DIRECT INVESTMENT AND CANADA'S BALANCE OF PAYMENTS

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Abstract

EFFECT OF FOREIGN DIRECT INVESTMENT ON CANADA'S BALANCE OF PAYMENTS, 1950-1965.

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The main finding of this study is that the service payments on direct investment for the 1950-1965 period almost equalled the direct investment inflows. In fact, Canada had net losses of foreign exchange in some years and net gains in some years. The burden of service payments on the Canadian economy was heavier in 1965 than it was in 1950, and from the balance of payments point of view, portfolio placement was found to be more favourable than direct investment. Because the extent of foreign ownership of Canadian resources due to direct investment has been increasing throughout the period, the burden of the associated service payments is likely to be even greater in future years.

EFFECT OF FOREIGN DIRECT INVESTMENT ON CANADA'S BALANCE OF PAYMENTS, 1950-1965

by

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A thesis submitted to the Faculty of Graduate Studies and Research in partial fulfilment of the requirements for the degree of Master of Arts.

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December 3, 1968.

Introduction

This thesis attempts to asses empirically the effects of foreign direct investment in Canada on the country's balance of payments over the 1950-1965 period. Chapter I discusses the differences in the effects of direct investment and portfolio placement on a host country's balance of payments. This discussion suggests that from a host country's balance of payments point of view, direct investment may not always be superior to the portfolio placement. Chapter II explains how the effect of direct investment on a host country-s balance of payments can be measured by the "total approach" method adopted in this study. Chapter III reviews Canada's balance of payments position over the 1950-1965 period and shows that the continuing and growing deficits in the current account were mainly due to the existence of large foreign investments in Canada. Chapter IV measures the direct capital-flow effect of direct investment in Canada over the 1950-1965 period. It points up that direct investment in Canada during this period contributed little foreign capital in overall terms to supplement domestic savings. In Chapter V an attempt is also made to estimate the trade-effect of direct investment. Here it appears that Canada probably had a trade deficit in overall terms from the operations of foreign affiliates in Canada over the period under consideration. As no detailed attempt is made to estimate the import-saving effects of direct investment, these results are not, however, conclusive.

Appendix I shows that during the 1950-1965 period (1) the service payments on portfolio placement have not exceeded the amount of new portfolio placement inflows, (2) the direct capital-flow effect of portfolio placement was more favourable to Canada than was that of direct investment and (3) the rate of income and the rate of return on direct investment were substantially greater than those on portfolio placement.

Appendix II uses a theoretical model to measure the extent of foreign ownership and to asses the direct capital-flow effect of direct investment in Canada over the 1950-1965 period. This reveals that the foreign-ownership ratio has been increasing during the whole period, and that the capital-flow effect was unfavourable to Canada both at the beginning of the period and towards its end.

TABLE 2

CANADIAN BILATERAL BALANCE OF PAYMENTS WITH THE UNITED STATES, SELECTED DATA, 1950-1965

A minus (-) indicates deficit

(Millions of dollars)

BASIC ITEMS	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965
Current Account																
Net Merchandise Trade	-50	-520	-473	-590	-440	-685	-1167	-947	-532	-536	-673	-615	-438	-488	-808	-1041
Net Investment Income	-273	-240	-176	-146	-176	-203	-247	-265	-253	-280	-246	-317	-324	-334	-422	-702
Net Business and Related Services	-136	-155	-133	-132	-137	-143	-169	-175	-176	-174	-168	-186	-203	-207	-230	-226(P)
Net Other Non-Merchandise Trade	74	-30	-48	-39	-47	2	-67	-192	-206	-234	-272	-223	-127	-119	-175	32
Net Total Non-Merchandise Trade	-335	-425	-357	-317	-360	-344	-483	-632	-635	-688	-686	-726	-654	-660	-827	-896
Net Current Account	-385	-945	-830	-907	-800	-1029	-1650	-1579	-1167	-1224	-1359	-1341	-1092	-1148	-1635	-1937
Capital Account																
Net Direct Investment	161	281	372	392	358	380	533	438	304	438	479	391	322	256	223	397
Net Other Long Term Capital	464	279	15	48	37	-171	471	525	646	489	267	562	358	587	790	708
Net Total Long Term Capital	625	560	387	440	395	209	1004	963	950	927	746	953	680	843	1013	1105
Net Short Term Capital	321	-4	-493	-241	-16	157	-143	-21	95	385	228	358	393	-14	626	-668
Net Capital Movements	946	556	-106	199	379	366	861	942	1045	1312	974	1311	1073	829	1639	437
Balance to be Settled	561	-389	-936	-708	-421	-663	-789	-637	-122	88	-385	-30	-19	-319	4	1500
Official Monetary Movements	694	39	80	-42	121	-42	34	-104	108	-67	-39	227	535	59	31	43

P: Provisional

Source: see Table 1.

Acknowledgements

This study was completed while I was working in the Office of Economics and Trade Analysis, Department of Trade and Commerce, Ottawa. I wish to thank Mr. V.J. Macklin, Director General, Office of Economics and Trade Analysis for providing me with all the facilities needed to complete this study.

I owe a special debt of gratitude to Mr. T.R. Vout, Chief, International Companies Division, Office of Economics and Trade Analysis for his constant help in the preparation of this study.

I am most grateful to my research direct, Professor Kari Levitt for her comments and suggestions.

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CHAPTER I

DIRECT INVESTMENT VERSUS PORTFOLIO PLACEMENT

Foreign investments have been traditionally divided into two main groups: direct investment and portfolio investment. The purpose of this Chapter is to discuss the distinctive characteristics of each of these groups, particularly the distinguishing features which are important and relevant in a host country's balance of payments context.

Direct investment is made usually to create or expand some kind of lasting interest in an enterprise in the investee country, i.e., to create a permanent organization to make, process, and market goods for local consumption and, in many instances for sale in foreign countries. It consists mostly of equity capital covering the purchase or the construction of production facilities that will be owned and operated by the owners of the capital themselves. It does not involve any transfers of ownership of the resources utilized in the operations; the foreigners who brought the capital themselves utilize the financial assets to start real production.(1)

Direct investment takes a number of organizational forms, of which the two most important are branches and subsidiaries, which are referred to as affiliates in this study. Branches of foreign companies are typically direct extensions of foreign business activity

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(1). F. Pazos, "The Role of International Movements of Private Capital in Promoting Development", in J.H. Adler (ed.) Capital Movements and Economic Development, St. Martin's Press, New York, 1967, pp. 186-188.

to the host country, with the foreign head-offices not only owning all the assets including the working funds of the branches, but also formulating their entire policies. Thus a branch is a part of an establishment operating abroad and is not a separate entity. A subsidiary, on the other hand, is a company that is subordinate to a foreign company or group of foreign affiliates, who control a preponderant share of its voting stock and exert an important influence on its policies. There is a third type of direct investment organization called a "managed company", i.e., one that is controlled by a managing agency company which is itself a foreign controlled company.(2)

Direct investment is an extension of entrepreneurial activity of large business corporations located abroad by which capital, technology, organization, management, selling-skills, marketing channels, patents, trade marks, etc. are transferred to the host country. It is an extension of a foreign business company into the host country by which the principal extends its products, technology, management, innovations, research results and other techniques to the host country as well as financing either fully or partly the extended enterprise. Direct investment brings with it ready-made economic growth in the particular field to which it belongs. If it comes in adequate volume to the proper fields and is accompanied by the necessary amounts of capital

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(2). This form of direct investment was popular in India.

to finance the necessary capital facilities, direct investment is a shortcut to economic growth.(3)

Direct investment represents capital investment in a branch plant or subsidiary corporation where the investor has voting control of the concern.(4) The basic definition of direct investment, thus, runs in terms of control.(5) This control may cover any or all of a variety of separate functions, hiring and firing, investment programming, research and development, pricing, dividend remittances, marketing, etc.(6) Direct investment, thus, is that which involves a significant element of ownership, control and management, or in the language of economics, 'entrepreneurial investment'.(7) However, the nature of the classification is such that potential control is implied rather than the actual exercise of control over business policy, although the latter is usually present.(8)

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(3). F. Pazos, "Private Versus Public Foreign Investment in Underdeveloped Areas", in H.S. Ellis (ed.) Economic Development for Latin America, St. Martin's Press, New York, 1961, p. 224.

(4). A.E. Safarian, Foreign Ownership of Canadian Industry, McGraw-Hi l, Canada, 1966, p. 2.

(5). According to the International Monetary Fund, 'direct investment of a country is the amount invested by its residents in an enterprise or other commercial property abroad effectively controlled by its residents', Balance of Payments Manual, International Monetary Fund, Washington, 1948.

(6). C.P. Kindleberger, International Economics, (3rd ed.) Homewood, Illinois, 1963, p. 404.

(7). August, Maffry, "Direct Versus Portfolio Investment in the Balance of Payments", American Economic Review, May 1954, p. 614.

(8). Canada's International Investment Position 1926 - 1954, Dominion Bureau of Statistics, Ottawa, 1956, p. 21.

Direct investment can be made in different ways; by purchasing interests in existing concerns, by adding to share and loan capital, by increasing working capital including expanding trade and other credits granted affiliates, by supplying services of many kinds, and finally by plowing back the undistributed profits of the subsidiaries. It includes purchasing power to mobilize the host country's hitherto unemployed men and materials, to purchase resources which are already im employment, to acquire going-business establishments, to meet inventory financing requirements or to import all kinds of goods and services required for the continuous function of the new firm. Direct investment inflow is usually made up of investment in kind to a large extent, that is, capital goods, other goods and technical services. The ratio of imported goods and services to total investment flows is normally relatively smaller in the cases of subsidiaries than for branches of foreign companies, where the investment consists almost wholly of goods and services supplied by the head-offices. For branches the financial value of the investment flow is represented by the change in its indebtedness to the head office, excluding the effect of revaluations. For subsidiaries it is the sum of the parent company's share of unremitted profits, the cash value of any change in the parent company's holdings of share and loan capital, and the change in the indebtedness of the subsidiary to the parent company recorded in inter-company accounts, excluding the effect of revaluations. Borrowings

from the parent company by the subsidiary not covered by the issue of share and loan capital are included in the inter-company accounts, and loans received by the branch from its head office are included in the branch-head office accounts.

Portfolio investment is basically a financial import which provides additional funds to supplement domestic savings. It is the transfer of claims to resources to foreign savers from domestic enterprises directly or through financial intermediaries. It is confusing to call such financial transactions "investment" as this term should be applied only to the real economic activities of expanding production. Another term should be used for the purchases of financial claims. Following Mrs. Robinson's terminology we may call it "placement".

A Portfolio placement takes two forms: purchases of the host country's bonds and debentures and purchases of the host country's stocks by non-residents. Purchases of bonds or debentures are, like bank credits, made on fixed terms and carry no equity interest; purchases of stock involve equity interest. More specifically, it consists very substantially of (1) loan capital covering the acquisition of money claims against persons that are engaged in the establishment or operation of production facilities, and (2) the acquisition of money claims against financial intermediaries that will eventually purchase property shares or money claims from persons engaged in the construction or operation of production facilities. Equity Capital

covering the purchase of shares in the property or production facilities that will be operated by persons other than those who purchase the shares usually make up a small part of this. Portfolio placement in equities is distinguished by the investor holding shares in the stock of the corporation. Even though the owner of the portfolio placement may be entitled to vote his shares of stock, he plays a negligible role in the affairs of the corporation.(9) Portfolio placement is the claim to property or to fixed money amounts which are represented by transferable documents freely bought and sold in the market, but this ownership or, at least, the effective command of resources, will be transferred to the hands of an intermediary or of a real investor in exchange for a financial claim.(10) Portfolio placement is, thus, noncontrolling financial investment or, to be precise, it involves "no important element of ownership, or control of management".(11) It is involved where the form of the transactions (in bonds or loans) or the amount (in voting stock) does not involve legal control of the asset, at least short of bankruptcy. It comprises scattered minority holdings. The chief characteristic of portfolio placement is that neither legal control nor effective ownership of the asset is involved.

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(9). C.P. Kindleberger, op. cit., p. 404.

(10). F. Pazos, "The Role of International Movements of Private Capital in Promoting Development", op. cit., pp. 186-188.

(11). A. Maffry, op. cit., p. 614.

Thus the distinction between direct investment and portfolio placement arises chiefly out of the nature of ownership and control of the assets.

Direct investment is a financial operation in the sense that it transmutes savings into investment. But it transcends the purely monetary sphere and belongs more to that of real production activities. It is, thus, a process for transforming money savings into both financial investment and real investment. As direct investment is partly a financial phenomenon it should be distinguished from the foreign affiliates' expenditure on buildings, plants and machinery, and all other expenses, which may be financed from either the affiliates' own resources, or from funds raised in the host country without any new capital inflow from the parent country having taken place. Besides, there have always been differences in the timing of investment inflows and the consequent expenditures by the affiliates. Therefore, though the investment inflows and expenditures may be equal in value over a longer period, for example, a year, they may not be equal at any point of time.

The reasons why, and the manner in which, portfolio placement differs from direct investment are apparent when one thinks of the domestic equivalent, real investment and financial investment in bonds and stocks. Relative interest rates, which are of less concern to the business firm than the relative rates of profits anticipated from real investment in various countries, are clearly of great

importance to the person interested in lending out money at interest. There is every reason to believe, even after allowing certain qualifications, and much evidence, that cetris paribus, portfolio capital is attracted from one country to another by the offer of higher interest rates. To that extent, the received doctrine of international capital movements is valid for portfolio placement in fixed interest bearing securities in a way in which it is clearly invalid for direct investment.(12)

Portfolio placement is made on calculations of return versus risk in comparison with investment opportunities at home.(13) The owner of portfolio placement has no interest in playing any important role in forming the policies of the enterprise. Instead he is primarily influenced by such considerations of income yield, tax advantages, marketability and general safety. In general, portfolio placement has a passive character in contrast to the more dynamic influences of direct investment.(14)

Another significant difference between portfolio placement and direct investment is that in the case of the former, the initiative is with the borrower, in the case of the latter it is with the lender.(15)

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(12). H.W. Arndt, "A suggestion for Simplifying the Theory of International Capital Movement", Economia Internazionale, August 1954, p. 475.

(13). A. Maffry, op. cit., p. 620.

(14). Canada's International Investment Position, 1926 - 1954, op. cit, p. 21.

(15). Ohlin, Interregional and International Trade, Harvard University Press, 1935, pp. 350 and 370.

More importantly, direct investment involves activities which are associated with and influence decisions about the production of goods and services in a foreign country. These affect the composition, structure and output of the internal economy and the international transactions of that country, whereas the owners of portfolio placement have no such roles to play.

Direct investment usually brings to the host country sophisticated technology, entrepreneurial and managerial skills, marketing techniques, new ideas, new products, probably new markets, and other benefits, besides the actual capital. There is no waiting for the training of technicians and managers, for time-consuming and uncertain technological innovations, for trial runs and try-outs, and for the acquiring of the necessary experience. Direct investment is, thus, a "package" of product, technology, management and market access, as well as capital.(16) On the other hand, portfolio placement, by definition, is seldom associated with management and very rarely carries with it any technology, entrepreneurship or other type of techniques. This distinction is the major reason why direct investment has almost always been considered to be more productive in an economic sense than portfolio placement.(17) The validity of this assumption clearly depends on exactly what is meant by 'productive investment', whether it is a high rate of return on a dollar investment or a greater net contribution to the host country's economy after deducting

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(16). M.H. Watkins and Others, 'Foreign Ownership and the Structure of Canadian Industry', Privy Council Office, Ottawa, January 1968, P. 26.

(17). A. Maffry, op. cit., p. 619.

all related costs including external diseconomies. The latter criterion may be more appropriate and in that sense the assumption still remains an unproven fact.

A contrary view that portfolio placement is likely to be productive can be postulated. For example, assume two firms of the same size in the same industry whose products are for home-consumption; one is foreign-owned with imported technology, entrepreneurship, skill and capital and little knowledge of the domestic market; the other is native-owned with some portfolio placement, imported technology of similar efficiency to that of the direct investment firm on service payments, and knowledge and personal experience of the domestic product and factor-markets. In this situation the foreign-owned firm may be no better off than the domestic-owned firm as it is unlikely that the former could ever buy the personal experience which the domestic entrepreneur may have acquired over many years. In short, it is possible that the notion that direct investment spreads the blessings of capital and technology throughout an eager world has been exaggerated out of all proportion.(18)

Even the assumption that direct investment can be distinguished from portfolio placement on the grounds that only the former carries with it technology and management know-how has become questionable. The emergence of new types of international institutional lending,

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(18). F. McIntyre, "Foreign Investment and Foreign Trade Policy in the United States", American Economic Review, May 1954, p. 624.

such as the loans and credits provided by the Export-Import Bank and the International Bank for Reconstruction and Development represent a sort of hybrid. These loans are accompanied by a considerable amount of know-how, which in the past was rather exclusively a function of direct investment; but as in the case of portfolio placement it does not assume control.(19) Besides, direct investment, in response to a changed foreign investment climate, is increasingly exporting know-how of all types with capital playing a smaller role and involving reduced or no control of the enterprises. In this way it has moved closer to portfolio placement, which by definition is investment without control. Here it is relevant to recall that the Japanese acquired industrial techniques very effectively while rigidly limiting foreign business investment in their country. Also, the technical assistance programs now in operation show that there are other ways of spreading technical knowledge.(20) These supply patented knowledge, organization, and know-how rather than capital or capital goods. Two specific means which are alternative to direct investment are licensing agreements and joint ventures, that is, the licensing of an independent firm of the host country to manufacture its products, or the entering into a joint equity venture with an independent domestic firm by a foreign principal. Licensing agreement can take a variety of forms,

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(19). H.J. Dernburg, "Discussion on Corporate International Investment", American Economic Review, May 1954, p. 629.

(20). R. Nurkse, "International Investment To-Day in the Light of Nineteenth Century Experience", Economic Journal, December 1954, p. 753.

from the mere granting of the use of a patent or trademark to complex agreements involving an active contribution of the licensor to the assets and management of the licencee; agreements of the latter type are joint ventures. Whether these alternatives are efficacious from the viewpoint of the host country depends on how the firms, in fact, perform.(21) Moreover, to make merely the technological point, there is no need to combine a capital movement with technology, since the technology can be sold separately, either outright or under licensing and royalty arrangements.(22)

More attention might be given to the practicability of devices by which foreign technical know-how might be obtained without foreign capital and the dividend commitment limited in time. The corollary would be to obtain foreign capital, as far as possible in the form of fixed interest capital through government or even corporate bond issues.(23) Today the knowledge and the technology appropriate to some sectors, for instance public utilities, are well known and standardized. In those fields, since this knowledge can be imported on salary or service payments, direct investment would seem to carry an excessive burden. On the other hand, in new industries where know-how and management are not generally accessible and command a high price, direct investment may be eminently worthwhile. In between the

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(21). M.H. Watkins and Others, op. cit., p. 235.

(22). C.P. Kindleberger, op. cit., p. 410.

(23). H.W. Arndt, "Overseas Borrowing - The New Model", The Economic Record, August 1957, p. 261.

standardized and the widely variegated technology in different sectors there may be some intermediate sectors in which the plant's design and management is not completely standardized but in which the variety of design is limited. In those cases new forms of international investment may be appropriate (for instance, management contracts with or without a minority holdings).(24) In "Foreign Investment and the Growth of Firms", E.T. Penrose(25) cites a remark of H.W. Arndt that as far as policy towards future foreign investment in Australia is concerned, the Holden case(26) may induce some caution in giving indiscriminates encouragement to direct investment. Arndt suggested that Australia might do well to concentrate less on attracting American capital and more on hiring American technical and managerial know-how.

Direct investment is customarily made in line with the long range growth programs of the parent corporations, and hence, is not

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(24). P.N. Rosenstein - Rodan, 'Philosophy of International Investment in the Second Half of the Twentieth Century', in J.H. Adler (ed.) Capital Movements and Economic Development, St. Martin's Press, New York, 1967, p. 177.

(25). E.T. Penrose, "Foreign Investment and the Growth of Firms", Economic Journal, June 1956, p. 221.

(26). General Motors Holden's Ltd., the Australian wholly-owned subsidiary of General Motors Corporation in the U.S., made a profit of A£ 9.8 million after taxes in 1953-54, which is 560% on the original dollar investment of GMH, 39% on share holders' funds (net worth), 24% on funds employed or 14% on sales; and that a dividend was declared to the parent company of A£ 4.6 million, which is 260% on the original dollar investment of GMH, 18% on shareholders' funds or 11% on funds employed. The dividend declared is about 8% of the dollar export receipts of Australia for 1954-55, Ibid., p. 221.

as subject to short term considerations as is portfolio placement. It is rarely liquidated, and typically involves not merely the original inflow of capital but also a continuing accumulation of investments obtained through reinvestment of retained earnings, additional inflow of capital, and the extension of long-term and short-term credit by the parent company. In this context it would be more meaningful to argue that the growth of direct investment through the reinvestment of undistributed profits by firms should more appropriately be analyzed in the light of a theory of the growth of firms rather than a theory of foreign investment.(27)

J.N. Behrman has expressed the view that direct investment, unlike portfolio placement, does not affect international capital transfers considerably because it builds capital in host countries.(28) The investor tries to minimize his fresh cash investment through local borrowings and plowing back earned profits. Foreign exchange contributions of direct investment are kept to a minimum and are generally employed to the extent that the law of the host country requires or that sources of funds from the host country are not available. If this were the case, the difference between direct investment and portfolio placement would be profound, and direct investment should be regarded as primarily a movement of financial and entrepreneurial talent, and only incidentally a capital movement.(29)

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(27). Ibid., p. 224.

(28). Jack N. Behrman, "Promoting Free World Economic Development Through Direct Investment", American Economic Review, May 1960, p. 273.

(29). C.P. Kindleberger, op. cit., p. 411.

This distinction hinges on the fact that the owner of portfolio placement is interested in the higher return on his capital arising from the greater scarcity of capital abroad than at home, while the direct investor wants to cash in on a special advantage, arising from technology, large amounts of available capital, access to markets and so on. The capital movement here is merely incidental to the exploitations of a monopoly or technical advantage and frequently can be avoided. This analysis explains why direct investments can take place mutually and simultaneously between two countries, whereas portfolio placements, with rare exceptions for diversification of risk, move in a single direction.

In theory direct investment as well as portfolio placement can consist of both equity capital and debt capital.(30) But, in practice, direct investment is largely represanted by equity capital in the form of shares of incorporated subsidiaries and by the net assets of unincorporated branches. Direct investment thus, usually involves only a little funded debt, and instead of entailing fixed return, it carries a variable rate of return which is dependent on earning capacity. The level of profits remitted also varies depending on the total profits earned and on the decision of the parent company as to what percentage of it should be brought home. Portfolio placement,

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(30). Since, in practice direct investment is mostly represented by equity capital and portfolio placement is largely represented by debt capital, the following analysis in this chapter, for convenience, assumes that direct investment involves no funded debt and portfolio placement consists of only debt capital.

mostly represented by debt capital, is usually on a contractual basis and the rate of return flow which consists mainly of interest is usually fixed by the contract. In a balance of payments context, however, it should be emphasized that since direct investment consists mostly of equity investment while portfolio placement consists very substantially of loan capital, a straight comparison of the costs of the two is not possible. Nevertheless, ex-ante comparisons can be made in terms of the direct balance of payments effects.(31) Another point worth noting is that direct investment usually carries ownership rights of not fixed duration in contrast with the requirement of repayment or refinancing at a given time in the case of portfolio placement.(32)

It has been traditionally held that loans with fixed interest payments are likely to be more of a burden on the economy of the investee country than equity investment because in the former case the payments have to made at the same rate even in periods of depressed economic activities while in the latter, dividend payments fall when profits are low. In other words, direct investment was said to have the special advantage of being adaptable to cyclical fluctuations; no dividend need be declared in a bad year. Portfolio placement, on the other hand, carries fixed annual charges whose burden is very much heavier in the years of recession. Based on this contention, the

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(31). S.S. Tarapore, "Some Aspects of Foreign Investment Policy", Reserve Bank of India Bulletin, May 1966, p. 514.

(32). A.E. Safarian, op. cit., p. 2.

assertion has been made that dividend payments are preferable, from a balance of payments point of view, to interest payments, since the latter involve fixed charges which become relatively more burdensome when the rate of growth of the host-economy is falling. This alleged preference appears based on the possibility of another great world depression at some future date. Post-war national economic policies and experience tend to deny this pessimistic view; and many economists and policy-makers believe that another serious global depression is highly improbable.

The ratio of benefits from equity investment and from bond placement has changed markedly in our age. The cyclical fluctuations are less severe nowadays and of shorter durations. Furthermore, the overall post-World War II experience has been one of rising prices and this trend is expected to persist causing a continuing mild inflation. No government of a modern nation is prepared to leave its economy at the whim of market interactions. A rising price trend for the whole economy invariably suggest, contrary to what has been asserted, that the burden of fixed payments will continue to fall as time goes by, and this trend seems to be strengthened by the fact that almost all countries, even those with an overall free-enterprise system, are planning to achieve higher growth rates in the future than in the past. Also, it seems that in minor fluctuations companies do not reduce dividends rates but rather keep them stable so as to keep shareholders happy and their shares marketable. Thus the advantage derived from

the ability to declare a zero dividend during an economic crisis has become practically nil with the decreased possibility of such an event. In other words, bond credits have become relatively more attractive to the borrowing country than the equity investments. The appraisal of the relative costs and benefits of portfolio placement and direct investment must accordingly be revised as it seems very likely that the more severe depressions can be prevented by appropriate internal government policy.(33) In addition, the present international monetary system provides the opportunity for non-competitive devaluation, which also reduces the burden of fixed payments in two ways, (1) by reducing the value of domestic currency and (2) by the devaluation-induced inflation. Of course, the service payments on foreign-held securities, which are payable in foreign currency, will increase the burden on the depreciated currency. On the other hand, devaluation-induced inflation will increase the profit margin on direct investment, for which higher remittances will have to be made in the future. Thus, it is high time to question the flat assertion that portfolio placement is less preferable than direct investment.

It is true that in the case of portfolio placement the return flow of debt service charges including part of the principal will bring immediate constraints to the economy of the host country, assuming that no part of the return flow is utilized for either

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(33). E.T. Penrose, op. cit., p. 231.

refinancing or new investments. But this assumption seems to be unrealistic. While direct investors are unlikely in normal circumstances to repatriate the equity capital they have acquired, it is also true that little public overseas debt has in practice been repaid in normal circumstances.(34) The only remaining question is what are the rates of remittances in terms of both portfolio placement and direct investment. Here, indeed, for the better understanding of both academic economists and policy-makers a detailed empirical analytical study is urgently needed. However, the available evidence may show that, even though only a part of the profits on direct investment is remitted, the rate of remittance may be higher in the case of direct investment than in that of portfolio placement. Besides, as far as portfolio placement is concerned the amount and time of repayment are definitely set out and known in advance while in the case of direct investment they are neither known in advance nor fixed. In the latter case they will tend to increase to the extent the firms achieve success. Their level also depends upon a number of variables such as political decisions.

It has been cited that the return on equity investment in general is between 15 and 24 per cent before taxes, and between 10 and 15 per cent after taxes. Bond credit, on the other hand, costs, from 5 to 6 per cent.(35) To those lower bonds returns, additional

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(34). H.W. Arndt, "Overseas Borrowing - The New Model", op. cit., p. 257.

(35). P.N. Rosenstein - Rodan, op. cit., p. 176.

payments for complementary technological service and technical assistance would have to be added to permit comparison with the higher return on equity investments. However, it is very unlikely that the payments for imported technology and other skills and techniques would amount to more than the difference between the returns on equity investment and bond credit. Furthermore, it is not clear whether the quoted rate of return on equity investment included payments for royalties and other fees related to equity investment or not, the traditional practice has been to exclude these payments when the rate of return is calculated. If they are excluded, as the usual practice, as mentioned above, the gap between the rate of return on equity investment and bond placement would be further widened by adding in these payments for royalties and associated fees.

Because equity investment carries a high rate of return, a very high proportion of foreign investment in equity form would show that the cost of direct investment in terms of the transfer burden would be greater; too great probably to permit the transfer of dividends and other payments and the occasional repatriation of capital. Since the transfer burden of direct investment is larger today while the scarcity of technical knowledge is smaller, a change in the 'optimal' distribution of bond placement and equity investment among different sectors may be envisaged.

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(36). P.N. Rosenstein - Rodan, op. cit., p. 176.

In the context of New Zealand's experience with foreign investments, Rosenburg(37) has concluded that since the returns on direct investment tend to be a multiple of the return on fixed-interest-bearing placement, especially on government borrowings, it seems advisable for a country to borrow on a fixed interest basis rather than allow foreign capital to take over equities. Besides, the burden of interest on fixed-interest placement, tends to lighten with inflation. If a country's internal policy is based on maintenance of full employment in times of falling external prices of exports, the danger of the burden of remitted profits becoming unbearable at such times is undeniably great. Finally, the best way to check the growth of service charges is to reduce the foreign debt. This is relatively easy with investments bearing fixed interest for fixed terms. On the other hand, investors who have entrenched themselves in particular direct investment activities which give opportunities for the fuller employment of their resources and which earn an attractive profit, are difficult to buy out. If such buying out is to be successful it will usually be at capital values much in excess of the funds actually brought into the country, so that the capital burden of direct investment tends to grow without inflation, and even more so when inflationary conditions exist. It is claimed on the basis of an econometric study that the balance of payments profile of the direct investment appears in more favourable

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(37). Rosenburg, "Capital Imports and Growth - The Case of New Zealand - Foreign Investment in New Zealand, 1840 - 1958", The Economic Journal, March 1961, p. 106.

light during the early years while, portfolio placement is more advantageous over the long period.(38) Thus, any a priori conclusion that, in general one form of foreign investment is more advantageous than another would not only be a non-sequitur, but it would be highly misleading for policy-making purposes.

It has been contended(39) that if more of Canada's economic development had been initiated and continued by Canadian controlled industries, at least part of the large amounts that came in as direct investment would have come as portfolio placement instead. Consequently, the more flexible return on direct investment would have been replaced by the rigid payments arising out of the contractual obligations of the Canadian companies. Though in this argument it is implied that rigid payments are less desirable than flexible payments, why is it not spelled out nor is it explained how rigid debits on portfolio placement would have been a greater burden on the Canadian economy in the light of the actual experience since World War II.

Portfolio placement, assuming no holdings of stock shares, contracts for the payment of interest at fixed intervals and the repayment of the capital when the bonds mature. Direct investment, on the other hand, entails the transfer of profits as they arise with the interest payments being unimportant. Domar(40) examined the

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(38). S.S. Tarapore, op. cit., p. 514.

(39). F.A. Knox, "United States Capital Investment in Canada", American Economic Review, May 1957, p. 607.

(40). E. Domar, "The Effect of Foreign Investment on the Balance of Payments", American Economic Review, December 1950, pp. 805-806.

relationship between inflows and outflows of funds due to the continued borrowing abroad through bond issues. He found that because of the influence of compound interest, outflows resulting from an intial portfolio placement mount in volume very quickly. A host country, therefore, may be forced to borrow continuously so that it can pay its debt charges. Maffry(41) also has contended that as the amount of service payments on portfolio placement grows with the volume of outstanding portfolio placement, it must soon overtake the amount of new investment, so that on balance, there is no net contribution of foreign exchange to the host country. Although Rosenberg(42) has shown that this is not just a theoretical possibility because it did happen to New Zealand for several years, it need not be always true in all cases. The case of direct investment is different; the real question revolves around the transfer of profits. Here too, the volume of profits remittances can increase very rapidly, especially when the initial investment generates profits that are re-invested to generate even more profits later. This is especially true in periods when the host country's economy experiences an inflationary growth. It will be empirically shown elsewhere in this study that in the case of direct investment, too, there was also no net gain of foreign exchange on balance in many individual years and even over a fifteen year period.

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(41). A. Maffry, op. cit., p. 619.

(42). Rosenburg, op. cit., p. 105.

On certain restrictive assumptions, i.e., constant returns, full employment and monopoly returns to specialized foreign capital, it has been concluded that for the host country portfolio placement is more costly than direct investment.(43) These assumptions are too unrealistic for policy formulations. In reality, it seems probable that the rate of return on direct investment may be higher if one takes account of all the related current payments on direct investment. For example, it is estimated that the Latin American countries pay out a return of 15 per cent on direct investment for entrepreneurial services in addition to a real rate of interest on capital.(44) Furthermore, if one allows for the almost spontaneous capacity of direct investment to generate larger and larger investment income liabilities in the long run, say 15 years, it would appear that the average rate of remittance as well as the average total return, on direct investment are higher than on portfolio placement. In other words, while there may be a net outflow of foreign exchange related to direct investment, i.e., income outflow on direct investment may exceed the net direct investment inflow, foreign direct investment can increase at an ever-growing rate by plowing back its own unremitted earnings. Consequently, total income accruing to direct investment would become substantially larger and larger as the years pass, so that the average total income and even the average total remittance, on a $100 initial

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(43). K.J. Rothwell, "The Extra Borrowing Costs of Fixed Returns Over Equity Foreign Capital", Indian Economic Journal, vol. 2, January-March, 1964, pp. 304-310.

(44). F. Pazos, "Private Versus Public Foreign Investment in Under-Developed Areas", op. cit., p. 224.

direct investment over a long period, say 15 years, would be greater than in the case of a $100 portfolio placement for the same period.

It should be noted that portfolio placement and direct investment are very different in their effects both in the short-run and in the long-run because while outstanding portfolio placement is reduced over time, direct investment tends to increase through the re-investing of retained earnings. The argument that direct investment is more advantageous from a balance of payments viewpoint, seems to be the result of confused thinking, for, apart from repatriation of capital and dividends remittance, retained earnings in turn create new investment income liabilities which in future, may reach very high values. The main reason for confusion here is the failure to distinguish clearly between a short-term phenomenom and a long-term one. It is true that since portfolio placement is almost entirely on a contractual basis it sets up an immediate return flow in the form of payments for interest, sinking funds and amortization. On the other hand, the practice of plowing back retained earnings on direct investment in the host country has the effect of reducing, from the balance of payments point of view, the amount of investment service transferred across the exchanges.(45) This argument, if cited as a lasting advantage of direct investment over portfolio placement, is misleading since the advantage is only for

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(45). A. Maffry, op. cit., p. 620.

the short-run and may constitute a greater hardship and threat to the balance of payment problem of the host country in the long-run.

The effects of direct investment on the balance of payments of the host country are far more widespread and deeper than the effects of the portfolio placement. Both direct investment inflow and portfolio placement inflow affect the capital account of the balance of payments, but direct investment invariably and significantly influences the current account also. The establishment of either a branch or a subsidiary invariably brings the imports of goods and services from the parent country. Moreover, the effects of a particular direct investment on the current account are continuous and last until the whole investment is repatriated. Production by the foreign affiliate may entail the continued buying of certain components and parts, managerial services, research services etc. from the parent or other affiliates abroad.

It is stated that direct investment also brings access to markets abroad and will likely result in increased exports. (46) But this may or may not occur. This may be true in some resource industries, such as petroleum extraction. The proposition, however, is very questionable with respect to manufacturers. The available empirical knowledge does not permit the validity of this advantage of direct investment over portfolio placement to be assessed and

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(46). M.H. Watkins and Others, op. cit., p. 249.

generalized. It seems that at least three weak or unrealistic assumptions are involved in this affirmation. First, the parent-policy effect on the affiliate is assumed to be a positive one, that is, it encourages additional export-creation. This is not necessarily so. Second, it is assumed that the parent company's contact, reputation and standing will still be of great benefit to an affiliate established in another country where much of the environment is different from that of the parent's country. In other words, the assumption is made that an affiliate is a homogeneous and identical part of the parent business; this neglects a number of factors including different consumer preferences. This is somewhat similar to the assumption that the establishment of a common market will remove all hurdles to factor movements among member countries which factually is simply not true. Third, it is assumed that all firms started by foreigners are more export-creating than domestic-owned firms though all other conditions are similar; this may be true in individual cases but such a blanket generalization cannot be accepted as it ignores differences in the degree of enterprise of individual entrepreneurs. The question of the overall effect of direct investment versus portfolio placement on import-displacement also cannot be accurately predicted until individual cases have been studied and quantified to determine the aggregate effect.

The obligatory return payments abroad on portfolio placement

are mostly interest payments with a smaller portion contributed by dividends. Direct investment, on the other hand, requires return payments on capital, a large share of which is dividends and much a smaller share interest. But, direct investment carries with it management, technology and other skills and techniques which require additional payments, i.e., royalties, technical and managerial fees and other related business services. Besides these direct payments, other indirect ones may be generated by the intricate relationship between affiliates and parents, for instance, higher travel and freight expenses than might be the case otherwise. Furthermore, the size of large corporations in which direct investment is usually concentrated, is partly due to the degree of their mechanization, so they pay less for wages per dollar of value added, and hence their profits and capital costs, and potential payments abroad, are relatively large.(47)

Successful direct investment, it is claimed, unlike portfolio placement, usually generates further increase in investments through the reinvestment of retained earnings. Here too the argument seems somewhat unfavourably biased against portfolio placement since the returns on portfolio placement can also be used for additional placement either in the old enterprise itself or in new ventures. It is true that the plowing back of retained earnings temporarily eases

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(47). C.D. Blyth and E.B. Carty, "Non-Resident Ownership of Canadian Industry", Canadian Journal of Economics and Political Science, November 1956, p. 607.

the drain on foreign exchange and cushions the balance of payments problem. There is, however, an important distinction; portfolio placement compels the economy to pay off returns as they come due and the economy adjusts to the strain of the payments, while direct investment can defer payments and by such action greatly increase the amount to be remitted in future. If the retained earnings are plowed back the earning-capacity of the direct investment is greatly increased without any inflow of new funds. At any future date, the investing company can decide to transfer its entire profits, a sum greatly in excess of the original amount, and this could be a serious blow to the foreign exchange position of the host country as they could happen even when the host country is facing a foreign exchange crisis. Some of the balance of payments problems that direct investment may create are masked so long as substantial proportions of the profits of foreign firms are retained in the host country. But as total profits of foreign firms grow and the firms become more solidly established, dividend remittances from direct investment will tend to involve larger transfers of foreign exchange than would have been the case if only portfolio placement had been received. Consequently, a 'real balance of payments problem' in this sense may arise.(48)

Another serious balance of payments problem may arise from the practice followed by many foreign affiliates of only remitting

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(48). E.T. Penrose, op. cit., p. 231.

part of the earned profits to their parents and retaining the balance in the host country. Unremitted profits in excess of requirements for business needs are invested in the bonds and stocks of the host country's businesses and governments, liquid assets which can be quickly converted to cash when desired. Normally, these assets are liquidated over various periods of time as the owners find other uses for them and this process does not disrupt the money and exchange markets. But, at times, however, there can be unusually heavy liquidations of these liquid assets to convert into the investing country's currency in order to transfer to parent country. These actions may be taken in response to either a directive issued by the Government of the investing country ordering its affiliates to repatriate their retained earnings or a decision by the share holders of the parent company. The result for the host country will be a heavy and unexpected drain on its foreign exchange reserves and a sharp attack on the international value of its currency. If this happens, the host country's Government would be forced to take drastic action to avoid a full-scale balance of payments crisis, i.e. issue counter-guidelines to the foreign subsidiaries in it, impose exchange controls, devalue its currency, etc. The presence of these large liquid holdings in the host country under foreign ownership and control is a direct result of the direct investment in it and of the associated practice of retaining a substantial share of its earnings in the host country.

It has been said that portfolio placement is often unrelated to the means of repayment or even unproductive in an economic sense because it is not for carefully defined productive purposes and usually not of a kind that will contribute directly or indirectly to the means of servicing the loans.(49) Actually, it appears that it is not the type of investment that is important as regards to the repayment question but the sector in which the investment is being made, if one looks at it from micro-level, and assuming all other economic environments are the same. On a macro-level, an optimal distribution of investment irrespective of the repayment capacity of particular sectors is a prerequisite for the fast and balanced growth of any economy. This applies particularly to investment in infra-structure which is by itself unproductive as far as the repayment is concerned but is the basic requirement to generate and maintain growth in other sectors of the economy. It is the overall structure of the economy that determines the capacity to repay.

Direct investment may or may not create disposable foreign exchange. The investment can be in the form of imports of goods and services or in the form of capital funds to be spent in the host country. In the former case direct investment does not create any freely disposable foreign exchange, but in the latter case it does. In other words, direct investment in the form of required goods and services does not increase the host country's supply of foreign

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(49). A. Maffry, op. cit., p. 616.

exchange. If, on the other hand, the investment is in the form of money-capital the host country will get that much additional foreign exchange and will be free to dispose of it as it sees fit. There are instances of tied portfolio placement in which loans were made for defined purposes, including the purchase of specified goods and services from the loan-granting country. Usually, however, the borrowing country can use the receipts of portfolio placement in any way it wishes. Mostly it thus creates 'freely disposable foreign exchange which borrowers could use with wide latitude'.(50) Most people will agree that a native entrepreneur is much better acquainted with the nature, requirements and potentialities of his own country's economy than non-residents. If so, it is reasonable to assume that the portfolio placement has the advantage over direct investment of leaving the foreign resources involved free to be utilized to the best advantage of the host country. Furthermore, portfolio placement gives the host country the opportunity to buy from the most competitive market. These traits are in contrast to direct investment where the foreign exchange involved is tied to the specific project and to the particular source, and where the foreign parent company can obtain a higher price than if faced with international competition.

As mentioned earlier, a major proportion of direct investment consists of imported machinery and equipment, frequently with

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(50). Ibid., p. 616.

most of the money needed to pay for labour and materials raised in the host country itself, either by borrowing from local sources or through the local sale of equities. To the degree that this is true, direct investment is comparable to a tied loan and entails the risk of creating a transfer problem in reverse, that is, an import surplus without the capital to finance it.(51) If the financing of the local shares of foreign direct investment enterprises is done by creating the credit, the investment expenditure is inflationary. The new credit created when used to finance the new foreign facility will increase national income and frequently imports. This increase in imports will create an import surplus for the host country if the currect account had been in balance or it will increase the import surplus if there was a deficit in currect account previously, since the direct investment concerned does not provide any additional foreign exchange to pay for the increased imports involved. This type of problem seldom arises in the case of portfolio placement which is generally not tied to the imports on goods and services.

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(51). C.P. Kindleberger, op. cit., p. 407.

CHAPTER II

DIRECT INVESTMENT AND THE BALANCE OF PAYMENTS

The balance of payments of a country is an inventory of estimates of transactions involving settlements, over a given period of time, between that country and the rest of the world.(1) As theoretically conceived it is made up of two parts: current account and capital account. The currect account comprises a country's exports and imports of merchandise, its receipts and payments of investment income, its receipts and payments for business and related services, and for all other services rendered and received by it, such as the freight and insurance charges on goods exported and imported, the expenditure of its residents travelling abroad and of foreign visitors in it, etc.

The capital account presents all transactions of a financial nature; it shows capital inflows and official monetary movements. A net surplus in a country's current account will be reflected in an increase in that country's holdings of foreign assets and/or a reduction in its foreign liabilities. Similarly, a deficit on the current account results either in a reduction in its foreign claims or an increase in its foreign liabilities. Theoretically, the final balance on capital account must exactly equal the balance on the

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(1). Professor Kindleberger defines the balance of payments of a country as a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time. C.P. Kindleberger, op. cit., p. 17.

current account but there, generally, is a difference between the two balances which is shown under 'errors and omissions'.

The balance of payments is an essential tool in the kit of the modern statesman charged with the task of policy formulation in modern directed or partially directed economies.(2) It sheds light on the operations of a country's economy by showing the nature and magnitude of its international transactions. If all the payments to other countries are viewed against all the receipts from other countries, the balance, favourable or unfavourable, will show the amount of the settlement to be made in foreign exchange. Thus the balance of payments of a country shows the net gain or loss of foreign exchange resulting from its total transactions with all other countries during a certain period.

A country, like an individual, must meet its financial obligations. If the current debits exceed the current credits, the balance of payments is said to be in a deficit on current account. This means that a country's net external indebtedness has increased and may indicate that it has been living beyond its means internationally. The capital account of the balance of payments show the composition of this increased indebtedness. A country with a surplus on current account is in the reverse position. This change in net indebtedness is important for long-term viability.

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(2). W.J. Wasserman and R.M. Ware, The Balance of Payments, Simmons-Boardman Publishing Corporations, New York, 1965, pp. 162-163.

Fluctuations in foreign exchange reserves, that is, in currently available international purchasing power, have more immediate consequences for day-to-day economic policy. Such reserves increase or decrease accordingly as the net credits on capital account in the balance of payments exceed or fall below the deficit on current account. A non-reserve country cannot run a deficit indefinitely. Sooner or later its holdings, its capacity to procure additional reserves by borrowing, by drawing on the IMF or by obtaining aid from others is likely to be used up. Deficits in the case of such countries are a distinct danger signal. Although the balance of payments may indicate the immediate source of the deficit in the several accounts which it carries, it seldom points a finger at the definite cause. Surpluses and deficits are more of the nature of a sympton than a diagnostic tool.(3)

The deficit or surplus in the balance of payments measures the differences between the total autonomous payments and the total autonomous receipts by a country to and from other countries, over a stated period of time. 'Autonomous' transactions encompass both private and government payments for imports of goods and services, profits, expenditures on travelling and living abroad, remittances by immigrants and so on. If the sum total of the autonomous expenditures of a country are greater than its autonomous receipts, or vice versa, the difference is made up by accomodating transactions,

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(3). Ibid., p. 163.

principally in the form of changes in monetary reserves. In formal presentations, accomodating transactions usually are shown separately, following the autonomous transactions. The autonomous transactions are said to be 'above the line' while accommodating transactions are said to be 'below the line'.

The balance of payments of a country forms an integral part of its national income and gross national product accounts. Its emphasis is, of course, on the performance of the economy in the field of international economic relations, rather than in the domestic field. A surplus in the balance of merchandise trade of a country means that it is providing foreign countries with more goods in value terms than it is receiving from them, and that the effect on the domestic economy will be expansionary. A deficit in the balance of trade has the opposite effect.

On the other hand, from the point of view of the effect of domestic economic activities on the balance of payments, it is apparent that domestic expansion will tend to increase the demand for imports and that domestic contraction will tend to reduce the market for imported goods and services. This relationship also applies to all other forms of non-merchandise trade except investment income and business service payments. The magnitude of these latter payments depends mainly on the amount of foreign investment, its profitability, and the decision of the foreign owners whether or not to transfer the whole or part of the earned profits. An increase in investment income

transferred does not necessarily mean that the demand on a country's resources have been reduced to its full extent because a part of it may be spent in that country, but that command over some of its production has been transferred to foreign residents.

As far as the effects of capital inflows are concerned, it is reasonable to expect that they will exert a net expansionary influence on the economy of the receiving country unless they are wholly in the form of goods. The capital inflows which are not goods will increase demand for the host country's labour and other resources because they are linked with investment expenditures which would not otherwise have taken place. Thus, changes in the balance of payments affect the domestic economy and changes in the domestic economy affect the balance of payments.

The different components of a country's international transactions which make up the balance of payments are closely intertwined. A change in any one item of the balance of payments can affect all other components and the entire balance of payments position. The interactions resulting from a change in one component can be determined only by analysing how this particular item influences other basic items of both the current and capital accounts of the balance of payments. Accordingly, any analysis on the effect of direct investment on the balance of payments of a recipient country necessitates a detailed and comprehensive consideration of changes in all items of current account, both receipts and payments, and in capital

account, both long-term and short-term capital movements, which could be theoretically attributable to direct investment activities. Thus, the effect of a direct investment in a country on its balance of payments goes far beyond the inflow of that investment and the remittances of earnings.

Direct investment inflows usually lead to some imports of goods and services, and the production of foreign affiliates may create exports to the investor country and other countries. In addition, there are some other indirect effects on trade in goods and services and complementary and offsetting capital movements. Moreover, it should also be borne in mind that the consequences of a single act of investment will be spread over a number of subsequent years, in fact, as long as that investment is not repatriated. All these characteristics make the judgement of the effect of direct investment on the balance of payments enormously complex and complicated. In short, it means that an act of direct investment should not be regarded as an isolated foreign exchange transaction, or the simple receipt of foreign capital but one that has direct and indirect effects on all items in the current and capital accounts of the balance of payments.

Ideally one would wish to measure the effect of one unit of direct investment on the balance of payment, by estimating the net balance of initital inflow and subsequent inflows and outflows of foreign exchange, directly or indirectly associated with the initial

investment. Such a measure would enable us to compare the net impact on the balance of payments following one unit of direct investment, with the situation if the particular investment had not been made. This is a very hazardous, indeed an impossible, task.

Instead, we address ourselves to what effect the continued flow and existence of direct investment has had on the balance of payments of a host country over a selected period of time.(4) The approach adopted here may be called 'the total approach' since it is meant to measure the total inflow and outflow of foreign exchange associated with direct investments for all the years in the period chosen.

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(4). It is acknowledged that the following studies, P.W. Bell, "Private Capital Movements and the Balance of Payments Position", in Factors Affecting the United States Balance of Payments, 87th Congress, 2nd Session, 1962, Washington, W.S. Salant et al., The United States Balance of Payments in 1968, The Brookings Institution, Washington, 1963, J. Polk, I.W. Meister and L.A. Veit, U.S. Production Abroad and the Balance of Payments, National Industrial Conference Board, New York, 1966, W.B. Reddaway and Others, Effects of U.K. Direct Investment Overseas, An Interim Report, Cambridge University Press, London, 1967, and L.B. Krause and K.W. Dam, Federal Tax Treatment of Foreign Income, The Brookings Institution, Washington, 1966, particularly that P.W. Bell, op. cit., a pioneer model approach to measure the effects of direct investment abroad on the U.S. balance of payments, have helped in visualizing the problems involved and the approach adopted to these problems in this study.

In this approach the emphasis is on the stream of payments and receipts of foreign exchange related to direct investment over a period of time. The basic advantage of this approach is that it can link the balance of payments effect of direct investment to the international investment position of the host country which is the result of cumulative inflows and outflows. It is the total international investment position that is responsible for generating the greater portion of the total inflows and outflows of foreign exchange associated with direct investment. In addition, this approach explicitly reveals how much net capital associated with direct investment has moved into the host country year by year to supplement domestic savings. It also shows the amount of net foreign exchange in various ways related to direct investment that came into the host country each year to add to its foreign exchange resources and to ease the balance of payments position. Finally, as this approach links the balance of payments effect of direct investment to the host country's international investment position, it helps to make some rough estimates of what the effect of direct investment on the balance of payments will be in future years.

It should be made explicit here that we do not ascribe the current outflows of foreign exchange associated with the direct investment of a given year or a given number of years, to the current inflow of direct investment because this would be an attempt to relate two unrelated events. In other words, 'the total approach' does not

assume that the outflow of foreign exchange associated with direct investment of year 1 or years 1, 2 and 3 are due to the inflow of year 1, or years 1, 2, and 3, respectively. Our approach only reveals how much of foreign transactions related to direct investment coming under the spectrum of balance of payments, has taken place in each year and for the selected period as a whole. More importantly, it would show whether the investee country or the investing country had a net foreign exchange gain on these transactions, without pointing up the effect of each unit of direct investment on the balance of payments.

A careful study of the problem reveals that there are seven variables which may be either directly or indirectly related to direct investment and the balance of payments.

1. The Inflow of Direct Investment

The inflow of direct investment includes money capital, plant and equipment, raw materials and semi-finished goods, technical and managerial personnel, technology and other services. This is recorded in the capital account of the balance of payments as a long-term capital inflow for direct investment. As part of the inflow usually consisted of goods and services, it will in turn affect the current account of the balance of payments as an increase in imports. Thus, direct investment creates a current account debit equal to the value of these complementary imports. In addition, the money capital portion of the inflow generally adds to foreign exchange holdings of the country.

Thus, direct investment inflows simultaneously affect the capital account, the currect account, and the foreign exchange reserves of the host country.

2. Unremitted Profits

A portion of the earned profits of foreign subsidiaries, provided there is no policy directive from the investing country's government, is generally set aside as unremitted profits to be used for the further growth of the foreign-owned enterprises or to be invested in other profitable fields. Its effect on the host country's balance of payments is quite complex. At the actual time when a part of the earned profits are retained in the host country as unremitted profits, there is no visible effect on the balance of payments and is not usually shown in the balance of payments accounts. Even if it were to be included, it would not affect the net balance of payments position. Retained earnings, if remitted abroad and then brought back as new capital for direct investment, would increase the recorded current account deficit but would simultaneously increase the recorded net capital inflow by the same amount. In short, the same amount would be recorded as a current account debit and as a capital account credit. However, for the short-run it does assist in holding down balance of payments deficits since a part of the earned profits which could be transferred abroad, is not. If it were remitted, the host country would have been forced to find additional foreign exchange, the deficit on current account would have increased,

and the monetary reserves would have fallen, assuming that other items remained the same. However, a part of the additional profits remitted might still have been spent in the host country. In this case there would be an offset to the current account deficit and to the ultimate drain on the foreign exchange reserves.

However, the more complex and pervasive effect of unremitted profits on the balance of payments is visible only in the long-run. For, the very act of plowing back the unremitted profits will increase the value of foreign direct investment. Thus, even while there is a net outflow of direct investment, i.e., disinvestment exceeds new investment, the total value of foreign assets can increase through the effect of unremitted profits. This increase in foreign assets will usually generate more income and probably, more income will be remitted abroad increasing further the burden on the host country's balance of payments.

The host country does not benefit to the same extent and in the same manner from retained earnings as from the inflow of direct investment. An inflow of direct investment adds to the available foreign resources both as imports of goods and services and as transfer of foreign exchange. But the plowing back of retained earnings not only does not increase the foreign exchange reserves but may actually increase the demand for foreign exchange to pay for new imports stemming from the expansion of the foreign enterprises financed by these retained earnings. Though in the short-run there

may be some relief since a part of the earned profits is not remitted, the indirect effects may cancel out even this short-run advantage. Thus, while we cannot be sure of any short-run advantage, we do know that in the long-run the unremitted profits will impose a greater transfer payments burden on the host country.

3. Dividends and Interest Remittance

The inflow of direct investment and its continued existence generates a return flow in the form of dividends and interest. Dividends remitted consist of dividends paid abroad by foreign subsidiaries and the earnings of branches of foreign companies sent back to head offices abroad. This transfer of dividends and interest can be the most serious constraint that direct investment can bring to a host-economy. As a rule, only a part of the total dividends of the foreign subsidiaries are remitted, the remaining being held back in the host country for further investment. The level of dividends remitted depends on the total profits earned and on the decision of the parent company as to what proportion of it should be brought home. This decision can also be influenced by the policies of both the investment and the host country's governments. Dividends and interest transferred to the investing country are entered as 'investment income payments' in the current account of the balance of payments statement of the host country. These payments either increase the deficit or reduce the surplus of the current account of the balance of payments. In addition, these transfers also may affect the current account favourably, as a part of the remitted dividends and interest may be spent in the host country for

goods and services including travelling.

4. Royalties and Fees

In addition to profits and interest payments, direct investment invariably generates yet another direct payment, i.e., royalties and fees. Royalties and fees include payments for trademarks, patents, use of drawings, engineering or technological services, consultations or other services relating to industrial techniques and processes, management services, contribution towards the expenses of the parent companies for research and development, advertising, the recording of data, rent for some special machinery, etc. These royalties and fees on direct investment are also entered in the current account of the balance of payments statement as payments and their effect is similar to that of dividends and interest remitted abroad. The amount of the inflow of direct investment less payments of dividends and interest and royalties and fees shows the capital-flow effect of direct investment.

5. Direct Trade-Effect

Direct investment is closely linked with the imports of goods and services, mainly from the investing country. The establishment of a new foreign affiliate usually involves the imports of machinery and equipment, raw materials and goods in different stages of production, and technical, managerial and marketing services from the investing country because foreign affiliates are frequently smaller-scale replicas of the foreign entrepreneurs' home enterprises. In

measuring the effect of direct investment on the balance of payments of the recipient country, these complementary imports must be deducted from the inflow of capital in order to find exactly how much of the new direct investment inflow reached the host country in the form of free foreign exchange. In terms of a single investment, these imports may well be substantial in the early years following the investment but may taper off as the foreign facilities are properly established and diversified. The speed at which this happens depends on to what sector the direct investment has been channelled to, the nature and industrial structure of the host country, and the policy of the parent company with regard to its exports to the affiliates. These complementary imports may normally be thought of as once-and-for-all increases in the host country's imports. However, the operation of the foreign affiliates generally generates continuous demand for imports of replacement machinery, raw materials, semi-finished goods and services.

The magnitude of these complementary imports is partly determined by the economic dependence, particularly the technological dependence, of the host country on the investing country. The more broad-based the host country's industrial capacity is, the less may be the need for imports from the investing country as the domestic economy can provide alternative sources for goods and services. However, in reality, the level of imports is mainly determined by the policy of the parent company, and in some cases large imports are made despite the availability of similar economic goods in the host country.

In measuring the effects of direct investment on the balance of payments of the host country by 'the total approach', although direct import requirements can be considered as a continuous stream of imports, it is empirically more meaningful to consider these related imports as 'total' for a particular period, say a year. Thus, the total net direct investment inflow of one year minus the total foreign affiliates' imports would give the actual increase in foreign exchange as a result of direct investment made in the host country during that year.

On the other hand, direct investment may also have a favourable effect on the host country's balance of trade. Production of foreign affiliates may create new exports to the investing country and/or to third countries. Assuming that direct investment only supplements residents' investments, these newly created exports very likely would not have taken place in the absence of the foreign production facilities. Besides, it is a known fact that comparative cost advantage is not a static phenomenon. Even if some affiliates are unable to export competitively at the beginning of their operations, they usually do develop comparative advantage at least in some markets after some time. The time needed to develop the required comparative advantage to penetrate some foreign markets depends on the sector in which the direct investment took place. Similarly, the amount of exports created also depends on the industry in which the foreign capital is invested and the policy of the parent company towards the export development of the affiliates.

In addition to creating exports, the production of foreign affiliates may replace goods previously imported from either the investing country or from third countries. This import-displacement effect of direct investment is as significant as the export-creating effect; the former will save foreign exchange and the latter will earn foreign exchange. Again, the amount of import displacement due to direct investment depends in which sector of the economy it has been taking place.

The foreign exchange savings ascribed to the displacement of imports by foreign affiliates production and the gains of foreign exchange created by the newly-created exports of foreign facilities are recorded as favourable movements in the current account of the balance of payments of the host country. But the complementary imports generated by the foreign affiliate enterprises as a normal consequence of their operation, have to be shown as an unfavourable item in the current account. The net of these two represents the net effect of direct trade on current account. The amount of the inflow of direct investment minus the remittance of dividends and interest and royalties and fees and plus or minus the direct trade-effect measures the direct effect of direct investment on the host country's balance of payments. These effects are called direct because they are directly linked to the act of production by foreign affiliates, and are the invariable direct consequences of direct investment.

6. Indirect Trade-Effect

Although it may be difficult to quantify, account must be taken, at least theoretically, of the so-called indirect and induced effect of direct investment on imports and the exports of goods and services of the host country. These indirect and induced trade effects are related to both the production and the presence of foreign affiliates. The following few instances will illustrate how direct investment activities indirectly affect the host country's international trade in goods and services.

Foreign affiliates often import more than the actual requirements needed to start and to continue production in their enterprise. Usually a part of their imports of goods and services consists of finished goods from the parent country which is traded in the host country. The foreign affiliates' contact with the host country's markets generates additional new demand for certain imports which would not have occurred had there been no foreign affiliates functioning. Even the resident-owned companies in response to a more foreign-orientated domestic demand created by the presence of the foreign affiliates are induced to import more. The establishment of foreign affiliates may also result in the development of more efficiently organized marketing facilities both domestically and between the parent country and the host country. In all these transactions, the foreign affiliates serve as connecting links, between the host country and the investing country.

The production activities of foreign affiliates may create additional capacity to produce more goods and services in the host country. Increases in supply capabilities generally exert their effect on trade in goods and services by improving competitive position, i.e., by lowering costs relative to those elsewhere through the economies of scale. And it is likely that the higher the output capacity of the host country, that is, the host country's capability of producing more goods, the more effectively it can compete with the investing country, and the more it can meet its own demand for goods and services, and frequently those of both the investing country and third countries. Therefore, increases in the investee country's output capacity tend to reduce its imports and increase its exports.

It is likely that direct investment inflow will cause the host country's level of spending to rise. The inflow of direct investment capital may cause the level of domestic spending to rise by a larger amount than the capital inflow in two ways: (1) when the foreign affiliates finance part of their investment spending by raising additional capital domestically, or (2), when they stimulate more domestic investment than they replace. The net effect of the capital inflow in such cases is to increase the imports of goods and services by the host country, the extent depending on the import coefficient of expenditure.

The establishment of foreign affiliates may lead the host country to have increased communication and association with the

investing country which may influence the consumption pattern, attitude to travel, production pattern, etc., all of which together can be called the "demonstration effect of direct investment". This "demonstration effect" will likely increase the trade of goods and services. It is reasonable to assume that this is an important factor in causing the investee country to have higher imports than exports as the investing country is usually relatively economically more developed, and the people of relatively less developed countries tend to imitate the people of the more developed countries.

If direct investment facilities become more profitable as a direct or indirect result of a rise in host country's export prices or of domestic inflation, the investing country's receipts of remitted income on direct investment will also increase. This increase in investing country's income may increase the imports of the investing country from the host country.

7. Induced-Capital Movements

Another variable which may be related to the balance of payments effect of the flow of direct investments consists of complementary and offsetting financial movements which are induced by the flow of direct investments. The establishment of foreign affiliates may lead to increased utilization of the investing country's financial markets by the host country to finance imports from the parent country. It may also cause increased flows of funds such as portfolio placement and short term capital into the host country from the parent country's

financial markets. It is likely that there will be increased outflows of capital from the host country as more and more information becomes available through foreign affiliates concerning investment opportunities in the investing countries, both in the financial markets and in real production activities. Moreover, the financial policies of some firms, particularly where they are wholly owned by non-residents, may reflect the requirements of parent companies more than those of the affiliates, and this attitude may lead to the underdevelopment of some sectors of the domestic capital market, and thus cause serious balance of payments problems.(5) Though conceptually this variable has great significance it is impossible to measure it quantitatively since the available statistical information does not shed any light on this aspect.

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(5). A.E. Safarian, op. cit., pp. 19-20.

CHAPTER III

CANADIAN BALANCE OF PAYMENTS SINCE 1950

In balance of payments terms, the year 1950 represents a convenient point at which to commence an analysis of recent Canadian balance of payments experience, since it marks the beginning of a period of continuing and persisting currect account deficits. The statistics in Table 1 show the basic items in the current and capital account balances from 1950 to 1965. Depending on the nature and purpose or the analysis, the entries in the balance of payments account can be grouped in a large number of ways, and balances struck for each group. Accordingly, the data in Table 1 are grouped in summary form and the statement is slightly modified from the usual presentation in order to bring out the main points on which we intended to comment.

With the exception of the year 1952, Canada has had a deficit in the current account of its balance of international payments every year since 1950. In the whole fifteen-year period between 1950 and 1965, Canada's cumulative net deficit on current account was $12.7 billion. The balance of trade - commodity exports minus imports - was in Canada's favour in 1950, 1952 and 1954 and has been so each year since 1961, while a large deficit is shown in other years particularly between 1955 and 1960. For the fifteen years between 1950 and 1965, there was only a small cumulative deficit on

TABLE 1

CANADIAN BALANCE OF INTERNATIONAL PAYMENTS, SELECTED DATA, 1950-1965

A minus (-) indicates deficit

(Millions of dollars)

BASIC ITEMS	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965
Current Account																
Net Merchandise Trade	7	-151	485	-60	18	-211	-728	-594	-176	-421	-148	173	184	503	701	118
Net Investment Income	-371	-333	-269	-247	-281	-318	-392	-480	-477	-535	-537	-606	-646	-720	-768	-764
Net Business and Related Services	-137	-153	-125	-127	-138	-144	-168	-174	-178	-173	-171	-190	-201	-204	-222	-218
Net Other Non-Merchandise Trade	182	125	96	-14	-23	-14	-84	-203	-306	-358	-377	-305	-167	-100	-135	-266
Net Total Non-Merchandise Trade	-326	-361	-298	-388	-442	-476	-644	-857	-961	-1066	-1085	-1101	-1014	-1024	-1125	-1248
Net Current Account	-319	-512	187	-448	-424	-687	-1372	1451	1137	-1487	-1233	-928	-830	-521	-424	-1130
Capital Account																
Net Direct Investment	260	290	275	380	335	360	545	465	390	485	620	480	400	145	175	410
Net Other Long Term Capital	350	376	180	269	264	54	945	855	763	694	309	450	288	492	645	454
Net Long Term Capital	610	666	455	649	599	414	1490	1320	1153	1179	929	930	688	637	820	864
Net Short Term Capital	431	-98	-605	-239	-51	229	-70	26	93	297	265	288	297	30	-33	423
Net Capital Movements	1041	568	-150	410	548	643	1420	1346	1246	1476	1194	1218	985	667	787	1287
Balance to be Settled	722	56	37	-38	124	-44	48	-105	109	-11	-39	290	155	146	363	157
Official Monetary Movements	722	56	37	-38	124	-44	48	-105	109	-11	-39	290	155	146	363	157

Net: Denotes balance of receipts minus payments

Source: 1. The Canadian Balance of International Payments A Compendium of Statistics from 1946 to 1965, Dominion Bureau of Statistics, Ottawa, March 19
pp. 94, 95, 103, 104, 114-117, 123, 147-150, 164, 182; Tables 4.A1, A3- A11, B1, B4-B11, C4, D1-D3, D5-D8, E1-E3, F, 5.06, 20.

2. Quarterly Estimates of the Canadian Balance of International Payments Fourth Quarter 1966, Dominion, Bureau of Statistics, Ottawa, March 1967, p. 7.

3. Quarterly Estimates of the Canadian Balance of International Payment Fourth Quarter 1967, Dominion Bureau of Statistics, Ottawa, March 1968, p. 22,

Note: In the following pages the above references 1, 2 and 3 will be cited in abbreviated forms as 1. 'Compendium', 2. 'Quarterly IV, 1966', and 3. 'Quarterly IV, 1967' respectively.

merchandise trade account of $300 million; and this comprised only a little more than 2 per cent of the total current account deficit incurred in this period.

In spite of a small acceleration in the outflow of Canadian capital abroad, on balance, investment income showed a large deficit for each of the years in the period, 1950-1965. Moreover, this deficit has been accelerating, rising from $371 million in 1950 to $764 million in 1965, an average annual compound rate of increase of about 5 per cent. For the whole period between 1950 and 1965 there was a cumulative net outflow of $7.7 billion on investment income account. This $7.7 billion accounts for about 61 per cent of the total cumulated current account deficit. Exactly the same trend is shown by the balance on business service and related transactions. Although independent Canadian producers also purchase business services from abroad, most of these payments are the result of foreign direct investment in Canada. On this account there was a net deficit of $2.7 billion over the fifteen-year period; this is about 22 per cent of the total cumulated current deficit for the 1950 to 1965 period. The net outflow in this regard in 1965 was about 59 per cent more than in 1950. Thus, total service payments on foreign capital, i.e., investment income plus other service payments, alone accounted for not less than 75 per cent of the total current account deficit incurred over the 1950-1965 period. This points up that the main factor responsible for the continued and growing deficit on current

account has been the payments associated with the servicing of foreign investments. Although the residual item on current account, that is, all other non-merchandise trade excluding investment income plus business and related service payments, shows a surplus in the early years, it has been in deficit annually since 1953. The total deficit on this account amounted to $1.9 billion for the whole period, accounting for about 15 per cent of the total current account deficit incurred in thos years.

Consequently, year after year, from 1950 on, Canada faced a deficit in its current account. In 1950 the deficit was only $0.3 billion but it amounted to $1.1 billion in 1965, representing an average annual compound rate of increase of about 8.8 per cent. For the whole period from 1950 to 1965 there was a cumulative deficit of $12.7 billion on Canada's current account. Each component has contributed to the current account deficit shown for the period as a whole; the unfavourable balance rising by a little more than 2 per cent for merchandise trade, 61 per cent for investment income, 22 per cent for business and related services, and 15 per cent for all other non-merchandise items. Furthermore, the deficits shown in almost all the service items have been growing steadily since 1950. For the 1950-1965 period as a whole, the deficit incurred on non-merchandise account was responsible for about 98 per cent of the total deficit shown on current account.

If we now turn to transactions with specific regions of the world we see, here too, that there is a consistency in Canada's transactions with other countries. The data in Table 2 show that throughout the period 1950-1965, Canada's merchandise trade balance with the United States was in deficit, and it seems that the deficit tended to swell in times of prosperity and to shrink in periods of recession. For the fifteen-year period Canada's merchandise trade overall balance with all countries shows a deficit of $300 million but the deficit with the United States was a massive $10 billion.

Thus, throughout the period under consideration Canada earned a surplus in its merchandise trade balance with all other countries excluding the United States (see Table 3) for the period between 1950 and 1965; this totalled $9.7 billion. Thus the deficit of $10 billion incurred with the United States during this period was almost offset by the surplus earned in the dealings with other countries, i.e., $9.7 billion.

On balance of investment income Canada experienced a net outflow with both the United States and the rest of the world, the accumulated net outflow being $4.6 billion in the case of the United States and $3.1 billion for the rest of the world. But the trend was slightly different in the case of the balance of business services and related transactions; each year in the entire period Canada had a deficit with the United States, and a surplus in some years with the rest of the world and a deficit in others. The deficit on this

TABLE 3

CANADIAN BALANCE OF PAYMENTS WITH ALL COUNTRIES EXCEPT THE UNITED STATES, SELECTED DATA, 1950-1965

A minus (-) indicates deficit

(Millions of dollars)

BASIC ITEMS	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965
Current Account																
Net Merchandise Trade	57	369	958	530	458	474	439	353	356	115	525	788	622	991	1509	1159
Net Investment Income	-98	-93	-93	-101	-105	-115	-145	-215	-224	-255	-291	-289	-322	-386	-346	-62
Net Business and Related Services	-1	2	8	5	-1	-1	1	1	-2	1	-3	-4	2	3	8	8(P)
Net Other Non-Merchandise Trade	108	155	144	25	24	-16	-17	-11	-100	-124	-105	-82	-40	19	40	-298
Net Total Non-Merchandise Trade	9	64	59	-71	-82	-132	-161	-225	-326	-378	-399	-375	-360	-364	-298	-352
Net Current Account	66	433	1017	459	376	342	278	128	30	-263	126	413	262	627	1211	807
Capital Account																
Net Direct Investment	99	9	-97	-12	-23	-20	12	27	86	47	141	89	78	-111	-48	13
Net Other Long Term Capital	-114	97	165	221	227	225	474	330	117	205	42	-112	-70	-95	-145	-254
Net Long Term Capital	-15	106	68	209	204	205	486	357	203	252	183	-23	8	-206	-193	-241
Net Short Term Capital	110	-94	-112	2	-35	72	73	47	-2	-88	37	-70	-96	44	-659	1091
Net Capital Movements	95	12	-44	211	169	277	559	404	201	164	220	-93	-88	-162	-852	850
Balance to be Settled	161	445	973	670	545	619	837	532	231	-99	346	320	174	465	359	1657
Official Monetary Movements	28	17	-43	4	3	-2	14	-1	1	56	..	63	-380	87	332	114

P: Provisional

.. Denotes Nil

Source: see Table 1.

account with the United States over the fifteen-year period totalled $2.8 billion while a surplus of $27 million is shown for the rest of the world. Except for the years, 1950, 1955, and 1965 Canada had a deficit each year on the balance of all other non-merchandise trade with the United States, the accumulated deficit on this account amounting to $1.7 billion. With the rest of the world on this account, Canada had surpluses between 1950 and 1954, deficits between 1955 and 1962, surpluses again in 1963 and 1964 and finally a deficit in 1965; showing an overall deficit of $278 million. The service transactions balance, that is, the balance on total non-merchandise transactions, thus shows a deficit with the United States for each year in the 1950-1965 period, with the total deficit for the entire period aggregating $9 billion. Canada had a deficit with the rest of the world on total non-merchandise transactions each year in the period except 1950 to 1952 and the deficit for the entire period came to $3.4 billion.

Finally, Canada's current account with the United States showed a deficit each year in the period; it increased from $385 million in 1950 to $1.9 billion in 1965, and totalled $19 billion over the fifteen years. With the rest of the world the picture was the opposite, Canada having a surplus each year except for 1959, and a surplus of $6.3 billion for the whole period. However, as we have seen earlier, Canada has had an overall deficit in its dealings with the world over the 1950-1965 period because it has not been able to

offset, except to a small degree (about one-third), the very large imbalances incurred in its transactions with the United States. The main factor responsible for this overall deficit on current account shown for the period is the net outflow incurred on service payments on foreign investment.

F. Knox's estimates(1) allow us to make some historical comparisons. According to him, Canada had an almost constant trade deficit during the period 1900-1913, and after that, generally a trade surplus. Investment income was a deficit item for all the years from 1900 to 1934 and other service payments were also a deficit item for the greater part of the period. The net result was a continual current account deficit from 1900 to 1915, a surplus from 1916 to 1919, another deficit from 1920 to 1922, a surplus again from 1923 to 1928, and deficit from 1929 to 1931 and a surplus from 1932 to 1934. These alternate deficits and surpluses shown in the 1900-1934 period represent quite a different pattern from that which we have experienced since 1950.

On the capital account side we find how the deficit on current account has been balanced. The balance on direct investments, foreign direct investment in Canada minus Canadian direct investment abroad, has been fluctuating widely during the period; it reached $620 million

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(1). F. Knox, "Canadian Capital Movements and the Canadian Balance of International Payments, 1900-1934", in Marshall, Southard, and Taylor, Canadian-American Industry, A Study in International Investments, Yale University Press, New Haven, 1936, pp. 314-317.

in 1960 but was down to $145 million in 1963. Changes in both foreign direct investment in Canada and Canadian direct investment abroad are responsible for the variations shown. There was a net inflow of direct investment of $6 billion during the period 1950-1965: this was equivalent to about 47.3 per cent of the total current account deficit incurred during this period. The same fluctuating trend is shown by the other long-term capital movements during the period. Between 1950 and 1965 on this account, a net total of $7.4 billion came to Canada, the equivalent of 58.1 per cent of the total current account deficit. In total, the balance on long-term capital movements, that is, direct investments plus other long-term capital movements, shows a surplus of over $13 billion, and about $687 million more than the total current account deficit. Although the last item, the balance on short-term capital movements, was unfavourable in six years in the 1950-1965 period, the net result was a surplus of about $1.3 billion. Thus, the surplus of $687 million on long-term capital movements plus the surplus of $1.3 billion on short-term capital account together contributed about $2 billion to Canada's monetary reserves over the period in question.

The Canadian Government's action in initiating a fluctuating exchange rate in September 1950, appears to have reduced, as desired, the volume of exchange reserves. In 1950, Canada had a phenomenal increase in her reserves, i.e., a gain of $722 million compared with a rise of $128 million in 1949, but this was taken place entirely

earlier to the introduction of flexible rates. For, in the last quarter of 1950 when flexible rates came into existence, there was a net loss of $131 million compared with the net gain of $853 million in reserves during the first three quarters of the year. Moreover, during the eleven years between 1951 and 1961, there was a net outflow of foreign exchange in five years, but since 1962, there has been a continuous net annual increase in monetary reserves. Also, during the period 1951 to 1961, when different types of floating rates, i.e., "true" floating exchange rate, "nudged" floating rate and the "manipulated" floating rate, were in existence, Canada's foreign exchange reserves rose by $427 million, while in the other five years, that is 1950, and from 1962 to 1965, the increase totalled $1.5 billion. If we exclude 1961 when the government gave effect to a "manipulated" floating rate by openly intervening in the foreign exchange market, the net rise in the reserves was only $137 million over this 1951-1960 period compared to the net inflow of $1.8 billion for the six years, 1950 and 1961 to 1965.

We have seen that year after year, from 1950 on, with the exception of the year 1952, Canada's current account balance was in deficit, and this deficit has been growing at a higher rate from $0.3 billion in 1950 to $1.1 billion in 1965. In addition, it is also noted that the deficit incurred on non-merchandise account particularly the service payments on foreign investment was responsible for the overall deficit on current account. This implies, it is to be emphasized

that it is not enough to achieve a favourable balance in merchandise trade alone. Canada has to develop a very large and growing commodity export surplus to meet the rising deficits on non-merchandise account, particularly the various service payments on foreign investment and the induced effect of foreign investment. In this respect it must be remembered that the Canadian economy is very deeply involved in foreign transactions, and the international sector has a very substantial and perhaps a unique impact on other sectors of the Canadian economy. More specifically, Canada's balance of payments problem, if any, is a reflection of Canada-United States relationship in the sense that the annual imbalance on current account are wholly the problems of Canada's trade and payments with the United States, problems caused largely by the high level of U.S. investments in Canada. This problem can only be resolved by increasing exports and/or reducing imports, or by adopting new policies towards foreign investment in Canada.

The question of long-run viability is complex. Canada has been able to meet its mounting current deficits up to the present because it has been able to attract very large amounts of capital from foreign countries. If Canada had not been able to attract long-term investments in amounts equal at least to the deficits incurred on current account, its foreign exchange reserves, although sizeable, would have been exhausted long ago. However, it should be remembered in this context that the incurring of foreign debt is itself a cumulative process because more and more funds are required each year to

service this indebtedness as it grows, unless the balance of trade and/or other balances are substantially improved. This process, if allowed to go on for too long, may eventually result in a situation where Canada may not be able to find sufficient funds from abroad to make service payments on foreign investments unless measures will be taken to reduce its imports or increase exports substantially. In the meantime a very substantial part of its resources would have come under foreign control which in turn entails increased outward service payments. Thus, Canada has drawn heavily on foreign funds between 1950 and 1965 and if the economy is to grow at an increasing rate, assuming no policy change, it must continue to depend heavily on foreign resources, and to continue to increase its international indebtedness. The question is to what extent and for how long. This is the crucial problem. The most desirable and reasonable proposition in this context would be to find some way to achieve a higher and steadily increasing growth rate while endeavouring to reduce, or, at least not to increase its foreign debt.

Before concluding this section some mention should be made of how the past trend of the Canadian balance of payments can be used to forecast its possible future trend. The annual average current account deficit for the first half of the fifteen year period, 1950 to 1965, was $628 million while for the latter half of the period under consideration it was $961 million. A simple extrapolation of this trend, cetaris paribus, would place the annual average current account

deficit for the next eight years, from 1966 to 1973, at about $1.5 billion. For the whole period, the cumulative current account deficit would amount to about $11.8 billion.

The deficit on investment income account has recorded a very high rate of increase; the annual average deficit between 1950 and 1957 being $336 million and from 1958 to 1965, $630 million. Assuming that the rate of increase of each factor contributing to the increase in the deficit on investment income remains the same for the next eight years, the annual average deficit on it would probably be about $1.2 billion. The annual average deficit on business services and related transactions was $146 million between 1950 and 1957 while it was $195 million over the 1958-1965 period. Applying the same rate of increase for the next eight-year period, i.e., from 1966 to 1973, the deficit on this account would average about $260 million. Thus, the projected annual average deficit on investment income and business services and related transactions would be about $1.5 billion during the period from 1966 to 1973. This anticipated annual deficit of $1.5 billion on these two accounts is exactly equivalent to our projected total deficit on current account. It implies that on all other items of the current account the receipts would be equal to the payments. Let us assume that this is probable.

A simple extrapolation thus, shows that by 1973 Canada will be having an annual average deficit of at least $1.5 billion in its current account and which will have to be met by capital inflow from

abroad. Thus, for the 1966 to 1973 period, the accumulated deficit would be about $11.8 billion, so that Canada's external debt would be $11.8 billion greater in 1973 than it was in 1965. This trend looks somewhat like a vicious circle, the higher the foreign debt, the higher the current account deficit, and the higher the current account deficit the higher the foreign debt.

In this context it should be noted that the above analysis implies that the current account deficit necessitates the capital inflows. This is not completely true. The inflow and continued existence of foreign investments, particularly direct investment, is one of the major causes of the continued deficit in Canada's current account. The setting up of foreign firms as well as the continued existence of foreign firms in Canada are, in fact, likely to affect one or more items in the current account balance. Hence, we may say that capital inflow causes part of the current account deficit and which in turn necessitates part of the capital inflow in Canada. This inter-relationship also may contribute significantly to the above-mentioned "vicious circle" characteristic of the Canadian balance of payments problem.

Over the last seven or eight years a number of responsible Canadians have contended that excessive reliance on foreign capital was the most important cause of the growing imbalances in Canada's balance of international payments and of the development of chronic and structural unemployment during the 1950's. The former Governor of

the Bank of Canada, Mr. Coyne, has argued[2] that the excessive inflow of foreign capital during the 1950's under the existing flexible exchange rates system pushed up the value of the Canadian dollar, induced a massive inflow of imports and prevented or discouraged Canadians from investing in many of the most fruitful and rapid-growth types of domestic economic activities. His thesis was that there was an obvious connection between the net inflow of capital, the excess of imports, and the failure of Canadian production to expand sufficiently to provide an increase in employment to match the growth of the labour force. His contention was that capital inflow created new imports which would not have taken place otherwise, and reduced the value (in Canadian dollars) of Canadian exports and held them to a level lower than might otherwise have been achieved. Thus, these actions not only caused unemployment but prevent employment in general from rising in Canada.

Professor Barber subsequently expressed[3] the view that the dominant cause of the drop in the Canadian growth rate in the early 1960's was the excessive volume of capital inflow during the latter part of the 1950's. He claimed that during the 1950 to 1954 period the capital inflow was moderate in size and the Canadian economy adjusted to it without apparent difficulty. But when capital

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(2). J.E. Coyne, Foreign Debt and Unemployment, Speech at a meeting of the Canadian Club of Toronto, November 14, 1960 (mimeo) pp. 9-11

(3). C. Barber, "Canada's Unemployment Problem", The Canadian Journal of Economics and Political Science, February, 1962, pp. 89-91

spending began to recede from the peak reached in 1957, a corresponding decline in the capital inflow and the current account deficit did not take place. He asserted that it was clear that since 1957 the net inflow of capital has been much larger than could be readily absorbed by the Canadian economy. Canada has been borrowing funds from other countries to finance the purchase of imports which directly or indirectly could have been produced with its own unemployed resources. Thus, Canada's high level of unemployment during the latter years of the 1950's was primarily due to the Government's failure to encourage a reduction in the capital inflow and in the size of the current account deficit.

R.G. Penner has noted(4) that the net effect of long-term capital inflow is deflationary or not depending upon its composition and on the economic forces at work in the borrowing economy. However, he concluded that the theoretical and empirical evidence indicates that the type of capital inflow entering Canada during the 1950's was certainly not deflationary and that a strong possibility exists that it was in fact expansionary on balance. Penner's theoretical framework has been slightly improved by J.R. Melvin who has found(5) that in general we cannot predict whether a capital inflow will be expansionary or contractionary. If a capital inflow is used to purchase newly produced goods and services, either foreign or domestic, then

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(4). R.G. Penner, "The Inflow of Long-term Capital and the Canadian Business Cycle, 1950-1960", The Canadian Journal of Economics And Political Science, November 1962, p. 542.

(5). J.R. Melvin, "Capital Flows and Employment Under Flexible Exchange Rates", The Canadian Journal of Economics, May 1968, pp. 331-332.

in order to know whether national income has risen or fallen, we must know the domestic elasticity of demand for imports and the degree of substitution which exists between imports and domestic products. If the capital inflow is used to purchase existing real or financial assets we must know the elasticities and the substitution parameters for both countries, as well as the marginal propensities to save and import. However, Melvin has warned the readers that his findings should not be considered as the final answer, for there are many real-world phenomena which he has not been able to take into account.

Though the Coyne-Barber argument is apparently appealing in its simple form, it does not take into consideration a number of qualifications affecting any general conclusion on the effect of capital inflow on the level of employment under flexible exchange rates. When these qualifications are taken into account, the general conclusions arrived at will be those of Melvin's, i.e., in general a capital inflow under flexible exchange rates can be either contractionary or expansionary. Furthermore, although Melvin's theoretical framework is a slightly improved version of Penner's, he has not analysed the Canadian experience in the 1950's as did Penner, and Penner's conclusion on the Canadian experience in the 1950's refutes the Coyne-Barber argument that the capital inflow into Canada during this period was deflationary.

A close examination of the total net capital inflows and current account deficits during the 1950-1965 period reveals the

argument that large and continuing current account deficits in the Canadian balance of payments have been entirely due to the net total capital inflows is based on a serious conceptual misunderstanding. It seems that this argument overlooks a factor which is perhaps more important than the one it considered basic. It is true that to the extent the deficit on current account is generated by the capital inflow, the cessation of the inflow will itself directly lead to an improvement in the deficit. R.J. Ball has meaningfully argued(6), however, that it does not follow that it is in fact always desirable to reduce the inflow of capital, since the major concern may be really the existence of an autonomous or fixed import surplus which induces a capital inflow rather than the other way around. This point is of great significance because in the former case the balance on current account improves automatically with a reduction or cessation of the capital inflow, while in the latter it does not, and will not until drastic direct action is taken by the responsible authorities to restore some kind of equilibrium.

The movements in gross national expenditure of a country do not affect each item of its current account proportionately. Depending on the effect of changes of gross national expenditure on each component, the items in the current account may be divided into

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(6). R.J. Ball, "Capital Imports and Economic Development: Paradoxy or Orthodoxy", Kyklos, Fasc 3, 1962, p. 619.

two parts: these may conveniently be called 'variable' items and 'fixed' items. The variable items consist of merchandise imports and exports, travel expenditure payments and receipts, and freight and shipping payments and receipts. The fixed items include investment income payments and receipts, inheritances, immigrants and emigrants funds, official contributions and other government transactions, and business services and other transactions.

The variable current expenditures abroad are affected by movements in gross national expenditure, increasing during periods of expansion and decreasing during periods of contraction. The level of gross national expenditure in turn is affected by capital inflows. The overall current payments abroad consist of the sum of variable current expenditures and fixed current payments. The size of the latter items is not directly related to the current gross national expenditure or for that matter, to the current capital inflows. In particular, investment income payments are determined by the volume of accumulated foreign investments, their profitability and the decisions of non-resident corporations as to what proportion of the total profits is to be remitted. They are also determined by the policies of the governments of both the investing and borrowing countries on matters of repatriation of investment income, the nature of foreign investment, i.e., whether in stocks or in bonds, and the proportion of branch profits to total profits of foreign investment.

While the level of gross national expenditure undoubtedly has some effect on the amount of profits earned in any particular year, remittances of investment income are not very sensitive to changes in gross national expenditure. Furthermore, in practice, the rates of remittances are not even directly related to changes in the earned profits. There is evidence that the amounts of dividends remitted may even fall in years in which total profits increase.(7) Other components of fixed payments are obviously unrelated to short-term changes in gross national expenditure. It is thus evident that the current total payments abroad will not vary directly with changes in gross national expenditures; indeed, they may move in the opposite direction.

The annual deficit on the current account of the Canadian balance of payments is not merely the excess of what Canadians bought abroad over what they sold abroad during the year. It also includes deficit on fixed current account. This deficit on fixed current account is not the excess of current expenditures over receipts incurred in buying goods and services abroad. In fact, it is the excess of payments over receipts which is determined by factors having little or nothing to do with the level of any particular year's gross national expenditure.

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(7). For instance, in 1950, dividends remitted and profits earned totalled $296 millions and $446 millions respectively, but dividends remitted totalled only $260 millions when profits earned increased to $595 million in 1955; see Table 14.

It is the variable current account balance and not the fixed current account balance which is influenced by the capital inflows. In other words, actually it is the fixed current account balance that shows the requirements of net total capital inflow in order to balance Canada's total external payments and receipts, assuming no changes in the monetary reserves and no adjustments in the variable current account balance. The factors, however, which determine the capital inflows, particularly long-term foreign investments, in any one year are quite unrelated to these requirements. They are related, of course, to general investment opportunities as seen by the investors. Thus, if the rate of inflow of new foreign capital was to fall, there would have to be a cutback in the variable current account deficit.

From Table 4 we may observe that there were deficits on variable current account for eight years. But in the remaining eight years, the variable current account shows surpluses despite the fact that there were large net capital inflows in seven out of these eight years. Furthermore, the deficit on variable current account, accounted for only 15.4% of the net total capital inflows during those eight years. In addition, over the 1950-1965 period as a whole the variable current deficit was only $269 million, or only 1.8% of the net total capital inflows.

In particular, Table 4 shows the dramatic difference between the period 1955-1960 and the period 1961-1965. In the earlier

TABLE 4

NET CAPOTAL MOVEMENTS AND CURRENT ACCOUNT DEFICITS, 1950-1965

(Millions of dollars)

Year	Net Total Capital Movements	Variable Current Account Deficits (1)	Fixed Current Account Deficits (2)	Total Current Account Deficits
1950	1041	202	-521	-319
1951	568	-10	-502	-512
1952	-150	577	-390	187
1953	410	-35	-413	-448
1954	548	46	-470	-424
1955	643	-194	-493	-687
1956	1420	-787	-585	-1372
1957	1346	-682	-769	-1451
1958	1246	-271	-866	-1137
1959	1476	-585	-902	-1487
1960	1194	-284	-949	-1233
1961	1218	93	-1021	-928
1962	985	210	1040	-830
1963	667	596	-1117	-521
1964	787	761	-1185	-424
1965	1287	94	-1224	-1130
Total	14,686	-269	-12447	-12716

(1) It is the sum total of merchandise exports and imports, travel expenditure receipts and payments, and freight and shipping receipts and payments.

(2) It is the net total of investment income payments and receipts, business services and other transactions, official contributions and other government transactions, personal and institutional remittances, inheritance and immigrants and emigrants funds.

Source: 'Compendium' pp. 94, 95, 97, 103-105, 107, 114; Tables 4. A1, 4. A4, 4.A6, 4.A3 to A11; 4.B1, 4. B4, 4. B6, 4. B4 to B11; 4. C4

'Quarterly IV, 1967', p. 22, Table 2

period, net capital inflows were large enough to cover the fixed current account deficit and to cause a substantial variable current account deficit in every year. These variable current account deficits in each year of this period may be attributed to the heavy net capital inflows during those years. In the subsequent period, however, though net capital inflows did not diminish substantially, the variable current account balance has become surplus in each year. This trend in the latter period is not consistent with the trend in the earlier period. Hence, the past experiences do not substantiate conclusively that variable current account deficits or for that matter, total current account deficits move each year corresponding to changes in the net capital inflows.

It is evident from Table 4 that the fixed current account deficits continue to increase year after year. Undoubtedly, this continuing increase resulted mainly from the growing foreign investment assets. This accelerating service charge payment on foreign investment seems to necessitate continued net capital inflows despite a continuing surplus on the variable current account between 1961 and 1965. This situation requires, if total current account is to be completely eliminated, a very substantial reduction in the value of imports and an increase in the value of exports in order to increase the variable current account surplus so as to completely offset the fixed current account deficit.

CHAPTER IV

DIRECT CAPITAL-FLOW EFFECT OF DIRECT INVESTMENT

We may now attempt to quantify variables which are relevant to the analysis of the direct capital-flow effect of direct investment in Canada. For convenience, this Chapter is divided into three sections. Section I deals with the growth of direct investment in Canada. The income payments to foreigners on direct investment in Canada is discussed in Section II, and Section III compares the annual and accumulated direct investment inflows and the annual and accumulated income payments on direct investment for the 1950-1965 period to determine the direct capital-flow effect of direct investment in Canada.

At the very outset a short description of the nature of the statistics which are going to be used here may be appropriate. We propose to depend mainly on the information provided by the Balance of Payments Division of the Dominion Bureau of Statistics, Ottawa.(1)

The definition of direct investment used by the DBS(2) includes the following categories:

(a) Branches of foreign enterprises, incorporated or unincorporated, i.e., including branches of foreign sole proprietorships and partnerships.

(b) Other unincorporated enterprises operating separately in Canada but owned by non-residents or in which non-residents are controlling partners.

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(1). For convenience, in the following this source will be cited as the 'DBS'.

(2). Canadian Balance of International Payments, 1961 and 1962 And International Investment Position, Dominion Bureau of Statistics, Ottawa, August, 1964, p. 96.

(c) Incorporated enterprises (such as subsidiaries) operating in Canada, in whose policies non-residents exercise an important voice.

(d) Commercial real estate owned by non-residents, if this category of direct investment enterprise does not take any of the forms mentioned above.

Thus the category of direct investments generally includes all concerns in Canada which are known to have 50 per cent or more of their voting stock held by the residents of any single foreign country. In addition, a few concerns are included where it is known that effective control is held by a non-resident parent firm with less than 50 per cent of the stock. In effect, this category includes all known cases of unincorporated branches of foreign companies in Canada, all wholly-owned subsidiaries and a number of concerns in which a parent company outside of Canada holds less than all of the capital stock but sufficient to exercise effective control. In addition, there is a small number of Canadian companies included where more than one-half of their capital stock is owned in a single country outside of Canada but where there is no parent concern. These exceptional cases are confined to instances where control is believed to rest with non-residents.(3)

In addition, we intend to utilize whatever statistical information is available from U.S. Balance of Payments Division, Washington(4), to supplement and to reinforce the conclusions that may be derived from the Canadian statistics. It is to be noted here that direct comparisons cannot be made between data published by the U.S., and the D.B.S., because the U.S. definition of direct investment is different from that of Canada, as is clear from the following definition of the concept of direct investment used by the U.S.

A Canadian corporation qualifies as U.S. direct investment if 25 per cent or more of its voting stock is owned by a U.S. resident or an affiliated group of residents. Analogous U.S. equity interest in an unincorporated Canadian enterprise is also classed as direct investment. Furthermore, U.S. investment in a Canadian corporation is considered direct investment if all the U.S. stockholders taken together

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(3). Canada's International Investment Position 1926-1954, op. cit., p. 24.

(4). This source will hereafter be cited as 'the U.S.'.

hold 50 per cent or more of its voting stock even when no affiliated group of them holds as much as 25 per cent. A Canadian enterprise in which a U.S. resident or group has equity ownership of between 10 and 25 per cent is classified as an associated foreign enterprise. This category of investment is really intermediate between direct and portfolio investment but investments of this kind have been few, and data on them have been included with direct investment data in the balance of payments. Furthermore, the concept of direct investment extends to foreign branches and subsidiaries of foreign affiliates if as much as 25 per cent of the equity of the secondary organization is owned indirectly by a U.S. parent.(5)

The basic definitions of direct investment used by Canada and the U.S. are similar but the U.S. statistics show a higher level of direct investment in Canada than do the Canadian statistics. In general, U.S. statistics cover all investments by U.S. residents in controlled companies, while the Canadian statistics cover only transactions of a long-term character with principal owners.(6)

I THE GROWTH OF DIRECT INVESTMENT

In this section we shall examine the inflow of direct investment and unremitted profits. These two together form the annual increase in direct investment. The annual increase in the book value of direct investment can be found by adjusting the annual increase in direct investment for factors such as revaluations, reclassifications and similar accounting adjustments. It is the book value of direct investment that shows the value of total direct investment assets in Canada which generate the income to be remitted abroad in different forms, or retained in Canada.

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(5). E.M. Bernstein, The Balance of Payments of the United States, The Review Committee for Balance of Payments Statistics, Washington, April 1965, p. 62.

(6). Canadian Balance of International Payments 1963, 1964 and 1965 and International Investment Position, Dominion Bureau of Statistics, Ottawa, August 1967, p. 49.

The concept of direct investment inflow followed in the Canadian balance of payments statistics is somewhat different from that used in estimating the data for the investment position.(7) While year-end estimates of the total value of direct investment inflow shown in the investment position include the total value of long-term investments in Canada owned by all residents of the country in which control lies, the figures shown as net direct investment inflow in the balance of payments statements cover only those of the controlling, affiliated, or principal owners.(8) The difference between the total value of direct investment inflow shown in the investment position and the net direct investment inflow shown in the balance of payments statement, is called "other factors". In the Canadian balance of payments statement, the "other factors" are, it seems, included in other long-term capital movements. Consequently, it is not possible to segregate the total annual direct investment inflow as shown in the investment position in the Canadian balance of payments statement.(9)

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(7). The investment position presents the estimates of Canada's assets abroad and foreign assets in Canada. The difference between them is described as the Canadian balance of international indebtedness.

(8). Canada's Balance of International Payments, 1961 and 1962 And International Investment Position, op. cit., p. 97.

(9). It may be said, therefore, that the compiling of statistics on direct investment in Canada is not balance of payments oriented. This deficiency means that the item net direct investment inflow in Canada shown in the balance of payments statement and the total annual direct investment inflow shown in the investment position cannot be directly reconciled even though a complete balance of payments statement is tripartite, including not only the current and capital accounts but a statement of its international investment position also. It would be desirable for purposes of clarity and consistency for this source to show total direct investment inflow as it is shown in the investment position in the balance of payments statement.

As we said above, the total net annual direct investment shown in the investment position consists of two constituents, that is, net capital inflow for direct investment and "other factors". The "other factors" include not only capital inflow but changes resulting from revaluations, reclassifications and similar accounting adjustments.(10) The published amount for "other factors" thus is an unreal number which can be either very much less or very much more than the actual capital inflow included in it because each of the accounting adjustments can be either positive or negative.

However, the DBS does publish an item called "other capital movements" from the U.S. for direct investment, in addition to the item net capital inflow for direct investment. The item "other capital movements" from the U.S. includes not only new issues, retirements, borrowing, investment abroad etc. affecting the total value of investment in Canada by American residents in U.S. controlled enterprises but also certain classification adjustments in respect of direct investment transactions representing significant investment in non-U.S. controlled enterprises.(11) However, while the item "other capital movements" from the U.S. does include an element of classification adjustment it does not cover revaluation, reclassifications and other accounting adjustments which are included in the item "other factors". But it does not appear possible to isolate the factor classification

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(10). Canadian Balance of International Payments 1963, 1964 and 1965 And International Investment Position, op. cit., p. 113.

(11). Ibid., p. 112.

adjustment included in the item "other capital movements". The net direct investment inflow from U.S. combined with "other capital movements" does add up to the published figure for total net direct investment inflow from the United States. It is suggested[12] that the financial structure, organization and home capital markets of the direct investment enterprises controlled by countries other than the United States, were such that "other capital movements" inflows from those countries would be relatively small. Accordingly, the amount shown "other capital movements" from the U.S. is taken as an approximate equivalent to the total "other capital movements" from all countries.

It should be clearly remembered that what is considered as total direct investment inflow in the official statistics does not necessarily mean that an equivalent amount of foreign exchange actually came to Canada. If a foreign principal ships goods and services to its affiliates in Canada on credit this is recorded as capital inflow, but no foreign exchange came to Canada. This is true also where the services of expert personnel on the payroll of a foreign parent company are lent to its affiliates in Canada for a period of time. The accumulated remunerations of these technical personnel, a portion of which is perhaps retained in the parent country, may be shown as a loan from the foreign principal, or may be paid for by giving equity interest in exchange for the skilled services. These two items and similar transactions really should be recorded separately

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(12). Letter to this writer from E.B. Carty, Director, Balance of Payments and Financial Flows Division, Dominion Bureau of Statistics, Ottawa, February 7, 1968.

as intercompany accounts. It is odd that Canada unlike many other countries,(13) does not show intercompany accounts which often form a major portion of the annual total direct investment inflow.

Again, in head office-branches relationships, branch profits are recorded as investment income transferred to the head office and any amount not actually repatriated to the head office is recorded as a capital inflow, although no foreign exchange, goods or services came to Canada. These non-repatriated branch profits have a similar effect on the foreign exchange inflow as do the unremitted profits of foreign subsidiaries. Hence, these amounts should be treated like unremitted profits. Similarly, parent companies may extend credit to their foreign subsidiaries in Canada to cover a dividend declared by the subsidiary, and this transaction also appears to be considered part of the total direct investmert inflow. This item also should be included with the unremitted profits instead of with direct investment inflow.

These discrepancies point up the fact that the amount shown as direct investment inflow may often be very much greater than the actual new capital inflow which came to Canada for direct investment. It is interesting to note that the DBS does not give any idea of the magnitude of the different constituents on the item called total direct investment inflow. All that one can do under these circumstances in a study like this is to accept, knowing these limitations, the amount

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(13). For instance, the United Kingdom and Mexico.

shown for direct investment inflow as equivalent to the sum of the inflow of foreign exchange and the value of goods and services imported from the parent country.

Direct Investment Inflow

The statistics in Table 5 show the annual net total direct investment flows into Canada from abroad from 1950 to 1965. This Table also gives the cumulative net total direct investment for each of the years in the 1950-1965 period. Annual net total direct investment as used here denotes annual gross direct investment minus annual disinvestment. It is evident from Table 5 that the annual net total direct investment does not show any definite trend, either up or down, over this period as it fluctuated from year to year. These fluctuations may have been caused by the economic policies and business conditions of the investing countries and/or of Canada. During the whole 1950 to 1965 period, there was a cumulative net total direct investment of $8,910 million in Canada by all investing countries. It should be clearly understood that this amount of $8,910 million is the total sum of capital associated with direct investment that came into Canada during the period under consideration. It comprised both money capital and goods and services. In other words, Canada has drawn $8,910 million as direct investment from foreign savers in order to supplement Canadian savings for investment. Or this means that direct investment contributed the equivalent of $8,910 million, taking associated imports as equivalent to foreign exchange, to Canada's foreign exchange earnings between 1950 and 1965.

TABLE 5

DIRECT INVESTMENT INFLOWS, CANADA, 1950-1965

A minus (-) indicates an outflow from Canada

(Millions of dollars)

Year	Net Direct Investment	Other Capital Movements(1)	Net Total Direct Investment	Cumulative Net Total Direct Investment
1950	225	17	242	242
1951	320	34	354	596
1952	360	135	495	1,091
1953	450	-3	447	1,538
1954	425	36	461	1,999
1955	445	63	508	2,507
1956	650	269	919	3,426
1957	545	241	786	4,212
1958	430	182	612	4,824
1959	570	109	679	5,503
1960	670	77	747	6,250
1961	560	257	817	7,067
1962	505	117	622	7,689
1963	280	52	332	8,021
1964	270	-66	204	8,225
1965	535	150(2)	685	8,910

(1) New issues, retirements, borrowing, investment abroad, etc. affecting the total value of investment in Canada by residents in U.S. controlled enterprises; also includes classification adjustments in respect of direct investment transactions representing significant investment in non-U.S. controlled enterprises.

(2) DBS estimate.

Source: 'Compendium', pp. 184 - 186, Tables 6.1 and 6.2
'Quarterly IV, 1967', p.22

TABLE 6

DIRECT INVESTMENT INFLOWS FROM OTHER COUNTRIES[1], CANADA, 1950-1965

(Millions of dollars)

Year	Net Direct Investment	Cumulative Net Direct Investment
1950	23	23
1951	44	67
1952	37	104
1953	93	197
1954	120	317
1955	128	445
1956	185	630
1957	142	772
1958	126	898
1959	142	1,040
1960	209	1,249
1961	194	1,443
1962	177	1,620
1963	60	1,680
1964	82	1,762
1965	114	1,876

(1) All countries except the U. S.

Source: See Table 5

The annual volume of net direct investment in Canada from all countries except the U.S. as shown in Table 6, also fluctuated from year to year. The total net direct investment for the whole period, 1950 to 1965, was $1,876 million. It should be borne in mind that this amount may be a little less than the actual net total direct investment made during the period because it is not possible to get figures for "other capital movements" from these countries. However, as was said earlier, the value of "other capital movements" from these countries seems to be very small. The cumulative net direct investment for fifteen years of $1,876 million by these other countries accounts for about 21 per cent of the aggregate net direct investment made in Canada by all foreign countries.

Similarly, the data in Table 7 show that annual net total direct investment from the U.S. also fluctuated. Over the 1950-1965 period the cumulative net total direct investment was $7,034 million, representing 79 per cent of the cumulative net total direct investment from all countries together.

Statistics in Table 8, from the U.S. source, show the total net direct investment that came from the U.S. to Canada between 1950 and 1965. Though the Canadian definition and the U.S. definition of direct investment are reportedly different, and it has been popularly believed that the U.S. definition of direct investment yields a higher level of direct investment in Canada than does the Canadian one, Table 8 shows a remarkable correspondence. Between 1950 and 1965 the cumulative total

TABLE 7

U.S. DIRECT INVESTMENT INFLOWS, CANADA, 1950-1965

A minus (-) indicates an outflow from Canada

(Millions of dollars)

Year	Net Direct Investment	Other Capital Movements (1)	Net Total Direct Investment	Cumulative Net Total Direct Investment
1950	202	-17	219	219
1951	276	34	310	529
1952	323	135	458	987
1953	357	-3	354	1,341
1954	305	36	341	1,682
1955	317	63	380	2,062
1956	465	269	734	2,796
1957	403	241	644	3,440
1958	304	182	486	3,926
1959	428	109	537	4,463
1960	461	77	538	5,001
1961	366	257	623	5,624
1962	328	117	445	6,069
1963	220	52	272	6,341
1964	188	-66	122	6,463
1965	421	150 (2)	571	7,034

Notes: See Table 5

Source: See Table 5

TABLE 8

U.S. DIRECT INVESTMENT INFLOWS, CANADA, 1950-1965

(Millions of dollars(1))

Year	Net Direct Investment	Cumulative Net Direct Investment
1950	313	313
1951	247	560
1952	421	981
1953	397	1,378
1954	397	1,775
1955	348	2,123
1956	591	2,714
1957	650	3,364
1958	409	3,773
1959	400	4,173
1960	437	4,610
1961	306	4,916
1962	336	5,252
1963	394	5,646
1964	273	5,919
1965	983	6,902

(1) U.S. dollars are converted into Canadian dollars using annual noon average rates given by the Bank of Canada.

Source: Balance of Payments, Statistical Supplement, Revised Edition, Office of Business Economics, Washington, 1963, pp. 178-182,184,186,208, 209, Tables 50, 51, 52, 57.
Survey of Current Business, Office of Business Economics, Washington, August 1962, p. 23, Table 3; August 1963, p. 19, Table 3; August 1964, p. 10, Table 3; September 1965, p. 25, Table 3; September 1966, p. 35, Table 6; September 1967, p. 43, Table 4;

direct investment inflow from the U.S., according to the Canadian definition, was $7,034 million, while the cumulative net capital outflow from the United States for direct investment in Canada, according to U.S. definition, was only $6,902 million, $132 million less.

Unremitted Profits

At the outset it may be mentioned that although it is now mid-1968 data on various constituents of direct investment in Canada for the year 1965 are still not available from the DBS. Among the items not available from this source are the unremitted profits, book value of investment, total earnings, allowance for witholding tax, etc. On the other hand, statistics on the various aspects of U.S. direct investment in Canada are available from the U.S. source right up to the year 1967. Therefore, it seems that the U.S. source requires only a one-year lag between the actual events and publication of statistical information about them while the Canadian source requires a three-year wait. This time lag is a serious handicap to Canadian policy makers who need up-to-date figures to formulate policies for the immediate future.

As no other reasonable basis could be found, the unremitted profits for 1965 have been estimated on the average ratios of unremitted profits to total dividends remitted for the five years, 1960-1964. As the total dividends remitted in 1965 are known, the unremitted profits for 1965 can be readily estimated by this method. This crudely estimated

figure looks reasonable when compared with the relationship between the volume of unremitted profits and dividends remitted to the U.S. by the U.S. affiliates in Canada for the year 1965, available from the U.S. source.

Annual unremitted profits also, as is shown in Table 9, do not show any particular trend over the 1950-1965 period as they fluctuated widely from year to year. Over the fifteen-year period, the cumulative unremitted profits totalled $5,204 million.

Unremitted profits of the subsidiaries are not shown separately for the U.S. or for any other country. The DBS does publish figures for the unremitted profits of the U.S. affiliates, but these include changes resulting from revaluations, reclassifications and other accounting adjustments. There is no way to isolate the actual volume of unremitted profits of the U.S. affiliates from these totals.

The annual unremitted profits of the U.S. subsidiaries shown in Table 10 are taken from the U.S. source. They also show wide variations from year to year. The accumulated total of unremitted profits of U.S. subsidiaries between 1950 and 1965 amounts to $5,648 million.

Increase in Direct Investment

Annual increases in direct investment stem from two main sources, i.e., annual total net direct investment and unremitted profits. Since both annual total net direct investment and annual unremitted profits have fluctuated widely during the period, the sum of these two,

TABLE 9

UNREMITTED PROFITS OF DIRECT INVESTMENT, CANADA 1950-1965

(Millions of dollars)

Year	Unremitted Profits	Cumulative Unremitted Profits
1950	150	150
1951	190	340
1952	295	635
1953	305	940
1954	280	1,220
1955	335	1,555
1956	400	1,955
1957	425	2,380
1958	235	2,615
1959	350	2,965
1960	280	3,245
1961	240	3,485
1962	305	3,790
1963	410	4,200
1964	455	4,655
1965	549[E]	5,204

E: Estimated

Source: 'Compendium' p. 186, Table 6.2

TABLE 10

UNREMITTED PROFITS OF U.S. AFFILIATES, CANADA 1950-1965

(Millions of dollars (1))

Year	Unremitted Profits	Cumulative Unremitted Profits
1950	159	159
1951	191	350
1952	234	584
1953	296	880
1954	267	1,147
1955	337	1,484
1956	434	1,918
1957	342	2,260
1958	271	2,531
1959	377	2,908
1960	377	3,285
1961	270	3,555
1962	397	3,952
1963	575	4,527
1964	539	5,066
1965	582	5,648

(1) U.S. dollars are converted into Canadian dollars using annual noon average rates given by the Bank of Canada.

Source: See Table 8 (U.S.).

TABLE 11

ANNUAL INCREASE IN DIRECT INVESTMENT, CANADA, 1950-1965

(Millions of dollars)

Year	Net Total Direct Investment	Unremitted Profits	Total Increase In Investment	Cumulative Total Increase In Investment
1950	242	150	392	392
1951	354	190	544	936
1952	495	295	790	1,726
1953	447	305	752	2,478
1954	461	280	741	3,219
1955	508	335	843	4,062
1956	919	400	1,319	5,381
1957	786	425	1,211	6,592
1958	612	235	847	7,439
1959	679	350	1,029	8,468
1960	747	280	1,027	9,495
1961	817	240	1,057	10,552
1962	622	305	927	11,479
1963	332	410	742	12,221
1964	204	455	659	12,880
1965	685	549[E]	1,234	14,114

E: Estimated

Source: See Tables 5 and 9

i.e., the annual increase in direct investment, also shows variations from year to year. This annual increase in direct investment in Canada from 1950 to 1965 is shown in Table 11.

The cumulative total increase in direct investment during the period 1950 to 1965 is $14,114 million. The total net direct investment portion accounted for 63 per cent and unremitted profits part for the remaining 37 per cent of the cumulative net increase in investment. The foreign ownership of Canadian resources would have been 37 per cent less in 1965 if the non-resident investors had repatriated their entire earned profits. And the profits earned by the foreigners in turn would have been considerably less because with direct investment less in each year, the capacity to generate profits through the compound rate effect would have been considerably lower by 1965. It should be noted that these non-resident investors are getting the higher profits created by plowing back unremitted profits not just for a year or two but indefinitely, or until the investment is repatriated.

At the end of 1949 direct investors owned Canadian assets valued at $3.6 billion,(14) but at the end of 1965, the value of the foreign direct investment assets had risen to $18 billion, an increase of $14,114 million. This means that during this fifteen-year period, foreign ownership of Canadian resources increased by about 400 per cent over the level at the beginning of this period. In other words, at the

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(14). The Canadian Balance of International Payments, 1961 and 1962 And International Investment Position, op. cit., p. 133, Table XIII.

beginning of 1950, direct investment in Canada was only one-fifth of its value at the end of 1965. This eighty per cent increase during the fifteen years resulted, as we have seen, from new direct investment which accounted for about 50 percentage points of the increase and unremitted profits which contributed the other 30 percentage points.

It is not possible to make a similar analysis to show how much the U.S. and other countries have shared in this increase in the foreign ownership of Canadian assets, as we do not have the figures for the unremitted profits of the U.S. and of other countries' affiliates in Canada. However, we can get an idea of how this increase was effected in the case of U.S. owned assets in Canada from the pertinent statistics published by the U.S.

The cumulative increase in total U.S. direct investment in Canada between 1950 and 1965 as shown in Table 12, is $12,550 million. This total comprises the cumulative increase in net direct investment, $6,902 million, and the cumulative increase in unremitted profits, $5,648 million. In other words, toward the accumulated increase of U.S. direct investment during this fifteen-year period, net direct investment and unremitted profits contributed about 55 and 45 percent, respectively. At the beginning of 1950, U.S. direct investors owned $3.2 billion worth of Canadian resources[15] while at the end of 1965

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(15). Balance of Payments Statistical Supplement, Office Business Economics, Washington, 1959, p. 185.

TABLE 12

ANNUAL INCREASE IN U.S. DIRECT INVESTMENT, CANADA, 1950-1965

(Millions of dollars)

Year	Net Direct Investment	Unremitted Profits	Total Increase In Investment	Cumulative Total Increase In Investment
1950	313	159	472	472
1951	247	191	438	910
1952	421	234	655	1,565
1953	397	296	693	2,258
1954	397	267	664	2,922
1955	348	337	685	3,607
1956	591	434	1,025	4,632
1957	650	342	992	5,624
1958	409	271	680	6,304
1959	400	377	777	7,081
1960	437	377	814	7,895
1961	306	270	576	8,471
1962	336	397	733	9,204
1963	394	575	969	10,173
1964	273	539	812	10,985
1965	983	582	1,565	12,550

Source: See tables 8 and 10, (U.S.)

their Canadian assets were worth $16 billion, or $12,550 million more. During this fifteen-year period, Canadian assets owned by the U.S. direct investors had increased by about 400 per cent from their 1950 level. In other words, at the beginning of 1950, U.S. direct investors owned only 20 per cent of the total assets they held at the end of 1965. Towards this 80 per cent increase shown in U.S. owned Canadian resources over these fifteen years, net direct investment from the U.S. contributed 44 percentage points and unremitted profits 36 percentage points. Compared with the other countries percentage-wise, the U.S. thus actually provided relatively less capital than other countries, since the increase in all foreign countries taken together of 80 per cent comprised 50 percentage points of new capital versus the 44 percentage points of new capital forming part of the 80 per cent increase shown by the U.S. direct investment during these fifteen years.

It should be borne in mind that it is the period 1950 to 1965 that the substantial increase in foreign ownership of Canadian resources has taken place. Much of this increase was due to the plowing back of profits earned right in Canada. In addition, by plowing back $5,204 million in unremitted profits, foreigners had created more permanent assets which will generate income indefinitely. Finally, during this period, Canada has received only a total of $8,910 million in <u>new</u> foreign capital to supplement its domestic saving for capital investment purposes.

II INCOME PAYMENTS ON DIRECT INVESTMENT

Income payments on direct investment consist of two main types of remittances, those covering (a) dividends and interest, and (b) royalties and fees.

Dividends and Interest Remitted

Dividends on direct investment include net profits earned by unincorporated branches of foreign companies in Canada as well as the dividends of Canadian subsidiaries and other companies controlled by the foreigners paid to non-resident shareholders. They do not include dividends paid by the same companies to shareholders residing in foreign countries other than the parent country as such payments are classified as dividends on portfolio placements. It should be noted that some significant amounts of dividends accruing to non-residents are not shown in the statistics of dividend payments as they are included in the "miscellaneous income account" of the item, "miscellaneous current transactions", mainly because the stock generating the dividends are held through intermediaries in Canada.(16)

As we know, direct investment usually involves only a little funded debt which entails a fixed return as interest. Interest payments which are included in the item "dividends and interest" remitted on direct investment are payments for the loans contracted by the foreign affiliates in Canada. Here also it should be noted that intercompany payments in the form of interest on funded debt appear in the interest

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(16). Canadian Balance of International Payments, 1959 and International Investment Position, Dominion Bureau of Statistics, Ottawa, 1960, p. 22.

item while interest on intercompany borrowings and other unfunded forms of debt are shown in "the miscellaneous income items" as part of the larger item "miscellaneous current transactions".(17) Thus since a part of the dividends and interest paid is not shown in the statistics of dividends and interest remitted, the available statistics on dividends and interest payments are not complete and always slightly understate the true total.

These dividends and interest remittances take different forms. They may be accomplished by the transfers of foreign exchange, i.e., by converting Canadian dollars into the investing country's currency, by movements of goods and services unaccompanied by any foreign exchange, or partly by the movement of foreign exchange and partly by the sending of goods and services. We do not have any information on what proportion of the remiited profits and interest is paid as foreign exchange and what proportion of it is transferred in the form of goods and services. This lack of information limits any analysis on the economic significance of the form taken by the remittance of earned income.

In Section I we have noted how capital inflow for direct investment is usually inflated by the practice of including retained branch profits and credit extended for a dividend declared, in the capital inflow for direct investment. These practices, as far as the profits and interest remittances are concerned, also inflate the actual

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(17). Ibid., p. 22.

remittances which have taken place because the amount of retained branch profits and the amount of credit extended for a dividend declared, are also considered as income outflows even though they do not leave Canada. All these limitations on available statistics should be kept in mind in assessing the findings of this study.

Dividends and interest payments are the most significant payments item on direct investment. The figures in Table 13 show the annual outflow of dividends and interest and the cumulative outflow of dividends and interest between 1950 and 1965. It is evident that at least since 1960 the annual outflow of dividends and interest has been increasing rapidly. In 1965 the dividends and interest paid on direct investment was about 128 per cent higher than the 1950 total. But it was also 122 per cent higher than the 1960 level. This rise in the outflow since 1960 represents a 17.2 per cent annual compound rate of increase. This rapid upsurge in the payments of dividends and interest may be significant for the future trend of the outflow of dividends and interest. The Table also points up another significant implication, namely that the size of the interest component has been declining steadily since 1954, so that the interest component in 1965 was only 44 per cent of what it was in 1953. Over the fifteen years the total interest paid comprised only 3 per cent of the total dividends and interest remitted abroad. In 1960 the amount of dividends paid abroad was $310 million while in 1965 it amounted to $696 million, representing an increase of about

TABLE 13

DIVIDENDS AND INTEREST REMITTANCE, CANADA, 1950-1965

(Millions of dollars)

Year	Dividends & Interest	Cumulative Dividends & Interest	Dividends	Cumulative Dividends	Interest	Cumulative Interest
1950	309	309	296[E]	296	13[E]	13
1951	272	581	258[E]	554	14[E]	27
1952	239	820	224[E]	778	15[E]	42
1953	217	1,037	201[E]	979	16[E]	58
1954	230	1,267	215[E]	1,194	15[E]	73
1955	274	1,541	260[E]	1,454	14[E]	87
1956	310	1,851	297[E]	1,751	13[E]	100
1957	340	2,191	328[E]	2,079	12[E]	112
1958	339	2,530	329	2,408	10	122
1959	365	2,895	356[E]	2,764	9[E]	131
1960	318	3,213	310	3,074	8	139
1961	396	3,609	388[E]	3,462	8[E]	147
1962	398	4,007	390	3,852	8	155
1963	424	4,431	417	4,269	7	162
1964	562	4,993	555	4,824	7	169
1965	703[(1)]	5,696	696[(1)]	5,520	7	176

(1) DBS estimate
E: Estimated.
Source: 'Compendium' p. 164 Table, 5.06; p. 172, Table 5.13

125 per cent and this increasing trend continued right up to 1965.

It should be noted that this increase in dividends payments was primarily due to the increase in total profits and not to a higher proportion of total earned profits being remitted. From Table 14, for example, we observe that the rate of remittance was the same in 1962 and 1965. Remitted profits, however, increased from $390 million in 1962 to $696 million in 1965. Thus the rate of remittance does not appear to bear a direct relationship to the amount of profits earned.

During the 1950-1965 period Canada paid $5,696 million as dividends and interest on direct investment, of this amount $5,520 million was dividends and $176 million was interest. The statistics in Table 15 show the amount of dividends and interest remitted to foreign countries other than the United States. For the entire period under consideration these other countries received $679 million as dividends and interest which represents 12 per cent of the total dividends and interest paid abroad on direct investment. Out of the $679 million total of dividends and interest payments only $14 million, or 2 per cent, was interest while the remaining $665 million, or 98 per cent, was dividends.

A major share of the total dividends and interest paid go to residents of the U.S., who own about 80 per cent of the total direct investment in Canada.(18) Canada sent $5,017 million (see Table 16) to the U.S. in dividends and interest on direct investment; this

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(18). See The Canadian Balance of International Payments, 1963, 1964 and 1965 And International Investment Position, op. cit., p. 123 Table 10.

TABLE 14

TOTAL PROFITS ON FOREIGN DIRECT INVESTMENT, CANADA, 1950-1965

(Millions of dollars and percentages)

Year	Dividends Remitted	Unremitted Profits	Total Profits	Ratio Of Dividends Remitted to Total Profits
1950	296	150	446	66
1951	258	190	448	58
1952	224	295	519	43
1953	201	305	506	40
1954	215	280	495	43
1955	260	335	595	44
1956	297	400	697	43
1957	328	425	753	44
1958	329	235	564	58
1959	356	350	706	50
1960	310	280	590	53
1961	388	240	628	62
1962	390	305	695	56
1963	417	410	827	50
1964	655	455	1,110	59
1965	696	549	1,245	56

Source: See Tables 9 and 13

TABLE 15

DIVIDENDS AND INTEREST PAID TO THE OTHER(1) COUNTRIES, CANADA, 1950-1965

(Millions of dollars)

Year	Dividends & Interest	Cumulative Dividends & Interest	Dividends	Cumulative Dividends	Interest	Cumulative Interest
1950	17	17	17	17	..	..
1951	14	31	13	30	1	1
1952	25	56	24	54	1	2
1953	20	76	18	72	2	4
1954	25	101	23	95	2	6
1955	31	132	29	124	2	8
1956	30	162	28	152	2	10
1957	33	195	32	184	1	11
1958	36	231	36	220	..	11
1959	45	276	45	265	..	11
1960	38	314	38	303	..	11
1961	46	360	45	348	1	12
1962	46	406	45	393	1	13
1963	52	458	52	445	..	13
1964	77	535	76	521	1	14
1965	144	679	144	665	..	14

(1) All countries except the U.S.

.. Nil

Source: See Table 13

TABLE 16

DIVIDENDS AND INTEREST REMITTED TO U.S., CANADA, 1950-1965

(Millions of dollars)

Year	Dividends & Interest	Cumulative Dividends & Interest	Dividends	Cumulative Dividends	Interest	Cumulative Interest
1950	292	292	279	279	13	13
1951	258	550	245E	524	13E	26
1952	214	764	200E	724	14E	40
1953	197	961	183	907	14	54
1954	205	1,166	192E	1,099	13E	67
1955	243	1,409	231E	1,330	12E	79
1956	280	1,689	269E	1,599	11E	90
1957	307	1,996	296E	1,895	11E	101
1958	303	2,299	293	2,188	10	111
1959	320	2,619	311E	2,499	9E	121
1960	280	2,899	272	2,771	8	129
1961	350	3,249	343E	3,114	7E	136
1962	352	3,601	345	3,459	7	143
1963	372	3,973	365	3,824	7	150
1964	485	4,458	479	4,303	6	156
1965	559(1)	5,017	552	4,855	6	162

(1) DBS estimate

E: Estimated

Source: 'Compendium', pp. 164, 174, Tables 5.06, 5.14

TABLE 17

DIVIDENDS AND INTEREST REMITTED TO U.S., CANADA, 1950-1965

(Millions of dollars)(1)

Year	Dividends & Interest	Cumulative Dividends & Interest
1950	320	320
1951	248	568
1952	218	786
1953	205	991
1954	232	1,223
1955	289	1,512
1956	321	1,833
1957	321	2,154
1958	306	2,460
1959	331	2,791
1960	350	3,141
1961	470	3,611
1962	509	4,120
1963	491	4,611
1964	684	5,295
1965	758	6,053

(1) U.S. dollars are converted into Canadian dollars using annual noon average rates given by the Bank of Canada.

Source: See Table 8 (U.S.)

represents about 88 per cent of the total paid abroad as dividends and interest over the 1950-1965 period. Of this total sent to the U.S. dividends on direct investment amounted to $4,855 million, representing 88 per cent of the total dividend payments. Since 1960, although there was not much increase in 1962 over 1961, the dividend payments to the U.S. have risen considerably, following the same trend shown by total dividend payments. The interest portion amounted to only $162 million, or 3 per cent of the total dividends and interest paid to the U.S. over this period. With 92 per cent of the total interest payments in contrast to the 88 per cent of total dividends payments, going to the U.S., relatively a slightly lower ratio of interest, i.e., 8 per cent compared to the dividends share of 12 per cent, has gone to countries other than the U.S.

The statistics in Table 17 showing the dividends and interest remitted by the U.S. subsidiaries in Canada to the U.S. from 1950 to 1965 are taken from the U.S. source. They show that since 1958 the dividends and interest remitted by the U.S. affiliates in Canada have been increasing steadily and, in 1965 they were 148 per cent higher than in 1958. This trend reinforces what was said earlier regarding the probably trend of dividends and interest payments abroad in the future. According to the U.S. source, U.S. affiliates in Canada remitted $6,053 million as dividends and interest during these fifteen years; this is $1,036 million greater than the dividends and interest total paid their parents by the U.S. affiliates in Canada according to the data provided by the DBS.

Royalties and Fees

This is the second component of the income payments on direct investment. The item "royalties and fees" includes remittances for royalties, patents, trade marks and trade names, rent on equipment, payments for management, technical, professional and administrative services, payments for research and development, payments for advertising and so on. Unfortunately, the DBS does not publish any information[19] on the details of these various payments which are associated with the direct investment. This important item of payments on direct investment is not even mentioned in the context of the international investment position or in the discussions on payments on direct investment. In the annual Canadian balance of international payments statements it seems this item is included along with many other miscellaneous items in "all other current payments". "The Canadian Balance of International Payment A Compendium of Statistics from 1946 to 1965" published by the DBS, shows the different constituents of the item called "all other current payments" from 1946 onward. But the item "royalties and fees payments on direct investment" is not shown separately even here, but it is included in the category entitled "business service and other transactions".

However, the Corporations and Labour Unions Returns Act (CALURA) Organization does collect and publish information on payments made as royalties and fees to non-residents since 1962 by the reporting

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(19). Once it is mentioned that in 1953 Canadian companies controlled abroad paid to non-residents over $90 million in business services, and those Canadian companies received about $15 million for similar services to non-residents, mainly from parent and affiliated companies; Canada's International Investment Position, 1926 - 1954, op. cit., p. 61.

corporations.[20] But CALURA Division does not show these items of payments associated exclusively with direct investment as defined by the DBS. This is because the CALURA concepts of foreign-owned corporations are different from those used by the DBS. Another technical problem is that the CALURA figures do not cover all foreign affiliates since all foreign controlled companies are not included in the survey. However, CALURA estimates these payments separately for enterprises which are controlled by foreign companies whose capital was over 50 per cent owned abroad. This more or less approximates the definition of direct investment adopted by the DBS.

In order to achieve full coverage, the amount of payments of royalties and fees made by the companies which are foreign controlled and whose capital was over 50 per cent owned abroad have been inflated on the basis of dividends payments. This was possible because CALURA also shows the dividends paid by those reporting companies abroad along with royalties and fees. The amount of royalties and fees shown by CALURA were inflated by the ratio of dividends reported by CALURA and by the DBS. By this method we were able to obtain the approximate amount of total of royalties and fees paid abroad on direct investment from 1962 to 1965. This procedure assumes that the ratios of dividends payments to the royalties and fees payments made by the foreign controlled

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(20). See Corporations and Labour Unions Returns Act, Report for 1963, Part I, Dominion Bureau of Statistics, February 1967.

companies included and excluded by CALURA are the same.

In order to get an approximate amount for royalties and fees on direct investment for the other years in this period, that is, from 1950 to 1961, the rate of change of the remittance of the royalties and fees during this period by the U.S. affiliates in Canada to their parent companies, published by the U.S., were combined with the estimated figures of royalties and fees payments provided by CALURA for 1962 to 1965. For example, the amount of royalties and fees paid to the non-residents controlled companies in 1962 was $224 million (the inflated CALURA figure) and this amount is multiplied by the ratio (0.82) of the amount of royalties paid by the U.S. affiliates in Canada to their parent companies in 1961 to that of 1962 (calculated from Table 21) as is shown in the U.S. source to get the amount of royalties and fees paid in 1961. This yields an estimated total amount of royalties and fees of $184 million for 1961. It is assumed here that the rate of change of royalties and fees paid abroad on direct investment from 1950 to 1961 is the same as the rate of change in royalties and fees paid by the U.S. affiliates in Canada (see Table 21) to their parent companies (published by the U.S.). One has to keep in mind that these are only estimates based on certain assumptions, as explained above, and which may involve errors if the assumptions do not hold. However, as Bagehot pointed out in his Economic Studies, "this abstract science (Economics) holds good only upon certain assumptions, but though the assumptions are often not entirely correct, the results may yet be approximately true".

The figures in Table 18 show the annual and the cumulative estimates of the royalties and fees on direct investment remitted abroad from 1950 to 1965, estimated by the procedure described above. Since 1953, the annual payments of royalties and fees have increased steadily year after year, reaching a total of $336 million in 1965, which is about 680 per cent greater than in 1950. This increase from $43 million in 1950 to $336 million in 1965 represents an average annual rise of 14.7 per cent. For the whole period from 1950 to 1965, $2,099 million were sent abroad from Canada as royalties and fees on direct investment. This $2,099 million is equivalent to about 29 per cent of the total dividends and interest paid abroad during this period. Since this item has been increasing steadily since 1953 and has maintained an average growth rate of 14.7 per cent between 1950 and 1965 it seems probable that it will continue to increase at a similar annual rate in the future.

In addition to the CALURA Reports, the DBS and the Department of Trade and Commerce jointly published "Foreign-owned Subsidiaries in Canada"(21), a report on the operations and the financing of the larger subsidiary companies based on information received by a survey.(22) This source provides some information on royalties and fees payments

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(21). Foreign-Owned Subsidiaries in Canada, known as "guide lines" or "Survey" first published in June 1967, gives information for 1964 and 1965. The second one, soon to be published, will show revised data for 1964 and 1965 and preliminary data for 1966.

(22). This publication, Foreign-Owned Subsidiaries in Canada, will be denoted by the word 'Survey' in the following pages.

TABLE 18

ESTIMATED (1) ROYALTIES AND FEES REMITTED, CANADA, 1950-1965

(Millions of dollars)

Year	Royalties & Fees	Cumulative Royalties & Fees
1950	43	43
1951	51	94
1952	58	152
1953	38	190
1954	53	243
1955	56	299
1956	80	379
1957	82	461
1958	84	545
1959	123	668
1960	151	819
1961	184	1,003
1962	224	1,227
1963	257	1,484
1964	279	1,763
1965	336	2,099

(1) Estimated on the basis of: information received from the CALURA Organization, Ottawa and the Balance of Payments Division, Department of Commerce, Washington.

since 1964. There are a few technical problems in relating the information on royalties and fees provided by this Survey with the statistics on other items provided by the DBS. First, the Survey definition of foreign control, i.e., a corporation is non-resident controlled if 50.1 per cent or more of its shares are controlled by non-residents, is somewhat different from the definition given by the DBS. Secondly, this Survey does not cover all the foreign-owned and foreign-controlled companies operating in Canada, but only a selected group including most of the large ones. Thirdly, and more importantly, Survey data go back to only 1964 and hence this source does not provide any information for the earlier years in the 1950-1965 period.

However, this Survey does provide some important information not available in the CALURA Reports. The Survey data show the royalties and fees paid to the U.S. and, to all other countries except the U.S., separately. The ratios of these payments to the U.S. to the total payments abroad works out at 92.3 per cent, 91.3 per cent and 91.5 per cent in 1964, 1965 and 1966 respectively.(23) This seems to be a fairly stable relationship and hence suitable for estimating the amount of royalties and fees paid going to the U.S. and to other countries. The method used here is to use the average percentage payments of these years to the estimated total payments of royalties and fees abroad (see Table 18) to obtain separate estimates of royalties and fees paid

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(23). These percentages are worked out from the revised and extended data published in the Survey. They are obtained from the Department of Trade and Commerce, Ottawa.

to the U.S. and to all other countries.

The figures in Table 19, estimated as explained above, show the annual and cumulative royalties and fees remitted to foreign countries other than the U.S. between 1950 and 1965. During this period, Canada paid $175 million in royalties and fees associated with direct investment to these countries. Similarly, Table 20 shows the estimates of the annual and cumulative payments of royalties and fees to the U.S. on U.S. direct investment in Canada. It shows that Canada paid to the U.S. $1,924 million as royalties and fees over the 1950-1965 period, or 92 per cent of the total royalties and fees payments abroad. This $1,924 million is equivalent to 38.3 per cent of the amount paid as dividends and interest on U.S. direct investment in Canada to the U.S.

The statistics in Table 21 show the royalties and fees remitted by the U.S. affiliates in Canada according to the U.S. source. It should be recognized that the amount of royalties and fees shown in this Table covers only the payments of U.S. affiliates to their parent companies in the U.S. During the fifteen year period from 1950 to 1965 the U.S. affiliates in Canada paid their U.S. principals $1,265 million as royalties and fees.

III DIRECT CAPITAL-FLOW EFFECT

The direct capital-flow effect can be defined as the net effect, either positive or negative, during a period of time on the foreign exchange reserves and on the capital mobilization for home investment of the capital inflow for direct investment. In other words, the capital-

TABLE 19

ESTIMATED ROYALTIES AND FEES PAID TO OTHER COUNTRIES,[1] CANADA, 1950-1965

(Millions of dollars)

Year	Royalties & Fees	Cumulative Royalties & Fees
1950	4	4
1951	4	8
1952	5	13
1953	3	16
1954	4	20
1955	5	25
1956	7	32
1957	7	39
1958	7	46
1959	10	56
1960	13	69
1961	15	84
1962	19	103
1963	21	124
1964	23	147
1965	28	175

(1) All countries except the U.S.

Source: See Table 18.

TABLE 20

ESTIMATED ROYALTIES AND FEES REMITTED TO U.S., CANADA, 1950-1965

(Millions of dollars)

Year	Royalties & Fees	Cumulative Royalties & Fees
1950	39	39
1951	47	86
1952	53	139
1953	35	174
1954	49	223
1955	51	274
1956	73	347
1957	75	422
1958	77	499
1959	113	612
1960	138	750
1961	169	919
1962	205	1124
1963	236	1360
1964	256	1616
1965	308	1924

Source: See Table 18.

TABLE 21

ROYALTIES AND FEES(1) PAYMENTS, CANADA, 1950-1965

(Millions of dollars(2))

Year	Royalties and Fees	Cumulative Royalties & Fees
1950	26	26
1951	31	57
1952	35	92
1953	23	115
1954	32	147
1955	34	181
1956	49	230
1957	50	280
1958	51	331
1959	75	406
1960	92	498
1961	112	610
1962	136	746
1963	145	891
1964	175	1066
1965	199	1265

(1) Excluding film rental

(2) U.S., dollars converted into Canadian dollars using annual noon average rates given by the Bank of Canada.

Source: Letter to this writer from Balance of Payments Division, Office of Business Economics, U.S. Department of Commerce, January 26, 1968.

flow effect, i.e., total direct investment inflow minus total income remitted on direct investment, will show how much of foreign exchange the host country has either gained or lost in overall terms as a result of the direct investment. It also provides information on the volume of net foreign capital associated with direct investment ir the host country available for domestic investment in that country. This information can be ascertained for individual years and/or for a number of years together. This direct capital-flow effect is crucially important for any host country because the basic reasons for attempting to attract direct investment are to supplement insufficient domestic savings of capital for investment, and to bolster the host country's foreign exchange resources to avoid or ease balance of payments difficulties.

In addition, in this section we will examine changes in the capacity of the host country to pay earnings on direct investment during this period. This is done by: (1) comparing the total payments on direct investment with export earnings to show the capacity to meet the investment income in terms of foreign exchange earned and (2) comparing the total payments on direct investment with gross national product to determine the volume of resources which would have been available for investment in the host country had there been no payments made on direct investment.

The statistics in Table 22 provide information on annual net total direct investment inflow, the sum of dividends, interest, royalties

TABLE 22

DIRECT CAPITAL-FLOW EFFECT OF DIRECT INVESTMENT, CANADA, 1950-1965

(Millions of dollars)

Year	Net Direct Investment	Cumulative Net Direct Investment	Dividends Interest Royalties & Fees Payments	Cumulative Dividends, Interest, Royalties & Fees Payments	Annual Difference Between Inflow Of Investment & Outflow Of Income	Cumulative Difference Between Inflow Of Investment & Outflow Of Income
1950	242	242	352	352	-110	-110
1951	354	596	323	675	31	-79
1952	495	1091	297	972	198	119
1952	447	1538	255	1227	192	311
1954	461	1999	283	1510	178	489
1955	508	2507	330	1840	178	667
1956	919	3426	390	2230	529	1196
1957	786	4212	422	2652	364	1560
1958	612	4824	423	3075	189	1749
1959	679	5503	488	3563	191	1940
1960	747	6250	569	4032	278	2218
1961	817	7067	580	4612	327	2455
1962	622	7689	622	5234	..	2455
1963	332	8021	681	5915	-349	2106
1964	204	8225	841	6756	-637	1469
1965	685	8910	1039	7795	-354	1115

.. Nil

Source: See Tables 5, 13 and 18

and fees payments, the annual difference between these two variables and the cumulative totals of all these items for the 1950-1965 period. Canada shows net gains in capital for domestic investment and in foreign exchange to increase the exchange reserves each year in the period between 1951 and 1961. But in 1950, 1963, 1964 and 1965 Canada paid more abroad than it received as foreign capital, while in 1962 payments and receipts were exactly equal. For the period 1950-1965, as a whole Canada paid abroad a total of $7,795 million as income on direct investment capital. This $8,910 million of direct investment received by Canada includes an element of classification adjustments in respect to direct investment transactions representing significant investment in non-U.S. controlled enterprises. There is no way of knowing how much this classification adjustment accounts for in the "other capital movements" total of $1,670 million. Perhaps, this contributes to making the cumulative net total direct investment of the U.S. in Canada shown by the DBS $132 million larger than the cumulative net total U.S. direct investment in Canada shown by the U.S., despite the fact that the U.S. definition of direct investment should yield the higher level for direct investment in Canada.

Turning to the difference between the total capital inflow for direct investment and the total income paid on direct investment between 1950 and 1965, it is evident from Table 22 that during these fifteen years Canada had a net gain of only $1,115 million. A part of this can be accounted for by the inclusion of accounting adjustments

shown in "other capital movements" total and to the incomplete coverage of dividends and interest paid on direct investment. It does show, however, that according to the DBS information, Canada received only something less than $1,115 million as net foreign capital to supplement her savings for domestic investment and to increase her foreign exchange reserves from direct investment, during the whole 1950-1965 period.

Table 23 shows the net gain of foreign capital through direct investment from all foreign countries other than the U.S. The data show that until 1962, Canada had an annual gain in foreign capital from these foreign countries, that is, the annual net inflow of direct investment from all countries except the U.S. was greater than the annual payments to these countries as income on direct investment. During the three years, 1963 to 1965, the annual payments of income exceeded the annual inflow of direct investment. For the period as a whole, Canada had a net gain of $1,022 million of foreign capital through the direct investment of these countries.

The statistics in Table 24 show the direct capital-flow effect of U.S. direct investment in Canada from 1950 to 1965. Each year from 1951 to 1961 Canada had a net gain of U.S. capital through U.S. direct investment, but in 1950 and again from 1962 to 1965, Canada's payments as income on U.S. direct investment exceeded the amount of U.S. direct investment coming to Canada. Over the whole 1950 to 1965 period, Canada had a gain of only $93 million from U.S.

TABLE 23

DIRECT CAPITAL-FLOW EFFECT OF DIRECT INVESTMENT OF OTHER COUNTRIES,(1) CANADA, 1950-1965

(Millions of dollars)

Year	Net Direct Investment	Cumulative Net Direct Investment	Dividends Interest Royalties & Fees Payments	Cumulative Dividends, Interest, Royalties & Fees Payments	Annual Difference Between Inflow of Investment & Outflow Of Income	Cumulative Difference Between Inflow Of Investment & Outflow of Income
1950	23	23	21	21	2	2
1951	44	67	18	39	26	28
1952	37	104	30	69	7	35
1953	93	197	23	92	70	105
1954	120	317	29	121	91	196
1955	128	445	36	157	92	288
1956	185	630	37	194	148	436
1957	142	772	40	234	102	538
1958	126	898	43	277	83	621
1959	142	1040	55	332	87	708
1960	209	1249	51	383	158	866
1961	194	1443	61	444	133	999
1962	177	1620	65	509	112	1111
1963	60	1680	73	582	-13	1098
1964	82	1762	100	682	-18	1080
1965	114	1876	172	854	-58	1022

(1) All countries except the U.S.

Source: See Tables 6, 15 and 19

TABLE 24

DIRECT CAPITAL-FLOW EFFECT OF U.S. DIRECT INVESTMENT, CANADA, 1950-1965

(Millions of dollars)

Year	Net Direct Investment	Cumulative Net Direct Investment	Dividends Interest Royalties & Fees Payments	Cumulative Dividends, Interest, Royalties & Fees Payments	Annual Difference Between Inflow Of Investment & Outflow Of Income	Cumulative Difference Between Inflow Of Investment & Outflow Of Income
1950	219	219	331	331	-112	-112
1951	310	529	305	636	5	-107
1952	458	987	267	903	191	84
1953	354	1341	232	1135	122	206
1954	341	1682	254	1389	87	293
1955	380	2062	294	1683	86	379
1956	734	2796	353	2036	381	760
1957	644	3440	382	2418	262	1022
1958	486	3926	380	2798	106	1128
1959	537	4463	433	3231	104	1232
1960	538	5001	418	3649	120	1352
1961	623	5624	519	4168	104	1456
1962	445	6069	557	4725	-112	1344
1963	272	6341	608	5333	-336	1008
1964	122	6463	741	6074	-619	389
1965	571	7034	867	6941	-296	93

Source: See Tables 7, 16 and 20.

direct investment, a very small contribution toward Canadian savings for investment and towards improving Canada's foreign exchange reserves. We have to keep in mind that the "other capital movements", one component of the total U.S. direct investment, includes an element of classification adjustment, as explained above. The inclusion of this factor definitely did affect the figure for the actual amount of capital movements.

Bearing this in mind, let us look at Table 25 taken from the U.S. source which shows the direct capital-flow effect of U.S. direct investment from 1950 to 1965. It shows that Canada had an annual gain only in the years between 1952 and 1958 and in 1965, while in every other year in the period, i.e., 1950, 1951 and 1959 to 1964 inclusive, Canada's remittances as income on direct investment exceeded the annual total of U.S. direct investment in Canada. More importantly, it shows that for the whole period of fifteen years Canada actually lost $416 million, net, that is, Canada paid out $7,318 million as income on U.S. direct investment to the U.S. while it received only $6,902 million as U.S. direct investment. In other words, in overall terms Canada was not able to utilize even a single dollar that came from the U.S. to increase total domestic investment or to supplement its foreign exchange resources. On the contrary, in addition to what it had received from the U.S. as direct investment, Canada had to draw down $416 million from its savings to meet its obligations to the U.S.

TABLE 25

DIRECT CAPITAL-FLOW EFFECT OF U.S. DIRECT INVESTMENT, CANADA, 1950-1965

(Millions of dollars)

Year	Net Direct Investment	Cumulative Net Direct Investment	Dividends Interest Royalties & Fees Payments	Cumulative Dividends, Interest, Royalties & Fees Payments	Annual Difference Between Inflow Of Investment & Outflow Of Income	Cumulative Difference Between Inflow Of Investment & Outflow Of Income
1950	313	313	346	346	-33	-33
1951	247	560	279	625	-32	-65
1952	421	981	253	875	168	103
1953	397	1378	288	1106	169	272
1954	397	1775	264	1370	133	405
1955	348	2123	323	1693	25	430
1956	591	2714	370	2063	221	651
1957	650	3364	371	2434	279	930
1958	409	3773	357	2791	52	982
1959	400	4173	406	3197	-6	976
1960	437	4610	442	3639	-5	971
1961	306	4916	582	4221	-276	695
1962	336	5252	645	4866	-309	386
1963	394	5646	636	5502	-242	144
1964	273	5919	859	6361	-586	-442
1965	983	6902	957	7318	26	-416

Source: See Tables 8, 17 and 21 (U.S.)

The statistics from the DBS source show that Canada had a net gain of $93 million of U.S. capital through U.S. direct investment, while the data in the U.S. source indicate that Canada lost about $416 million through U.S. direct investment. But if we take account of the fact that the royalties and fees payments reported by the U.S. source do not include royalties and fees paid by the U.S. affiliates in Canada to the companies or individuals other than their parents in the U.S., Canada would appear to have lost a little more than $416 million through U.S. direct investment in Canada. Even if this is ignored altogether, there is a difference of $509 million between the figures in the U.S. source and the DBS publication. This could be due to a number of reasons such as the DBS inclusion of an element of classification adjustments, and its incomplete coverage of dividends and interest earned by the direct investment as explained above, the errors which may be involved in estimating royalties and fees, the differences in the U.S. and in the Canadian definition of direct investment and so on. However, the U.S. statistics appear to be the more reliable since they have wider coverage and do not include any classification adjustments. For these reasons, it is preferable to use the figures in the U.S. source for drawing our conclusions.

Finally, let us see how Canada's capacity to earn foreign exchange has fared during the period, 1950 to 1965, taking account of the changes in the total income remitted on direct investment. In addition, it is interesting to note the changes in the ratios of income

remitted on direct investment to the gross national product, an index of the portion of Canadian resources that has been devoted to making payments on direct investment, and which could have been invested in Canada had it not been necessary to make these payments to non-residents.

Table 26 shows that the ratio of income remitted on direct investment to the total current account receipts (excluding mutual aid to NATO and inheritances and immigrants funds) has increased from 8.4 per cent in 1950 to 9.2 per cent in 1965. This ratio averaged 6.1 per cent during the first eight years, i.e., from 1950 to 1957, and went up to an average of 7.6 per cent during the last eight years, that is, from 1958 to 1965. These ratios reveal that Canada had to utilize a relatively greater part of her export earnings in 1965 than in 1950 to make direct investment income payments. In addition, the proportion of remitted income on direct investment to Canadian merchandise exports also increased slightly over the period, rising from 11.2 per cent in 1950 to 11.9 per cent in 1965. The average ratio of 1950 to 1957 also rose from 8.0 per cent to 9.8 per cent in 1958 to 1965. This means that a greater part of the revenue from Canadian produced goods sold abroad had to be set aside in 1965 than in 1950 for payments of income remitted on direct investment. Thus, these different indexes point up the same fact, that more of Canada's earnings of foreign exchange was utilized in 1965 than in 1950 to meet the payments of income on direct investment.

TABLE 26

RATIO OF CAPACITY TO PAY INCOME ON DIRECT INVESTMENT, CANADA, 1950-1965

(Percentages)

Year	Remitted Income To Current Account Receipts(1)	Remitted Income To Merchandise Exports	Remitted Income To Gross National Product	Earnings To Current Account Receipts(1)	Earnings To Merchandise Exports	Earnings To Gross National Product
1950	8.4	11.2	2.0	12.0	16.0	2.8
1951	6.4	8.2	1.5	10.1	13.0	2.4
1952	5.3	6.8	1.2	10.6	13.6	2.5
1953	4.7	6.1	1.0	10.4	13.5	2.2
1954	5.5	7.2	1.1	10.9	14.3	2.3
1955	5.7	7.6	1.2	11.5	15.4	2.5
1956	6.1	8.1	1.3	12.4	16.3	2.6
1957	6.6	8.6	1.3	13.2	17.3	2.7
1958	6.7	8.6	1.3	10.4	13.4	2.0
1959	7.3	9.5	1.4	12.5	16.3	2.4
1960	6.7	8.7	1.3	10.6	13.9	2.1
1961	7.5	9.8	1.5	10.7	13.7	2.2
1962	7.5	9.8	1.5	11.2	14.6	2.3
1963	7.5	9.7	1.6	11.9	15.6	2.5
1964	8.0	10.1	1.8	12.3	15.6	2.7
1965	9.2	11.9	2.0	14.1	18.1	3.0

(1) Total current account receipts excluding mutual aid to NATO and inheritance and immigrants funds

Source: 'Compendium', pp. 100, 102, Tables 4. A7 and 4. A12.
'Quarterly IV, 1967', pp. 22
Statistical Summary Supplement, Bank of Canada, Ottawa, 1966, pp.156-157
National Accounts Income and Expenditure, 1926-56, 1962, 1966, pp. 32 - 33, 26 and 28, Tables 13, 14 and 18

Another index, the proportion of gross national product required to pay the income remitted on direct investment, shows the proportion of the Canadian resources that had to be sent abroad because of direct investment in Canada. This ratio was 2 per cent in 1950, and declined to 1 per cent by 1953. Since then it has risen steadily and stood at 2 per cent in 1965. The average ratio during 1950 to 1953 of 1.4 per cent has gone up to 1.7 per cent in 1962-65. This means that during the last four years from 1962 to 1965, Canada has had to devote a higher proportion of its gross national product to payments of income on direct investment than during the period 1950 to 1953.

Another interesting feature apparent in Table 26 is the proportion of Canada's foreign exchange earnings and gross national product that would have had to be sent abroad if the foreign investors had remitted abroad all the income earned on direct investment, instead of keeping part of it in Canada as unremitted profits. The ratio of total earnings (after paying all taxes including withholding taxes) to the total current account receipts (excluding the mutual aid to NATO and inheritances and immigrant funds) rose from 12.0 per cent in 1950 to 14.1 per cent in 1965. This indicates that more than 14 per cent of Canada's total foreign exchange earning would have to have been used in making payments on direct investment if all the earnings on such investment had been remitted abroad. The ratio of earnings of direct investment to merchandise exports increased from 16.0 per cent in 1950

to 18.1 per cent in 1965. And the proportion of earnings on direct investment to gross national product also went up, rising from 2.8 per cent in 1950 to 3 per cent in 1965.

These indexes all show that Canada was paying a higher proportion of its foreign exchange earnings and gross national product to the foreigners as earned income on direct investment in 1965 than in earlier years of this period. Moreover, if the present U.S. policy, i.e., balance of payments guidelines which compel the U.S. residents with investments abroad to repatriate the entire amount of earned income, had been adopted by all other foreign countries with direct investments in Canada (and if Canada had not subsequently been exempted from the U.S. regulations), it would have taken 14.1 per cent of the total current account receipts and 3 per cent of the gross national product to meet the remittances on direct investment.

The above analysis does permit the drawing of a few conclusions on the direct capital-flow effect of direct investment in Canada.

1. Direct investment in Canada during the period between 1950 and 1965 contributed little foreign capital in overall terms to supplement domestic savings to increase overall investment or to supplement the foreign exchange resources.

2. Whatever net foreign capital Canada received through direct investment during this period came from countries other than the United States.

3. Canada did not gain any net U.S. capital for home investment or to meet foreign exchange requirements from the U.S. direct investment in Canada for the 1950-1965 period as a whole.

4. Canada's receipts of capital through U.S. direct investment have all gone to pay the income earned on U.S. direct investment in Canada which have rapidly increased (by approximately $11 billion) during this period, and there was actually a net capital outflow on direct investment account for the period as a whole.

5. With very little net capital inflow during the period of fifteen years, 1950-1965, foreigners have still acquired the ownership of additional Canadian resources worth $14,114 million which will generate more and more income in the future.

6. In 1965 Canada had to use a higher proportion of its foreign earnings in terms of both current account receipts and merchandise exports, and of its gross national product to meet the total income payments on direct investment than in 1950.

7. The ratios of total earnings, not only income payments, on direct investment to current account receipts, merchandise exports and gross national product, were all higher in 1965 than they were in 1950.

CHAPTER V

TRADE-EFFECT OF DIRECT INVESTMENT

It is only logical to assume that the functioning of foreign affiliates in Canada which are established by non-residents will create certain amounts of additional exports and imports which would not have taken place otherwise. The net trade-effect of direct investment, that is, the value of total direct and indirect exports plus the value of import displacement minus the value of complementary and other indirect imports created by the operations of foreign affiliates, may be a surplus or a deficit. As we said of the direct capital-flow effect of direct investment, the trade-effect of direct investment can also be estimated for any time period, either for individual years or for a number of years together.

Although we can itemize the different factors involved in estimating both the direct and the indirect trade-effects, it is almost impossible to quantify the variables involved because of the lack of statistical data. The quantification of the indirect trade-effect of direct investment would be, indeed, difficult even if statistics were available since it requires discretionary judgements. But even the basic data on the direct trade-effect are not available despite the fact that the collection of information on the exports and imports of foreign affiliates do not pose any formidable problem. Consequently we have neither full coverage for any year nor even incomplete coverage of any kind for a number of years, and any attempt to remedy these past shortcomings now involves serious problems. Hence, we propose in this Chapter to consider the trade-effect of direct investment in two ways

which do not exactly correspond to the direct and indirect trade approach set out in Chapter II. In Part I we draw upon whatever statistics that are available on the total exports and imports of foreign affiliates in Canada. These we may conveniently call the direct trade-effect, although some indirect trade-effects, as we have visualizaed earlier, are included in the total imports of foreign affiliates. We will discuss the overall pattern of Canadian exports and imports during the 1950-1965 period in Part II. Although, it is almost impossible to form conclusive judgements concerning the total relationship between direct investment and the pattern of external trade, we have no other means to make even the crudest quantitative assessment of indirect trade-effect of direct investment.

I DIRECT TRADE-EFFECT

The direct trade-effect can be estimated by deducting the value of the complementary imports which are essential to the functioning of the foreign affiliates from the amount of foreign exchange saved through the import displacement created through the production of foreign facilities, and the foreign exchange earned by their exports. It should be noted that the DBS does not collect information separately on the exports and the imports of foreign affiliates in Canada. However, the Foreign-Owned Subsidiaries in Canada (the Survey) presents information on the exports and imports of some foreign affiliates. Unfortunately, these data only commenced in 1964 and it is not possible to get any idea of the trade of these foreign affiliates prior to that year.

Furthermore, as we have noted earlier, this Survey does not cover all foreign affiliates. It only includes non-financial companies incorporated in Canada which have assets exceeding $5 million and whose voting shares are more than 50 per cent held by a non-resident corporation. The reporting corporations however, do account for a substantial proportion of the business conducted by all non-financial corporations in Canada more than 50 per cent foreign owned. This proportion was about 60 per cent for all industries and about 70 per cent for those engaged in manufacturing and mining operations. According to CALURA(1) there were about 4,500 reporting foreign-owned corporations in Canada in 1963 while the Survey covered only about 820 companies. It is known, however, that most of the foreign-owned corporations which are not covered in the Survey are very small in size, and are proportionately greater in the fields of utilities and merchandising.

The data provided by the Survey on the foreign trade of foreign-owned companies in Canada do not permit us to take account of the value of the import displacement caused by the production of these foreign facilities. Hence, the import displacement effect, theoretically a part of the direct trade-effect, cannot be discussed further in this Section, but is dealt with in overall terms in the next Section. Imports for resale with no processing, theoretically, should not be included in the direct trade-effect of direct investment since they are

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(1). Corporations and Labour Unions Returns Act Report For 1963, Part 1, op. cit., p. 20, Table IX.

not essential for the operations of the foreign affiliates. However, since the Survey shows only the total imports of foreign-controlled companies, we are compelled to include imports for resale.

The available data from the U.S. on the exports and imports of U.S. affiliates in Canada will be utilized in addition to the information available from the Survey. This U.S. source, however, gives comparable and consistent data on total imports and exports for only the U.S. manufacturing affiliates, and not all U.S. affiliates, in Canada and only for the three years, 1963-1965. This means that the data available from the U.S. source are also neither complete nor available for all the years in the 1950-1965 period.

As a result of the deficiencies mentioned above, all that this Section attempts to do is to see whether some qualitative and tentative generalizations can be made on the direct trade-effect of direct investment from the data that are available. The reader must bear in mind then that the tentative conclusions drawn here are based on incomplete and inadequate information. Furthermore, no attempt is made to estimate the exports and imports of foreign affiliates for the other years in the 1950-1965 period, because the available data are considered too unreliable and scanty for meaningful estimates.

The statistics in Table 27 show the annual and cumulative direct trade-effects of the reporting foreign-controlled companies for the years 1964, 1965 and 1966. In each of these three years the value of these imports from the U.S. exceeded the value of their exports to

TABLE 27

DIRECT TRADE EFFECT OF FOREIGN AFFILIATES REPORTING, CANADA, 1964-1966

(Millions of dollars)

	1964			1965			1966		
	U.S.	Others	Total	U.S.	Others	Total	U.S.	Others	Total
Export Sales To	1,753	1,105	2,858	1,961	1,115	3,076	2,692	1,165	3,857
Imports Purchase From	1,771	662	2,433	2,274	684	2,958	2,742	708	3,450
Balance of Trade	-18	443	425	-313	431	118	-50	457	407
Cumulative Export Sales To	1,753	1,105	2,858	3,714	2,220	5,934	6,406	3,385	9,791
Cumulative Import Purchase From	1,771	662	2,433	4,045	1,346	5,391	6,787	2,054	8,841
Cumulative Balance Of Trade	-18	443	425	-331	874	543	-381	1,331	950

Source: Revised and extended data published in Foreign-Owned Subsidiaries In Canada, obtained from Department of Trade and Commerce, Ottawa.

the U.S., and the cumulative deficit with the U.S. amounted to $381 million. These annual deficits with the U.S. were far exceeded by the trade surpluses earned in trading with all other foreign countries except the U.S. The cumulative overall trade surplus for the years 1964 to 1966 was $950 million. The annual trade surpluses earned with all countries except the U.S. remained almost unchanged during these three years at between $431 and $457 million and in each of these three years the value of the total exports to all countries exceeded the value of the total imports from all foreign countries. The question now is can this trend be accepted as (1) the probable general trend of the direct trade-effect of the whole direct investment during these three years, and (2) for the whole period under consideration, 1950-1965.

However, before we dwell on this question let us consider the data shown in Table 28 taken from the U.S. source. They show the direct trade-effect of U.S. manufacturing affiliates in Canada from 1962 to 1964. They indicate that the value of imports from the U.S. exceeded the value of exports to the U.S. of the U.S. manufacturing affiliates in each of the three years, 1962, 1963 and 1964. The annual deficit increased each year and the cumulative deficit for the three years was $2,691 million. It is interesting to note also that the value of the imports of U.S. manufacturing affiliates from the U.S. alone, exceeded the value of their total exports to all countries including the U.S. in each of these three years. The deficit incurred with all countries was greater in 1963 ($110 million) than the deficits in 1962 ($69 million)

TABLE 28

DIRECT TRADE EFFECT OF U.S. MANUFACTURING AFFILIATES, CANADA, 1962-1964

(Millions of dollars (1))

	1962	1963	1964
Imports From U.S.	1,774	2,001	2,290
Exports To U.S.	951	1,099	1,323
Balance of Trade With U.S.	-823	-901	-967
Cumulative Balance Of Trade With U.S.	-823	-1,724	-2,691
Exports To Other Countries	754	792	945
Total Exports	1,705	1,891	2,268
Balance of Trade	-69	-110	-22
Cumulative Balance of Trade	-69	-179	-201

(1) U.S. dollars are converted into Canadian dollars using annual noon average rates given by the Bank of Canada.

Source: The United States Balance of Payments, An Appraisal of U.S. Economic Strategy, International Economic Policy Association, Washington, 1966, pp. 28 - 31, 42 - 43, Tables IV 2, IV 3, IV 7.

and in 1964 ($22 million). The cumulative deficit of these U.S. affiliates from 1962 to 1964 thus amounts to $201 million. And this deficit would probably be greater if we could take account of the value of the imports of the U.S. manufacturing affiliates in Canada from foreign countries other than the U.S.

Now let us go back to the question whether we can accept the results shown by the Survey data as representing the overall trend of the exports and imports of foreign affiliates in Canada. First, it must be said that on many counts the trends shown in Table 27 cannot be considered representative of the external trade activities of the foreign affiliates in Canada, particularly in the early years of the 1950-1965 period. Among the reasons for this are that the Survey covers only less than one-fifth of the total number of foreign controlled companies. While these reporting companies do account for about 60 per cent of the business conducted by the non-financial corporations more than 50 per cent foreign-owned, this means that most of the non-reporting foreign-owned companies are very small. Also, what evidence is available indicates the smaller companies do not conform to the pattern of the large ones. This is because the large corporations are very specialized, technologically more advanced, far more competent in launching efficient and aggressive export promotion activities, better known in the outside world, favoured with relatively lower unit cost of production due to the economies of large scale, well equipped to produce better quality products, and

thus enjoy a better competitive position in international markets. Therefore, they have a greater comparative advantage in exporting their products compared with the small companies. Futhermore, the smaller companies are prone to import a higher proportion of their inputs(2) than the large corporations because the latter are frequently integrated both vertically and horizontally. Also, the large companies can import both the quantities and varieties of goods to exploit all the advantages of a buyer's market, while the small companies do not have this advantage. This means that imports of the small companies usually cost more per unit. In addition, the small companies, unlike the larger ones, are often more dependent upon their foreign parent companies for policy direction which is frequently more import-oriented.

Furthermore, a higher proportion (70 per cent) of mining companies are included in the Survey and Canadian mining companies are very much export-oriented(3) compared with manufacturing and utility companies, so it can be assumed that if all foreign-owned companies were covered, the ratio of exports to imports would be smaller than

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(2). See A.E. Safarian, op. cit., Chapter V.

(3). The Canadian mining industry, embracing the mining and preparation of metallic ores and concentrates, non-metallic minerals and fuels had a production value of close to $3.5 billion in 1966. In value terms, approximately one-half of the production was exported in ores, concentrates and other crude forms. Industrial Activity in Canada: Review and Outlook, Department of Trade and Commerce, Ottawa, November, 1967 (unpublished).

the one shown by the data on the selected companies covered by the Survey. Also, since the data in Table 28 show a different picture from those in Table 27, i.e., the U.S. manufacturing affiliates in Canada had imported from the U.S. alone more than they had exported to all foreign countries including the U.S. Thus, on account of all these reasons, we must conclude that the trend shown by the statistics in Table 27 is not representative. And finally, the data in the Survey may not be representative for the earlier years of the 1950 to 1965 period, because, as said earlier, in terms of a single investment the associated imports may well be substantial in the early years following the investment, but may taper off as the foreign affiliates become established and diversified. It should be noted that the ratio of new investment to the total value of existing direct investment is much smaller in each of the three years covered by the Survey than in the early years of the period of 1950-1965.

One feature common to both the Survey's data shown in Table 27 and to the data from the U.S. source shown in Table 28, is that the foreign affiliates in Canada always show a trade deficit with the U.S. The important question then is to what extent this deficit with the U.S. was offset by the trade surplus with other countries. The data shown by the Survey indicate that the deficit with the U.S. was more than offset by the trade surplus earned with foreign countries other than the U.S. On the other hand, Table 28 shows that the exports of the U.S. manufacturing affiliates to all countries other than the

U.S. were not enough to offset the excess of their imports over their exports to the U.S. And if we could include the value of the imports of U.S. manufacturing affiliates from foreign countries other than the U.S., the yearly and cumulative overall deficits would undoubtedly be larger still. And all that can be said in these circumstances is that we do not have adequate information in the light of the problems mentioned above, to generalize the indications provided by the Survey so as to arrive at any definite conclusion on the question of the direct trade-effect of foreign affiliates. Guessing on no firm basis is more dangerous than leaving the question unanswered. However, considering the qualifications and limitations of the Survey data including its incomplete coverage, compared with the data provided by the U.S. source, one could make the guess-estimate that the overall cumulative direct trade-effect of direct investment in Canada for the whole period, 1950-1965, would more likely be a deficit than a surplus.

II DIRECT INVESTMENT AND THE PATTERN OF TRADE

In this Section we will make an attempt to review the pattern of Canadian imports and exports so that we may be able to make a few general remarks on the extent of import substitution and export creation during the 1950-1965 period.

It is evident from Table 29 that the ratio of the value of the fuels and lubricants imported to the value of total merchandise imports has been declining steadily since 1950, and was only 7.3 per cent in 1965 compared with 15.8 per cent in 1950. Although the ratio

TABLE 29

RATIO OF EACH CLASSIFICATION TO TOTAL MERCHANDISE IMPORTS, CANADA, 1950-1965

(Percentages)

Year	Fuels & Lubricants	Industrial Materials	Investment Goods	Consumer Goods	Special Items	Total Imports
1950	15.8	32.1	22.5	29.2	0.4	100.0
1951	13.4	34.1	25.7	26.2	0.6	100.0
1952	12.8	29.0	30.7	26.6	0.9	100.0
1953	11.8	27.6	31.4	28.7	0.5	100.0
1954	11.5	26.8	30.7	30.1	0.9	100.0
1955	10.7	28.0	31.1	29.8	0.4	100.0
1956	10.1	27.7	33.6	28.1	0.5	100.0
1957	10.8	26.7	33.6	28.5	0.4	100.0
1958	9.9	26.5	31.0	32.1	0.5	100.0
1959	9.2	26.5	31.1	32.7	0.5	100.0
1960	8.7	26.5	31.6	33.4	0.8	100.0
1961	8.2	26.9	31.6	32.3	0.9	100.0
1962	7.8	27.6	31.7	32.0	0.9	100.0
1963	8.2	27.3	30.4	33.1	1.0	100.0
1964	7.3	27.8	31.6	30.5	2.8	100.0
1965	7.3	26.8	31.9	30.9	3.1	100.0

Source: Statistical Summary Supplement 1963, 1965 and 1966, Bank Canada, Ottawa, pp. 158-159, 156 and 158.

of the value of imported industrial materials to total merchandise imports fluctuated slightly during the period, the ratio was down to 26.8 per cent in 1965 versus 32.1 per cent in 1950. The ratio of imported investment goods to total merchandise imports rose from 22.5 per cent in 1950 to 31.9 per cent in 1965. The ratio of consumer goods imported to total merchandise imports also went up, rising from 29.2 per cent to 30.9 per cent over the period. Thus, in 1965 compared with 1950, a lesser proportion of Canadian imports were absorbed by two sectors (fuels and lubricants, and industrial materials) and a larger proportion by the other two sectors (investment goods and consumer goods).

Table 30 which shows the ratio of merchandise imports to gross national product, reveals that lower percentages of gross national product were devoted to both imported fuels and lubricants, and industrial materials, in 1965 than in 1950, while a greater percentage was spent on imported investment goods. The portion of gross national product going for imports of consumer goods remained unchanged. This Table also shows that in overall terms, there has not been much change in the proportion of the gross national product devoted to total imports, over the 1950-1965 period. More specifically, the ratio of total merchandise imports to gross national product has fallen slightly, from 17.4 per cent in 1950 to 16.6 per cent in 1965, an insignificant decline considering the time period and the increase in the absolute figures involved. Furthermore, this ratio has been rising since 1963 while no trend, either falling or rising, was evident prior to 1963. This is interesting

TABLE 30

RATIO OF MERCHANDISE IMPORTS TO GROSS NATIONAL PRODUCT, CANADA, 1950-1965

(Percentages)

Year	Fuels & Lubricants	Industrial Materials	Investment Goods	Consumer Goods	Special Items	Total Imports
1950	2.7	5.6	3.9	5.1	0.1	17.4
1951	2.5	6.4	4.9	5.0	0.1	18.9
1952	2.1	4.7	5.0	4.3	0.2	16.3
1953	2.0	4.7	5.3	4.9	0.1	17.0
1954	1.8	4.3	4.9	4.8	0.1	15.9
1955	1.8	4.7	5.2	5.0	0.1	16.8
1956	1.8	5.0	6.1	5.1	0.1	18.1
1957	1.8	4.6	5.8	4.9	0.1	17.2
1958	1.5	4.1	4.8	4.9	0.1	15.4
1959	1.5	4.2	4.9	5.2	0.1	15.9
1960	1.3	4.0	4.6	5.1	0.1	15.1
196.	1.3	4.1	4.9	5.0	0.1	15.4
1962	1.2	4.3	4.9	4.9	0.2	15.5
1963	1.2	4.1	4.6	5.0	0.2	15.1
1964	1.1	4.4	5.0	4.8	0.5	15.8
1965	1.2	4.5	5.3	5.1	0.5	16.6

Source: National Accounts Income and Expenditures, 1926 - 1956, 1962, 1966, Op. Cit., pp. 32-33, 26, 18, Table 2; and see Table 29.

in view of a statement made by Professor B. Wilkinson in his book[4] that 'We observed in the preceding chapter that there has been a long-run decline in imports relative to GNE (all in current prices), which has continued up to the present'. The statistics (all in current prices) shown in Table 30 which pertain to a slightly longer period do not support the above statement which pertain to the 1953-1963 period.

One can argue that the domestic demand for goods and not the gross national product should be related to the total merchandise imports because the gross national product includes services as well as goods. The data in Table 31, which show the ratio of merchandise imports to the total Canadian domestic demand for goods between 1950 and 1965, also support the findings described above. They reveal that the proportion of fuel and lubricants imported to the total domestic demand for goods has fallen from 3 per cent in 1950 to 1.4 per cent in 1965 and that the ratio of industrial materials imported to the total domestic demand for goods has gone down from 6.2 per cent in 1950 to 5.2 per cent in 1965. This Table also shows that investment goods and consumer goods imported to the total domestic demand for goods has risen from 4.3 per cent and 5.6 per cent in 1950, to 6.2 per cent and 6 per cent in 1965, respectively. More importantly, the ratio of total merchandise imports to total domestic demand for goods is shown

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(4). B.W. Wilkinson, Canada's International Trade: An Analysis of Recent Trends and Patterns, Canadian Trade Committee, Montreal, 1968, p. 19.

TABLE 31

RATIO OF MERCHANDISE IMPORTS TO TOTAL DOMESTIC DEMAND FOR GOODS, CANADA, 1950-1965

(Percentages)

Year	Fuel Lubricants	Industrial Materials	Investment Goods	Consumer Goods	Special Items	Total Imports
1950	3.0	6.2	4.3	5.6	0.1	19.2
1951	2.7	7.0	5.2	5.4	0.1	20.4
1952	2.4	5.4	5.7	5.0	0.2	18.7
1953	2.2	5.3	5.9	5.4	0.1	18.9
1954	2.1	4.9	5.7	5.5	0.2	18.4
1955	2.1	5.3	5.9	5.7	0.1	19.1
1956	2.0	5.4	6.6	5.5	0.1	19.6
1957	2.0	5.0	6.3	5.4	0.1	18.8
1958	1.8	4.7	5.5	5.7	0.1	17.8
1959	1.7	4.8	5.6	5.9	0.1	18.1
1960	1.6	4.8	5.5	6.0	0.2	18.1
1961	1.5	4.9	5.8	6.0	0.2	18.4
1962	1.5	5.2	6.0	6.0	0.2	18.9
1963	1.5	5.1	5.7	6.2	0.2	18.7
1964	1.4	5.3	6.0	5.8	0.6	19.1
1965	1.4	5.2	6.2	6.0	0.6	19.4

Source: National Accounts Income and Expenditure, 1926-1965, 1962, 1966, op. cit., pp. 32-33, 42-43, 82-83, 88-89, 26, 31, 54, 58, 18, 23, 46, 47, Tables 2, 10, 43, 47; and see Table 29.

to have increased somewhat from 19.2 per cent in 1950 to 19.6 per cent in 1965.

The data in Table 32 pertain to another index, i.e., the ratio of merchandise imports to domestic demand for domestically-produced goods during the 1950-1965 period. This index shows the change in the proportions of imported goods absorbed by different sectors to the total Canadian demand for goods. This Table indicates that the percentage share of imported fuel and lubricants has gone down substantially during the period, with the Canadian economy depending upon imported fuels and lubricants for 3.8 per cent of the total domestically consumed goods in 1950, and for only 1.7 per cent of the total in 1965. In 1950 Canada's consumption of imported industrial materials comprised 7.6 per cent of total consumption of goods, but in 1965 Canada utilized a slightly smaller proportion of imported industrial materials, i.e., 6.5 per cent. In the case of both investment goods and consumers goods the ratio of consumption of foreign-produced goods to total demand for goods was higher in 1965 than in 1950. In the investment sector, this ratio was 5.3 per cent in 1950 while in 1965 it was 7.7 per cent. Similarly, in the consumption sector, this proportion was 6.9 per cent in 1950 and in 1965 it increased to 7.4 per cent. Finally, the proportions of total foreign goods and total home-produced goods utilized were 23.7 per cent and 76.3 per cent respectively, in 1950 and 24.1 per cent and 75.9 per cent respectively, in 1965.

TABLE 32

RATIO OF MERCHANDISE IMPORTS TO DOMESTIC DEMAND FOR DOMESTICALLY-PRODUCED GOODS, CANADA, 1950-1965

(Percentages)

Year	Fuel & Lubricants	Industrial Materials	Investment Goods	Consumer Goods	Special Items	Total Imports
1950	3.8	7.6	5.3	6.9	0.1	23.7
1951	3.4	8.8	6.6	6.7	0.2	25.7
1952	3.0	6.6	7.0	6.1	0.2	22.9
1953	2.7	6.4	7.3	6.8	0.1	23.3
1954	2.6	6.0	6.9	6.8	0.2	22.5
1955	2.5	6.6	7.4	7.0	0.1	23.6
1956	2.5	6.7	8.2	6.8	0.1	24.3
1957	2.5	6.2	7.8	6.6	0.1	23.2
1958	2.1	5.7	6.7	6.9	0.1	21.5
1959	2.0	5.9	6.9	7.3	0.1	22.2
1960	1.9	5.8	6.7	7.3	0.2	21.9
1961	1.9	6.1	7.1	7.3	0.2	22.6
1962	1.8	6.4	7.3	7.4	0.2	23.1
1963	1.9	6.3	7.0	7.6	0.2	23.0
1964	1.7	6.5	7.4	7.2	0.7	23.5
1965	1.7	6.5	7.7	7.4	0.8	24.1

Source: See Table 31

It is evident from the above analysis that substantial import substitution has taken place in one sector of the economy, i.e., fuel and lubricants, and a moderate import displacement has occurred in the sector of industrial materials. But in the other two sectors, i.e., investment goods and consumer goods, where higher a degrees of processing is required, there was more import creation than import substitution. As a result, whatever import substitution took place in the less advanced two sectors was more than offset by import creation in the advanced sectors. Thus, it appears that though direct investment in Canada increased by 400 per cent during the period 1950 to 1965, it has not created any overall import displacement in the national economy. It implies further that Canada has to stress more development in these advanced sectors which are at present the most active in import creation.

Now let us see how the pattern of Canadian merchandise exports has changed during the 1950-1965 period. The statistics in Table 33 indicate that there was a fair amount of change in the composition of exports during this period. The significance of primary products, i.e., farm and fish products and forest products, in total exports declined considerably between 1950 and 1965. The proportion of these primary products exports to total merchandise exports fell from 64.8 per cent in 1950 to 43.8 per cent in 1965. The item metals and minerals on the other hand, has captured a higher share of total exports, rising from 19.3 per cent of the 1950 total to 30.6 per cent of that of 1965. Similarly, the item 'other manufactured goods and miscellaneous products'

TABLE 33

RATIO OF EACH GROUP OF EXPORTS TO TOTAL MERCHANDISE EXPORTS, CANADA, 1950-1965

(Percentages)

Year	Farm & Fish Products	Forest Products	Metal & Minerals	Chemicals & Fertilizers	Other Manufactured Goods & Misc.	Re-Exports	Total Exports
1950	29.7	35.1	19.3	3.0	11.7	1.2	100.0
1951	29.1	34.9	19.4	3.3	12.0	1.3	100.0
1952	30.6	31.4	21.3	2.9	12.5	1.3	100.0
1953	30.3	30.9	21.8	3.3	12.4	1.3	100.0
1954	25.1	34.8	23.3	3.9	11.2	1.7	100.0
1955	21.2	34.7	28.3	4.2	9.9	1.7	100.0
1956	23.2	30.9	30.4	3.8	10.1	1.6	100.0
1957	20.7	29.7	32.7	4.0	10.9	2.0	100.0
1958	23.9	28.8	29.4	4.0	11.7	2.2	100.0
1959	21.2	29.4	32.2	3.9	10.9	2.4	100.0
1960	18.9	29.4	33.7	4.4	11.1	2.5	100.0
1961	22.0	27.5	31.5	4.3	12.2	2.5	100.0
1962	19.9	26.8	32.4	3.9	14.2	2.8	100.0
1963	21.0	26.1	31.0	3.8	15.4	2.7	100.0
1964	22.2	24.2	30.0	3.7	17.4	2.5	100.0
1965	19.8	24.0	30.6	3.8	19.0	2.8	100.0

Source: Statistical Summary, Supplement 1966

Bank of Canada, Ottawa, pp. 156-157

has increased its share in the total exports considerably, rising from 11.7 per cent in 1950 to 19.0 per cent in 1965. The item 'chemicals and fertilizers' has shown a small increase up from 3 per cent in 1950 to 3.8 per cent in 1965. Although there has been a considerable structural change in the composition of Canada exports during the period, in 1965 the share of primary products and metals and minerals together still accounted for 74.4 per cent of total exports, and the manufactured goods including the miscellaneous products for only 22.8 per cent, or less than one-fourth of the total.

The statistics in Table 34 show the ratios of merchandise exports to gross national product from 1950 to 1965. It is interesting to note that the ratio of merchandise exports to the gross national product has fallen from 17.4 per cent in 1950 to 16.8 per cent in 1965. Even if we take three years' averages (1950-1952) at the beginning and three years' averages (1963-1965) at the end of the period, instead of comparing the first year (1950) in the period under consideration with the last year (1965) the proportion of merchandise exports to the gross national product still show a decline, falling from 18.0 per cent (1950-1952) to 16.8 per cent (1963-1965). This means that Canada was actually exporting a lower proportion of its gross national product at the end of the period under consideration than at its beginning.

TABLE 34

RATIO OF MERCHANDISE EXPORTS TO GROSS NATIONAL PRODUCT, CANADA, 1950-1965

(Percentages)

Year	Farm & Fish Products	Forest Products	Metals & Minerals	Chemicals & Fertilizers	Other Manufactured Goods & Misc.	Re-Exports	Total Exports
1950	5.2	6.1	3.4	0.5	2.0	0.2	17.4
1951	5.4	6.5	3.6	0.6	2.3	0.2	18.6
1952	5.6	5.7	3.8	0.5	2.3	0.2	18.1
1953	5.0	5.1	3.6	0.6	2.1	0.2	16.6
1954	4.0	5.5	3.7	0.6	1.8	0.2	15.8
1955	3.4	5.5	4.5	0.7	1.6	0.3	16.0
1956	3.7	4.9	4.8	0.6	1.6	0.3	15.9
1957	3.2	4.5	5.0	0.6	1.7	0.3	15.3
1958	3.6	4.3	4.4	0.6	1.7	0.3	14.9
1959	3.1	4.3	4.8	0.6	1.6	0.4	14.8
1960	2.8	4.4	5.0	0.7	1.6	0.4	14.9
1961	3.5	4.3	5.0	0.7	1.9	0.4	15.8
1962	3.1	4.2	5.1	0.6	2.2	0.4	15.6
1963	3.4	4.2	5.0	0.6	2.5	0.4	16.1
1964	3.9	4.2	5.3	0.7	3.0	0.4	17.5
1965	3.3	4.0	5.1	0.7	3.2	0.5	16.8

Source: See Tables 31 and 33

The data in Table 35, showing the ratio of merchandise exports to the total domestic supply of goods from 1950 to 1965, reveal that the proportion of total domestic supply of goods exported almost follows the trend shown by the ratio of merchandise exports to the gross national product. The proportion of the total domestic supply of goods exported went up slightly from 21.3 per cent in 1950 to 21.8 per cent in 1965. But the average ratio of the first and last three years of this period has gone down from 22.8 per cent to 22.0 per cent. As the average comparison is likely to be more reliable than just end years comparison, it can be stated that the proportion of the domestic supply of goods exported has also fallen during the period under consideration.

Thus these two indexes, the ratio of merchandise exports to the gross national product and the ratio of merchandise exports to the total domestic supply of goods, reveal that Canada has not improved its export performance in overall terms over the 1950-1965 period. In this context it may be interesting to look at the Canadian performance relative to the world and the industrial countries' performances. The data shown in Table 36 show that Canada's performance relative to world performance in the exports of goods has declined over the period being considered. So also has the ratio of Canadian exports to the export of industrial countries. The drop in Canada's share of the exports of the industrial countries was fairly substantial, i.e., from 9.26 per cent in 1950 to only 7.21 per cent in 1965.

TABLE 35

RATIO OF MERCHANDISE EXPORTS TO TOTAL DOMESTIC SUPPLY OF GOODS, CANADA, 1950-1965

(Percentage)

Year	Farm & Fish Products	Forest Products	Metals & Minerals	Chemicals & Fertilizers	Other Manufactured Goods & Misc.	Re-Exports	Total Export
1950	6.3	7.5	4.1	0.6	3.5	0.3	21.3
1951	7.1	8.4	4.7	0.8	2.9	0.3	24.2
1952	6.8	7.0	4.7	0.6	2.8	0.3	22.2
1953	5.9	6.0	4.2	0.6	2.4	0.3	19.4
1954	4.4	6.1	4.1	0.7	2.0	0.3	17.6
1955	4.2	7.0	5.7	0.9	2.0	0.3	20.1
1956	4.7	6.3	6.2	0.8	2.1	0.3	20.4
1957	3.7	5.2	5.8	0.7	1.9	0.4	17.7
1958	4.1	4.9	5.1	0.7	2.0	0.4	17.2
1959	3.9	5.3	5.8	0.7	2.0	0.4	18.1
1960	3.4	5.3	6.0	0.8	2.0	0.5	18.0
1961	4.3	5.3	6.1	0.8	2.4	0.5	19.4
1962	4.0	5.4	6.5	0.8	2.9	0.6	20.2
1963	4.4	5.4	6.5	0.8	3.2	0.6	20.9
1964	5.2	5.6	7.0	0.9	4.0	0.6	23.3
1965	4.3	5.2	6.7	0.8	4.2	0.6	21.8

Source: See Tables 31 and 33

TABLE 36

RATIOS OF CANADIAN EXPORTS TO WORLD EXPORTS AND EXPORTS OF THE INDUSTRIAL COUNTRIES (1), 1950-1965

(Percentages)

Year	Canadian Exports As % Of World Exports-	Canadian Exports As % Of The Exports Of Industrial Countries
1950	5.58	9.26
1951	5.37	8.63
1952	6.55	10.02
1953	6.23	9.57
1954	5.78	8.86
1955	5.73	8.70
1956	5.67	8.40
1957	5.44	7.93
1958	5.69	8.29
1959	5.63	8.21
1960	5.18	7.40
1961	5.19	7.34
1962	5.02	7.12
1963	5.01	7.11
1964	5.31	7.47
1965	5.18	7.21

(1) Industrial countries comprise the U.S.A., the U.K., industrial Europe, Canada and Japan.

Source: International Financial Statistics, Supplement to 1966/67 Issue, International Monetary Fund, Washington, D.C., pp.XVI-XIX

Thus, Tables 34, 35 and 36 all indicate that Canada had not shown any improvement in her export performance during the period 1950-1965 and that its competitive position has actually worsened. This is a serious problem for a country like Canada whose dependence on international commercial transactions, both trade and capital movements, is very high. This is even more serious, considered in the light of the probable future trend of rising profit remittances abroad by foreign-controlled companies operating in Canada. The fact that despite an increase of 400 per cent in direct investment in Canada over the 1950-1965 period, Canada has not been able to increase its share of world exports or improve its international competitive position, is a cause for concern. However, it is likely that the large amounts of direct investment received during this period have contributed to Canada faring as well as it has in view of the great changes that have taken place in world exports since 1950.

It is evident from Table 37 that Japan and industrial continental Europe, achieved a significant increase in their share of world exports over the 1950-1965 period. At the same time the shares of the U.S.A., and the U.K. in total world exports declined considerably. This had happened because certain countries, particularly West Germany, Italy, and Japan, devastated by World War II have regained their competitive position following the re-building of their economies. In this respect the year 1950, i.e., a pre-recovery year, is not suitable as a base year to compare the changes in the competitive position of

TABLE 37

THE RATIOS OF EXPORTS OF SELECTED COUNTRIES TO WORLD EXPORTS, SELECTED YEARS, 1950-1965

(Percentages)

Ratios Of:	1950	1951	1957	1958	1964	1965
U.S. Exports To World Exports	18.6	20.1	21.0	18.9	17.5	16.6
U.K. Exports To World Exports	11.5	10.1	9.9	10.0	8.4	8.3
Industrial Europe's To World Exports	23.0	24.9	29.4	30.9	35.4	36.6
Exports Of France To World Exports	5.5	5.5	5.1	5.4	5.9	6.1
Exports Of Germany To World Exports	3.6	4.6	8.6	9.3	10.7	10.9
Exports Of Italy To World Exports	2.2	2.2	2.6	2.7	3.9	4.4
Exports Of Japan To World Exports	1.5	1.8	2.9	3.0	4.4	5.1
Exports Of Australia To World Exports	3.0	2.7	2.2	1.8	2.0	1.8
Exports Of Canada To World Exports	5.6	5.4	5.4	5.7	5.3	5.2

Source: See Table 36

various countries. But the share of Canadian exports to world exports despite these developments abroad declined only very slightly, falling from 5.6 per cent in 1950 to 5.2 per cent in 1965. This means that Canada, unlike the U.S.A. and the U.K., has almost maintained its 1950 position more or less the same. However, this may only be partly due to the operations of foreign affiliates in Canada, as despite an increase of 469 per cent in direct investment in the case of Australia during the 1950-1965 period(5), that country's share of world exports declined (as is seen in Table 37) from 3 per cent in 1950 to 1.8 per cent in 1965.

It should be mentioned finally that we cannot draw any definite conclusion from the above analysis on the overall trade-effect of direct investment in Canada during the period considered. It does, however, seem that our examination of both the direct trade-effect and the indirect trade-effect suggests the probability that Canada had a trade deficit in overall terms from the operations of foreign affiliates in Canada, over this 1950-1965 period.

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(5). Private Overseas Investment in Australia, Supplement to the Treasury Information Bulletin, Commonwealth Treasury, Canberra, May, 1965, p. 18, Table 12; and estimated for the year 1965.

Appendix I

Capital-Flow Effect of Portfolio Placement

The purpose of this appendix is to examine empirically three different but related questions: (1) whether, in the Canadian context during the 1950-1965 period, the service payments, i.e., retirements plus dividends and interest, both annually and cumulatively, on the portfolio placement exceeded the amount of new portfolio placement inflows, annually and cumulatively; (II) whether the capital-flow effect of the direct investment or that of the portfolio placement in Canada during the 1950-1965 period was the more favourable to Canada from a balance of payments point of view; and (III) whether the rate of income was higher on the direct investment or on the portfolio placement during the 1950-1965 period. The statistical answers to these questions would clarify certain of the hypotheses referred to in Chapter I.

1. In his famous article Domar has agreed[1] with other writers that since the inflows of portfolio placement are usually subject to the payment of amortization, dividends and interest, the outflow of funds so produced is expected, after a relatively short interval, to exceed the inflow. We have also noted in Chapter I Mr. Maffry's contention[2] that as the amount of service payments on portfolio placement grows with the volume of outstanding portfolio placement, it must

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(1). E. Domar, op. cit., pp. 805-806.

(2). A. Maffry, op. cit., p. 619.

soon overtake the amount of new portfolio placement inflow, so that on balance, there is no net contribution of foreign exchange to the host country. It is obvious from the above two statements that the generally accepted position is that within a short period of time, the service payments on portfolio placement will exceed the gross annual inflow of portfolio placement, and the difference must be offset by foreign exchange earned through other sources. In other words, after a short while the annual gross inflow of portfolio placement will not be sufficient to meet the required service payments on accumulated portfolio placement, and there would be a net foreign exchange loss for the host country in this regard.

It is cited(3) that Jacob Viner estimated in his 'Canada's Balance of International Indebtedness 1900-1913' that the total non-resident investment in Canada amounted to $1,232 million in 1900, almost entirely in the form of portfolio placement. In 1926 the value of the accumulated outstanding portfolio placement in Canada was $3.9 billion.(4) These historical figures indicate that the period under consideration, 1950-1965, is by no means the first period at which portfolio placement started coming to Canada. On the other hand, the 1950-1965 period is more than half a century after the earlier date at which portfolio placement inflow is known to have been high. Consequently, according to the generally accepted hypothesis noted above, the annual service payments on portfolio placement should have been exceeding the annual

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(3). Canada's International Investment Position 1926-1954, op. cit, p. 11, Statement I.

(4). Ibid, p. 72, Table I.

inflow of portfolio placement because the period being considered here, 1950-1965, is very much beyond the suggested limits, i.e., a 'short interval' or 'soon'.

The statistics in Table A-1 show the gross inflow of and the gross service payments on portfolio placement, their different constituents, and the net foreign exchange movements associated with portfolio placement in Canada during the 1950-1965 period. The Table shows that the service payments on the portfolio placement do not exceed the inflow of portfolio placement in every year in this period, as among the sixteen individual years from 1950 to 1965 there are only seven in which service payments on the portfolio placement were larger than the inflow of portfolio placement. For the other nine years the inflow of portfolio placement exceeded the service payments on the outstanding portfolio placement. In detail, there were net foreign exchange gains, (i.e., outflow was smaller than the inflow) in 1950 and 1951, services payments exceeded the capital inflows and there were consequent foreign exchange losses in the next four years, 1952 to 1955, in the next four years, 1956 to 1959, there were net foreign exchange gains while the next three years, 1960 to 1962, show foreign exchange losses, and finally, during the last three years, 1963 to 1965, there were net foreign exchange gains. Thus, during the 1950-1965 period changes in the net movement of foreign exchange associated with the portfolio placement in Canada followed regular cycles, i.e., the net inflow and net outflow occurred for the same number of years in succession. During the period under consideration, there were

TABLE A-1

INFLOW OF AND SERVICE PAYMENTS ON FOREIGN PORTFOLIO PLACEMENT, CANADA, 1950-1965

A minus (-) indicates an outflow from Canada

(Millions of dollars)

Year	Trade in Outstanding Issues	New Issues	Portfolio Placement Inflows	Retirements	Dividends & Interest	Gross Out-Flows	Net Movements of Foreign Exchange	Cumulative Net Movements of Foreign Exchange
1950	329	210	539	-284	-166	-450	89	89
1951	38	411	449	-184	-178	-362	87	176
1952	-95	323	228	-89	-174	-263	-35	141
1953	-31	335	304	-146	-189	-335	-31	110
1954	63	333	396	-205	-194	-399	-3	107
1955	-28	166	138	-185	-199	-384	-246	-139
1956	198	667	865	-141	-214	-355	510	371
1957	97	800	897	-134	-254	-388	509	880
1958	88	688	776	-158	-275	-433	343	1223
1959	202	709	911	-258	-306	-564	347	1570
1960	54	448	502	-266	-338	-604	-102	1468
1961	100	548	648	-301	-368	-669	-21	1447
1962	-51	729	678	-319	-385	-704	-26	1421
1963	-131	984	853	-404	-436	-840	13	1434
1964	-21	1100	1079	-382	-448	-830	249	1683
1965P	-219	1240	1021	-382	-490	-872	149	1832

P Provisional

Source: 'Compendium', pp. 118, 121, 122, 164-165, Tables 4.D3, 4.D4, 4.D5, 5.06.

net gains in foreign exchange in the first two years, net losses of foreign exchange in the next four years, net gains of foreign exchange again in the next four years, net losses of foreign exchange for another three successive years, and net gains in foreign exchange associated with the portfolio investment in Canada in each of the final three years.

Furthermore, Table A-1 shows that in the Canadian case during the 1950-1965 period, despite the fact that the amount of service payments were larger than the volume of portfolio placement inflow in seven individual years, portfolio placement still contributed a net increase in foreign exchange of $1,832 million in overall terms. In other words, the excess of the portfolio placement inflow over service payments on the portfolio placement totalled $1,832 million over this period.

The above findings show that in the Canadian case the accepted hypothesis is not supported by the empirical evidence. If the accepted hypothesis applied to the Canadian case there would have been a net outflow of foreign exchange each year during the 1950-1965 period, and this of course would have resulted in a net cumulative outflow of foreign exchange for the whole period under consideration. Factually, then, instead of conforming to the accepted hypothesis which postulates that additional foreign exchange from other sources is needed to meet the service payments of the outstanding portfolio placement, portfolio placement in Canada contributed about $1,832 million to the Canadian foreign exchange resources over the 1950-1965 period. Thus, the

hypothesis that the new portfolio capital inflow is soon exceeded by the associated service payments is not true in the case of Canada over the 1950-1965 period.

11. Now we may examine the second question, whether direct investment or portfolio placement imposed the higher burden on the Canadian balance of payments position during the 1950-1965 period. This can be determined by comparing the direct capital-flow effect of the direct investment with that of the portfolio placement during the period. It is evident from Table A-2 which compares the capital-flow effects of direct investment with those of portfolio investment, that Canada had a net gain of foreign exchange through direct investment in eleven individual years in the 1950-1965 period. On the other hand, in the same period Canada received net foreign exchange through portfolio placement in only nine individual years. However, what is important in such a comparison is not the number of individual years in which there were net foreign exchange gains or losses but the amount of foreign exchange lost or gained by Canada as the result of direct investment and portfolio placement. Accordingly, Table A-2 shows that on account of direct investment there were net losses of foreign exchange in only four individual years and that these totalled to $1,450 million, yielding an annual average of $382.5 million. In the case of portfolio placement during the period under consideration, Canada experienced net foreign exchange losses in seven years, the total of which was $464 million for an annual average of only $66 million.

TABLE A-2

CAPITAL FLOW EFFECT OF DIRECT INVESTMENT AND PORTFOLIO PLACEMENT, CANADA, 1950-1965

A minus (-) indicates an outflow from Canada

(Millions of dollars)

Year	Annual Difference Between Inflow of Direct Investment and Outflow of Income	Cumulative Difference Between Inflow of Direct Investment and Outflow of Income	Annual Difference Between Inflow of Portfolio Placement and Outflow of Service Payments	Cumulative Difference Between Inflow of Portfolio Placement and Outflow of Service Payments
1950	-110	-110	89	89
1951	31	-79	87	176
1952	198	119	-35	141
1953	192	311	-31	110
1954	178	489	-3	107
1955	178	667	-246	-139
1956	529	1196	510	371
1957	364	1560	509	880
1958	189	1749	343	1223
1959	191	1940	347	1570
1960	278	2218	-102	1468
1961	237	2455	-21	1447
1962	..	2455	-26	1421
1963	-349	2106	13	1434
1964	-637	1469	249	1683
1965P	-354	1115	149	1832

P: Provisional

.. Nil

Source: See Tables 22 and A-1.

Thus, while there were net losses of foreign exchange on portfolio placement for more years than for direct investment, the size of the net losses were much smaller in the case of the portfolio placement than in that of direct investment. Furthermore, as mentioned earlier, through direct investment Canada shows a net gain of foreign exchange in eleven years for a total of $2,565 million, and an annual average of $233 million. In the case of the portfolio placement, however, as mentioned above, there were net gains of foreign exchange in nine individual years for a total of $2,296 million and an annual average of $255 million. Thus, the average annual net gain was also smaller in the case of the direct investment than in portfolio placement. Above all, over the 1950-1965 period while Canada had a net gain of only $1,115 million from the direct investment, the net gain from portfolio placement amounted to $1,832 million, or $717 million more.

A very important point in this context is that during the 1950-1965 period while Canada had a greater net gain of foreign exchange from the portfolio placement, Canada's liabilities rose substantially more on account of direct investment than because of portfolio placement. Thus, during the period under consideration non-residents increased their ownership of Canadian resources by $14,114 million through direct investment, but by only $6,446 million through portfolio placement. In other words, while Canada received through the portfolio placement about 64 per cent more foreign exchange than it received through the direct investment during this period, the debt created by portfolio placement

was only 45.6 per cent of the one created by the direct investment. Furthermore, the latter will generate greater income and greater debt in the future. At the beginning of 1950 Canada's foreign liability due to accumulated portfolio placement was $4.1 billion and at the end of 1965 it was approximately $10 billion, representing an increase of 144 per cent during the 1950-1965 period. But at the beginning of 1950 outstanding direct investment in Canada totalled only $3.6 billion, while it had risen to $18 billion by 1965 for an increase of 400 per cent over the period. Thus, Canada's external liability over 1950-1965 period rose by 144 per cent through portfolio placement compared with an increase of 400 per cent through direct investment. At the same time, Canada received a net foreign exchange inflow from the portfolio placement 64 per cent more than through direct investment. It should be noted also that the increase of 400 per cent in direct investment compared with the 144 per cent rise shown in the portfolio placement, would generate a much greater amount of income in the future.

In this context, it should be understood that the greater increase in direct investment compared with portfolio placement, despite the higher volume of net foreign exchange inflow through portfolio placement, was made possible by their inherent characteristic differences, i.e., direct investment accumulates through the process of reinvesting the retained earnings while a part of portfolio placement is automatically repatriated annually, and there are no associated retained earnings to be plowed back in the case of portfolio placement. Another contributing

factor is that direct investment generated a higher income than did the portfolio placement during this period, although the accumulated liability on account of the portfolio placement was much greater ($4.1 billion) at the beginning of the period under consideration than that of the direct investment ($3.6 billion). During the 1950-1965 period direct investment generated a total of about $12,999 million of income in Canada while portfolio placement generated only $4,614 million of income, or only 35.4 per cent as much. Thus, while the outstanding portfolio placement was 14 per cent higher than that of direct investment at the beginning of 1950, and while more funds for portfolio placement than for direct investment came to Canada in the period, ($10,284 million versus $8,910 million, a difference of 15.4 per cent), direct investment still generated 182 per cent more income than portfolio placement over this period.

To sum up the above analysis shows that:

(1) Portfolio placement contributed a higher volume of net foreign exchange than did direct investment during the 1950-1965 period to supplement the foreign exchange resources of Canada.

(2) The volume of direct investment in Canada increased substantially more than that of portfolio placement despite the fact that the latter brought a larger foreign capital inflow over the period.

(3) Direct investment generated and remitted a higher total income than did portfolio placement although

the outstanding portfolio placement at the beginning of 1950-1965 period was greater than the outstanding direct investment, and despite the fact that more portfolio placement capital came to Canada during the period.

(4) The gap between the total incomes generated by direct investment and by portfolio placement will be substantially wider in the future, since the outstanding direct investment was much greater than that of portfolio placement in 1965.

111. The third question can be answered by a comparison of the annual average rate of income on direct investment with that on portfolio placement for the period. This shows the average cost of the direct investment and of the portfolio placement to the Canadian economy.

While the average rate of income is known to be a somewhat nebulous concept, since it is used here for comparison purposes only, whatever deficiency involved will influence equally the average rate of income on both direct investment and portfolio placement. Hence its use can be justified here. The annual average rate of income on portfolio placement is arrived at by dividing the total annual dividends and interest earned, by the amount of outstanding portfolio placement at that date, The annual average rate of income on direct investment is calculated by dividing the total of annual remitted dividends,

interest, royalties and fees and unremitted profits, by the outstanding direct investment at the end of the year. These annual average rates of income show whether direct investment or portfolio placement was the more remunerative from the investor's point of view.

The statistics in Table A-3 show the annual average rate of income on direct investment and on portfolio placement during the 1950-1965 period. The average rate of income on direct investment was 12.6 per cent in 1950, that is, each $100 of direct investment in Canada earned an income of $12.60 in 1950. The average rate of income on direct investment fell steadily each year until it reached 6 per cent in 1958, it rose to 7 per cent in 1959, fell to 5.8 per cent in 1960 and has moved up steadily ever since reaching 9.3 per cent in 1965. In the case of portfolio placement the rate of income was 3.8 per cent in 1950, that is, a portfolio placement holder received only $3.80 per $100 invested in 1950. The annual average rate of income on portfolio placement fluctuated narrowly (between 3.7 per cent and 4 per cent) until 1959, since then it rose slowly and steadily to 4.9 per cent in 1965. During the period the highest average rate of income on portfolio placement was 4.9 per cent compared with 12.6 per cent for direct investment. Table A-3 shows that in every year during the 1950-1965 period the average rate of income on direct investment was greater than that on portfolio placement, the differences ranging from 8.8 percentage point to 1.5 percentage point. The average rate of income on direct investment

TABLE A-3

AVERAGE RATE OF INCOME ON DIRECT INVESTMENT AND PORTFOLIO PLACEMENT, CANADA, 1950-1965

(Percentages)

Year	Average Rate of Income on Direct Investment(1)	Average Rate of Income on Portfolio Placement(2)	Excess Average Rate of Income on Direct Investment Over Portfolio Placement
1950	12.6	3.8	8.8
1951	11.3	3.9	7.4
1952	11.3	3.7	7.6
1953	9.3	3.8	5.5
1954	8.4	3.7	4.7
1955	8.6	3.9	4.7
1956	8.9	3.7	5.2
1957	8.4	4.0	4.4
1958	6.0	3.9	2.1
1959	7.0	4.0	3.0
1960	5.8	4.3	1.5
1961	6.0	4.5	1.5
1962	6.3	4.6	1.7
1963	7.1	4.9	2.2
1964	8.2	4.8	3.4
1965P	9.3	4.9	4.4

P: Provisional

(1) It is calculated by dividing the annual remitted dividends & interest, remitted royalties & fees, and unremitted profits by the book value of direct investment at year ends.

(2) It is measured by dividing the remitted dividends & interest by the book value of portfolio placement at year ends.

Source: 'Compendium', pp. 232-233, Table 12; and see Tables 9, 13, 18 and A-1.

during the whole period was 8.4 per cent compared with only 4.2 per cent in the case of the portfolio placement or exactly twice as much. In other words, from the Canadian point of view the cost of direct investment was exactly twice that of portfolio placement.

Perhaps, some may argue that it is not logical to include royalties and fees payments in calculating the rate of income on direct investment. But royalties and fees payments are very much a part of the total income on direct investment, and are as relevant as dividends or interest payments. However, it may be interesting to compare only the rate of dividends and interest generated by the direct investment and by the portfolio placement. Such a comparison will show differences between the "rate of return", a traditional concept covering dividends and interest, on portfolio placement and direct investment. However, it should be borne in mind that it is the "rate of income", and not the "rate of dividends and interest" that is relevant, both from the investing and investee countries' points of view when the required payments on portfolio placement and direct investment are being considered.

Bearing this in mind, let us look at Table A-4 which compares the average rate of dividends and interest on direct investment and on portfolio placement during the 1950-1965 period. Between 1950 and 1960 the rate of dividends and interest on direct investment fluctuated from year to year. It was 11.5 per cent in 1950, it declined to 4.6 per cent in 1960, then rose steadily reaching 7.3 per cent in 1965. Dividends

TABLE A-4

AVERAGE RATE OF DIVIDENDS AND INTEREST ON DIRECT INVESTMENT AND PORTFOLIO PLACEMENT, CANADA, 1950-1965

(Percentages)

Year	Average Rate of Dividends & Interest on Direct Investment(1)	Average Rate of Dividends & Interest on Portfolio Placement(2)	Excess Average Rate of Dividends & Interest on Direct Investment Over Portfolio Placement
1950	11.5	3.8	7.7
1951	10.2	3.9	6.3
1952	10.2	3.7	6.5
1953	8.7	3.8	4.9
1954	7.6	3.7	3.9
1955	7.9	3.9	4.0
1956	8.0	3.7	4.3
1957	7.6	4.0	3.6
1958	5.3	3.9	1.4
1959	6.0	4.0	2.0
1960	4.6	4.3	0.3
1961	4.6	4.5	0.1
1962	4.8	4.6	0.2
1963	5.4	4.9	0.5
1964	6.4	4.8	1.6
1965P	7.3	4.9	2.4

P: Provisional

(1) It equals remitted dividends & interest and unremitted profits divided by the book value of direct investment at year ends.

(2) See Table A-3.

Source: See Table A-3.

and interest are, of course, the only components of income on portfolio placement and the changes in it during this period have already been discussed and need not be dealt with further here. It is obvious from Table A-4 that in each and every year in the 1950-1965 period the rate of dividends and interest on the direct investment was greater than that on the portfolio placement. The difference ranged from 7.7 percentage points in 1950 to 0.1 percentage points in 1961; since 1962 it has risen gradually and steadily reaching 2.4 percentage points in 1965. For the period as a whole the average rate of dividends and interest on direct investment was 7.3 per cent compared with only 4.2 per cent for portfolio placement. This means that during the 1950-1965 period a non-resident investor received an annual average of $3.10 more on each $100 in direct investment than on the same amount in portfolio placement. This comparison between the rate of dividends and interest on direct investment and on portfolio placement clearly demonstrates, that over the 1950-1965 period, direct investment was more costly than portfolio placement in the case of Canada. Thus, the comparison of the rates of only dividends and interest on direct investment and on portfolio placement fully supports the conclusions drawn from the comparison of <u>incomes</u> on direct investment and on portfolio placement that direct investment was more costly for Canada than the portfolio placement during the 1950-1965 period.

APPENDIX II

FOREIGN OWNERSHIP AND CAPITAL-FLOW EFFECT OF DIRECT INVESTMENT

This appendix attempts to use the theoretical model developed by G.G. Moffat(1) to measure the extent of foreign ownership and the direct capital-flow effect of direct investment in Canada. His model consisted of two parts, i.e., one of which shows how to determine the extent of foreign ownership in an economy and the other shows conditions under which investment provides a net foreign exchange receipt to the host country. After discussing the foreign ownership and capital-flow effect conditions separately, he then, combines them to show the circumstances under which direct investment from abroad can provide net foreign exchange gains without increasing the proportion of local enterprises owned by non-residents.

Depending upon whether the rate of growth of the direct investment is greater than, equal to, or less than the rate of growth of resident investment the proportion of non-resident owned Canadian productive assets will increase, remain unchanged, or fall. This is written as:

$$b \gtreqless a \qquad (1)$$

where: b = rate of growth of direct investment

a = rate of growth of resident investment

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(1). G.G. Moffat, "The Foreign Ownership and Balance of Payments Effects of Direct Investment from Abroad", Australian Economic Papers, June, 1967, pp. 1-24.

$$b = \frac{N + jBi}{B} \qquad (2)$$

$$n + ji$$

where: N annual net direct investment inflow from abroad

j the proportion of income payable on direct investment which is ploughed back into the local enterprises

B the value of direct investment at the end of each year

i the rate of income after tax on direct investment

n $\frac{N}{B}$ the annual rate of net direct investment inflow

By substituting equation (2) in equation (1) and re-arranging the terms, the condition becomes:

$$n \gtreqless a - ji \qquad (3)$$

where: $a = \frac{I}{S}$ the rate of growth of investment owned by residents

I annual net resident owned investment

S the value of resident owned assets

The annual net inflow of direct investment from abroad must exceed the sum of dividends, interest, royalties and fees remitted on direct investment abroad in order to create a favourable direct capital-flow effect to the host country, i.e., to achieve a net earning of foreign exchange. That is

$$N > (1-j)\,Y \qquad (4)$$

where: Y = income payable on direct investment.

By substituting Bi for Y in equation (4) and dividing through by B, the direct capital-flow effect condition becomes:

$$n > (1 - j)\, i \qquad (5)$$

which can be re-arranged to

$$n + ji > i \qquad (6)$$

when the foreign ownership and capital-flow effect conditions are combined four possible cases emerge.

(1) Direct investment inflow can continue indefinitely as a net source of foreign exchange without any increase in the foreign ownership ratio, if

$$a \geqslant n + ji \geqslant i \qquad (7)$$

It implies that the greater the rate of growth of local enterprises owned by residents the higher the level of annual direct investment inflow which can be undertaken to satisfy the direct capital-flow effect condition without increasing the proportion of foreign-ownership.

(2) The proportion of foreign ownership will increase while direct investment continues to provide a favourable direct capital-flow, when

$$a < n + ji > i \qquad (8)$$

(3) The foreign ownership ratio will fall and direct investment will cause an unfavourable direct capital-flow effect, if

$$a > n + ji < i \qquad (9)$$

(4) The proportion of foreign ownership increases while direct investment results in a net outflow of foreign exchange, when

$$a < n + ji < i \qquad (10)$$

This is the most adverse condition a host country may perhaps face at some point of time in its history of foreign direct investment.

Now let us attempt to use this theoretical model to measure the foreign ownership and direct capital-flow effect of direct investment in Canada. Table A-5 shows the combined foreign ownership and direct capital-flow effect of direct investment in Canada over the 1950-1965 period. The method by which the different variables are estimated are explained at the end of this appendix. Through the whole 1950-1965 period the foreign ownership ratio has been increasing as "a" was always less than "b" (=n + ji). This is also evident from the values of n, which was 14.2 per cent in 1950 but had risen to 21.7 per cent by 1965. The direct capital-flow effect was favourable to Canada during 1951 to 1960, while it was unfavourable in 1950 and in the years 1961 - 1965. This is also shown by the values of m, i.e., in 1950 the outflow as income was only 68.8 per cent of the total inflow, but during the

TABLE A-5

FOREIGN OWNERSHIP AND CAPITAL FLOW EFFECT OF DIRECT INVESTMENT, CANADA, 1950-1965

(Estimates based on $ 1949)

Annual Average During	n	j	i	b (n+ji)	a		m %	n %
1950	0.057	0.299	0.120	0.093	0.066	$a < n+ji < i$	68.8	14.2
1951-1955	0.064	0.483	0.082	0.104	0.059	$a < n+ji > i$	153.7	16.2
1956-1960	0.057	0.431	0.058	0.082	0.040	$a < n+ji > i$	173.0	19.2
1961-1965	0.027	0.339	0.055	0.046	0.038	$a < n+ji < i$	76.0	21.7

m = the ratio of inflow of direct investment to the outflow of income on direct investment.

n = the proportion of the value of direct investment to the total value of productive assets owned by residents in Canada.

1951-1955 and 1956-1960 periods, the average ratios of inflows to outflows were 153.7 per cent and 173 per cent, respectively. But in the 1961-1965 period the average ratio of inflow to outflow was only 76 per cent.

Finally, the joint conditions reveal that (1) in 1950 the foreign ownership ratio was increasing while causing an unfavourable direct capital-flow effect, the most serious situation, (2) in the 1951-1960 period, though the foreign ownership ratio was increasing, there was a favourable direct capital-flow effect, and (3) during the 1961-1965 period foreign ownership ratio was again increasing and the direct capital-flow effect was unfavourable to Canada. This latter most adverse case calls for the prompt attention of the policy-makers.

Method of Estimation

Annual total net direct investment inflow (N), annual amount of income payable abroad which is ploughed back (J) and annual total income payable abroad on direct investment (Y) are obtained from Tables 5, 9 and 22 respectively. By using the GNE implicit price indices(2) of new non-residential construction these items were converted into constant 1949 dollars.

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(2). From 1950 to 1955: W.C. Hood and A. Scott, Output, Labour and Capital in the Canadian Economy, Royal Commission on Canadian Economic Prospects, Queen's Printers, Hull, 1957, p. 242, Table 6.2. From 1956 to 1965: National Accounts Income And Expenditure, 1962 and 1966, Dominion Bureau of Statistics, Ottawa, p. 28, Table 6 and, p. 20, Table 6 respectively.

The value of direct investment (B) at the end of 1949 is obtained from Canada's International Investment Position 1926-1954.(3) The annual increase in direct investment (N + J) in 1949 prices for the year 1950 calculated as explained above, is added to the value of direct investment for 1949 which gives the value of direct investment for the year 1950 at 1949 prices. The annual increase in direct investment for each subsequent year is calculated, in the same way, and added to the previous year's value of direct investment to get the value of direct investment from 1951 to 1965 in 1949 prices.

The above information on N, J, Y and B were used to calculate n, i, j and n+ji.

The net fixed capital stock plus physical inventory stocks held by the total commercial and institutional economy which covers the total economy less residential housing, government departments, defence and postal services is taken here as equivalent to the total value of productive assets in Canada. This commercial and institutional economy which accounted for approximately 91 per cent of the total value added in 1965.(4) The net fixed capital stocks under the straight line depreciation rate and inventory stocks in 1949 prices for 1950-1965

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(3). Op. Cit., p. 72, Table 1.

(4). S. Magum, The Source of Potential Output in the Canadian Economy, 1946-80, A Production Function Analysis, Ph. D. thesis (Draft), Unpublished, p. 1.

were obtained from Magum.(5) It is explained above how the annual value of direct investment in 1949 prices for the years 1950-1965 was calculated. Similarly, the annual value of portfolio placement in 1949 prices was calculated for the years 1950-1965 using the value of portfolio placement in 1949(6) and net annual increase in portfolio placement (See Table A-1) converted into constant dollar of 1949. The sum of the annual value of direct investment and portfolio placement deducted from the sum of net fixed capital stock and inventory stock gives the annual value of the productive assets owned by residents in Canada (S).

Yearly total investments by resident were estimated by the following method:

(1) Net fixed investments in 1949 prices, taken from(7)

plus (2) changes in physical inventory in 1949 prices, obtained from National Accounts Income and Expenditure for various years.(8)

minus(3) direct investment and portfolio placement in 1949 prices, calculated as explained above.

equals(4) annual investment by residents (I).

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(5). Ibid., p. 99, Table A-III-4.

(6) Canada's International Investment Position 1926-1954, Op. Cit., p. 72, Table I.

(7). S. Magum, Op. Cit., p. 89, Table A-III-1.

(8). National Accounts Income And Expenditure, 1926-1956, 1962 and 1966, p. 60, Table 26, p. 40, Table 26 and p. 32, Table 26, respectively.

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