosperity has followed. This has been true of all periods of substantial capital inflows, but especially during the early 1950s.

At the same time Canada has had to pay a

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1 This in turn is a result of America's attempts to invest, lend, and give away far more than its positive balance of trade will permit. The normal solution for other countries, devaluation of the currency, is not open to the United States for its currency is the basing point for so many others that such a move would at best only delay the ultimate corrections required. Reluctantly the American government has only recently employed the second-best alternative, deflation, through raising its discount rate. It is also attacking the problem directly by impeding the outflow of American funds through a special tax. This will serve to strengthen the attempts of the Canadian government to decrease the flow of American funds, as we shall see in chapter VIII.

price for these benefits. In direct costs the price has been very low but the long-run effects will likely prove more of a burden. The substantial American investment in Canada has placed that country in the hands of its creditors. This is the most serious charge against foreign investment and the one which touches Canada's sore point.

The situation has aroused considerable resentment in Canada and the imbroglio which has resulted is not purely an economic one. Nevertheless it is the economic undercurrent which provides the base for much of Canada's complaint. It is only natural that poorer countries should be jealous of richer ones and manifest their envy by some form of attack on their more affluent neighbours. In less-advanced countries this takes the form of denunciations of the United States and stone-throwing marches on her embassies. Canada manifests her displeasure in more intellectual forms. Her complaints are more subtle and, as a consequence, less easy to counteract.

It is the duty of the economist to analyze American investment in economic terms. What are its consequences? Does it aid economic development? Will it lead to economic assimilation? What would be the effect of the withdrawal of American investment or even a drastic reduction in capital inflows? How does foreign investment affect the opportunities for domestic investors to exploit their own economy? To answer many of these questions the economist must frequently go beyond the purely financial considerations. American investment generally involves much more than a simple loan of funds. Investment in equity forms, at least, also places part of the economy in the control of foreigners.

In this paper we will often speak of investment when only direct investment is meant. Many of the effects of direct investment, good and bad, are not present in portfolio investments. This divergence must be noted. Since direct investment is the more all-embracing of the two and since quantitatively it has been the larger in Canada's case, we shall devote more time to it than to portfolio investment.

One further point should be noticed. Although the primary concern of this paper is American investment, much of the analysis applies equally well to all foreign investment. Because it is by far the biggest part of all foreign investment in Canada and because it establishes ties to the United States which Canadians are worried about, we shall concentrate on American investment. Nevertheless, throughout the paper the two terms may generally be used interchangeably.

We shall look first at the theory of foreign investment, briefly examining its causes and consequences. Applying this to Canada we will study it as a practical illustration of the theory. After seeing the size of American investment we shall examine in detail its effects, making an arbitrary distinction between financial and non-financial consequences. After looking at the role of policy in Canada and elsewhere, we shall draw some conclusions as to what Canada's goals are and set up a corresponding strategy.

The conclusions drawn are intended to be economic ones. Having given the economic considerations involved, the economist's job is done. These must then be weighed against political and other factors and decisions taken based on them. The policy conclusions drawn here obviously imply that some such juncture has been made. Nevertheless I hope the evidence presented does not stray from its economic base.

II THE THEORY OF FOREIGN INVESTMENT

The Development of the Theory

The study of capital movements as an element in international economic analysis is essentially a twentieth century development. Although writers from the mercantilists onwards have been concerned with the causes and effects of "specie flows" (i.e. gold) and other unilateral movements, the main interest before the present century was the balance of trade.[2] Indeed the central tenet of the classical theory of international trade was the immobility of factors. The classical model held factors of production to be perfectly immobile beyond a country's borders. This included capital. Thus their studies centered on the problem of how equilibrium was restored after an imbalance in the trade account occured.

The patent lack of realism in this analysis is readily acknowledged by the latter-day classicists (J.S. Mill was the first to note the defect) who nevertheless feel it remains a useful tool and continue its exposition. The "pure theory" of international trade found in all textbooks retains the assumptions of the

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2 See Carl Iversen, International Capital Movements, Copenhagen, 1935, pp. 95-105, for a summary of the history of thought on capital movements. For a summary of the movements themselves up to 1930 see M. Palyi, "Foreign Investment," Encyclopedia of the Social Sciences, Vol. VI, pp. 367-74

classical model. Factor movements are added as an afterthought. Their existence is a minor qualification to a valid doctrine.

Contrast this with the role assigned to capital by Iversen:

> "Capital sets out in search of the other immobile factors, so to speak, in order to get combined with them in the most advantageous proportions. Its movements tend to neutralize the disadvantage of the uneven productive equipment of different countries."[3]

To Iversen the flow of capital, rather than commodity trade, is the great equalizer. Capital movement enables production to achieve economies of scale by offsetting the disadvantages resulting from the lack of factor divisibility.

The factor-price equalization theorem, on the other hand, developed by Heckscher and Ohlin, and perfected by Samuelson, is a direct offspring of the classical theory. Its acceptance as a point of discussion gives weight to the influence of the pure theory.

All this is in direct opposition to the theory of foreign investment and capital flows. Capital is the most mobile of the factors of production and naturally has received the most attention from the dissidents. Foreign investments were common during the seventeenth and eighteenth centuries (although they frequently were confined to the colonies of the mother country) and their importance has increased steadily,

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3 Iversen, op. cit., p. 156

if somewhat irregularly due to the interruptions of wars and depressions. While almost all peoples today are politically independent, the underdeveloped countries rely heavily on outside assistance to remain economically viable. It is under these conditions that foreign investment assumes its importance.

The Concept

What is foreign investment? It is not money, nor foreign exchange, nor purchasing power, nor capital funds. The transfer of money represents only the commitment to invest. Until it is translated into the flow of goods and services from abroad no investment takes place. Thus foreign investment is the placing of goods abroad, generally to obtain a better return on them than could be obtained at home. "If no goods at all were able to move between countries a real capital transfer would be impossible."[4]

This does not mean that the actual goods (i.e. plant, machinery, inventory, etc.) in which the investment is made must originate in the investor's home country. This is unnecessary. The transfer of purchasing power will enable the recipient country to add to its resources in total; where any particular funds are used is not important. If the capital funds so transfered are actually used for consumption goods, for

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4 *Ibid.*, p. 47

example, this simply allows the domestic funds which might have been used for consumption to be diverted to the capital project for which the investment was intended. It is also possible, of course, if a foreign loan is made, to devote it entirely to consumption goods. This merely increases present consumption at the expense of that in the future. The lending and repayment equate present and future marginal utilities just as in the domestic market.

In fact all international investments differ from domestic investments only in external qualifications. These include the problems of foreign exchange (its possible future depreciation); separate political units following different and possibly contradictory economic policies and following discriminatory (either adverse or favourable) policies towards foreign investment; and the natural barriers of geography, language, and culture. It offers a special field of study due to the importance (from a national rather than world viewpoint) of relative changes in welfare resulting from a shift in resources. The causes and effects of foreign investment, while in essence the same as those of domestic investment, merit separate analysis as long as nationalist considerations outweigh those of the world-oriented outlook.

The Balance of Payments

In measuring all international transactions the balance of payments is generally divided into sections to reflect the nature of the money movements. The current account section includes all sales of goods and services, including the interest and dividend payments on previously invested capital. The current account reflects the commercial side of international economic activity in that it shows those things bought from and sold to non-residents of one's own country. The "balance" on current account is considered positive (or "active") if a country receives more payments than it makes and negative (or "passive") if purchases exceed sales.

More important for our study is the other section of the balance of payments, the balance on capital account. As the name implies, this records all capital movements across a country's borders. Again this is subdivided to show some meaningful grouping of the transactions. The major division is by duration of the transfers. Investments are considered long-term if they are made for more than a year and short-term if for less. In instances where there is considerable international trading activity in organized markets, as in the Canadian case (e.g. Americans buying and selling on Canadian stock exchanges), this classification is sometimes misleading since investors will purchase what are normally considered long-term assets with the intention of reselling them in the near future.

Long-term investment is further distinguished by its control after it is invested. Direct investment is that in which the investor controls the enterprise his funds are advanced to. Portfolio investment is that in which the investor exercises no control over the use of his funds once they are committed. The two types correspond generally to equity stock and bond investments, although there are exceptions both ways: minority stockholdings are considered portfolio investment and bond issues by controlled companies are included with direct investment. Again just when a company becomes a controlled subsidiary is not always easy to identify and balance of payments statisticians must frequently make interpretative judgements.

A more meaningful distinction in the capital account is that between those flows which are autonomous and those which are accomodating. Autonomous movements are those which arise independently of any current account transactions. They are genuine investments, for the investor wishes to place his funds in a foreign country for the purpose of earning a return (other motives are possible, as we shall see below). Accomodating transactions are those which are made to offset, or "accomodate" current account movements. They take the form of credit arrangements, or if these are unavailable, a transfer of gold or foreign exchange (i.e. the currency of the paying or some third country). By their nature accomodating movements are almost universally short-term movements. Although some of the latter can also be autonomous, their close connection to the interest rate differential usually leads to the generalization that all short-term movements are accomodating, and vice-versa.

It is a truism to say that the current account and capital account in the balance of payments must offset one another. The double-entry bookkeeping method ensures that this is so. But for purposes of meaningful interpretation several items are usually removed from the two and placed in their own categories. International donations (government grants and private charity) are technically capital movements but because they are non-refundable they are usually considered apart from the capital account. Reparations and tributes are also of this nature. They are true unilateral movements: there is no quid pro quo at the time of the transaction and the movement will never be reversed.

In like manner gold and foreign exchange movements are also segregated. They are the pure accomodating movements and occur in significant quantity only under a system of fixed exchange rates where a central bank or stabilization fund enters the market to maintain the relative international value of its currency. To do this the stabilizer must accomodate imbalances in autonomous movements and private credit arrangements by buying or selling the appropriate amount of gold and foreign exchange at the exchange rate it desires to preserve. This requires maintaining a sufficiently large reserve of funds to handle any imbalance which might occur. These transactions play an important role in the "transfer mechanism" which we shall look at. They must do the work which the exchange rate itself does when it is permitted to fluctuate.

Causes of Investment

Having seen the skeleton of the international money flow, we can now turn to its causes. Short term capital flows move in response to interest rate differentials. If current interest rates are higher in Canada than in the United States, funds will flow from the latter country to the former. This inflow will reduce the availability of funds in the United States, driving up interest rates there.

The short-term movements thus help maintain equilibrium in the balance of payments. The changing interest rates will themselves generally reflect the imbalance in international transactions. An excessive inflow of funds will increase the money supply and lower interest rates, thus driving the excess money out again. The short-term movements provide an important cushioning effect for the international accounts by allowing a breathing spell for trade and capital movements to adjust themselves to changing conditions.

> "Whatever form it takes, the international movement of short-term funds derives its importance for the mechanism of adjustment of international balances from the fact that these funds are highly mobile and in the absence of financial or political disturbance respond quickly, especially as between well-developed money markets, to even moderate relative fluctuations in interest rates."[5]

Such responses will continue until the rates are again equal, or until the difference between them reflects the cost of transfer and the premium for risk involved in the international movement. To hedge against part of this,[6] buyers of foreign funds will usually sell forward the same amount to cover themselves against any possible depreciation. Normally arbitrageurs will borrow in the cheap market, lend in the dear, and hedge by buying forward exchange. This will continue until the differential in interest rates is offset by the discount on the forward currency.

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5 Jacob Viner, Studies in the Theory of International Trade, New York, 1937, p. 403

6 The premium takes into account not only the risk of depreciation or default, but also the danger of such discriminatory actions as freezing of foreign assets, rigid exchange controls, and the like. Moreover it also reflects an imperfect money market. As the raising of capital increases and a well-informed market develops, the rate of interest tends to drop, reflecting the lower risk involved when conditions become known to the potential investors.

This assumes, however, that the exchange rate is relatively stable. If speculation is that inflation and exchange depreciation will devalue the high-interest currency further, the forward market will collapse. This is the case of capital flight, or "hot money."

> "The mobility of short-term capital, which makes it an ideal balancing item, also makes short-term capital movements especially dangerous to international equilibrium where distrust of currencies leads to capital flight."[7]

In this case capital will flow out of, rather than into the high interest market. The continually greater interest rate differential is always insufficient to cover the ever-mounting risk premium demanded. Such a flow will of course only worsen the situation and bring about the inflation it is trying to escape.

Long-term capital movements will react to interest rates and profits in much the same manner as short-term flows. If the high interest rate in the receiving country is a reflection of the scarcity of capital and a corresponding high marginal efficiency of capital, investors will move funds there from countries where capital is relatively plentiful and has a correspondingly lower marginal efficiency rate. This has the effect of converting savings into investment and equating supply and demand in the capital markets of

7 Donald Bailey Marsh, <u>World Trade and Investment</u>, New York, 1951, p. 47

both the receiving and sending countries. From a world point of view this increases the overall earnings of capital which reflects a better world-wide allocation of resources.

In general, the same motives govern the use of portfolio and direct investment. But portfolio investment naturally entails less uncertainty and therefore requires a lower risk premium to attract it to a given country. Its fixed return and relatively certain repayment ally it more closely to the short-term movements than to equity investment. The term 'investment' is more correctly applied to the latter. Direct investment implies the application of funds with the intention of expanding productivity. More than the portfolio loan it leads to the increasing of the world's productive resources.

Marsh distinguishes four incentives for direct investment.[8] The first is of course the prospect of profits, which is the marginal efficiency of capital noted above. Indeed this element is essential for any investment (other than philanthropic 'soft loans' by international agencies, governments, foundations, and individuals) to be undertaken at all and is implicit in the other three motivations. Second are cost differentials. Here the benefits of lower wages, taxes, and the like cause an investor to exploit a more favourable climate for production. Probably even more important is

8 Ibid., pp. 497-501

the saving in transportation costs. Here the investor is simply following the theory of location. If an extractive export industry has a great volume of waste or a fabricating import industry a premium over bulk transport, it will pay an entrepreneur to locate at the source of the raw materials or at the market for the finished products, respectively. Third is the advantage of better marketing and customer good will. The identification of a product with a local company has great sales value and the better services made possible through local outlets also add a selling point. Finally the type of competition has a bearing. The possibility of a monopoly and the ability to avoid competition may often induce businessmen to invest in a market where competitive (or monopoly) conditions are favourable.

A fifth class of incentive should be added, that of deliberate government policy. If the foreign government offers concessions in the form of tax and tariff abatements this may provide a further attraction. The inward tariff barrier itself is an encouragement to locate in the country of sale. Other instruments include the limiting of patent protection to domestic producers, easier labour and social laws, reflected in less costs for fringe benefits, and provisions in a government's own contracts giving preference to materials produced at home. Government interference might work the other way around as well: a government with political ambitions abroad might encourage its entrepreneurs to invest there to increase its own influence in the foreign country by threatening the use of its economic tools.

Other classes might include a simple desire to diversify. This would hedge against domestic upsets due to inflation or depression. International investment also provides an opportunity to make full use of a company's technical knowledge where it has a decided advantage over any foreign competitors. Such international investment allows a company to reap the full benefits of its research and development which forms a fixed charge on its operation, making earnings on foreign investment clear profits. This of course assumes that such sales cannot be handled through domestic production.

Foreign investments in many cases are made to guarantee a source of raw materials required in the domestic production process. Such vertical integration is not uncommon within an economy and its extension abroad merely indicates the exhaustion (actual or potential) of domestic sources of supply.

The Pattern of Investment

The necessity of foreign investment is apparent in any country which is classed as underdeveloped. But even countries which are highly developed still attract and welcome foreign investment. In such cases the investing country usually has a highly developed specialty which could not be economically duplicated by others. Instead the originator extends his territory to include all potential customers. This is the division of labour theory applied to the entrepreneurial factor of production.

In the underdeveloped countries, however, this flow of specialties is all one way. The receiving country lacks technological know-how and the capital to go with it. Due to its low level of income it cannot generate the savings necessary to finance an expansion of capital. Without foreign investment it is caught in a vicious circle which defeats, or a best slows to a crawl, any attempts to increase its welfare by increasing its stock of capital goods.

> "It is theoretically possible, if plenty of time is allowed, for any country to develop its own industrial economy, even without foreign investment. But in a capital-poor country such a development might require an intolerable reduction of the national consumption in order to release the amount of savings necessary to finance the new investment. Or, in real-goods terms, a great deal more of the community's limited resources would have to be devoted to the production of capital goods, less to the production of goods for current consumption. The function of foreign investment is to bridge this transition by 'grubstaking' the new economy during the stage of 'industrialization.' Once this process is completed, or well advanced, the required savings can be accumulated 'after the fact.' with much less hardship than if they had been squeezed out of the low income of the underdeveloped economy. Or, in real goods terms, resources can be set aside for producing goods in repayment for the loan when total production is

> high, without a dangerous limitation of the nation's current consumption."[9]

We have seen that foreign investment responds to differences in the efficiency of capital between countries. However such differences do not remain the same over time. As a country develops, it tends to change its position as an international debtor or creditor. Initially an underdeveloped country imports a great deal of capital and, having a low level of income, can afford to export none. As it develops, its service charges and repayments on existing loans eventually match and exceed any further inflows until it begins to export capital on its own and becomes a creditor nation.[10]

These changes in the flow of capital across international boundaries are reflected in the variations in market interest rates which in turn reflect the overall demand and supply of capital. Such changes occur as an economy develops. The introduction of new technical processes alters the production function and further increases the demand for capital. All these changes are reflected in the gradual lowering (relative to other countries) of the market rate of interest in the developing economy.

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9 *Ibid.*, p. 75
10 See G. Crowther, *Balances and Imbalances of Payments*, Boston, 1957, pp. 8-12 for a detailed table.

In this process it encounters the repayment problem. As the capital inflows slow down in response to the diminishing marginal efficiency of capital, the borrower must meet its interest and dividend obligations by sacrificing more of its production in the form of exports to pay the real costs of the foreign investment. This is likely to be aggravated as foreign earnings which were plowed back into the expanding business are now repatriated due to the lesser opportunities available.

Effects of Investment

Foreign investment benefits the borrower and the lender. It benefits the borrower by allowing him to expand production without having to sacrifice consumption. In the case of the undeveloped country it also introduces technical knowledge without which it could not increase output even with its own capital resources. To achieve this it is necessary that labour move internationally along with capital. It is this migration of labour, either permanently or temporarily, which introduces the technology, but since it rarely moves without capital, the two are considered concomitant partners in foreign investment.

> "That a certain number of technicians from the creditor country will go abroad together with its capital is but natural, since the creditor countries are likely to have a more advanced productive technique than

the debtor countries to which the capital moves. Thus international capital movements tend to diffuse the knowledge of all sorts of technical improvements much more rapidly than would otherwise be possible."[11]

In the case of the developed country it is generally more a reciprocal arrangement, an extension of comparative advantage to entrepreneurial abilities.[12] The lender also benefits by earning a higher return on his investment than he would at home. The overall effect is to increase the world's output by transfering capital from lower-yielding to higher-yielding efforts.

But for the effects of foreign investment on the individual country we must take a more detailed look at the specific operations of a given investment. Such a micro-analysis has been made by Sir Donald MacDougall, based on the Australian case but with universal applicability.[13] He considers the effects of a relatively small change in the amount of foreign capital invested in a given country. In the diagram (on page 22) the original capital invested, AC, was split between domestic owners AB and foreign owners BC.

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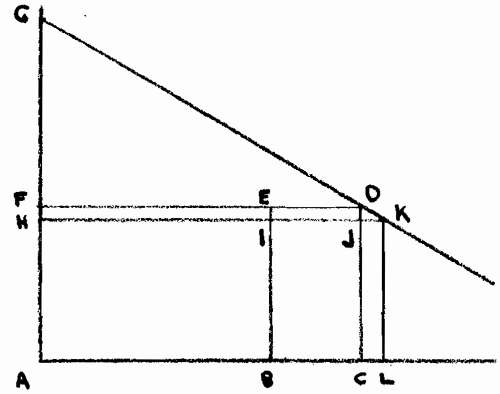
11 Iversen, op. cit., p. 179

12 Kindleberger feels that this motive for foreign investment prevails in the case of direct investment, rather than a pure attraction of differing marginal efficiencies of capital. He cites the Canadian outflow of direct investment at the same time as Canada is in need of more domestic investment as a primary example. Charles P. Kindleberger, International Economics, Third Edition, Homewood, 1963, p. 414

13 G.D.A. MacDougall, "The Benefits and Costs of Private Investment from Abroad: A Theoretical Approach," Oxford University Institute of Statistics Bulletin, 1960

The marginal efficiency of capital function GDK shows that the earnings FACD were divided accordingly. The residual GFD is the earnings of the other (domestic) factors in the economy. The small



increase in foreign capital (CL) results in a lowering of the profit level to HK. This has the following effects: 1)domestic profits are reduced by FHIE; 2) foreign profits are increased by JCLK - EIJD (it is unlikely that the elasticity of demand for capital, indicated by the marginal efficiency schedule, would be less than one); and 3) the redistribution of income increases the earnings of the other factors by FHJD plus the very small new earnings DJK. The total domestic gain is therefore EIKD, or approximately EIJD, the amount of earnings redistributed from foreigners to natives. Sir Donald considers the effects on domestic investment are uncertain. The accelerator may increase the need for investment or it may be reduced by the less favourable earnings. Likewise, if immigration is not prohibited or restrained by government policy, it may increase the labour force, shifting the marginal efficiency curve upward and to the right, thus forcing down wages to the old level and increasing profits again. Sir Donald concludes that the greatest benefits of foreign investment come from three sources: the increased government revenue derived from taxation on the foreign earnings; the external economies which result from the introduction of superior technical knowledge and the removal of bottlenecks (if such economies are labour-saving, however, they might redistribute the increased income unfavourably); and the economies of scale which are possible with the increased demand which follows.

The Transfer Mechanism and the Terms of Trade

An important aspect of the theory of foreign investment is how it actually is achieved. The original money movement must be turned into a flow of goods and services for the real transfer to be effected. The problem of the "transfer mechanism" has long puzzled economists.[14] As noted above, the classical school believed a restoration of the balance of trade was inevitable and the only question was how this was brought about. Today economists are still concerned with this problem but current theory rests on the restoration of the balance of autonomous movements. Such a balance is indicated whenever gold and foreign exchange movements are unnecessary. In the case of freely fluctuating exchange rates the balance is automatic. The supply of and demand for a given currency are equated

14 For a summary of the discussion see Viner, op. cit., pp. 290-338.

on the international market and their point of equation determines the amount of capital (and of goods and services) which will actually move across the border.

In the case of fixed exchanges the mechanism is more complicated and it is here that the controversey arose. According to the classical theory any imbalance of autonomous movements (originally confined to the balance of trade rather than all money flows) will result in an accomodating movement of gold or currency. (This can be delayed by the use of accomodating short-term credits but unless the imbalance is meanwhile corrected the monetary flow will follow once these credits are exhausted.) This transfer will increase the money supply of the receiving country and contract that of the paying country. The effect of this will be to raise prices for the receiver's goods and lower them for the payer's. This will cause a movement away from the dearer goods and to the cheaper ones. Exports of the payer will expand and imports fall off. The combined effect, and its reciprocal in the receiving country, will be to improve the balance of payments for the payer. This process will continue up to the point at which the improvement just equals the initial imbalance. In this way the "money" is returned to the payer and he gives up goods of equal value.

This method can be cut short by the operation of short-term movements as we have already seen.

Here the funds respond quickly to slight changes which result in the interest rate due to the payment of funds by the sending country to the receiving country. The initial movement will be reversed by the flow of funds back to the country with the higher interest rate. Only when such short-term funds are exhausted will the price adjustments called for come into play.

The modern theory emphasizes rather the effects that the money flow resulting from the initial imbalance will have on spending. The increase in incomes, with the usual multiplier effects, will result in a two-fold increase in spending: on domestic goods and on foreign goods. A similar, reverse effect will take place in the paying country. Depending on the size of the marginal propensities to import of both countries, a good part of the real transfer will take place through this increase in imports of the receiver and its decrease in exports due to the payer's lower income.

However, as long as there exists a positive marginal propensity to save, the income effects of the transfer will not be sufficient of themselves to effect the real transfer. Metzler has constructed a model[15] to show why this is so. Without price changes (he assumes some unemployment, rigid wages, competition, and constant returns to scale to achieve this) the income

15 Lloyd A. Metzler, "The Transfer Problem Reconsidered", Journal of Political Economy, 1942

effect will bring about only part of the real transfer. How much will depend upon how the money transfer is raised. The effect will be strongest when both countries operate through tax changes or similar direct effects on income. Weaker changes occur when one or the other of the countries handles the sum through expansion or contraction of the banking system. (This generalization is not valid if one of the countries is "unstable in isolation," that is, its propensity to spend domestically and abroad are greater than one. In some such cases the transfer might be overeffected, that is produce an imbalance in the opposite direction.)

There are many exceptions to these general rules. They apply to cases where the transfer is treated as normal and income and price changes react accordingly. It is possible that the transfer will be achieved by making the initial payment in kind, or spending the entire sum in the paying country. In this case the marginal propensity to import is one. This is the case with American international aid which takes the form of gifts of its surplus foodstuffs. At the other extreme the receiving country may not spend the money at all (the marginal propensity to spend anywhere is zero) but use it instead to retire old debts. This is the thinking behind reparations, which supposedly are to offset the expenses incurred by the victorious nation in fighting the war.[16]

The transfer, in summary, is more easily effected the greater the reaction of income and spending to the change, the less the repercussions imposed by foreigners, and the less the banking system absorbs the changes in the money supply. Normally the income effect will provide the greater share of the transfer and price changes the balance.

It should be noted that, whether a country operates on a fluctuating or fixed exchange rate, it is usually the capital flow which causes the current account imbalance and not vice-versa. This serves to show the futility of attempting to achieve a balance on current account unless a country is prepared to adopt measures to balance the capital account at the same time. It is the capital movement which determines the imbalance on current account, and does so whether or not the lender specifies that the money must be used to buy goods of his own country. As Iversen points out,

> "In principle, all measures to induce or force foreign borrowers to use the funds put at their disposal to buy the products of the capital-exporting country must be condemned as superfluous... Even if preference for the capital-exporting country's export goods were stipulated in <u>all</u> foreign contracts it would make no addition... to the total ex-

16 It was the apparent inability of the Germans after World War I to pay their reparations which led to the Keynes-Ohlin controversey over the transfer problem. Interestingly, it was Keynes who argued against the aggregate income effect of transfers in contrast to his later general theory.

> cess exports of the creditor countries in the new state of equilibrium."[17]

However, he does concede that such tie-in clauses do avoid the difficult process of reorganization which capital flows can cause.

This problem of cause and effect has troubled many economists and the generalizations of the preceding paragraph do not meet with universal approval. While it is generally acknowledged that autonomous and spontaneous capital flows will automatically set in motion the transfer mechanism, many argue that a current account imbalance can also cause a subsequent capital flow.[18]

A problem related to that of the transfer mechanism is that of the terms of trade. The terms of trade are essentially price indices of all exports and of all imports. If the terms of trade deteriorate a country must give up more exports for the same amount of imports, and vice-versa. The classicists felt that the terms of trade would shift in favour of the receiving country. Such a conclusion follows directly from their theory on price adjustments. The receiver's prices rise and the payer's prices fall. The payer must therefore provide more real goods and the receiver less to maintain the same value of trade. This will always be true if the transfer occurs via price changes.

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17 Iversen, op. cit., pp. 90-1
18 Cf. Viner, op. cit., p. 364

Under the income effect, however, assuming equal and opposite changes in income, the terms of trade will favour the payer if his marginal propensity to consume is greater than the marginal propensity to import of the receiver, and if his marginal propensity to import is less than the marginal propensity to consume of the borrower. This one would assume to be the normal condition. The conclusions with unequal income changes are uncertain. Moreover with unequal elasticities of supply generalizations are again impossible. Kindleberger notes that a capital-importing country will often supply raw materials and a capital-exporter manufactured goods, which are in more elastic supply. Under such conditions the terms of trade will favour the capital-importer.[19]

General conclusions about the terms of trade are evidently impossible.[20] We must draw assumptions about the nature of the imports and exports themselves, the conditions of demand and supply, and the extent that price changes are necessary, before we can say anything about how they will shift as a result of the transfer payment.

19 Kindleberger, op. cit., pp. 369-70

20 Cf. Bertil Ohlin, Interregional and International Trade, Cambridge, 1933, p. 343

III CANADA AS A PRACTICAL CASE

Canada in the Textbooks

Canada has long held a prominent position in the eyes of international trade and finance theorists. Rare is the text which does not cite Canada as an example of the workings of capital movements. Studies abound which are devoted exclusively to the task of proving a theory by pointing out how it worked in the Canadian case, It is an easy matter, then, to demonstrate how Canada is a good model for the theory of foreign investment.

Canada has thrived on factor mobility internationally. As the next chapter will show, it has received an almost uninterrupted flow of capital since the turn of the century. It has also opened its doors to millions of immigrants. These two factors, together with the know-how they have introduced, have propelled the Canadian economy to the point where it has the second-highest per capita income in the world.

These capital inflows have been achieved, as one would expect, by corresponding deficits on current account. Heavy foreign investment occured in the years prior to World War I, in the 1920s, and especially in the 1950s. It is not surprising that in these same periods Canada has had large trade deficits. Likewise during the '30s and '40s, when Canada was actually exporting capital, her current account showed a positive balance. These facts are really truisms in the light of our definitions. What has interested economists is how one led to the other. The chicken or egg argument is important not only in its sequence but also in its mechanism. We should be able to satisfy all arguments over capital transfer theory by studying the Canadian case, which is replete with pertinent statistics, especially beginning in 1926, when the Dominion Bureau of Statistics began its official compilations.[21] Unfortunately, even this generous array of available data has not settled many of the disputes.

Canada's Need of Capital

That Canada has had a need of foreign assistance is readily acknowledged by all. The high level of national income she enjoys today would not likely have been achieved even with the most stringent sacrifice of current consumption levels. This applies especially to the post-war years which have seen the greatest increase in income and a capital inflow which dwarfs those of all previous periods together.

The volume of Canadian savings, although a relatively high one on a per capita basis, could not

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21 Earlier figures are available based on various estimates. The most frequently cited are those of Viner and Knox. See Jacob Viner, Canadian Balance of International Indebtedness 1900-1913, Cambridge, 1924, and Frank A. Knox, "Canadian Capital Movements and the Canadian Balance of Payments, 1900-1934," in Canadian-American Industry, New Haven, 1936

have supplied the necessary funds to provide the rapid industrialization Canada has experienced. In this respect Canada has played the role of an underdeveloped country, requiring foreign assistance to achieve a "take-off" into industrialization and a level of income which will allow domestic savings to provide all the capital needed for future expansion.[22] Canada has thus welcomed foreign investment for the benefits it has brought. For the average consumer it has meant more automobiles, television sets, air conditioners, summer cottages, and three-week vacations. He has been able to pay for these out of a rising income which has been based on the past savings of others, rather than his own.

But the provision of savings is not the only contribution foreign investors have made. The type of investment they have initiated has generally been capital-intensive. The development of Canada's natural resources has required great outlays on equipment for extraction, processing through the early stages, and

22 The concept of a "take-off" was introduced by W.W. Rostow to mean a period during which the increase in the rate of investment, accompanied by radical changes in production methods and income distribution, introduces a self-perpetuating growth in national income. He has estimated that such a period occured in Canada from 1890 to 1914, propelled chiefly by the inflow of foreign capital. W.W. Rostow, "The Take-Off Into Self-Sustained Growth," Economic Journal, 1956, reprinted in A.N. Agarwala and S.P. Singh, The Economics of Underdevelopment, New York, 1963
The notion that Canada's growth is self-perpetuating is, however, extremely tenuous when it is considered that it has continued to depend on external demand in the forms of foreign investment and exports.

transportation to the location of the final production stage. This involves a high proportion of capital and a relatively small labour force. Moreover, absolutely each project of this nature often involves an investment running into seven and eight figures. In terms of financing this means that this money must be obtained from a single pool of readily available funds. Such "venture capital" is a rarity in Canadian financial circles. In the United States it is far more common.[23] This is most evident in the investments that take the form of a wholly-owned subsidiary of a large American complex. Its own capital and retained earnings provide a compact source of investable funds.

> "Investment undertakings which would entail a considerable element of risk for Canadians are often a routine operation for large non-resident corporations. The Canadian venture, large though it may be by Canadian standards, is typically only a small part of the non-resident's global operations. Furthermore ... the non-resident corporation may be expected to have the ancillary facilities including technology, skills and markets, in the abundant quantities which are required to

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23 This difference in entrepreneurial spirit does not seem to have any clear-cut explanation. Even allowing for the "risk is relative" argument Canadians are less venturesome. They tend to plow their savings into safe portfolio holdings rather than risk them in business undertakings. This is reflected in the facts that Canadians carry the highest per capita value of life insurance in the world and that their industry has the highest percentage of foreign ownership and control. Suggested causes include: a natural reticence to bear risk; the easier alternatives of benefitting from American experience; the disincentives of taxation differentials; and a greater preference for government direction verging on socialism.

reduce the risks involved to more or less negligible proportions."[24]

Moreover with the vast sums of money the United States has poured into Canada have come an inassesable flow of technological advancements, adapted to Canada's needs by men of proven entrepreneurial ability. That Canada could have matched these independently is doubtful, that she could not have done so as quickly is certain. American know-how, gained through the trials of experience, have undoubtedly saved Canada the great costs she would have to incur to learn alone. American patronage in this line has been mutually profitable. Brecher and Reisman summarized it in these words:

> "Connections with a parent or affiliated company abroad often involve advantages which either cannot be duplicated by a purely Canadian enterprise, or can be duplicated only at greater cost to the firm and the public at large. These advantages do not flow exclusively from the availability of capital in the form and amounts required. Availability of capital is extremely important, but so too are technology, research, product development, technical and managerial personnel, training facilities, market and supply contacts and accumulated experience over the whole range of business activity."[25]

Canada's Ability to Attract Foreign Investment

How has the inflow of American and other foreign capital confirmed the theoretical motives for

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24 Royal Commission on Canada's Economic Prospects, Final Report, Ottawa, 1958, p. 386
25 Irving Brecher and S. Reisman, Canada-United States Economic Relations, Ottawa, 1957, p. 138

foreign investment we saw earlier? The most tangible evidence is the interest rate differential. Canadian rates of interest (treasury bills are regarded as the best indicator of a "pure" rate of interest, carrying virtually no risk premium) have regularly been at a premium over corresponding American rates. From 1954 to 1962, for example (a period of heavy capital inflows), Canadian 91-day treasury bills had a higher yield than their American counterparts in all but three brief periods. In the same years rates on long-term government bonds varied without exception against Canada, the difference ranging from one-half to one and a half percentage points.[26]

This differential has been responsible for much of the capital inflow. Government and corporate bonds still account for some 38% (1959) of foreign long-term investments in Canada.[27] Presumably this is a reflection of the continuing opportunities for high yields in Canadian production. The differential can be cited as the American assessment of the cost of transfer and risk premium required to undertake foreign investment, even in a climate as favourable as Canada's.

The inflow of direct investment in the postwar years, however, has overwhelmed all portfolio

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26 Canada, Bank of Canada, Annual Report, 1962, p. 48
27 Canada, Dominion Bureau of Statistics, The Canadian Balance of International Payments, 1960, and International Investment Position, p. 76

holdings. Again we must point to the profit motive as the primary reason. Yields on Canadian investments have been high relative to those in the United States.[28] Moreover, their prospects have been equally good, as is reflected in the large amount of earnings which investors have chosen to plow back into their businesses rather than remit them in the form of dividends. All other motives cited are also here visible. Most costs are lower, although the wage level is a direct reflection of the lower productivity of Canadian labour. Location theory is still applicable. Canada is a next door neighbour and her industry is concentrated in the south, close to America's own northern industrial areas. Much of Canada's export trade is in raw materials, which are partially refined at the source to reduce transport costs. From the sales point of view many American firms set up subsidiaries and branches to appeal directly to their Canadian customers.

The role of government in the flow of foreign capital into Canada has in many cases been the deciding factor. Today it seems likely to become a negative factor, in contrast to earlier situations where it has tipped the balance in favour of investment in Canada. The importance of government policy warrants

28 In 1959 pre-tax profits as a percent of corporate assets were 3.7% in the United States and 4.8% in Canada. Americana Annual, 1963, and Department of National Revenue, Taxation Statistics, 1959

a special study which we shall postpone to a later chapter, where we will also look at comparable situations in other countries similar to Canada.[29]

But foreign investment in the Canadian case has often responded far more directly to natural economic conditions than to government influences. Canada's ability to attract American investment is perhaps best summarized by saying that Canada resembles the United States more closely than any other country. The Canadian way of life in many respects is a copy of American modes. This is a result of the modern media of communication. Radio, television, the magazines, the press, all blare out the high living that Americans enjoy. Their message is infectious and translates itself into a desire for things American. Thus as the two countries become more similar, more Americans tend to think of outlays in Canada as international only in a formal sense. The investment climate is further enhanced by the presence of a skilled labour force and the facilities (transportation, power) necessary for efficient operations.

Perhaps the strongest attraction in the postwar period has been the availability in Canada of the raw materials American industries have come to require in ever-increasing quantities. The bulk of

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29 See Chapter VII

American investment has been in the raw materials industries. Not coincidental is the fact that these same commodities make up the greater part of Canadian exports to the United States. It would be reasonable to conclude that there is a strong connection between foreign investment and Canada's export markets.

A comprehensive explanation of an American-eye view is given by Hugh Aitken:

> "Canada occupies a distinctive position as a field for American resource investments, for it offers at one and the same time all the advantages of a highly developed commercial society and all the attractions of a resource frontier whose potentialities have so far barely been tapped. The positive virtues of the developed and the undeveloped are there present in a single economy. A vigorous society, highly commercialized in its outlook, enjoying stable government under a well established political and legal system, alert to new opportunities for advance and yet conscious of its historical traditions, it can claim the second highest standard of living in the world and a climate for investment that, despite an embryonic nationalism, leaves little to be desired. At the same time, it commands resources of a richness and variety that were undreamed of fifty years ago and that, if they are to be developed efficiently, require exploitation on a large scale; they therefore must be sold in foreign as well as domestic markets. Add to these considerations similarity of language and culture, geographical proximity, a closely integrated continental transport system, and commitments to joint defense, and the rationale for American investment in Canada becomes clear."[30]

Canada's Stage of Growth

Canada fits well into the pattern of inter-

30 Hugh G.J. Aitken, American Capital and Canadian Resources, Cambridge, 1961, p. 97

national capital movements. From confederation to the great depression she was a debtor in her international trade and accumulated a mounting volume of indebtedness. The depression brought this to a halt as imports fell and foreigners attempted to repatriate their investments. Canadians have a steeply mounting import function and this has proved a highly stabilizing influence on the economy. In boom times Canadian imports rise sharply, in effect dampening the expansion, and in poorer times they fall off, lessening the drain on the economy. In the great depression this phenomenon again manifested itself and Canada became, briefly, a creditor nation (though her past debts still exceeded her growing assets). Foreign assistance during the war and in the postwar reconstruction further reduced Canada's net international indebtedness. Her interest and dividend payments during these periods followed a similar but lagging pattern.

The huge inflows of the 1950s reversed this short trend. Again this is linked with the corresponding boom witnessed in the domestic economy. While Canadian capital exports have continued to increase, they have been overshadowed by the inflows from the United States. In Crowther's terminology, Canada still remains a young debtor nation.

The Effects of Foreign Investment

The effects of this can be readily summarized. The Canadian Gross National Product has increased fastest in times of heavy capital inflows. From 1900 to 1913 it almost tripled and doubled itself again in the postwar decade.[31] During the 1930s Canadian incomes, aggravated by the withdrawal of foreign investment, fell along with those of the rest of the world, and had barely surpassed the 1930 figure at the outbreak of World War II. The GNP in real terms stagnated after the war and it was not until the capital inflows resumed in quantity that output increased. From 1950 to 1960 the GNP doubled to 36 billion dollars. The correlation is unmistakeable. Canadian growth has been achieved largely at the hands of foreign investment. While MacDougall's emphasis on economies of scale is uncertain here, the external economies that foreign investment has diffused are evident: a large measure of Canadian technology is the outgrowth of foreign capital and its concomitant technical assistance.

The Transfer Mechanism and the Terms of Trade

It is in connection with the theory of the transfer mechanism that "The Canadian Case" comes to the fore. Initially discussion centered around the experience prior to the First World War. Viner's pioneer

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31 Rough estimates in Kenneth Buckley, <u>Capital Formation in Canada 1896-1930</u>, Toronto, 1955, p. 135

study[32] claims to prove the classical proposition: the real transfer of capital comes about through adjustments in prices between the capital importer and exporter. Subsequent authors dispute this and cite instead the great rise in income and imports to back the validity of the modern theory.

In the period 1900-1913 the capital inflow into Canada exceeded 2.5 billion dollars. Viner and Taussig feel that the overwhelming size of this inflow is sufficient to attribute to it all changes during that period. Says Taussig of the experience, "The import of capital was so great, it overshadowed so completely all other [causes], that there can be no error in attributing to this the main economic changes which appeared."[33]

Viner traces through the operations of the transfer of foreign exchange and how this effected the ultimate real transfer. Gold inflows increased markedly, especially from 1908 on when the inflow was heaviest. The balance of trade deteriorated progressively during the period. Canadian deposits in New York increased greatly as much gold and foreign exchange (mainly sterling) found its way there. Bank credit in Canada increased from $350 million in 1900 to more than

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32 Jacob Viner, Canada's Balance of International Indebtedness, 1900-1913, Cambridge, 1934

33 F.W. Taussig, International Trade, New York, 1928, p. 235

$1100 million by the end of 1913. This monetary expansion followed the classical pattern of transfers although it frequently preceeded the gold movements as the Canadian bankers anticipated the inflow and discounted in New York.

Viner's chief evidence is the reaction of the price levels. While world prices in general rose during the period, Canadian prices rose considerably more than British prices. The Canadian general price index rose 32%, mostly after 1908; the British index increased only 17%. American wholesale prices rose 25%. This seems to substantiate the classical doctrine that the capital importer's prices must rise to allow exports to fall off and imports to increase to effect the transfer. Moreover, Viner attaches great importance to the fact that sectional price differences were pronounced. Domestic goods, which are most affected by the monetary expansion, rose 62%, and imports, least affected, rose only 14%, less than the world increase of 21%. Export prices occupied an intermediate position and rose 34%.[34]

The main criticisms of Viner are against his emphasis on price changes to the exclusion of the income effects. It is pointed out that the inflows were accompanied by great increases in Canadian incomes. The

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34 Gottfried von Haberler, <u>The Theory of International Trade</u>, London, 1936, pp. 96-101

capital imports were matched by an increase in real investments and the increased demand spurred on by the immigration flows further increased the feeling of optimism. Exports actually rose during the period. It is thus obvious that the transfer mechanism was not achieved entirely, or even largely by the shift in prices. The overall increase in economic activity and the accompanying demand for foreign goods played a large role. As Meier points out, the price increase in trade was far outweighed by the volume increase of over 250%.[35]

Later periods have come in for similar analysis. Malach is of the opinion that the inflows of the '20s were accomodating rather than autonomous.[36] The imbalances on current account were the result of the business cycle; the rules of the gold standard game, which Canada then followed, served to attract foreign investment. This cyclical pattern is further confirmed by Marcus in his study of the depression.[37] The demand for Canadian exports, he contends, is highly inelastic, depending more on the foreign level of

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35 G.M. Meier, "Economic Development and the Transfer Mechanism: Canada 1895-1913," Canadian Journal of Economics and Political Science, 1953. See also A.K. Cairncross, Home and Foreign Investment 1870-1913, Cambridge, 1953, pp. 37-58; and John A. Stovel, Canada in the World Economy, Cambridge, 1959, especially Part III.

36 Vernon W. Malach, "The Mechanism of Adjustment in Canada's Balance of Payments 1921-29," Canadian Journal of Economics and Political Science, 1952

37 Edward Marcus, "The Cyclical Adjustment Pattern of an 'Open Economy:' Canada, 1927-1939," Economic Journal, 1952

economic activity rather than Canadian prices. Thus Canada's export prices were relatively stable during the depression and the volume of exports fell with foreign, chiefly American, incomes. The Canadian imports fell more sharply. This results in an improved balance of trade which neatly coincided with foreign withdrawals of capital, making Canada a capital-exporter in the midst of the depression. "It would not be an exaggeration to say that the worse the state of domestic activity, the better the international position became."[38] It is also indicative that the Canadian national income declined considerably more than that of the United Kingdom during the 1930s, although it did keep slightly ahead of that of the United States.[39]

As noted earlier, the postwar stagnation and expansion of the 1950s were matched by similar current account balances, positive in the '40s and increasingly negative through the '50s. The price effects followed a similar pattern to earlier periods, though on a less severe scale. In the period 1946-49 export prices rose slightly slower than imports: 28% versus 33%. The Canadian dollar, freed from its peg in 1950, quickly rose to a premium and continued there throughout the decade. Export prices rose 20% from 1949 to 1960 while import prices advanced less than 13%. The

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38 <u>Ibid</u>., p. 307
39 <u>Stovel</u>, <u>op</u>. <u>cit</u>., p. 248

money supply during this period outpaced the increase in real income but fell far behind the dollar increase.[40]

Canada's terms of trade over the past century have tended to confirm the classical viewpoint. The terms of trade improved from 1869 (67) to 1895, declined slightly to 1900 (100 -the base year) and improved again to 1913 (117), especially after 1908.[41] With only two exceptions, the terms index followed the balance of trade, improving when the balance was negative, and deteriorating when it was positive. The terms improved irregularly again through the 1920s, declined from 1927 to 1933, and improved slightly to 1938, although never reaching the level of 1924.[42] The postwar period saw a slight decline. From 1950 to 1961 the terms again improved, from 98 to 104 (base year 1948).[43]

40 T.N. Brewis, et al., Canadian Economic Policy, Toronto, 1961, p. 198
41 Stovel, op. cit., pp. 97, 171
42 Ibid., p. 246
43 Calculated from Canada Year Book, various years

IV THE FACTS AND FIGURES

The History of Foreign Investment in Canada

Canada has always attracted foreign investment, though the pattern has been one of spurts rather than a smooth flow. Its allurement goes back to Cabot and Cartier whose discovery of the natural resources available brought waves of settlers and merchants anxious to profit from the beaver pelts, the buffalo, and the fisheries. They were encouraged by their governments back home, who saw the colonial trade as a means of increasing their own wealth. Both the English and French monarchs readily granted charters to exploit certain fields.

With the defeat of France in the Seven Years War, confirming British rule in 1763, Canada became an exclusively English domain. Many French merchants packed up and returned home, leaving a vacuum to be filled by a new wave of English entrepreneurs. They held a monopoly of the Canadian economy for almost a century.

But the success of the American revolution, economically as well as politically, turned the eyes of the United States northward. The American capital inflow which is so great today can trace its beginnings to the 1840s. The fields which attracted investment then have not changed much. Lumber was the chief attraction and the forests of New Brunswick were the chief beneficiaries. Copper and silver received some attention, to be followed in the '60s and '70s by gold, manganese, asbestos, iron, phosphate, and even oil (a small deposit was discovered in Cape Breton). The pattern prevalent today was thus established more than a century ago. American financiers invested in Canada to obtain its natural resources which they transported back to the United States for further processing. In addition some investments were made in manufacturing activities, in the more populous areas of Upper and Lower Canada.

But this perhaps exaggerates the importance of the American inflow at that time. Compared to the British investment it was minute. It was the British Isles which provided the foundations of today's economy: Scotch farmers developed the sturdy Canadian wheat grains, Irish immigrants provided cheap labour in the cities, and British capital opened the hinterlands with the Canadian Pacific Railway (with American help).

By the beginning of the twentieth century British investment in Canada had passed the billion dollar mark (in then current dollars) while American investment was only 168 million dollars.[44] The immigration boom that preceded World War I brought with it a

44 Knox, *op. cit.*, p. 299

continuing inflow of British capital which fostered a very rapid growth rate in Canada. This capital inflow was almost exclusively in the form of government and government-guaranteed railway bonds. Its subsequent withdrawal was thus easier to effect than would have been the case were the investment in equity form. But already the United States, having eliminated its own "frontier," was making gains. At the outbreak of war British investment had sky-rocketed to 2.8 billion dollars. It only managed to regain that peak in 1956 and in 1961 totalled only 3.5 billions.[45] American investment had, by 1914, climbed to 881 million dollars,[46] already almost a quarter of the foreign investment in Canada, but that was only the beginning. Its own opportunities in the newly settled west still took precedence.

The heavy drain of war caused Great Britain to all but abandon her imperial investments. British investment in Canada remained stagnant during the 1920s. American investment, by contrast, was doubling and redoubling until on the eve of the great depression it was worth almost five billion dollars.[47] Less than

45 All figures are in accumulated book value dollars which tend to understate the worth of older investments.
46 Knox, _op. cit._, p. 299
47 All figures for the remainder of this chapter, unless otherwise noted, are taken or calculated from the following publications: Dominion Bureau of Statistics, _The Canadian Balance of International Payments, 1926-1945_; _Canada's International Invest-_

40% of this was in the form of direct investment; the remainder was in government and corporate bonds and minority participation in corporate equities.

The depression of the 1930s saw a halt to this steady inflow. Apparently only the general illiquidity of the depression prevented further withdrawals. As it was Americans repatriated some 400 million dollars in capital during the '30s. Combined with British withdrawals this made Canada a capital-exporter. It is significant that this occured while Canada suffered a decline in her GNP. The only other period in the twentieth century, the immediate postwar years, when Canada exported capital on balance was also one of economic stagnation.

During the war years Americans increased their participation by almost a billion dollars and added another 1.7 billions from 1945 to 1950. The latter year marks the beginning of an unprecedented snowballing of American investment. In the following decade American investment increased to over 18 billion dollars. This inflow has tended to concentrate in the area of direct investment; from the 40% level in 1930 it has increased to almost 60%.

It is only fair to note, however, that this

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ment Position, 1926-1954; The Canadian Balance of International Payments and International Investment Position, various years; Quarterly Estimates of the Canadian Balance of Payments, 1963; and Canada Year Book, various years.

has not been an entirely one-way movement. Canadian investments abroad have shown a considerable increase following a much similar pattern. Wartime assistance doubled Canadian assets abroad to four billion dollars and postwar reconstruction added another 1.9 billion. Of this total of 5.9 billions in 1950 more than two-thirds represented government loans or holdings of foreign exchange. The next decade saw a further increase of 3.5 billion dollars but this was almost exclusively private investment. Nevertheless, this jump of 57% palled beside the corresponding increase of 155% for the American buildup in Canada.

The Relative Magnitude of Foreign Investment

The importance of this increase might be judged in a variety of ways. Probably the most telling is the ratio of net international indebtedness, both American and aggregate, to total assets, or national wealth. Unfortunately there no longer exist any such measurements. Apparently the difficulties involved in adding together historical values and the unreliability of these values themselves render any such estimates impractical.

A second approximation is the share of capital formation, or addition to accumulated wealth, which comes from non-residents. Figures are available in total for the period 1946-1960. On balance, i.e. considering capital outflows as well as inflows, and including retained earnings, gross capital formation was 27% financed by foreign resources in the years 1956-60 (up from 17% in 1950-55 and nil in 1946-49 but down from the estimated level of the 1920s).

A further guide to Canadian dependence on foreign investment is the relationship of indebtedness to the ability to pay it off, as measured by Gross National Product. The pattern here is the same whether considered in terms of gross liabilities or net indebtedness. From 1930 to 1950 Canada's indebtedness in terms of GNP showed a marked decline. The heavy inflow of American capital since then, despite a substantial increase in Canada's own foreign assets, has not been matched by a corresponding increase in total output and the ratio has again risen (more than doubling from 22 to 46% in terms of net indebtedness). All these figures are summarized in Table I on the following page.

The Nature of American Investment

American investment has shown several peculiar properties in the direction it takes within Canada. Many of the motives ascribed to capital flows earlier could apply here. Evidently, however, it is Canada's natural resources which have been the chief goal of American entrepreneurs. While the Dominion Bureau of Statistics does not break down investment into manufacturing stages, the details it does give

CANADIAN INTERNATIONAL INDEBTEDNESS

TABLE I

$ billion

	1930	1939	1945	1950	1955	1960
Gross Liabilities	8.0	7.4	8.0	9.9	15.3	26.1
- as percent of GNP	140	131	68	55	56	73
Gross U.S. investment[1]	4.9	4.5	5.4	7.1	11.1	18.0
- as percent of Gross Liabilities	61	61	68	72	73	69
U.S. Direct Investment	2.0	1.9	2.3	3.4	6.5	10.6
- as percent of Gross Liabilities	25	26	26	34	42	41
Canadian Assets Abroad	1.5	1.9	4.0	5.9	7.4	9.3
Canadian Assets in U.S.A.[2]	.9	.9	.9	1.1	2.2	3.7
Net Balance of Indebtedness	6.5	5.5	4.0	4.0	7.9	16.8
- as percent of GNP	113	98	34	22	29	46

1 excludes short-term assets
2 excludes official holdings of American dollars

indicate the concentration of American capital at the stages of extraction and preliminary processing. By far the biggest share of the inflow has gone into the mining industry. Petroleum, natural gas, and other minerals have attracted more than three and a half billion dollars of American investment in the 1950s. The iron ore deposits have received over 700 million dollars and pulp and paper and allied areas 400 millions. These and other figures are summarized in Table II on the following page.

There is moreover a high correlation between American capital imports and commodity trade between the two countries. American enterprises established in Canada tend to import American input materials, apply them to Canada's natural resources, and sell the product back to their American customers. The United States Department of Commerce estimated that half of the fourteen leading commodities (which accounted for 60% of total trade) imported from Canada in 1952 were attributable to American direct investment in Canada.[48]

A look at Canada's leading exports and imports (Tables III and IV, pages 55-6) will quickly verify the nature of the products concerned. With the sole exception of wheat (which requires little capital

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48 Survey of Current Business, December, 1953, p. 14

AMERICAN INVESTMENT IN CANADA BY SECTOR ~~TABLE II~~
$ million

<table>
<tr><th></th><th>1930</th><th>1939</th><th>1945</th><th>1950</th><th>1955</th><th>1960</th></tr>
<tr><td>Total Direct Investment</td><td>1993</td><td>1881</td><td>2304</td><td>3426</td><td>6513</td><td>10625</td></tr>
<tr><td>Wood and Paper Products</td><td>334</td><td>281</td><td>316</td><td>446</td><td>684</td><td>886</td></tr>
<tr><td>Iron and Products</td><td>199</td><td>188</td><td>272</td><td>420</td><td>706</td><td>1198</td></tr>
<tr><td>Non-ferrous Metals</td><td>113</td><td>130</td><td>203</td><td>311</td><td>585</td><td>890</td></tr>
<tr><td>Chemicals and Allied Products</td><td>86</td><td>88</td><td>118</td><td>194</td><td>291</td><td>478</td></tr>
<tr><td>Petroleum and Natural Gas</td><td>141</td><td rowspan="2">(198)</td><td>138</td><td rowspan="2">(453)</td><td>1637</td><td>2885</td></tr>
<tr><td>Mining and Smelting, other</td><td>191</td><td>218</td><td>781</td><td>1348</td></tr>
</table>

TOTAL CANADIAN EXPORTS AND TEN LEADING COMMODITIES — TABLE III

$ million

	1930[1]		1945		1950		1955		1960	
	All	U.S.	All	U.S.	All	U.S.	All	U.S.	All	U.S.
Newsprint Paper	146	126	179	146	486	463	666	578	758	631
Wheat	216	7	476	129	326	28	338	11	410	14
Lumber and Timber	90	71	169	92	291	250	385	273	346	260
Wood Pulp	45	37	106	79	209	191	297	234	325	256
Aluminum[2]	14	5	122	105	107	50	213[3]	84[3]	268	54
Uranium	--	--	--	--	--	--	27	27	264	239
Nickel[2]	26	18	55	45	105	76	215	146	258	89
Copper[2]	40	36	41	23	88	42	175[3]	82[3]	211	85
Iron Ore	--	--	--	--	13	12	100	80	155	102
Asbestos, unmfd.	10	6	22	15	63	45	98[3]	56[3]	120	54
Total Exports	1120	515	3218	1197	3118	2021	4282	2559	5264	2932

1 fiscal year
2 primary and semi-manufactured products only
3 includes some manufactured material

and for which there is no market in the United States), the leading Canadian exports are ones which have been heavily invested in by Americans. Petroleum and natural gas are just beginning to expand their exports to the United States. Seven of the ten leading imports are in the non-agricultural capital goods category and six of these are supplied principally by American producers.

We can conclude that Americans have tended to invest in areas where they can supply the capital and where they require the materials being extracted or processed. Moreover, investment in these lines tends to be almost exclusively American. The extent of American control in 1959 was more than 50% in the following industries: automotive (96%), rubber (90), petroleum and natural gas (69), electrical apparatus (67), agricultural machinery (55), mining and smelting (53), and chemicals (52). Some 70% of all American direct investment was concentrated in the above seven industries. If we include pulp and paper (38% U.S. controlled) the percentage rises to 77. Some 44% of all manufacturing in Canada in 1960 was American controlled. (All foreign investors together controlled 59% of Canadian manufacturing activity.)

These industries are, not coincidentally, capital-intensive. This helps explain why American investments take the form they do. A further by-product, however, is the relationship of production and employment. American-controlled establishments having an investment of one million dollars or more in 1953 provided 30% of output but only 21% of employment. Apparently American capital is more productive than Canadian capital with the same labour force. A partial explanation lies in the nature of the chief American operations: oil and automobiles, for example, require less labour per unit of output.

The trend in recent years has been to intensify this concentration in particular industries and American control within these industries. The eight largest received 59% of all foreign investment in 1960. American capital inflows in that year were chiefly for petroleum, iron ore, and pulp and paper. Since that time American investment in the oil industry has continued at a slower pace and there has been a shift of emphasis to secondary manufacturing. This intensification of investment has also led to the acquisition of control through the purchase of existing assets previously owned by Canadians. This means that Americans are gaining control of Canadian assets without expanding output. This is in marked contrast with the bulk of the postwar inflows which have gone to open up virgin territory and have provided much of the increase in Canada's GNP during this period.

It is worth noting, in passing, that a still small but rapidly expanding portion of foreign investment currently is coming from the members of the European Economic Community. Their direct investments now pass the billion dollar mark.

This emphasis on direct investment has reduced the importance of portfolio investment. While many American insurance companies still hold substantial amounts of Canadian bonds, their significance has declined.[49] The non-resident share of the Canadian governments' funded debts has declined from 25% in 1936 to 14% in 1959. The corresponding figures for all funded debt are 34% and 18%.

The Cost of Foreign Investment

The out-of-pocket cost to Canada has been negligible. Measured by any yardstick the use of foreign funds to expand Canadian output has been a bargain. The effective rate of interest on all American investment has shown an erratic but downward trend since 1930. The cost of all investment has generally been a few points lower than that of American investment alone. If we measure the cost in terms of ability to pay the results are even better. Both relative to GNP and to gross receipts on current account, there has been a considerable improvement since 1930. The more recent trend, taking account of the great capital in-

49 The exemptions from the proposed American Interest Equalization Tax allowed new issues of Canadian bonds may restore this significance.

flows, is not as encouraging and seems to show that the trough in borrowing costs has been reached.

The major reason why the borrowings have been so cheap is that most holders of direct investment prefer to reinvest their earnings to enhance future potential through the growth of their capital. Such retained earnings in the fifteen years after the war totalled over four billion dollars! This represents 40% of the increase in direct investment. Moreover, this compounding will likely continue as recent ventures begin to "pay off." If we take these retained earnings into consideration, the service costs of Canada's debt rise 50%. It is also significant that more than half of all corporation dividends paid out in Canada accrue to foreigners. This removes from Canadian hands a major source of future investment funds, entrenching foreign control by depriving Canadians of an important means of redeeming their foreign liabilities.[50]

We can also compute the overall cost on balance by considering Canadian earnings on assets abroad. As one would expect these have been lower than foreign earnings in Canada. The large portion of government assets (easy-term loans and foreign exchange holdings) earn low returns and Canada's net service costs increase. These figures are all summarized in Table V which follows.

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50 Cf. C.D. Blyth and E.B. Carty, "Non-Resident Ownership of Canadian Industry," Canadian Journal of Economics and Political Science, 1956, p. 45

SERVICE COSTS OF CANADIAN INTERNATIONAL INDEBTEDNESS — TABLE V

$ million

	1930	1939	1945	1950	1955	1960
Interest and Dividend Payments Abroad	348	306	253	475	483	653
- as percent of Gross Liabilities	4.4	4.1	3.1	4.8	3.2	2.5
- as percent of GNP	6.1	5.4	2.1	2.6	1.8	1.8
- as percent of Curr. Acct. Receipts	26.8	21.0	5.5	11.1	8.0	9.1
Interest and Dividend Payments to U.S.	225	220	194	411	388	531
- as percent of Gross U.S. Investment	4.6	4.9	3.6	5.8	3.5	2.9
Foreign Earnings Retained in Canada	n.a.	n.a.	n.a.	155	365	350
Total Foreign Earnings	--	--	--	630	848	1003
- as percent of Gross Liabilities	--	--	--	6.4	5.5	3.8
Total Canadian Receipts	59	57	76	91	160	178
Net Payments Abroad	289	249	177	384	323	491
- as percent of Net Indebtedness	4.4	4.5	4.4	9.6	4.1	2.9

n.a. - not available

V THE FINANCIAL CONSEQUENCES

The Income Effect

Such massive inflows of foreign capital as Canada has experienced are not without major consequences for the economy. In order to assess these consequences we have to analyze how the capital inflow has affected each of the sectors of the economy. This requires some simplifying assumptions, the reality of which can greatly affect the reality of our theoretical outcome.

We must first assume that the Canadian outflows of investment which partially offset American and other inflows were autonomous. This is not unreasonable. Canadian outflows were inspired either by deliberate government policy or in response to opportunities abroad for Canadian entrepreneurs to expand their operations which presumably were not available at home. This movement would not be subject to influence by the level of foreign inflows. The assumption, then, allows us to isolate the gross capital inflows, rather than the net balance.

(a) Our second assumption is the behaviour of investment in Canada in the absence of foreign inflows. Would the volume of investment actually undertaken have been the same if Canadians were required to finance it all themselves? This question is crucial for around it revolves the entire problem of benefits versus costs of foreign investment. If investment can be undertaken domestically as an alternative to using foreign funds, the benefits of those funds are far less significant. If, on the other hand, foreign investment is an alternative to no investment at all, then it is a positive addition to growth.

In the Canadian case we shall assume the latter. This may appear to be begging the question but, in reality, it is entirely reasonable. As we have seen, much of the American investment has been undertaken in virgin areas which required massive accumulations of capital.[51] In view of the size of the operations of individual projects and given the state of capital funds markets in Canada, the likelihood of these projects being undertaken by domestic firms is remote. The huge investments in oil and iron ore, as primary examples, were the result solely of foreign initiative. For the Canadian economy to finance these itself would have placed on it an intolerable burden.

This important assumption, then, provides the base for much of the rest of our analysis. Indeed it anticipates what is a foregone conclusion: one of the consequences of foreign investment has been a great increase in demand for Canadian goods and services and

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51 This does not mean that American investors have always come into Canada by setting up new firms. Over half the postwar American direct investment funds were funnelled through existing companies. Cf. Brecher and Reisman, <u>op</u>. <u>cit</u>., p. 92

this has led to higher incomes.

In looking at the figures again to confirm this, we shall confine our study to the decade of the 1950s. This period is the most significant one for our analysis. The earlier inflows of the 1900s and the 1920s, while important at the time,[52] have been far overshadowed by the more recent inflows. Moreover, these have had far greater consequences because they have been, in the main, a) American, and b) in the form of direct investment.

The inflows of the 1950s are also important because they mark the reversal of a trend of the first half of this century. Up until then foreign investment had shown a relative decline in its importance to the Canadian economy, measured in terms of its contribution to Gross National Product and its cost to be charged against that same output. Since 1950 American funds have poured into Canada and have been reinvested in Canada at an average of over one billion dollars a year. This has represented an addition to Canadian incomes of from three to five percent annually.

Table VI, on the following page, tries to show the income effect of these inflows. The most direct effect has been on other investments in Canada. The American investment has had a multiplier-accelerator effect which has seen total domestic investment

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52 Cf. Taussig's remark, quoted above, p. 41

EFFECT OF AMERICAN INVESTMENT ON CANADIAN INCOMES
(based on current dollars)

TABLE VI

	Foreign Investment	American Investment	Index of Amer. Inv.	Index of Total Inv.	Annual % GNP Change	Index of Exports	Index of Imports
1950	1.0	.7	100	100	--	100	100
1951	1.0	.8	114	130	18	122	125
1952	.6	.6	86	106	12	133	120
1953	1.1	1.0	143	126	6	124	124
1954	1.2	.8	114	107	- 1	123	128
1955	1.2	.8	114	138	11	126	143
1956	2.4	1.5	214	188	14	152	171
1957	2.2	1.6	229	183	4	153	173
1958	1.9	1.3	186	156	3	151	163
1959	2.5	1.5	214	174	6	159	179
1960	1.8	1.0	143	169	4	168	188
1961	1.7	1.3	185	167	3	181	190

Sources: Canada's International Investment Position, 1958-60; Quarterly Estimates of the Canadian Balance of Payments; and Canada Year Book, 1951-62 keep pace with that from American sources alone. This, of course, is a natural consequence. American investments in mining, petroleum, and manufacturing have required Canadian materials and Canadian services. American loans to Canadian enterprises and governments have the same effect. It is no surprise then to find this twin pattern. In the twelve years from 1950 to 1961 the rate of American investment increased 85% while aggregate investment increased 67%. No attempt at a detailed correlation has been made, but the annual indices show that aggregate investment has followed the American trend in all but three years.

Relating this to Gross National Product is a less happy task. The pattern we would expect to find from theoretical considerations does not exist. The overall increase in GNP, 108% in current dollars, has more than matched the increasing rate of capital inflows, but the trend over the decade does not show the same close relationship that the investment sector does. Even if we apply any reasonable time lag to our statistics there still does not exist the tie-in one would expect. On the other hand, the Canadian GNP has varied closely with that of the United States. This is attributable to the operations of the business cycle which we shall consider presently.

This lack of strong correlation gives some weight to the view that American investment in Canada, rather than being expansionary, has actually had a deflationary tendency, in contradiction to our second assumption. This can come about if the country receiving capital inflows does not expand its output by the full amount possible. The existence of considerable unemployment in Canada from 1957 onward could be interpreted as a manifestation that American investment has not provided an expansionary force. A second deflationary case arises when the foreign funds are used to buy existing assets. If the domestic sellers do not reinvest their proceeds this constitutes a leakage from the economy. Some 11% of foreign funds were used for this purpose in the '50s.[53]

The Foreign Trade Effect

The effect of foreign investment on foreign trade involves two considerations: the transfer process and the long-term effects. The converting of foreign funds into foreign goods requires that the recipient country run a deficit on current account to effect the transfer. We have already seen how this has worked in Canada's case. Canadian incomes have risen, causing an increase in imports, and Canadian export prices have risen relative to import prices, allowing a further

53 Cf. Rudolph G. Penner, "The Inflow of Long-Term Capital and the Canadian Business Cycle 1950-1960," Canadian Journal of Economics and Political Science, 1962

widening of the trade imbalance. This is in accord with our transfer theory.

The long-term effects, however, point to a return to a favourable balance of trade. The foreign investment will expand exports if it is of the type inspired by the investor's desire to obtain direct access to foreign sources of supply, or reduce imports if it is of the type which seeks outlets for its products. Thus the overall result will be an improvement in the balance of trade which will allow for easier repayment of the interest and dividends due on the foreign investment as well as for its repatriation. A second and more important part of the trade effect, however, is its own income effect. By increasing exports and reducing imports it is contributing, through the multiplier process, an increase in national income.

The indices of exports and imports in Table VI (page 65) reflect the combined operations of these factors and assign a more direct role to investment in the determination of Canadian income. The transfer mechanism is evident in the increase in imports relative to exports: starting from a small negative balance of trade in 1950, Canada steadily lost ground from 1952 to 1960. The deficit on current account reached a maximum in 1959 when it totalled over one and a half billion dollars. The remainder of the capital import was effected through non-merchandise transactions, particularly interest and dividend payments on earlier borrowings, which by 1963 had climbed to $842 millions. Since 1961 Canada has returned to a positive balance of trade and the capital imports have been reflected entirely in the non-merchandise account.

However, because the capital inflow has persisted for so many years, the short run effects and long run effects are interacting. This is seen in the 81% rise in exports in this period. This can largely be attributed to the inflow of American investment, particularly direct investment. The commodities which have accounted for most of this increase (newsprint and the primary metals) are the very ones which have attracted much of the American capital. The expansion of Canadian exports also shows a strong correlation to GNP. The pattern here is one of a very marked interrelationship and if we are to assign an income effect to American investment we must do so via its role in the expansion of Canada's export markets.)

Implicit in this last consideration is our third assumption, that Canadian exports have been a function of American investment. The question we must ask here is similar to that posed in our second assumption: if the American investment did not take place, would Canada's exports have expanded to the same extent they did? There is considerable doubt that they would have done so, although there is not as strong a case for establishing this dependence as there was in our previous argument.

The focal point here is the attitude of the American investor. If he could not obtain direct access to Canadian raw materials by owning his own firm, would he look elsewhere or be content to deal with independent suppliers? On the further assumption that the alternative source of supply could be guaranteed by direct investment elsewhere, it is unlikely that he would choose the former alternative.

(It is probable, then, that American investment has stimulated Canadian exports. This is not to say that this is the primary factor but still an important one. Canadian exports have also been a function of rising American and world incomes which have generated greater demand for Canadian products. Moreover for many raw materials Canada is a major source of supply and that demand is not, therefore, subject to the options of the American investor.[54]

The effect of American investment on imports is ambiguous. While the investment that has gone into secondary manufacturing has undoubtedly served to cut back some imports, it has necessitated an increase in others. Thus, while the import of American automobiles has been kept to a very low figure, that of American automobile parts has almost doubled in the

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54 Cf. Aitken, American Capital and Canadian Resources, p. 85

1950s.[55] Moreover, the automobile industry has also imported much of its productive machinery for the Canadian manufacturing process. This category leads the list of Canadian imports.[56] American investment in the petroleum industry has not resulted in reduced Canadian imports but offsetting exports have been on the increase and all predictions point to Canada becoming a major supplier of American needs in the near future. The pattern has developed of Canada importing its oil needed in the east via the Atlantic, and exporting its western production to the United States by pipeline.

On balance, then, American investment has stimulated rather than cut back American imports. Moreover, this trend is not likely to be reversed even if the capital inflows stop. Canadian secondary industry is still only a mock-up in that many Canadian-made products are manufactured from American parts on machines imported from the United States. Until volume justifies the establishment of a heavy machinery industry in Canada, the need for such imports will continue, regardless of who is doing the investing.

The overall effect on the balance of payments has obviously thus far been negative. The imba-

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55 See Table IV, p. 56

56 The Canadian automobile industry in 1959 imported some 300 million dollars in automobile parts, or over 25% of the total value of its "Canadian" production. Nor does this figure include the value of productive machinery, which presumably would raise this percentage substantially.

lance on trade account has been further worsened by the ever-increasing interest and dividend payments Canada must remit on foreign investments. Should all capital inflows come to a halt, this balance could not be restored without severe deflation or a marked depreciation of the Canadian dollar. The recent improvements in the trade balance still leave Canada a negative balance, due mainly to the service costs of her foreign borrowings. The long-term effects of foreign investment on the balance of payments will thus outlast most others.[57]

The Price Effect

The effects of foreign capital flows on the Canadian price structure are far less dramatic. We have already seen, in chapter III, how Canada has experienced a steady improvement in her terms of trade, interrupted by only a few relapses, in the last hundred years. This trend continued in the 1950s, with an overall gain of about 9% in the decade, although the recent devaluation of the Canadian dollar and improvement in the balance of trade threaten to reverse this trend.

We would expect, however, that the size of the capital inflows Canada has experienced would exert a more general influence on all sectors of the economy, generating strong inflationary pressures. This has not

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57 Canadian imports are strongly correlated with the Canadian income level, increasing more than twice as fast as incomes, thus complicating Canada's problem of external balance. Cf. Imre de Vegh, "Imports and Income in the United States and Canada," <u>Review of Economics and Statistics</u>, 1941, p. 140

been the case, as Table VII on the following page reveals. The Canadian consumer price level rose only fractionally more than its American counterpart and the wholesale price index was considerably more stable, rising only 13% versus 19% for the American index. Within the decade there is also little correlation between capital flows and Canadian price movements.

The explanation of this phenomenon lies not in the monetary policy of the central banks but rather in Canada's exchange rate policy. The figures in the table show that the Canadian money supply was not allowed to expand to accomodate the inflow. Its movement was similar to that of the American supply, being slightly more contractionary in the first half of the decade although increasingly expansionary since, particularly after 1959. To avoid the strong inflationary pressures the inflow of foreign funds would normally exert, the Canadian government freed the Canadian dollar in September, 1950. Within a year it had risen in value, from a 10% discount, in terms of the American dollar, to a premium. With the greater inflows of the latter part of the decade, this premium[58] reached as high as 6%. Later policies designed to discourage

58 The term 'premium' is not intended to imply that the Canadian dollar has any inherent parity value with the American dollar, but only that its value relative to the latter during this period was considerably higher than the historical level.

EFFECT OF AMERICAN INVESTMENT ON CANADIAN PRICES TABLE VII

	Canadian Prices		American Prices		Money Supply ÷ GNP		Exchange Rate
	CPI,1949	WPI,1935-9	CPI,1947-9	WPI,1947-9	Canada	U.S.A.	Cdn.$ ÷ U.S.¢
1950	102.9	211.2	102.8	102.4	.41	.41	108.92
1951	113.7	240.2	111.0	112.1	.35	.38	105.28
1952	116.5	226.0	113.5	111.5	.34	.37	97.89
1953	115.5	220.7	114.4	110.4	.34	.36	98.34
1954	116.2	217.0	114.8	110.7	.37	.37	97.32
1955	116.4	218.9	114.5	110.9	.33	.35	98.63
1956	118.1	225.6	116.2	114.0	.32	.34	98.41
1957	121.9	227.6	120.2	118.1	.32	.31	95.88
1958	125.1	227.8	123.5	120.8	.35	.32	97.06
1959	126.5	230.6	124.6	120.6	.33	.30	95.90
1960	128.0	230.9	126.5	121.5	.36	.28	96.97
1961	129.2	233.3	127.8	121.0	.38	.28	101.32
1962	130.7	240.0	129.6	121.3	.38	.27	106.89

Sources: Canada Year Book, 1951-64; Survey of Current Business, Dec., 1962; Business Statistics, 1961; Federal Reserve Bulletin, January, 1964 capital inflows and improve Canada's balance of trade eliminated this premium and the Canadian dollar was again fixed in 1962 at a substantial discount. The buildup of Canadian foreign exchange reserves since then, as the inflows resumed, would suggest that inflationary pressures will play their usual role in Canadian expansion, as long as the dollar remains fixed.

It has been the floating exchange rate, adopted by Canada in the face of international opposition, which had, up until 1962, absorbed any inflationary pressures which foreign investment would otherwise have generated. The premium on the Canadian dollar priced Canadian goods upwards in the international market and cheapened Canadian imports. The contractionary effects of this are the same as if the exchange rate had remained fixed and the price levels been permitted to vary. The latter method of producing an import surplus would have required severe adjustments and redistributions within the economy while the policy actually followed left Canada's internal balance fairly stable.

Canadian-American Interdependence

A major consequence of American investment in Canada has been the ever-increasing interdependence of the Canadian and American economies. In the postwar period this has been a part of the general trend towards increased world interdependence, as evidenced by the lowering of tariff barriers, increases in trade, and greater factor mobility, especially capital.

But the Canadian-American case is a special one because it has been so all-pervasive. Since Canada is the smaller of the two economies, interdependence generally means Canadian dependence on the United States. This has recently been confirmed by a statistical study along input-output model lines.[59] In an elaborate tabulation of relative sensitivities, the author analyzes the dependence of various sectors on foreign demand. In the Canadian case, American demand exercises its greatest influence on the metal mining and refining and the paper products sectors, a conclusion readily acceptable in the light of our previous knowledge. American industry, on the other hand, is most sensitive in the textiles, transportation equipment, agricultural implements, and chemicals sectors. But there is a great disparity by the author's own conclusion, based on his statistical analysis:

> "Assume ... that demand in each country is to be increased by some equal <u>relative</u> amount - for example, 1%. In absolute terms this requires increasing U.S. demand by many times the increase in Canadian demand. In this case the impact on production in the two countries is approximately equal in absolute terms. But such an increase in the level of production has a much greater <u>relative</u> effect on Canadian than on U.S. production, due to the comparative size of the two economies. The importance to Canada as compared to the U.S. of such a relative demand increase in the other

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59 Ronald J. Wonnacott, <u>Canadian-American Dependence</u>, Amsterdam, 1961

> country may be estimated as ... 12.585 times. In this sense Canada is about 12.5 times as sensitive to relative changes in U.S. demand as the U.S. is sensitive to relative changes in Canadian demand - even though in absolute terms the reverse is true."[60]

Of course not all of this can be attributed to the presence of American investment in Canada. Even without such investment Canada would still depend heavily on the American economy. The Canadian economy has a long history of reaction to the American business cycle, although this reaction has varied in timing and intensity. Moreover, the Canadian economy is also dependent on its other trading partners whose investment in Canada is a far less important factor.[61]

Nevertheless, we must assign American investment the role of villain in many of Canada's downturns. If not the instigator of the trouble, it has often stepped in to aggravate it. When the American economy is on the downswing American investors run short of funds and, whenever possible, withdraw any liquid assets they hold abroad. This was most strikingly illustrated during the great depression when American investment in Canada declined by close to half a billion dollars. Had so much of it not been tied up in fixed investments which could not be disposed of in a bearish market, this total undoubtedly would have been

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60 Ibid., pp. 90-1
61 Brecher and Reisman, op. cit., pp. 63-4

higher. Moreover, the multiplier effects we assigned to the investment at the time of entry are equally effective when it flows out.

In this respect direct investment is kinder to Canada than portfolio investment. The latter is generally more highly liquid and can thus be withdrawn more easily in times of recession. Even if it is maintained, the interest payments thereon tend to aggravate balance of payment problems. Direct investment, on the other hand, is more permanently entrenched and in bad times dividend payments tend to fall off, lessening the burden on a falling export trade.

Canada is also subject to the American business cycle in the operations of subsidiaries whose costs are often higher than their American counterparts, due to their smaller volume. "Where temporary slack develops in the use of its plant, a global company must decide where and to what extent the cutbacks are to be made. Unless non-economic motives or pressures exist, it could presumably cut back most in those plants in which costs are highest,"[62] which is often those plants in Canada. This is more likely to be a factor, as Brecher and Reisman note, in severe depression than in a minor recession.

The very presence of American direct investment in Canada serves as a barometer. Its location

62 Ibid., p. 149

in the dynamic sectors of the economy makes it the spearhead of all economic activity. If American firms cut back on their investment plans, Canadian entrepreneurs read this as a sign of poorer times ahead and follow suit. Insofar as investment decisions are based on the generally prevailing mood of optimism or pessimism, this adds to Canada's frailty. Thus the very belief that the Canadian economy depends on that of the United States makes it so in reality. American influence on Canadian investment decisions, and thus on the whole economy, arises from the psychological belief that Canadian conditions are the direct outcome of American conditions.[63]

It is difficult to evaluate the role played in this cycle transmission by the American investment itself. If we return to our text question, What would have happened in the absence of American investment? the answer is not clear. Certainly direct investment contributes to this "dependence psychosis," but as we have seen it is the portfolio investment which provides a greater aggravation to Canada in terms of the effects of cyclical transmission of economic problems. On balance, however, we should attribute to American investment in Canada only a minor role in the business

63 Cf. R.B. Bryce, "The Effects on Canada of Industrial Fluctuations in the United States," Canadian Journal of Economics and Political Science, 1939

cycle. Any effects it created would likely occur with purely domestic investment as well. Canada's heavy dependence on her foreign trade, particularly with the United States, would seem to rule out any isolation from foreign business cycles by the expedient of eliminating foreign investment.

American investment has also contributed to the diversification of the economy, which in the long run will tend to reduce Canadian dependence on the United States. As well as opening up new industries, American funds have generated much of the increased incomes which have widened the market for Canadian producers as well. This expansion also allows Canadian companies to take further advantage of the mass production techniques introduced by American entrepreneurs which provide a direct increase in real income through higher productivity.[64]

American Domination

The overall effect of American investment is to place much of the Canadian economy at the mercy of non-Canadians. The percentage figures cited do not reveal the full extent of American influence. To get a better picture of this we have to return to the breakdown of direct investment by sector. This shows that American investment is concentrated in what are consi-

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64 Cf. Aitken, American Capital and Canadian Resources, p. 121

dered "growth" industries. These are the areas which provide the impetus for continuing expansion and can be expected to generate much of Canada's future investment. In contrast, Canadian entrepreneurs have staked their assets in the more conservative fields: utilities, agriculture, banking, and other service industries. At best these can be expected to keep pace with the rate of overall economic growth. With few exceptions they are not likely to be pace-makers themselves.

American direct investment, in return for the risks it has undertaken in pioneering much of Canadian industry, has reaped great rewards. Moreover, it now finds itself in the position of wielding a disproportionate influence over all Canadian economic activity. Because Americans control much of these very industries on which Canada's future depends, their plans, their decisions, their actions are important to Canada.

Canadians, not unnaturally, resent being subject to such foreign control. As a result they tend to condemn American domination while, at the same time, cashing in on the benefits it has brought. Their complaints tend to be based on other than financial grounds and we shall consider those in the next chapter.

But the financial consequences still stand out clearly: the great advance in Canadian output, particularly since 1950, has been fostered in large measure by American capital. Its initial inflow and the exports generated therefrom, along with the consequent multiplier effects, have greatly increased the level of Canada's income. Without it Canada would definitely be in an inferior position today.

The costs, in financial terms, have been twofold. Firstly, the service costs of Canadian borrowings have been negligible. The interest and dividend payments during the 1950s amounted to less than 3% of gross liabilities. Hidden in the costs have been an increasing amount of earnings which have been reinvested. If these are added the cost is increased about 50%, i.e. to between 4 and 5%. Canadian productivity has increased at a higher rate.

However, the basic problem is not the immediate out-of-pocket cost but the entrenchment which results from direct investment. There is little chance of American investors dropping a winning property, and as Canada's prosperity increases, its fruits will be shared in a corresponding measure with those American investors who "got in on the ground floor."

The second major cost has been the surrender of economic sovereignty. This is harder to evaluate. The Canadian level of income and employment now depends heavily on American investors. The years of prosperity in the postwar period, shared by Americans and Canadians alike (and increasingly by Europeans), have served to gloss over this hard fact: if and when poorer times return to the United States, Canada will follow suit. American investors will be unwilling to devote their funds to the Canadian economy when their own is not even an attractive prospect.

In summary, we may evaluate the financial consequences of American investment in Canada from their positive and negative viewpoints. On the positive side, the huge inflows of American capital have spawned prosperity, mitigated only by the prospect that the prosperity may end when the inflows do. On the negative side, this has placed the destiny of the Canadian economy in the hands of these same American investors. We may brighten this side with the thought that the Canadian economy under these circumstances should not fare any worse than that of the United States.

VI THE NON-FINANCIAL CONSEQUENCES

Limitation to Direct Investment

We turn next to those effects which are not revealed by such measurements as Gross National Product, price levels, and export volumes. In analyzing the consequences of foreign investment it is necessary to distinguish between such purely financial results which flow from the investment and the thousand and one other considerations it entails.

The distinction, nevertheless, is arbitrary and many effects have both implications. Many of these are not economic in nature and should be excluded from our study. The political and legal aspects of the problem are still of interest to the economist, however. The attitude of investor and borrower, their motives and reactions, are important. Moreover all causes and effects of foreign investment constitute a part of our analysis and must be included in the balance along with the pecuniary factors in assessing that investment.

What we may call the non-financial consequences are, however, generally confined to a particular type of capital flow, namely direct investment. Investment in bonds involves only an undertaking to lend and borrow a specific sum, repayable after a set term, and with a stated rate of interest. Minority stockholdings also fall into this category. The financial transfer here seldom has any further results, although there are exceptions (e.g. when government foreign aid includes technical assistance).

Direct investment carries these consequences by its very nature. It is a loan made without a fixed return and the earnings made on it depend on how it is used. This gives the investor a responsibility to follow up on the financial transfer to see that it is put to good use. The legal mechanism for this is the board of directors, which is elected by the stockholders to represent their interests. When the stock is held mainly by a parent corporation, as is the case with most American investments in Canada, this establishes a direct connection by which true control is maintained, in contrast with the nominal control the small stockholder has in a large corporation with widely-dispersed stock.

This direct control allows the owner to dictate the subsidiary's policy. Management appointments, expansion plans, marketing strategy, attitudes towards government, employees, competitors, and the general public are all subject to direction from the foreign owner. It is under such conditions that foreign investment takes on a special character. No longer does the investor merely supply the funds. He is here in a position to influence the politics, the economics, the entire array of social institutions of a country.

In the Canadian case, as we have just seen, foreign investment has in recent years tended increasingly to be of the direct type, and that foreign investment has been mainly American. It is not unnatural, therefore, for this position of influence to have aroused the concern of Canadians. Apart from the financial problems, American investment has had consequences which have influenced this entire array; and its potential for greater influence is almost unlimited.

The Legal Aspect[65]

The first evidence of the infiltration of foreign investment is the legal one. Canadian law is no longer the sole governing force in the relations of the company with its customers, employees, stockholders, and competitors. The firm whose ownership ties cross international boundaries, just as the firm which transacts any business abroad, is subject to international law and to the law of the foreign co-respondent.

In the Canadian instance it is the latter which has caused the greatest concern. The United States, for all its belief in the ability of private enterprise to thrive best when the government interferes least, has established a strict code of behaviour on its business community and enforces it rigidly

65 This section is based largely on Kingman Brewster, Jr., Law and United States Business in Canada, 1960

through several of its executive branches. This enforcement entends to foreign subsidiaries of American companies. The philosophy behind this is that it prevents Americans, corporate or individual, from avoiding American law via their foreign operations. Were this permitted, government policy-makers reason, it would discriminate against the "patriotic" people who remain under domestic law in the face of unfair competition from those who don't.

From an American viewpoint this is a fair and reasonable approach. Unfortunately its application has repercussions for the foreign parties to these international activities. As long as American law and that of the foreign country coincide, there is no cause for friction. In the Canadian case this is so for most areas. It is most evident in the field of taxation, where each country acknowledges the other's rights and allows the appropriate abatement on its own taxes. Generally the abatement is just equal to the foreign tax so that no one can profit by escaping to the lower tax country. This applies on corporation and personal income taxes, indirect taxes, and withholding taxes.

There are two major legislative areas, however, where enforcement of American laws brings them into conflict with Canadian interests. These are the Sherman Act and related anti-trust laws and the Trading with the Enemy Act. Both have been used in recent years against Canadian subsidiaries and have thereby resulted in situations adverse to Canada's interests, which have created some antagonism for the Canadian public. These actual instances were relatively minor and were not in themselves of serious concern. What has aroused resentment is the possibility that the threat of future similar applications of American law is preventing Canadian-based American subsidiaries from pursuing the most favourable policies from Canada's point of view.

The Sherman Act, passed in 1891 and revised several times since, is not dissimilar to related Canadian legislation. Through the years the anti-trust policies of the two countries have been roughly the same and succeeding laws have reinforced this pattern. In general, American enforcement has tended to be the more stringent of the two. This is mainly because of its greater belief in the advantages of competition for the working of the capitalist free enterprise system. The American enforcement extends to subsidiaries abroad because, as noted above, this serves to prevent less scrupulous firms from escaping anti-trust law through their foreign operations.

Such enforcement can be detrimental to Canada if it results in reduced commerce there, either domestically or in foreign trade. In practice only the latter is likely to be affected. The primary example of conflict here is in the electronics patent pool formed in Canada by General Electric, Westinghouse, and Philips, among others. These firms, two subsidiaries of American companies and the third Dutch, and the other parties to the agreement, allowed one another access to their patents. This cross-licensing was open to any interested Canadian manufacturer but closed to foreign importers. In American eyes this was a conspiracy to restrain the export trade of U.S. manufacturers. Court proceedings were initiated in 1958 to disband the cartel arrangements. This action would, in effect, reduce the favourable Canadian export market more than Canadian law requires.[66] The Canadian government accordingly protested. Top-level meetings resulted in an agreement for government consultation before any such cases were considered for prosecution in the future. The case was settled in 1962 with the withdrawal of the charges upon the defendants' agreement to disband the alleged combine. This settlement thus only served to strengthen the grounds of the Canadian complaint.

A similar incident occured in the enforcement of the Trading with the Enemy Act and related regulations governing control of American foreign assets. These are designed to prevent military trade with the communist bloc and any trade with Red China

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66 Under the 1960 amendments to the Combines Investigation Act combines for exports only are explicitly allowed.

and North Korea. Ford of Canada had an opportunity to sell motor vehicles to Red China in 1958. Fearing repercussions on its parent due to American law, it declined to follow up on the market possibility. No court action was ever taken as no direct negotiations, let alone an actual sale, ever took place. The possibility of prosecution served as an effective deterent. Ensuing meetings again achieved an agreement to consult on any future cases. The possibility of exemptions from American law in special cases was acknowledged.

When it is considered that these two incidents are among the major instances of American interference in the Canadian economy it is seen that this interference has, in reality, been negligible. What is more disturbing from the Canadian viewpoint is that these overt cases could be multiplied several times over. It is not known how many firms simply decline to pursue sales possibilities due to the threat, however remote, of prosecution under American law.

The United States anti-trust legislation adds another thorn to Canadian-United States good will in that it discourages the happy medium of joint ownership (and control?) advocated by the present Canadian government. American firms prefer complete ownership of their subsidiary as this removes the possibility of prosecution as a combine. Third party membership in the equity of a company opens the American partner to charges of conspiracy in restraint of trade if the American exercises direct control over its investment.[67] In addition, American firms can use their subsidiary's losses to offset domestic earnings only if they have more than 95% ownership of the subsidiary.

But these complaints are again minor ones. The overall effect of American law is probably quite favourable to Canada's economic interests. The complaints are rather a manifestation of the general Canadian fear of losing economic independence and national identity.

> "Far more important than demonstrated economic conflict ... is the interference with economic and legal self determination represented by the intrusion of U.S. law into what are considered the domestic affairs of Canadian firms. The nexus of U.S. parental ownership or the alleged impact of Canadian activities upon trade with or within the United States does not in Canadian eyes justify efforts of a foreign power to regulate the Canadian conduct of Canadian corporations. Whatever may be the pros and cons of various international legal concepts for testing the propriety of extraterritorial jurisdiction, the resentment it engenders is a fact of international political life. It is especially acute when the intruder is a neighbor whose economic dominance is already of powerful proportions."[68]

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67 The DuPont-I.C.I. case, in which American and British companies operated Canadian Industries Limited as a joint subsidiary is the best example of this. American court proceedings forced the split-up of the Canadian company into separate units, leading to the charge that these units are less efficient than their combined predecessor.

68 Brewster, _op. cit._, p. 22

The Practical Aspect

The problem, then, is not one of laws, but of practical application. The conflict lies in the divergence between American interests and Canadian interests. Whenever any international economic activity takes place the problem will arise. But when this activity is in the form of a permanent investment it is particularly acute. The large volume of American direct investment in Canada has magnified this problem several times over. When American owners make decisions on the operations of their Canadian subsidiaries, they quite naturally think of themselves first. The profit motive is dominant and will prevail. When this motive inspires actions which have some effect unfavourable, or even appearing unfavourable, the ensuing resentment is again a manifestation of this same desire for economic independence.

These unfavourable effects are a definite consequence of foreign ownership and control. It is part of the price of international borrowing, particularly in the form of direct investment. The inflow of capital is a boon to the borrower but the lender is free to dictate his terms. The direct investor will select his own executives, buy his raw materials where he wants to, sell how much and to whom he wants, and plan his operations in the foreign country in conjunction with those at home and elsewhere abroad. A domestic investor's scope is narrower and the benefits of any of his undertakings accrue to his own country. Therein lies the conflict of foreign investment.

In this context the legal problems become unimportant. They are overshadowed by the practical aspects. How does the foreign investor decide whom to employ, where to locate, whom to buy from and sell to? The answers in the Canadian case are not always encouraging. American investors are not doing business in Canada for the benefit of Canadians but rather for their own benefit. It is inevitable, then, that their decisions sometimes result in unfavourable consequences for Canada.

Canadian Complaints: The Negative Consequences

Canadian criticisms of American direct investment have been studied for the Canadian-American Committee set up jointly by the Private Planning Association of Canada and the National Planning Association of the United States. The results of their investigation are published in a booklet entitled Policies and Practices of United States Subsidiaries in Canada.[69] The investigation was in the form of lengthy interviews "in depth" of personnel of American businesses and their Canadian subsidiaries. These were carried out in 1960. Where necessary the responses have been given

69 John Lindeman and Donald Armstrong, Policies and Practices of United States Subsidiaries in Canada, Montreal, 1961

subjective and impressionistic, but logical interpretation in order to provide meaningful explanations of subsidiaries' behaviour.

The interviewers looked into six areas of policy most frequently criticized by Canadians: sale of equity shares to the public; Canadian personnel among top management and on boards of directors; publication of financial data; commercial policies, which includes exports to the United States and abroad, imports from parent and associate companies, and the Canadian share of the manufacturing process; research; and support of local charity and education.

Sale of minority holdings to Canadians received the support of the Royal Commission on Canada's Economic Prospects in 1957. It recommended twenty to twenty-five percent participation by Canadian investors. Its chairman, Walter Gordon, when created Minister of Finance in 1963, promptly introduced discriminatory withholding taxes and depreciation allowances to encourage the attainment of a minimum of twenty-five percent Canadian ownership. The philosophy behind this is that it forces American owners to consider the Canadian viewpoint. However, it is also designed to provide additional opportunities for Canadians to invest, which it is claimed they have lacked until now.

What has been the attitude of the American on this? It has been pretty well divided. Many American businessmen favour such minority participation. It encourages efficient operations, makes for good public relations, and some even allowed it as a moral right. American management in Canada frequently favoured it because it gave them a strong hand when dealing with their seniors to the south. The threat of minority stockholders' objections is enough to ensure policies favourable to Canadian interests.

On the other hand, opponents cited generally the same reasons in opposition to minority holdings. They introduce needless complications and conflicts of interest, result in a poorer bargaining position with the parent for financial, technical and other assistance, and generally are not sound investment opportunities as separate entities. The investigating team found that, "on the whole, U.S. subsidiaries with Canadian equity enjoy more autonomy than the others."[70] Its report says:

> "Much depends also on management philosophy. Management philosophy is almost as diverse as the personalities who make up top management, but there is one school which is obviously represented in several of the larger subsidiaries in Canada. This is the school which believes that the parent organization should operate on a global basis, and which is by no means limited to U.S. companies alone. There is no place in this management philosophy for less than full-scale membership in the corporate family, and the U.S. parent management which shares this philosophy will resist minority participation in any subsidiary -

70 Ibid., p. 11

> whether located in Canada or elsewhere - on what it believes to be sound business principles. Of course, this resistance can be overcome if the demand in Canada for ownership participation becomes insistent enough. However in such cases, the Canadian economy will run the risk that the subsidiary will be relegated to secondary status by the parent, with a consequent loss of valuable technical and financial support. That this possibility exists may appear unreasonable to some Canadians. Nevertheless, it is a fact which has to be taken into account.
>
> "The nature of the enterprise is another relevant factor. In particular, how important is it to the parent that management be, in effect, monolithic? There are a number of U.S. subsidiaries in Canada which were established for the sole purpose of providing an assured source of raw or processed materials to the parent. In such cases the parent may have no interest whatsoever in sharing its ownership if it entails the slightest risk to its control over the supply of a commodity that is essential to it. On the other hand, there are other types of enterprises in which management is highly decentralized ... In such cases there should be no difficulty inherent in the nature of the business which would prevent any very substantial Canadian equity participation."[71]

On the question of employment of Canadian personnel in executive positions there seems to be no such two-sided coin. American concerns in Canada almost universally will employ a Canadian for a given post if a competent man is available. Canadians are favoured not only because of their knowledge of local conditions but frequently also because Americans are unwilling to take foreign assignments without receiving substantial compensation over and above their already high American

71 Ibid., p. 32

salary levels. This dual preference results, if anything, in a discrimination against non-Canadians. (Moreover it sometimes results in denying Canadians opportunities for advancement elsewhere simply because they are indispensable at home.)

What is more important than nationality, then, is the autonomy of the administrative personnel in Canada. An American executive with considerable independence in decision-making can suit Canadian interests far better than a Canadian who must consult head office before every action. This applies as well, of course, to the composition of the board of directors, which frequently is such in name only, satisfying purely legal requirements. Here generalization again becomes impossible. The extent of Canadian participation in real management, as opposed to distinction in titles varies widely. The "management philosophy" noted above is again the determining factor. Where parent companies favour some independence for their subsidiaries, they will appoint independent executives and directors. Their independence should be of more concern to Canada than their nationality.

Lack of financial statements can be considered a serious economic obstacle. Publication of data on the operations of a firm serves to indicate the profitability of the industry and will attract more capital, including domestic funds, to that sector. This opening up of competition is precisely why firms are reluctant to release any more information to the public than required by law. However, the report found that more firms would be willing to publish financial statements as long as their competitors followed suit. The recently enacted Corporations and Labour Unions Statistics Act requiring such publication should remove most such grounds for complaint.

Subsidiaries' policies on buying, selling, and expansion are far less subject to the whims of their parents. We have already noted the legal restrictions on international trade. The tariff structures of Canada and the United States are also more important than the individual firm's desire to buy and sell abroad or to extend local processing. The tariff will usually make the decision for it by imposing an insurmountable addition to costs in crossing the international boundary. However, even here businessmen can be taken to task. As the Canadian-American Committee report notes:

> "The level of specific tariffs is subject to periodic negotiation among governments and the pressure on governments to negotiate this or that tariff usually comes from the economic interests concerned. It is unlikely that U.S. controlled subsidiaries in Canada will be as vigorous as their Canadian-owned counterparts in pressing the Canadian government to seek specific U.S. Tariff reductions, particularly if the interests of the parent in the U.S. would be adversely affected".[72]

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72 Ibid., pp. 55-6

Given the tariff structure, however, Canadian subsidiaries, with exceptions both favourable and adverse, will buy where goods are cheapest. When transportation costs are considered this usually favours Canadian materials. Canadian content requirements of Canadian and Commonwealth tariffs further encourage domestic purchase of supplies.

Foreign sales potential is likewise hampered by the American tariff structure. Cost barriers to outside manufacture in the form of Canadian tariffs protect the domestic market of Canadian producers but are of no value to potential exports. Natural costs are here the determining factor. The interviewers did find some instances, however, where Canadian subsidiaries which had opportunities to export were prohibited from doing so by their parents as they would, in effect, be competing with their own company. This seems to be the most blatant case of a direct cost to Canada of foreign control. It is perhaps the only tangible one that the report specifically cites.

The case against extending the processing of raw materials is also primarily the formidable American tariff. Historically Canada has successfully threatened export duties and other prohibitions[73] to force Americans to entend their Canadian operations but

73 See pp. 110 ff., below

today any such action is unlikely to come about except through bilateral agreements between the two governments. The recent liberalizing trend of multilateral arrangements under the General Agreement on Tariffs and Trade reduces even this possibility.

The complaint of lack of research carried out on Canadian soil was well founded, as the report indicates. Many firms do all or most of their research in the United States. This is generally because of a belief in the applicability of "economies of scale" theory: splitting up research efforts would lead to unnecessary duplication and waste of effort. Nevertheless many American subsidiaries do carry out independent research and actually lead their Canadian-owned counterparts. Recently-passed legislation subsidizing research indirectly by granting 150% tax deductibility should serve to encourage this further.

The final complaint, lack of adequate support of Canadian charitable and educational institutions is relatively minor and of little economic import. The report finds, moreover, that the problem is a question of poor public realtions rather than deliberate anti-Canadian behaviour. Small changes in their policies, involving little financial cost, would save many of these firms a considerable loss of good will.

In summary, the report finds that Canadian criticism of American corporate behaviour is exaggerated. This is not to say that it is groundless: several instances noted fully support the point that Canada would be better served if the companies in question were controlled in Canada. However, in general, American subsidiaries, in responding to the profit motive, behave just as similar Canadian companies do. The exceptions arise from the fact that the parent company's profit incentives are world-oriented rather than Canada-oriented.

In evaluating the economic consequences of the behaviour of American firms in Canada it is readily seen that they play a small role in the eyes of Canadians. It is the threat to "self-determination" which raises the loudest cries. Nevertheless, economic consequences have followed. Lack of Canadian participation in American-controlled investment has caused a drain on the Canadian economy in the form of higher interest and dividend payments. Reduced export markets, the confinement of the manufacturing process to the raw materials stage, the lack of information on investment opportunities, have all hampered the expansion of the Canadian economy and are a cost to be deducted from the gains of the initial investment.

The Impact of American Technology

Whatever economic role we have assigned to the behaviour of American firms thus far has been essentially a negative one. The very fact that control of economic undertakings rests in foreign hands makes this inevitable. This being so, why is American direct investment in Canada tolerated? The answer lies in the fact that all the negative consequences cited are insignificant when placed against the one positive consequence of this same investment: the vast inflow of American technology which has accompanied it.

We have already touched on this subject in chapter three. We saw there that this technology has been an essential concomitant of foreign investment. Without the know-how, the funds themselves would have been far less useful. This is the major reason why any country will allow direct investment from abroad within its borders. The capital funds alone will not fulfill its requirements. In addition, it needs technical personnel, management executives, in general, people who know how to get the greatest use out of capital funds.

It has been the United States' great fortune to be endowed with just such factors of production. The heirs of Edison, Rockefeller, and Ford have carried on the American tradition of discovery, innovation, and enterprise which pushed American industry into a position superior to any other nation. The bankers of England, the craftsmen of Germany, the labourers of Italy, have not gone as far as the entrepreneurs of America. They are the ones who have seized the advantage of the foundations established by others and by themselves and profited by them both.

It has only been natural that they would be unwilling to give this away to others. It is possible, and often is practised, that technology can be exported on a contractual basis. Patent licences, managment contracts, loans of technical personnel, are all means of transfering the benefits of experience to others. But these devices deny to the innovators the opportunity of reaping the full profits from their own efforts. Entrepreneurs under these conditions show a strong preference for the direct investment form of technical export.[74]

The application to Canada is obvious. Sharing with her southern neighbour a common cultural heritage, and striving to keep pace with the latter's ever-improving standard of living, she has been a natural lure for the American entrepreneur. An extension of his operations into Canada is little different from opening a branch in a neighbouring state.[75] At the same

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74 Cf. Kindleberger, op. cit., pp. 410-1

75 Contrast this with the results of an investigation for the American Management Association:

> "Most U.S. firms have insufficient (and often incorrect) information about investment opportunities abroad. Few U.S. firms have developed tools for evaluating opportunities in other countries. Because of lack of knowledge and a consequentially large allowance for risk, profitable investment opportunities are neglected and in many cases less favourable opportunities are preferred to others that are actually more favourable."

Robert Theobald, Profit Potential in the Developing Countries, New York, 1962, p. 15

time, Canada, ever busy building a defensive ring of nationalism around itself, has lacked pioneers in commerce.[76] The essential conservatism Canadians are so often accused of harbouring has shown itself nowhere to a greater degree than in their lack of business initiative. The contrast drawn by Viner in analyzing the American investments at the beginning of the century could be equally well applied to the investments of today:

> "They were not made in routine enterprises, but demanded for their success capable and venturesome business direction and modern industrial technique, they were not conservative investments, in the narrow sense of the term, but required the assumption of considerable economic risk; they offered a chance of unusually high profits as well as of losses."[77]

It is this assumption of risk which the Canadian was then, and generally is today, unwilling to undertake. It is this spirit of adventure of the American entrepreneur which distinguishes him from his Canadian confrere. He has had the vision to invest in risky undertakings and has made the appropriate profits. "The difference in capitalistic spirit in the two countries can explain the important role played by U.S. entrepreneurship initiative and U.S. capital, they have

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76 There are, of course, exceptions to this, and in recent years Canadian entrepreneurs have led the way in many developments in the fields of consumer goods as well as in basic industry.

77 Viner, <u>Canada's Balance of International Indebtedness, 1900-1913</u>, p. 286

perhaps taken the disproportionate share of the risks in Canada."[78] High compression automobiles, consumer appliances, jet planes are often the result of American technology at work; American ideas are likewise seen in oil-drilling, iron ore mining, and newsprint manufacture and these Canada has used to advantage.

These benefits cannot be calculated in dollars and cents. This is one of the intangibles which must be included in weighing the effects of American investment. It is difficult to picture a Canada minus the influences of American investment but if we could conjure one up it would show a far less prosperous one.

This brings up the point raised earlier, could Canada not have achieved her present status by importing technology by contract? This would involve a fixed outlay for a set period of time. After this she would proceed on her own, having gained from the external economies such imports would generate. The answer must be in the negative. If American entrepreneurs were forced to supply their services on a fixed return basis it would discourage full-hearted cooperation and undoubtedly reduce the amount of these services. Experience where such conditions have been imposed substantiates this.

78 H.M.H.A. Van der Valk, The Economic Future of Canada, Toronto, 1954, p. 13

VII THE ROLE OF POLICY: INTERNATIONAL COMPARISONS

A Government's Influence

The usefulness of economic studies lies in their application to real life. Models which are removed from everyday events provide good mathematical exercise but have little practical value. It is their ability to offer sound policy recommendations which gives most theories their *raison d'etre*. We must turn then to look at the role policy has played in the past and go from there to suggest what it may do in the future.

In analyzing the causes and effects of foreign investment the attitude of the governments of the sending and receiving countries is all important. In most cases government policy will decide whether a projected investment will be undertaken. This applies equally to portfolio and direct investments. A buyer looking for good bond buys will only consider foreign bonds which are relatively safe. Unstable governments, or governments which pursue discriminatory taxation practices generally rule out their countries as potential borrowers in foreign capital markets. Unstable exchange rates, often the result of a government's inflationary spending program or the imposition of highly restrictive trade barriers, will likewise deter foreign investment.

Direct investment suffers even more from these practices. However, firms which are already commited in a foreign country will view further opportunities in a different light than new investors. If a firm has made considerable capital outlays which are afterwards subjected to special penalties it must weigh the merits of withholding continued support to its undertaking against the possibility of losing its existing assets. Restrictive measures usually include strict controls on the withdrawal of investments. When this happens a firm is often forced to maintain its projects and increase them as part of an orderly long-term expansion in the hope that it will eventually recover its total commitment. If it feels that this is adding good apples to a rotten barrel it is, of course, better advised to write off previous investments entirely.

Government influence can work equally effectively in the opposite direction. A country in need of foreign capital and its concomitant technology and business acumen will welcome investment from abroad. The powers of government can here work all to the good. Taxation relief, assistance with local problems (location, raw materials, power, transportation, labour supplies), guarantees of free repatriation, and the promise of orderly government committed to financial stability, will all attract foreign lenders and investors. Obviously the person or firm with capital in search of outlets will have no problem deciding which of two countries to choose if they are pursuing the two extreme policies outlined above.

In the light of this it is well to see how Canadian policy has influenced foreign investment. Since so much of it has taken place, we can safely assume that Canadian policy has encouraged foreign investment in the past. However, in view of the current concern over the adverse effects of such capital inflows it is well to examine in detail the policy of the present government as a situation apart from the historical attitudes. Recent measures to discourage some forms of foreign investment indicate there has been a radical change in the thinking of the Canadian government on the matter.

Finally, knowing what the Canadian government has done and is doing we should compare its policy with that of some other countries. In particular we are interested in those nations comparable in size (in an economic sense) and whose investment opportunities are otherwise similar to those we have outlined in Canada's favour. We shall look at three such countries in some detail: Australia, Mexico, and Italy, whose approaches to the matter differ widely.

The History of Canadian Policy

It is difficult to generalize about the Canadian policy of the past. Policy, the dictionary tells us, means a "settled course" of action. This implies a continuous pattern of behaviour designed to achieve a long-run objective. Such a policy has been non-existent in the Canadian case. Government policies towards foreign investment have been singularly ad hoc arrangements, made to cover short-run situations. On balance these policies have encouraged foreign investment, although much of it has come to Canada in the absence of any specific policy, and because the other factors conducive to investment have been favourable.

From colonial days onward Canada has relied on foreign capital. Before the Seven Years War, French and British entrepreneurs came to Canada attracted by the profit potential of the fur trade. After the Treaty of Paris, French capital disappeared and the British joint stock companies had the field to themselves. British policy, often the personal instrument of a king anxious to bestow concessions for favours returned, supported the granting of monopoly powers to these companies of pioneering adventurers. The fur trade and later the lumbering industry were good targets for such grants.

With the advent of Home Rule and the increase in local powers industry expanded and any and all investors were welcomed. The prosperity of the 1850s was furthered by British and, to a lesser extent, American enterprises. From the 1840s onward every politician was interested in the railways. The interest was far from benevolent; most leading members of parliament had a financial stake in one or other of the ever-growing family of railway companies. A change of government meant a new division of the spoils. Loans to railways were authorized and altered with amazing frequency. Most of these schemes were backed by Americans and everyone was anxious to have their support.[79]

The first tariffs of a protectionist nature were imposed by the province of Canada in 1859. Under pressure from Ontario manufacturers to improve their competitive position, the Minister of Finance, coincidentally searching for new sources of revenue, sharply raised existing tariffs on manufactures. The range included hardware, machinery, textiles, and tobacco.[80] This marked a distinct reversal of the movements toward reciprocity and the continuation of the free trade versus protection controversey which dominated Canadian politics well into the twentieth century. The victory of the protectionists ultimately added an inducement to foreign investors in those fields which otherwise would

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79 W.G. Hardy, From Sea Unto Sea, Garden City, 1960, pp. 27-56

80 W.T. Easterbrook and Hugh G.J. Aitken, Canadian Economic History, Toronto, 1956, pp. 372-3

have been served through export sales.

Confederation introduced central control and brought a period of continuous government. The railways still held the spotlight. The entry of British Columbia into the Dominion in 1871 was effected through a promise of a trans-continental railway within ten years. Notwithstanding a public scandal over campaign contributions (indirectly from Americans with interests in the project) to Sir John A. MacDonald, the Canadian Pacific Railway was organized. With British and American capital and a huge subsidy ($25 million in cash, railway assets worth $37 million, and 25 million acres) from the Canadian government, it completed its thrust to the west in 1885.[81]

The completion of the railway left a temporary vacuum in international policy. The leading concern of the government was trade, not raising capital. MacDonald's National Policy inaugurated in 1878 raised a high protective barrier to keep out American goods. Its effect in thus encouraging the setting up of foreign branch plants was relatively minor.

The first substantial cases of government policy arose with the expansion of Canada's resource base. Pulp and paper exports began to grow in importance relative to the timber trade in the 1880s, with

81 Canadian Pacific Facts and Figures, Montreal, 1937, p. 13

the quick exhaustion of American low-cost sources of supply. American newspapers turned to Canadian timberlands, which were largely crown lands in the possession of the provinces. Initially the American companies obtained rights to cut timber, convert it to pulpwood, and ship it to their own American plants for processing into newsprint. Anxious to expand local employment, the provinces set out to force establishment of a domestic newsprint industry. In 1891 British Columbia prohibited the export of timber cut on crown lands. Ontario followed suit in 1902; Quebec set differential fees according to the disposition of its timber in 1900. The federal government meanwhile imposed export duties on pulpwood. After failure to achieve any agreement on a compromise, the United States retaliated in 1909 with an offsetting import tariff on all paper products. However the American newspapers, caught in the tariff war, finally agreed to process pulpwood in Canada and the American duty on newsprint was repealed. (It was retained on higher grades of paper, a factor contributing to modern-day complaints of a similar nature.) Aitken attributes the success of Canadian policy in this instance to the highly-inelastic demand of American newspapers and to the absence of alternative low-cost sources of supply.[82]

82 Hugh G.J. Aitken, "The Changing Structure of the Canadian Economy," The American Economic Impact on Canada, Dunham, 1959, pp. 13-5

A similar situation occuring simultaneously in another sector served to indicate that the policy was not universally effective in attracting foreign investment. The nickel industry was booming through a like expansion of American demand. The existing mines were under American ownership and control. A Royal Commission, the panacea of governments even then, appointed to study Ontario's mineral resources, recommended in 1888 that American investment be encouraged to develop provincial resources with land grants and other benefits. American duties on refined nickel, set in 1890 at the urging of American firms anxious to use existing facilities in the United States, prevented the extension of the process in Canada. Threats of federal and provincial retaliation followed but bills enacted were never proclaimed. Eventually, after World War I, International Nickel (a consolidation of American firms controlled by the United States Steel Company) established a refinery, but this can hardly be attributed to the influence of government policy.[83]

The boom of the early 1900s obviated any concern over particular investments. Encouraged by an intense government campaign waged throughout Europe, immigrants poured into Canada by the hundreds of thousands. Following the railway west, they opened up new

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83 Ibid., pp. 15-26, and O.W. Main, The Canadian Nickel Industry, Toronto, 1955, pp. 47-60

markets and provided ample labour supplies to accomodate all entrepreneurs. In the spirit of the Empire, British investors followed up with a massive capital inflow. Government and railway bonds in particular were sold in quantity on the London market.

World War I ended both inflows and the 1920s saw only a minor resumption of foreign, mainly American, investment. Under buoyant domestic conditions the government had little need for concern and its policy again expired. The depression turned the government's attention to the trade problem. Anxious to prevent the ill effects of any trade imbalance, Conservative and Liberals alike were content to let Americans remain at home. Nevertheless the effect of the protective tariffs raised during the depression was to attract many American subsidiaries and branch plants to Canada.[84] It was during this period that the Canadian automobile industry received its biggest force-feeding through the imposition of high tariffs on American-produced cars.

The Second World War refocused attention on trade: Canada had to finance her war effort with a very low level of exchange reserves. These were rationed to assign priorities to defense. The famous White Paper, issued in the closing days of the war, outlined the

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84 Orville J. McDiarmid, Commercial Policy in the Canadian Economy, Cambridge, 1946, pp. 329-30

government's policy on all phases of the nation's economy. Looking forward to an era of international cooperation and expanded trade under lower tariff barriers, it expressed concern over the balance of trade. An inflow of foreign investment was not anticipated. "The sources of credit within the country are ample to finance an expansion of investment," stated the report unequivocally.[85] The immediate postwar years bore out the government's optimism as its own international assistance financed a substantial capital outflow. In 1947 the government imposed a 5% withholding tax on dividends going abroad. It was intended as a gentlemanly retaliation against a similar American tax and was not aimed at restricting foreign investment in Canada.

The foreign exchange difficulties encountered through the 'forties were part of the adjustment process in the international trading process. Canada withdrew, reimposed, and withdrew again her wartime controls over foreign exchange. During this period she was sharing with Europe the problems of the "dollar gap" despite the fact that she was linked with the United States in the dollar area.

At the start of the 1950s, however, Canada suffered exchange difficulties of a different form. The American capital inflows, headed by the development of Canada's oil resources uncovered in Alberta in 1947,

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85 Minister of Reconstruction, Employment and Income, Ottawa, 1945, p. 11

were beginning to exert strong inflationary pressures. The buildup of official holdings of foreign exchange promised to continue indefinitely. Uncertain as to the possible size of the ultimate inflows and thus the desirable appreciation of the Canadian dollar necessary to accomodate them, and unwilling to accept the alternative of domestic inflation, the government freed the Canadian dollar from its peg and allowed the market to determine its level. In effect the government handed a carte blanche to American investors; as long as they were willing to climb over the rising exchange barrier, the government was willing to have them. In the prosperity of the '50s the government saw a justification of its position. As late as 1956 the Liberal government credited American investment with a good part of the expansion Canada was enjoying and saw no ill effects to offset this.[86]

The following year marked the first acknowledgement by the government that the capital inflows were having harmful side effects. The inflationary pressures which had abated with the premium exchange rate and the huge import surpluses had themselves died down. The continuing inflow and import surpluses and the growing service costs on the debt were for the first time recognized as a drain on the economy. But no

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86 Minister of Finance, Budget Speech, 1956, p. 4

relief measures were proposed.

The middle of 1957 brought a change in government. The Conservatives campaigned on a platform promising to reduce the import surplus and shift some trade to the United Kingdom. Nothing came of the proposal. In succeeding years the government continued to warn of the problems of expanding foreign investment (while acknowledging its benefits) but still chose not to do anything to alter the situation. It suggested that the mounting criticism of foreign investment might be lessened if foreign firms were to behave more like their Canadian-owned counterparts. But this was not a matter for the government to handle. "It would be much better if the desired result were achieved by ... persuasion than by legislation."[87] Remedial legislation, said the government, would destroy confidence among investors. In addition, the alternative of lowering Canada's exchange rate would be ineffective without elaborate controls. Late in 1960 the government changed its mind and raised the withholding tax on interest and dividends to 15% for non-residents. It also required investment companies and pension funds to increase the proportion of their Canadian assets.

During this period the governor of the Bank of Canada had been urging, in a series of public ad-

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87 Budget Speech, March 31, 1960, p. 7

dresses, a cutback in aggregate Canadian spending, upon which he placed the blame for purported existing inflationary pressures. (In fact, Canadian prices had been fairly stable since 1958.) The means he suggested was a reduction in the volume of capital expenditures, which were being financed in large measure with foreign funds as was reflected in the balance of payments deficit, then at an all-time high. This led, he argued, to an artificially high standard of living fostered by a too-high growth rate. Increases in consumption were outpacing production and were being paid for with borrowed money. This was "living beyond our means" and only resulted in postponing the inevitable day of reckoning. The remedy lay in the reduction of capital inflows. These should be offset partially by increased savings and partially through the curtailment of unproductive or destabilizing expenditures.[88]

This espousal of contractionary measures, at a time when Canada was experiencing unemployment which set postwar records, was reflected in Canada's monetary policy. Interest rates also were at their highest; real Gross National Product grew at less than 1.3% from 1957 to 1961, which meant a decline in per capita terms. The high interest rates also served to

88 J.E. Coyne, "Living Within Our Means," remarks prepared for delivery at a meeting of the Canadian Club of Winnipeg, January 18, 1960

attract foreign funds and thus contributed to the capital inflows whose reduction the governor was seeking.

Growing criticism of Canadian monetary policy, including an unprecedented joint demand by academic economists for the governor's removal,[89] led the Minister of Finance to disown government responsibility for Bank of Canada policy. Finally, in the face of his strong attacks on Canada's fiscal policy, the government forced the resignation of the governor in July, 1961. (Although its questionable tactics aroused great public indignation.) The 1961 budget announced the intention of the government to depreciate the Canadian dollar through the operations of the Exchange Fund Account in an effort to reduce Canada's deficit on current account.[90] A narrowing of the interest-rate differential was also advocated but was achieved to only a very limited extent.

The size of the capital account imbalance was reduced but continued at a high level throughout 1961 and 1962. The foreign exchange crisis in June of 1962, brought on by heavy speculation against the Canadian dollar resulting from the government's policies, produced heavy short-term outflows. These were reversed with the pegging of the Canadian dollar at a

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89 Cf. H. Scott Gordon, The Economists versus The Bank of Canada, Toronto, 1961

90 Budget Speech, 1961, pp. 7-8

substantial discount and the imposition of high interest rates.

In summary, it can be seen that the Canadian policy has not been aimed at a consistent long-term objective. Foreign investment has been welcomed when it favoured Canada's immediate interests and rejected when it harmed these. In the '50s it was a stimulus to the economy and was encouraged. By the '60s it had become a depressant to be resented. The overall ultimate effects of both attitudes were never considered. Canadian policy on foreign investment has historically been myopic and ill-considered.

Canadian Policy Today

The Liberal party was turned out of office in mid-1957 at a time when the great economic upsurge of the 1950s was coming to an end and when the accumulation of capital inflows was beginning to take its toll. The coincidence was fortuitous for the Liberals for they were able in the ensuing stagnation to lay the blame on the government in power.

A further coincidence was the publication late in the same year of the Final Report of the Royal Commission on Canada's Economic Prospects. Appointed in 1955 to assess the outlook for the coming decades, the Commission had spent the intervening time travelling across Canada, receiving several hundred submissions from public bodies, lobbying groups, businessmen, and individuals, as well as seeing first hand much of the Canadian economy in action.

Its Report was an optimistic appraisal of Canada's future. Warning of the difficulties in attempting projections, and ignoring such possibilities as nuclear war and worldwide depression, it predicted a significant expansion for Canada's economy and a slight improvement in its position relative to the United States. Its comments on American investment in Canada are of particular concern to us. It foresaw a continuance of the then current rate of capital inflow, which would mean a decline in its importance relative to Canada's growing Gross National Product. While acknowledging the role of American capital in Canada's past growth, it echoed the average Canadian's fear of domination by American businessmen through their direct investments.

> "The real concern about foreign investment in Canada is not so much about its aggregate amount as about the fact that its concentration in direct investment in subsidiary companies confers upon non-residents a large measure of economic control over some of our most important industries and industrial activities. We do not suggest that this control is, or is likely to be, used maliciously to damage Canadian interests or that it is being employed in a way which flouts the wishes of our people and our governments. Nevertheless a situation does exist in some sectors of the economy where legitimate Canadian interests may be overlooked or disregarded. The non-resident owners of the larger companies which have a dominating influence

> may not in all cases be aware of the Canadian point of view."[91]

In the light of this situation the Commission submitted what it considered should be Canada's objectives: 1) to shift foreign investment from equity shares to bonds and mortgages "which do not involve control of large sectors of the economy;"[92] 2) to have American direct investments associated with Canadian capital and Canadian interests; and 3) to keep control of Canadian banks and other financial institutions within Canada.

It likewise set objectives for the American controlled firms themselves: 1) to employ Canadians in senior positions and to use Canadian professional services; 2) to publish financial statements on Canadian operations; and 3) to include "independent Canadians" on the board of directors and to sell an "appreciable interest" in the equity of the company. It suggested that twenty to twenty-five percent participation would be appreciable.

> Its purpose in proposing these objectives, it said, "is to ensure that such concerns are aware of and susceptible to Canadian influences and opinions when they make decisions respecting their policies and activities in Canada. We believe Canadians should have more tangible assurance than they now have that the people who are responsible for the management of such foreign-owned concerns will, wherever reasonably possible, make

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91 Royal Commission on Canada's Economic Prospects, <u>Final Report</u>, Ottawa, 1957, p. 392
92 <u>Ibid</u>., p. 392

> decisions that are in the best interests of Canada, that such concerns in effect become more 'Canadian' in outlook."[93]

While hedging its point by emphasizing the need to maintain confidence in Canada and to treat existing investments fairly, it laid down several methods of reducing American influence on Canada via foreign investment. It proposed tax changes, alterations in depreciation and depletion allowances, and divesting new investors of voting rights in their stocks, all with the view of encouraging a greater Canadian voice through minority participation. It suggested that such changes be made gradually ("a year or two or even longer") to allow the gathering of Canadian capital necessary to replace American inflows. It also felt that insurance and trust companies, which hold much of Canada's financial resources, be allowed to place more of their funds in equity stocks. Its overall goal was to divert foreign capital to portfolio investment and Canadian capital to direct investment, in contrast to existing trends. The ultimate effect would be to increase Canadian influence and diminish that of others.[94]

The significance of these proposals for current government policy is that the chairman of the Commission, Walter L. Gordon, became the Minister of Finance in the Liberal government. Almost without ex-

93 Ibid., p. 393
94 Ibid., pp. 379-98

ception these proposals were effected in his first budget. The Liberal party platform had drawn many of its proposals from the ideas of Walter Gordon.

In 1961, two years before the Liberals were returned to office, he published a ringing condemnation of the party in power.[95] It contains, in addition to criticisms of monetary and fiscal policies and their effects, a resume of the size, advantages, and disadvantages of American investment in Canada. It also cites the incentives for such investment in the form of Canadian and American tax concessions. Gordon also reiterates the assessment and recommendations of the Royal Commission which he chaired.

Much of the later Liberal platform was set out here in a chapter entitled "A Positive Program for Expansion." The employment situation is the primary concern. Canada should enter a period of easy money, increase public capital expenditures, provide tax incentives to exporters and to industry generally, through larger depreciation allowances (particularly for depressed areas), and establish vocational and retraining programs. The exchange rate should be reduced (later that year it was, and was pegged at a discount in 1962). Permanent relief should come through a Department of Industry and a National Economic Council

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95 Troubled Canada, Toronto, 1961

whose duty it would be to study the economy and recommend positive measures to be adopted. Existing incentives for foreign investors vis-a-vis Canadians should be removed or counteracted.[96]

The connection between foreign investment and Canada's unemployment problem was emphasized during the campaign. Therefore, Gordon argued, "Tax measures should be devised that would encourage foreigners to sell some of their Canadian resources back to the people of this country. Tax devices also should act to discourage the sale of more Canadian companies to foreigners."[97]

The actual Liberal platform was almost a reproduction of the Gordon proposals. The entire economic program offered, with the exception of some welfare proposals, was taken from the earlier ideas espoused by Gordon.[98] The first opportunity to make good on this platform came with his first budget. It gives a clear statement of government policy: "We believe that industry in Canada, wherever it is controlled, should operate with due regard to the overall interests of Canadians and the Canadian economy."[99] This regard

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96 Ibid., pp. 101-34
97 Walter Gordon, "We must Buy Back Canada," Weekend Magazine, March 2, 1963, p. 21
98 National Liberal Federation, The Policies of the Liberal Party, Ottawa, 1963; and John Kettle, "The New Liberal Idea," Canada Month, September, 1963
99 Budget Speech, 1963, p. 8

should extend to their purchases of materials, extent of processing, hiring of outside services, research, and export sales. Canadian minority participation is the best way to see that this is done. "I suggest that a 25 percent equity interest is in most cases appropriate to ensure that a Canadian point of view is always available when company policy decisions are arrived at."[100] This equity is to be encouraged through differential withholding taxes; these are also extended to payments for foreign professional services. A further measure, a thirty percent "takeover tax" to be applied to all equity sales exceeding $50,000 to foreigners, was withdrawn in the face of stiff opposition from the financial community, which felt it would disrupt market activities beyond tolerance.[101]

The Canadian government's evident fear of American influence was borne out a month later when, to overcome its own balance of payments problems,[102] the United States government sought to impose a tax on American purchases of foreign stocks and bonds. Although apparently seeking the same ends (for different motives) as the Canadian measures, it served to encourage further control through its exemption of direct

100 Ibid., p. 8
101 For stronger objections to all the provisions aimed at foreign investment see the letter to the Minister of Finance from the president of the Montreal and Canadian Stock Exchanges, The Montreal Star, June 19, 1963, pp. 10, 12
102 Cf. p. 1 above, note 1

investments. Moreover it threatened to upset the Canadian economy by virtually eliminating capital flows to Canada much sooner than even the Canadian government was willing to consider possible. The latter subsequently succeeded in having the proposed legislation modified by providing for exemptions for Canadian bond issues when these are necessary to offset Canada's trade imbalance with the United States.[103]

The policy of the present Canadian government is evidently to discourage American investment. Its motives are threefold: it wants to alleviate the unemployment Canada has experienced and which has been intensified by the drain on the economy of the service costs of her balance of international indebtedness; it wants to eliminate Canada's chronic deficit on current account, which likewise is a deflationary force for the economy; and it wants to reduce Canada's vulnerability to foreign influences, particularly in their cyclical variation. These three motives are essentially the same. Canadian employment has been subject to American investment for over a decade; the seven years of plenty gave way to the seven years of want. The government would prefer a stable situation which it can control to one of such cyclical variation beyond its reach. The adverse effects of foreign control have manifest them-

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103 Cf. The Financial Post, August 24, 1963, pp. 1, 5

selves where it hurts, in the employment columns, and the government wants to eliminate them. "The government of Canada is determined to give priority in its economic policy to measures that will bring order, stability and better balance in our international trade and payments."[104]

The Australian Case

Australia presents a good model for comparison with Canada. The two countries share a British heritage which has left them with common concepts of democracy and economic justice. The two countries share a strong dependence on the land: both have small populations in relation to their vast territories whose yields provide much of their sustenance. The governments of both countries offer a wide range of welfare services while at the same time allowing a maximum of freedom to the capitalist sector consistent with their ideals of social equality.

Australia has a population of eleven million people. The pioneering British stock dominates the economy although immigrants increasingly are being provided by other European groups. The government pursues a policy strongly encouraging immigration and maintains bureaus throughout Europe to serve this end. Immigrants during the 1950s averaged well over 100,000 a year,

104 Walter L. Gordon, "What Canadians Must Do To Stay Solvent," The Financial Post, October 5, 1963, p.17

adding almost as much to the population as the natural increase. This has slowed down to around 60-70,000 in recent years, not due to any slackening of Australian efforts, but rather the increasing prosperity of Europe.

The federal system of government is similar to that of Canada and Australia shares some of Canada's federal-provincial problems. However the stronger position of the Australian central government and the greater homogeneity of the Australian population lessen the severity of this problem. The federal budget of some five billion dollars[105] includes roughly the same welfare services as Canada's. This is some 26% of the Gross National Product of 19 billions. Production has been increasing at the rate of 6-7%. Unemployment hovers around two and a half percent.[106]

Australia's balance of payments is precariously balanced and the exchange reserves of around one and a half billion dollars fluctuate widely. The principal exports are wool (almost fifty percent of the total) and wheat. A wide range of minerals exists but these are required domestically. Principal imports are machinery and textiles. Imports must be licensed.

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105 All figures for the remainder of this chapter have been converted to Canadian dollars at current rates of exchange, unless otherwise noted.

106 A rise to over three percent in early 1962 led the government to reduce taxes substantially and increase public works spending. The result was an immediate reduction in unemployment to more normal levels.

Dollar area imports are restricted and priority is given to capital goods.

The deficit on current account is of course offset by capital imports. Foreign investment has been increasing since the mid-1950s at an annual rate of 3-400 million dollars.[107] The United Kingdom provided much of the earlier foreign funds and it is still the main provisioner. The United States, Canada, and New Zealand have been supplying an increasing share of the foreign capital in the postwar years.

Figures for total investment in Australia are not available. However the postwar increase is close to four billion dollars. This includes undistributed profits which have made up 64% of all direct investment, which in turn has accounted for 90% of the total. This latter proportion has been reduced slightly in the last three years.

Service costs on foreign indebtedness, excluding retained earnings, have almost doubled relative to export earnings, amounting to 6.4 percent in 1959. If retained earnings are included this figure reaches eleven percent. Both amounts are considerably higher than corresponding figures for Canada. The significance

107 A feature of the Australian balance of payments is that it includes all retained earnings. These are debited to the current account as service costs and credited to the capital account as direct investment additions. This facilitates measurement of the true impact of foreign investment.

of foreign investment for the Australian economy in these terms is as great as in the Canadian case. The comparison of government policies is appropriate.

Australia vigorously seeks out foreign investment, promoting the advantages of location in Australia through world-wide trade commissions. Its arguments are based on the natural advantages of the Australian economy. Natural resources, including power (but with a deficiency in transport facilities) in abundance, and a growing population are its main attractions. Stable government, skilled labour, and a high level of general education are also stressed.[108]

The government offers no tax concessions to foreign investors, but Australian rates are lower than those of Europe or North America. The marginal corporation rate is 40% for public companies and 35% for private companies. Private company status is accorded all firms in which 75% of the shares are held by one group. Such companies which are subsidiaries of foreign firms must pay a 50% tax on undistributed profits. There is a two and a half percent payroll tax and the general sales tax varies from eight to thirty percent on various classes of goods. Withholding taxes are progressive and rise to 40% in the case of public companies. Lower rates are set for holdings of life insurance companies.

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108 Cf. Australia, Department of Trade, Investment in Australia, Canberra, 1960

Dividends paid abroad to individuals are assessed progressively to a maximum of 15%, which also applies to all payments to the United Kingdom, Canada, New Zealand, and the United States. There is no capital gains tax.[109]

Australia retains exchange controls, the severity of which has been negligible in recent years. Before any foreign investment is made it must be approved by the Exchange Control board. This approval carries with it a guarantee on the remission of dividends abroad. No such guarantee exists for the original capital. It is felt that a guarantee of repatriation is unnecessary and undesirable, being usually given by unstable countries which are not in a position to enforce it. Permission to withdraw capital is normally given on request and it is felt only a sharp deterioration in Australia's export position would result in a denial of such requests.

Australia adheres to the General Agreement on Tariffs and Trade and has lowered her tariffs in the world-wide pattern. The tariff is not used to attract the foreign investor although tariffs can be raised to support "efficient and economic manufacturers once the need for such aid is established by a thorough enquiry."[110]

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109 The Commonwealth Bank of Australia, Taxation, Melbourne, 1961

110 Australia, Department of Trade, loc. cit.

The philosophy of the Australian government on foreign investment is summarized in a report drawn up, at the request of the Minister of Trade, by the Manufacturing Industries Advisory Council.[111] Although not an official document, its publication was authorized by the government and the views expressed therein coincide with government pronouncements on the subject.

After examining the extent of foreign investment in Australia, the Council concludes that it has thus far been instrumental in Australia's economic growth and its results have more than justified its existence. The future development of Australia will require further assistance. Choosing among the forms such assistance should take, the Council argues in favour of direct investment and government bonds and against private portfolio investments, in marked contrast to the general recommendations made in Canada.

Portfolio investments, the report argues, tend to drive up the market prices for bonds in Australia. This distorts true values and prevents the efficient channeling of funds to those projects with the best yields. Portfolio investments come to Australia in response to purely monetary attractions and are thus highly speculative. Their sudden withdrawal when this attraction is exhausted or improved upon elsewhere would disrupt the Australian capital market, as well as

111 <u>Oversea Investment in Australia</u>, Sydney, 1960

the balance of international payments.[112]

On the other hand, direct investment is permanent in nature. It brings with it needed technology. It tends to flow in at the same time that imports increase (due primarily to the demand for capital equipment). Once established it often generates export earnings or produces import-saving products. It encourages the expansion of local industry through the demand it creates for supplies and related services. It improves the competitive position of Australia through its superior technology and management methods which spread through the economy, saving it the expense of its own research. Foreign investment helps the diversification of Australian industry.

The report rejects the Canadian arguments against foreign direct investment as inapplicable to the Australian case. There has been no conflict of interests in the past and there does not seem to be any likelihood of a conflict in the future. Foreign investment will not grow to the relative importance it bears in Canada. Moreover geography mitigates against any close integration with industries abroad. To avoid the difficulties of the Canadian case, the report suggests a frequent review of the figures to ensure that the situation does not deteriorate. Its policy is:

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112 Ibid., pp. 13-4

> "The Council favors a policy of local participation to the maximum extent possible in each case. It does not favour any formula or legislative action designed to attain this end, but it does suggest that the government and businessmen continue to make widely known the desireability of local participation ...
>
> "It does suggest that the government give full publicity to the importance of Australian companies having the widest possible franchise rights for export sales and it urges Australian businessmen in making agreements with oversea connexions to endeavour to obtain export franchise as a part of the initial agreement."[113]

Nor does the Council feel that the growing service costs, which have doubled relative to export earnings in the last decade, present a serious problem. They too should be kept under review so that they don't become a burden. Increases in service costs should be offset by increases in exports, rather than curtailed. It is also important, the Council states, to maintain the flow of capital imports to help pay for the service costs on outstanding international debts!

Government borrowing abroad is supported to ease the scarcity of domestic funds. Such capital imports are more stable than private portfolio investments. The demands for social-overhead capital during a period of rapid development can only be satisfied by the use of foreign resources. At present only 12% of Australia's public debt of some ten billion dollars is held abroad and the government can thus easily support

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113 Ibid., pp. 17-8

a higher foreign debt.[114]

The role of the government, in this philosophy, is to encourage foreign investment by offering the attraction of a suitable environment: a dynamic economy, exhibiting level prices, widening markets, and a plentiful supply of the many ancillary services. Direct inducements such as tax advantages and tariff barriers tend to distort the allocation of resources on the basis of sound economics.

The similarity of the Australian and Canadian economies is quite apparent. The difference in government policies is equally obvious. The Australian government is anxious to have foreign investment and will do everything short of direct subsidy to attract it. The Canadian government, after decades of actively or passively welcoming foreign investment, now finds its foreign indebtedness a greater burden than an aid, and is seeking to relieve itself of the burden.

The position of Australia today is strikingly like that of Canada a decade ago. Her growth is being fostered by foreign capital. Import surpluses and heavy immigration are helping to relieve the pressures which accompany rapid development. It is possible that the risks Australia is prepared to accept today may likewise prove an intolerable burden tommorrow.

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114 Ibid., pp. 14-23

The Mexican Case[115]

The position of the Mexican government is equally of note. If Australian policy today reflects that of Canada ten years ago, Mexican policy might well provide a model of Canada's ten years in the future. Mexico's economy is similar to Canada's in her rapid industrialization and growth rate. One of the few Latin American republics to achieve political stability, Mexico has devoted a great deal of attention to her economic problems.

The population of 35 million is confined to an area the size of Quebec and Labrador. It is growing at the rate of 3.4%, one of the fastest increases in the world. There is little migration, although many of the mixed Spanish-Indian stock moves across the border to the United States in search of work. Almost half of the population is rural and an equal proportion (largely the same group) illiterate. However, industrialization is reducing both these ratios quickly. Mexico's Gross National Product of twelve billion dollars has shown a constant upward trend. The growth rate exceeded five percent in the 1950s. Real per capita income has risen by about two percent annually for the last

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115 Information for this section has been obtained chiefly from the Commercial Attache of the Mexican Consulate General in Montreal and from the following publications: Banco Nacional de Comercio Exterior, S.A., Mexico, Mexico City, 1960, and Comercio Exterior de Mexico, published monthly; and Ministry of Industry and Commerce, Mexican Economic Highlights, Mexico City, 1963

several years. This has been achieved with relative price stability, a marked contrast to other American republics. The main contributing factors have been the development of the petroleum and electric power industries, both government operated.

The federal government has maintained a sound budget which has been specifically geared to economic development. Federal expenditures account for only ten percent of the GNP (excluding government enterprises) but almost 75% of this is devoted to providing a stimulus for growth, through direct investments and social overhead capital.

A negative balance of trade in the postwar period has been largely offset by tourist expenditures and the remission of earnings by Mexican labourers in the United States. Mexico's foreign exchange holdings have remained around US$400 million for the last five years. The formation of the Latin American Free Trade Association in 1961 has doubled and redoubled Mexico's trade. Her chief exports are Cotton (one quarter of the total), coffee, and cattle. Automobiles and parts, machinery and parts, trucks, locomotives, and tractors have headed her list of imports.

Mexico does not maintain any formal exchange controls on current account transactions but foreign investment is carefully controlled. Direct investment, while nominally welcomed, is hampered by regulations which effectively stiffle its development. In many sectors foreign participation is limited to 49% and in a few instances (e.g. oil, transportation, agriculture) foreign stockholders are forbidden outright.

Special treatment is accorded investors who wish to initiate new industries. Such undertakings receive substantial reductions in income taxes for a five-year period and may import required capital equipment duty-free. These provisions are available regardless of nationality, although Mexican control is usually required in practice. There are no restrictions on the remission of profits and in recent years interest and dividend payments have been almost as great as new inflows.

The nationalization of the oil industry in 1938 and the gradual "national takeover" of the automobile industry begun in 1962 have further served to discourage foreign participation. The former is managed by the giant PEMEX, a government enterprise which has spurred much of Mexico's growth. In the latter case the government is forcing the sale of American interests to Mexican nationals. It is force-feeding the domestic industry by barring imports of automobiles and encouraging capital imports by duty-free allowances on machinery and parts. Government plans call for the complete Mexicanization of the industry within ten years.

The proportion of capital inflows in direct investment form has fallen to less than fifty percent. Thirty to forty percent of this has been in the form of retained earnings. Figures on the accumulated investments are not available. Earnings on these totalled US$159 millions in 1962, including undistributed profits. Portfolio investments are handled chiefly through the Nacional Financiera, a government bank whose chief function is to facilitate operations of the capital markets. Capital inflows in this category have totalled over two billion dollars in the last twenty years. Almost one-third of this has been repaid and another half billion dollars in credits granted have not been used. Thus, at the end of 1962, the foreign debt on portfolio account stood at less than one billion dollars, or eight percent of GNP. Service costs on this debt in 1962 were US$54 million, or more than five percent of the total debt outstanding. Service costs on all foreign investment in that year amounted to 11 percent of export earnings, a figure which has remained constant for the last four years.

The policy of the Mexican government is to encourage foreign investment in the forms which will contribute to the overall economic development, subject to the limitations of political control. Thus direct investment is wanted only if foreign control can be mitigated by Mexican participation. Where existing industries are considered viable, foreign investment is thus limited to minority holdings. If, however, foreign investors are willing to open up new areas of industrial activity and local backing is unavailable, the government will exempt them from the general regulations and even provide special incentives for such undertakings. The main motivation here is to obtain the benefits of foreign technology, i.e. to save Mexico the cost of developing her own techniques. The government's readiness in the past to expel foreign interests when they no longer contribute innovations to the Mexican economy has provided a severe offsetting factor to the tax and tariff incentives available when such innovations can be contributed.

Portfolio investments have thus played a more favourable part in Mexican policy. The government has turned increasingly to such international agencies as the World Bank and such government agents as the United States Export-Import Bank for most of its financing. Direct credits from foreign exporters are the third major source. Commercial loans raised on the open capital market have provided less than 25% of the total portfolio investments in the last twenty years.

All foreign borrowing is now carefully arranged so that the proceeds are invested in profitable enterprises or needed social overhead facilities. Most loans are at commercial rates although small sums have been obtained from the International Development

Association and the International Finance Corporation at lower rates. Borrowing in the first half of 1963 totalled some $300 millions. More than half of this came from a commercial loan from France, to be repaid in eight years, and is being used to build up the petrochemical and sugar processing industries. Loans from the World Bank and its agencies carry longer maturities (generally 20 years) and are applied to land improvement projects. The proceeds of a government bond issue sold on open markets abroad are to be used to build up the power system.

The policy followed in such fund-raising is apparent. Mexico is pursuing a highly nationalistic development program. Realizing the need of foreign capital to aid in its expansion, it is borrowing at the most favourable terms possible. This means that it does not want to see itself permanently indebted to foreigners. The burdens of foreign debt thus far have indicated to the government that it should eliminate foreign indebtedness as soon as economically possible. It has settled long outstanding claims resulting from pre-war nationalization and looks to the eventual repatriation of all foreign debts. Foreign investment, in the view of the Mexican government, is a short-run phenomenon associated with the acceleration of economic development. When this development has become self-sustaining, its foreign instruments should be liquidated.

The Italian Case[116]

Italy follows a middle way in its attitude toward foreign investment. The poorest of the Common Market countries, she has been experiencing a period of rapid growth and industrialization. This has been only partially aided by foreign investment, which has not played the specific role of technical innovation common to the Canadian, Australian, and Mexican economies. It has been spread across all Italian sectors and its contribution cannot be evidenced in a concentration in particular industries. Italy has also been a major capital exporter, to the Western Hemisphere as well as to her Common Market partners, so that investment here seems to be geared to entrepreneurial specialization rather than designed to fill up capital deficiencies.

The Italian population of 51 million is concentrated in an area slightly smaller than Labrador. It lacks cultural and economic homogeneity; the southern part of the peninsula and the offshore islands are comparatively undeveloped. The government is attempting to remove this disparity through its <u>Cassa por il Messagiorno</u> set up in 1950 to channel investment into these areas. In 1962 for the first time their rate

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116 This section has been compiled chiefly from the following sources: Banco Nazionale del Lavoro, <u>A Guide for Foreign Investors in Italy</u>, Rome, 1962; Banco Nazionale del Lavoro, <u>Economic Trends</u>, published monthly; and the International Monetary Fund, <u>Annual Report</u>, 1963

of growth was higher than that of the rest of Italy.

Gross National Product for the entire country grew at an average of 5.5% in real terms during the 1950s; the stimulus of the Common Market has raised this to over 6% for the last three years. GNP in 1963 was $38 billion, or roughly $350 per capita. Prices and wages, kept down by a high rate of unemployment, were stable throughout this period but since 1962 inflation has become a serious problem. It coincides with a reduction to 2% from the postwar level of 10% of the rate of unemployment, mainly in the south. Government expenditures account for approximately 20% of GNP. The government has budgeted for modest deficits in recent years and the national debt is 9.7 billion dollars.

Italy has had a persistently negative trade balance in the postwar period. From 1957 to 1962 this was more than offset by a favourable balance on invisible items, including large remittances by Italians abroad, but the balance on current account again became negative last year. Combined with a positive balance on capital account, this has caused Italy's reserves of gold and foreign exchange to rise continuously since 1953 and they now stand at US$3.5 billion. Italy's comparative advantage lies in manufacturing and its main exports, except for fruit, are made from imported raw materials: textiles, iron and steel products, general machinery, and petroleum products.

Foreign exchange controls exist in the complexity of procedures required for the inward and outward movement of funds. The lire is fully convertible and no restrictions exist on either current or capital account transactions. But the laws governing foreign investment and its repatriation impose administrative impediments. All forms of foreign investment are welcomed (it is subject to restrictions in the transport and finance sectors). Investment is encouraged in the designated underdeveloped regions, the southern half of the peninsula, the islands, Trieste, and Trent. The incentives offered are available to domestic and foreign investors without distinction.

The concessions offered cover the entire range of Italy's taxation system. Imports of capital goods are permitted duty-free and lower freight rates apply to them. A ten-year exemption is granted on the corporate income tax and the turnover tax is cut in half.[117] Profits (to a maximum of 50%) on existing investments elsewhere put into these regions are likewise exempt from taxation. Most special taxes and local imposts are also reduced or waived. In addition in many cases the government will provide partial grants toward

117 Italy, in common with most European countries, relies mainly on indirect taxes for its government revenues and comparison with the North American system is difficult. The corporate income tax is only 15% but the turnover tax of 3.3% is assessed at each stage of manufacture. Various bond taxes, surtaxes, and local taxes are also imposed.

capital equipment expenditures and low-interest loans are available for the balance. Such grants are financed from the Cassa which has been endowed by the government with a three-billion dollar fund which has assisted in the development of over 200,000 projects.

Such strong incentives have met with results. Capital inflows in 1962 climbed to $912 million. Over one-third of this was in the form of loans. Concomitant borrowing and investing is encouraged by the foreign investment law (Law of February 6, 1956, Number 43) which guarantees the right of repatriation. In order to qualify for this protection foreign branches and subsidiaries must finance at least 50% of their operations with foreign funds. Corporations with minority Italian ownership must similarly raise part of their requirements abroad. The purpose of these restrictions is to guard against foreigners gaining control over Italian industry with the use of Italian funds. This unique approach allows foreign control of Italian investments, but only if the control is accompanied by foreign funds. Law Number 43 guarantees the repatriation of all investments ("non-productive" investments must be held for at least two years) and of profits up to 8%. Other remittances are permitted through a complicated system of bank transfers but do not enjoy the guarantees contained in this law.

Figures on total foreign investment in

Italy again are not available, but the amount apparently is a small proportion of Italy's GNP. In addition much of it is offset by Italian investments abroad. Capital outflows in 1962 amounted to $301 millions. The net capital inflow since the end of World War II has totalled approximately three billion dollars, excluding retained earnings. Gross service costs are less than three percent of export earnings and these are more than 50% offset by inward payments. Financing of foreign investment thus puts no strain on the economy.

The ultimate goal of free capital movements for the European Economic Community has been supported whole-heartedly by Italy. As a major capital exporter as well as importer it stands to gain by such a policy. In its ambitious program to stimulate the development of its poorer areas the government has welcomed foreign investment. The improvements so far shown still leave these regions behind the rest of Italy and the Common Market. It seems likely, given the continuing need for investment there, and the healthy position of her foreign balance, that Italy will continue to pursue policies favourable to the inflow of foreign capital.

VIII CONCLUSION

Past and Present

To summarize the position of American investment in Canada today need take only a few lines. Foreign investment has come into Canada in response to the prospects of higher returns. Increasingly it has shifted from the British preference for portfolio holdings to the American preference for direct investment. American investment now dominates Canada's foreign liabilities. It has been attracted to Canada by the natural similarity of the two nations and in many instances by the availability in Canada of large reserves of raw materials which American industry requires. Canada has welcomed this inflow because it has provided a rate of growth beyond her own capacity, given the domestic rate of savings and level of consumption. Whereas Americans, with their higher per capita incomes have been searching for profit-yielding sources of investment, Canadians have been looking for a way of keeping in step with American growth without sacrificing current consumption. American investment in Canada has kept both sides satisfied.

The capital inflow has been concentrated in three periods: the decade or so before World War I, the 1920s, and the current stretch which began around 1950. It is the last one which is most important in terms of its consequences. The funds coming into Canada during this period have gone largely into direct investments. The portfolio investments of the earlier periods were repatriated in the normal (and abnormal) course of Canada's international trade, although they did tend to intensify the business cycle.

In contrast, the direct investment of the '50s has gone into the heart of Canadian industry. By its nature it is not subject to withdrawal after a given number of years. With the trend to plow back profits rather than distribute them as dividends (encouraged by both Canadian and American tax laws), this investment has been self-generating. Some 40% of all direct investment since 1945 has come from this source.

Total foreign investment in Canada, expressed as a percent of Gross National Product, declined rapidly during the 1930s and '40s but has since taken an upward turn. In 1960 it totalled over 26 billion dollars, or 73% of the GNP. Of this some 69% was American, of which in turn 59%, or 10.6 billion dollars, was direct investment. But these figures do not tell the whole story. American investment has reached its position of prominence because it has been directed into Canada's growth areas. Concentrated in the extractive industries, with increasing holdings in secondary manufacturing, American investments have provided the core of Canada's growth. The dynamic nature of the Canadian economy in the postwar period has been based largely on the use of American capital.

The consequences of such a vast inflow of foreign capital, intricately woven into the Canadian economy, are far greater than those of earlier times when foreign investments were no more than foreign loans. The primary effects of the two are the same but there are additional results from direct investment.

An analysis of American investment in Canada since 1950 shows that it has increased Canada's income level through its spread effects on other investment and on Canada's export trade. The multiplier effects of both have caused Canada's GNP to double within a decade. Moreover, comparatively little of this has been in the form of price increases. By restraining the money supply in the face of the inflow of capital and allowing a floating exchange rate to absorb the price effects of increased demand, Canada has managed to prevent severe inflation during a time of rapidly rising incomes.

The effects on Canada's foreign trade of this investment have been mixed. While Canada's exports have risen markedly, and this is in great measure attributable to American entrepreneurs using their Canadian subsidiaries as supply bases, Canada's imports have risen even faster. This imbalance of trade has been necessary to allow Canada to receive the real goods and services on which real foreign investment depends. Canada's balance of payments has worsened steadily to accomodate the increasing capital inflow and payment of service costs on previous inflows. A concomitant effect has been a gradual improvement in the terms of trade, Canada's export prices rising relative to her import prices.

The outcome of such American investment, particularly the direct investment, has been to make Canada increasingly dependent on the United States. Since so much of her industry is controlled by Americans it is their decisions which determine the direction the Canadian economy will take. And since their decisions often are based on conditions in the United States, the Canadian economy tends to take the same direction the American economy does. This behaviour is reinforced by Canadian investors who regard American activity, both at home and in Canada, as a barometer of business conditions and make their plans accordingly. (The Canadian business cycle is tied in closely with aggregate American demand and Canadian dependence would still exist even if there were no American investment in Canada.)

American direct investment in Canada has a great many other effects. Many of these are political rather than economic in nature but they are frequently cited to back up the contention that American investment places the Canadian economy in grave danger of foreign control which can and does act against Canada's best interests. Some instances of this are based on the legal position of foreign investment. American investment abroad is still subject to American laws and these have been used in a few minor cases to restrain Canadian business. The possibilities of stronger action being taken has undoubtedly prevented American enterprises in Canada from using their opportunities fully.

In the same way American parent companies, in response to their overall profit motive, may cut back on Canadian operations (or perhaps expand them when Canada is already under inflationary pressures) in a manner favourable to their global plans, but adverse to the Canadian economy. Canadians resent these and other lesser irritants. Their irritation arises often from a sense of helplessness, that the Canadian economy and with it political autonomy, is slipping out of their control.

> "What is resented in each case is not so much the policies involved, for their implications are seldom adequately analyzed, but rather the fact that decisions are being taken which have a profound effect on Canada's economic future but which Canadians themselves are usually powerless to influence."[118]

Anxiety over such consequences leads to disenchantment with American investment and the pros-

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118 Aitken, American Capital and Canadian Resources, pp. 144-5

perity it has helped produce. This is Canada's peculiar form of "Yankee, go home" propaganda and so far has resulted in little more than talk. However, government policies are being framed in the light of this "talk" and we shall examine these shortly.

To relieve anxieties, Canadians often advocate the conversion of all their international indebtedness to the portfolio form which once predominated. This would remove most of the causes of complaint and would allow the cancellation of foreign liabilities as Canadians provided increasingly their own funds for investment. Such a plan, however, even if it were practicable, overlooks the primary benefit associated with American direct investment, the technological inflow which has accompanied the financial one.

The importation of administrative and technical personnel, whose experience and know-how were unmatched in Canada, have provided the greatest single source of improvement in Canada's welfare. The Canadian standard of living has managed to keep pace with that of the United States simply because Canadians have been able to copy Americans. This reveals itself in consumers' similarity in tastes. Canadian demand for American consumer goods has supplied a ready market for American products and led to corresponding American investment. The superior American technology has led to a similar demand on the producers' goods level. In the face of this need for American assistance, which American entrepreneurs have been unwilling to provide without sharing in its fruits, American investment in Canada has been a mutually profitable arrangement.

It is difficult to assess this inflow of American technology. The benefits to the American investor are tangible enough: a good yield further enhanced by the growth prospects of the Canadian economy, and in some cases enhanced by a guaranteed source of raw materials for his own domestic operations. Such dollars and cents values cannot be assigned to the Canadian side of the ledger. The interest and dividend payments are only part of the cost. Also to be added in are the disadvantages of "interdependence." Against this must be credited the benefits of the inflow of capital and technology, which we have delineated. When we consider the alternative Canada faced, much slower growth and less dependence on the United States (it could not have been eliminated), she seems to have chosen a better bargain.

Today's position is changed only slightly from the 1950s. The inflow of American capital has continued over the last four years. The current account deficit has been reduced almost to the half-billion dollar mark, but this reduction has been mainly at the expense of Canada's overseas trading partners; the American deficit from 1960-63 totalled over five billion dollars.[119] More than half of Canada's current account deficits have been paid for by direct investments. Nor do these figures include retained earnings which have been accumulating at the rate of over $300 million annually in recent years.

The announced intention of the previous Canadian government to force a reduction in the exchange rate (then floating) and its implied threats against American investment, caused severe short-term outward capital movements during 1961-2 but these were reversed in the second half on 1962. Moreover, there has been no apparent effect on the normal long-term capital flows. A similar pattern followed the announcement of the incumbent government in June of last year that it would discourage, by discriminatory taxation, foreign investment. The short-run effects have been negligible; Canada's foreign exchange reserves have held remarkably steady since then; the decline in capital flows has just matched the current account improvement. The longer-term effects will take some time to manifest themselves.

The Future

Predicting the future pattern of United States investment in Canada is at best only a guessing game. The precariousness of all investment, based as it

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119 Bank of Canada, Annual Report, 1963, p. 40

is on the subjective and often volatile estimates of entrepreneurs, what Keynes categorized as their psychological expectations, makes international investment all the less predictable. No one can say with any certainty what the likely trend in American foreign investment will be in five years, let alone twenty-five.[120] Nevertheless it is obviously necessary to make some estimates if we are to draw any conclusions and base policy recommendations on them.

An estimate for the Gordon Commission placed the Canadian balance of payments deficit for 1980 at approximately one billion 1955 dollars, allowing a range of 50% in either direction.[121] This estimate is apparently not much more than a projection of the figures for the years immediately preceeding the issue of the report. If we were to project on a similar basis for more recent years, when government action has instigated a concerted effort to reduce the deficit, and when the balance of trade has turned in Canada's favour, our figures would be considerably lower, possibly showing a surplus rather than a deficit.

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120 Compare the following, written in 1936:

> "All the evidence points to the fact that the stream of new branch plants in the four years 1929-32 has carried American industry in Canada to the saturation point ... It is probable that capital imports by Canada on a large scale are entirely a thing of the past."

Herbert Marshall et al., Canadian-American Industry, New Haven, 1936, pp. 292, 295

121 Royal Commission on Canada's Economic Prospects, Final Report, p. 376

Obviously any such attempt at precise forecasts is of little value when there are so many unknowns we cannot take into account. Our conclusion, then must be of a general nature. Our first point is that American investment will continue to be drawn to Canada. The expanding markets Canada provides are a strong attraction to the American investor looking for greater sales opportunities. Far more important are the raw materials Canada can provide. The inflow of the '50s, which was designed largely to obtain secured access to natural resources is not likely to dwindle. An estimate of supply and demand conditions for all raw materials to 1980 shows that the United States will rely increasingly on Canadian sources.[122] The list of American requirements includes most of the leading commodities of today: petroleum, natural gas, iron ore, cobalt, nickel, aluminum, copper, lead, zinc, asbestos, potash, sulphur, lumber, plywood, pulpwood, and paper. Many of these are already controlled by American firms and it is only natural that these should finance any increased production as well.

The second crucial point is Canada's continuing need of foreign capital. The Gordon Report expressed the view that Canada will not reach the point of supplying enough savings to finance all investment

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122 Wilbert G. Fritz, The Future of Raw Materials in North America, Montreal, 1960

by 1980, although foreign funds will provide a smaller relative portion of total capital formation.[123] This, of course, coincides with its estimate of the size of the balance of payments deficit. If this holds true, Canadians will continue to look to the United States, with its own increasing supply of savings, to make up this deficit. The relative scarcity and abundance of capital will be reflected in the interest rate differential and Canada will borrow via the bond markets as well as through direct investment.

In addition, there is no reason to anticipate a decline in the volume of retained earnings. As long as the Canadian economy prospers, earnings will increase and as long as they increase American investors will be encouraged to pour their profits back into the business for further expansion. Moreover, American incomes at home are likely to share in this prosperity. Given an increasing marginal propensity to save, investors will then be looking for additional opportunities to expand, rather than giving any thought to contracting their existing volume of outlays.

The self-propagating nature of direct investment is a major benefit to the Canadian economy. Moreover its downward operation would not tend to be as great, although it would still depress the Canadian economy severely. In times of recession Americans would

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123 Royal Commission on Canada's Economic Prospects, op. cit., p. 377

cut back on their expansionary activities but the withdrawal of previous earnings would be impeded by the poor cash position of a stagnant enterprise.

The future of American investment in Canada and of the Canadian economy is tied up directly with the future of the American economy itself. With governments on both sides of the border pledged to the maintenance of full employment, and the attainment of some measure of growth, prosperity seems more likely than depression in the years ahead. Under these circumstances, the worst that Canada can do is share the fate of the United States. The best that she can do is impossible to delineate.

What Canada Should Want

In the light of Canada's increasing economic dependence on the United States, it is important that she determine her overall objectives. When such aims are compared to the likely course of events, it is then easy to decide how conflicting economic trends and economic (and political) goals can be made to coincide. The attack on any such divergence would undoubtedly involve a cost, and it is this which must be weighed against the desirability of any movement towards autarky.

When applied to American investment in Canada, such a procedure could result in the projection of a course entirely opposite to that which Canada has been following. If the political objective of complete sovereignty extends to complete control of the economy, it would mean doing away with all foreign direct investment and imposing restrictions on all foreign borrowings. If we accept the predictions that Canada will not provide sufficient savings for future expansion, let alone the funds with which to take over ownership of existing capital investments, Canadians should reject this course as economically regressive. If followed, it would cut back the current level of consumption and reduce further expansion by diverting savings to buying out existing assets. Such a procedure should be rejected as too high a price to pay for a 100% Canadian-owned economy.

Allowing the need for foreign investment means that Canadians have to suffer some loss of control of their economy as a means of attracting the foreign entrepreneur. The good that he brings with him, in the form of technology as well as capital funds, is a positive gain for Canada. At the same time Canadians want to eliminate the negative aspects of that gain. To eliminate all of these will require the attainment of economic self-sufficiency which can only be achieved via a much higher per capita income level than Canadians now enjoy.

There are, nevertheless, many minor areas in which Canadians can legitimately seek to correct anomalies in their status as an independent nation. The Gordon report set out three objectives it felt Canadians could realistically obtain in the immediate future.[124] These steps, if taken, would serve as a dike to stem the advancement of American control. They would not prevent its continued existence. As a practical matter Canadians cannot expect to reverse this pattern until they are in a position where they can afford to act directly, either by saving more out of higher incomes, or consuming less out of lower incomes. Even then, the presence of American investment will continue unless Canada forces repatriation by oppressive taxation or outright nationalization.

However, as the Canadian income level increases, the role of American investment should decline relatively, although not absolutely. This will arise from the increasing domestic sources of finance. It will also be stimulated by the experience Canadians are gaining in running their own industry. This springs from copying existing American methods and from the increasing facilities in Canada. As more native entrepreneurs, engineers, and other technical specialists come forth, Canada will come to rely less and less on American help.

The aim of Canada, then, should be a

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124 See above, p. 122

gradual assumption of the management of her own economy. As it expands, Canadians should step in and invest where previously only Americans have been willing to do so. As opportunities arise to buy back American-held firms (and such opportunities are likely to be rare) Canadians should seize them. The portfolio investments can be repatriated when they fall due, although the need of this action is far less pressing for a country seeking restoration of control of the economy to itself. In the meanwhile such measures as would encourage foreign entrepreneurs to consider Canada's interests should be pursued when possible.

Policy Implications

What policy should a government follow which wants to attract foreign investment and its accompanying technology while at the same time discouraging that same investment from exercising any control over the economy? This paradox is hard to resolve, but not impossibly so.

Since the nineteenth century the policy of the Canadian government (and of the provincial governments) has been to encourage the inflow of foreign investment. By tariffs and taxes Canada has let the foreign investor know that he is welcome. The obvious coincidence of periods of prosperity with periods of massive capital inflows has not escaped the notice of legislators and they have reacted accordingly. This friendly attitude, prevalent for almost a century, has changed subtly in the last few years. The revelation to the public which followed the studies of the Gordon Commission that Canada was no longer sole master of its own economic fate aroused hostile opinion in many quarters. Government attempts to placate it have taken mild forms thus far. Withholding taxes were increased and then set at differential rates for those who offer minority (at least 25% of voting shares) participation by Canadians and those who do not; all companies and unions are required to publish financial data; encouragement is given to use Canadian tertiary industry through withholding taxes for similar foreign services; and research in Canada is promoted by indirect subsidies in the form of tax abatements. Despite the attention they have received, these measures have been minor ones. A stronger measure to discourage "takeovers" of existing Canadian firms by foreigners through a prohibitive tax was withdrawn in the face of Canadian opposition (mainly from financial interests whose business would have suffered as a result).

Nevertheless, these measures do force American investors to study their Canadian operations with the Canadian point of view in mind. Insofar as they presumably discourage some American investment from coming into Canada while the bulk of intended plans are carried out, they achieve an aim of gradual return of Canadian control. This will only be successful, however, if Canadians fill the gaps left by American withdrawals.

This is a good measure of the policy required in the light of present Canadian desires and American intentions: United States investors must be encouraged to continue their activities in Canada but at a declining rate, corresponding to the increasing ability of Canadians to finance their own operations; and Canadian investors must be encouraged to take up where Americans leave off. Canadian investment can be stimulated by a considerably easier monetary policy than has been followed in recent years.

To prevent the external imbalance which would result from reducing or eliminating the interest rate differential between Canada and the United States, this would require returning the Canadian dollar to a flexible rate. The value of the Canadian dollar would then decline. This would have a double effect: exports would be stimulated, expanding the Canadian economy further, and American inflows would be reduced while the lower exchange rate would discourage withdrawals of existing funds.

The happy medium of Americans continuing to send funds into Canada but at a slower and slower pace is a difficult balance to achieve. We have seen that

Americans will continue to look to Canada as a source for their raw materials and as a market for their finished products. This indicates increasing, rather than decreasing, capital inflows. Taxation designed to stem these must be light enough not to cause a withdrawal of all American investment and heavy enough to be effective in cutting back some of the flow. In this sense the "minor measures" which have so far been introduced probably achieve the best of both worlds.

Taxation is the best weapon to bend American capital flows to Canada's interests. Others, such as tariffs[125] and administrative regulations, are available but their effectiveness is not as strong as that of carrot and stick financial inducements. Taxation must be used with caution: the delicate position of Canada's economy requires continuing American support and any moves interpreted by United States investors as a sign that future earnings would be subject to

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125 As already noted, the tariff wall was originally a strong inducement to attract American investment. Higher tariffs today, apart from being contrary to the freer trade movement within GATT, would probably only meet with retaliatory measures abroad. Lower tariffs would discourage not only American investment, but all investment. Historically the overall effect of the tariff has been to encourage foreign investment at a cost of lower real incomes. Cf. Royal Commission on Canada's Economic Prospects _op cit._, p. 49, and Ohlin, _op. cit._, p. 365. Moreover, the joint effect of Canadian and American tariffs has produced the anomaly that Canadians often import goods manufactured from materials originally exported from Canada. Cf. Wonnacott, _op. cit._, p. 86

discrimination would dry up Canada's inflow. This the Canadian economy cannot yet afford.

For the same reason we can reject the extreme solution to the problem, namely nationalization. While this procedure might be criticized as going against the free enterprise philosophy which Canada shares with the United States, it is a legitimate weapon and could be used if Canada so desired. However, the prohibitive costs which nationalization would impose makes it an impractical policy for the foreseeable future.

At the other extreme, the Canadian government could choose to do nothing about American investment within its borders. Such a policy would leave market forces to determine how much investment Canada absorbs. The lower level of Canadian incomes and savings and the existing investment opportunities suggests that this would be a considerable amount. But it is precisely this which Canada is determined to avoid. While it cannot yet afford to reduce the extent of American control, it can prevent it from increasing at the same rate it has been during the past dozen years. *Laissez-faire* is ruled out.

Canadian government policy should try to be mildly discouraging towards American investment. This aerial balancing act will prove a continuing problem. The danger lies in American investors anticipating future discouragements in the form of discriminatory taxation and preventing such a possibility by withdrawing their investments.

During the stages of this gradual repatriation of control it is also important to have American investors behave in the same way as Canadian investors to preserve Canada's best interests. In many cases their global operations will preclude this, but in others the overhanging threat of government intervention should serve to promote a Canada-first policy.

Epilogue

In conclusion we may say that Canada has profited greatly by American investment. The use of funds at less than 5% is a small price to pay for the benefits gained. Moreover, the cumulative ill effects of increased investment seem to be exaggerated. If, in the future,a situation ever develops where the withdrawal of earnings and/or capital seriously threatens Canada's balance of payments and internal balance it is within her power to prevent such withdrawals: a moving exchange rate is the best guarantee of stability; or the government could impose prohibitive tax sanctions. This would, of course, be a drastic step and a complete reversal of the policy of the last century. However, it has been done many times in recent years for precisely this reason: nations prefer economic stability to moral esteem. Such an eventuality is academic today, but so is the possibility of a mass exodus of capital.

Outside of the bookkeeping debits and credits, Canada has also received a good bargain. The increase in living standards would not have been achieved simply with an inflow of capital. American technology, skills, and managerial ability, have all been essential ingredients in Canada's prosperity. Without them she would have had to incur the inestimable cost of trial and error, which would have delayed her progress by a considerable length of time. On the debit side, there appears the surrender of some measure of control. This undoubtedly has been a real cost. A more intensive business cycle, lost export markets, and the like seem a small price to pay, however.

Moreover, sovereignty is easily reassertable. Such an assertion would entail the surrender of all future potential gains to be received by following the present pattern. It is not impossible, nor even improbable, that Canada will do this when she is in a position to afford it. Meanwhile Canada is profiting from American investment, and if the investors are satisfied, both have gained from the bargain.

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