Canada and the Financial Crisis: The Perils of a Trading State in Times of Trouble

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The National Interest approach as I have presented it elsewhere suggests that there is a short list of fundamental objectives which all states pursue.[1] What makes Canadian Foreign Policy (or any state's foreign policy) unique is the particular circumstances in which Canada finds itself and the custom-made tactics it must adopt to pursue those National Interests.

In the economic realm, there are two particularly important National Interests: 1) the desire to be as wealth and prosperous as possible (for this paper, called NI1) and 2) the desire to be as autonomous (politically, economically and culturally) as possible (NI2). However, the tactics for achieving these goals may lead in opposed directions. For maximum economic growth, most modern mainstream economists suggest open international markets or at least a healthy respect for the competitive global market. On the hand, the quickest way to maintain complete domestic sovereignty and economic independence would appear to be protectionism and more nationalistic intervention in trans-border activities. This dilemma is sometimes presented as an all-or-nothing trade-off leading some to despair that the battle to preserve long-term Canadian autonomy was lost when the FTA and NAFTA were signed. But in the actual practice of states, both interests are pursued simultaneously and both are legitimate objects of state policy. Free Trade does in fact have implications for NI2 above, and the protection of autonomy now requires greater attention and efforts on its behalf. The goal should be to maximise both wherever possible: to find the ideal balance point between the two.

During the 1988 election debate over Free Trade, nationalists argued against the growth predictions of Free Traders by predicting the closure of US branch plants, as it would be more cost effect to consolidate production in the larger US market. The same logic it was argued would funnel future foreign and Canadian capital to the US, resulting in job- and capital-loss and economic decline for Canada. In a previous paper, I suggested using Canadian balance of payments data to monitor this situation.[2] Some eight years on, in this paper, I have revisited the National Accounts to again take stock in regards to the pursuit of both National Interests (NI 1&2.)

Prosperity under Free Trade

The Canada-US FTA, signed in 1988, began a ten-year-period of gradual reductions in most tariffs between the two with the NAFTA starting another such clock in 1994 for tariffs with Mexico. These Free Trade agreements were followed by a long period of steady economic growth for Canada until the recent recession of 2009 and 2010 (beginning roughly in the 4th Quarter 2008.) In fact, for the decade following 1977, Canada had the fastest growing economy among the G-8. This prosperity

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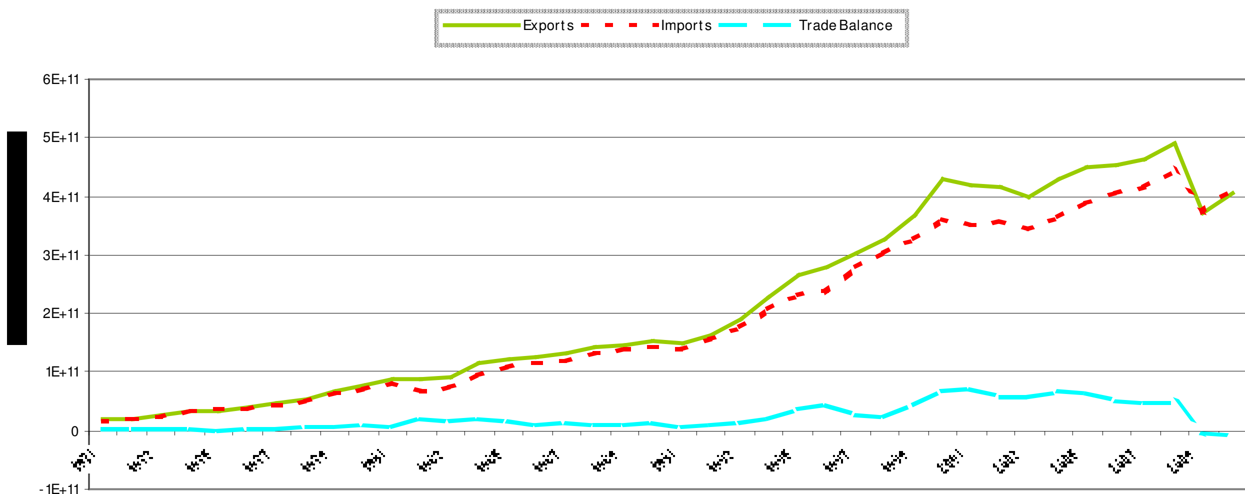
[1] Steven Holloway, *Canadian Foreign Policy: Defining the National Interest* (Toronto, University of Toronto Press, 2006).
[2] Steven Holloway, "The Effects of Free Trade on Canada: What National Accounts Data can tell us about Globalisation," paper presented at ISA Annual Conference in New Orleans, March 2002.

allowed Paul Martin as Finance Minister to reduce the Federal government deficit, even running surpluses for seven years in a row and reducing the net public debt to 30% of GDP. In the recent recession, his fiscal rectitude along with Canada's large and conservative national banks, ameliorated the downturn and has kept Canada clear of the mortgage foreclosures, bank failures and general financial and credit problems plaguing the US, Greece, Ireland, Portugal and other Canadian allies.

Much of these economic results are credited to the rapid growth in Canadian exports (and their subsequent decline in 2009 & 2010). Figure 1 shows the rapid growth trend in exports, which also grew as a share of GDP. Since much of that expansion is due to a growing surplus in trade with the US, the FTA would appear to be a successful tactic at least in the short-run for achieving NI1.

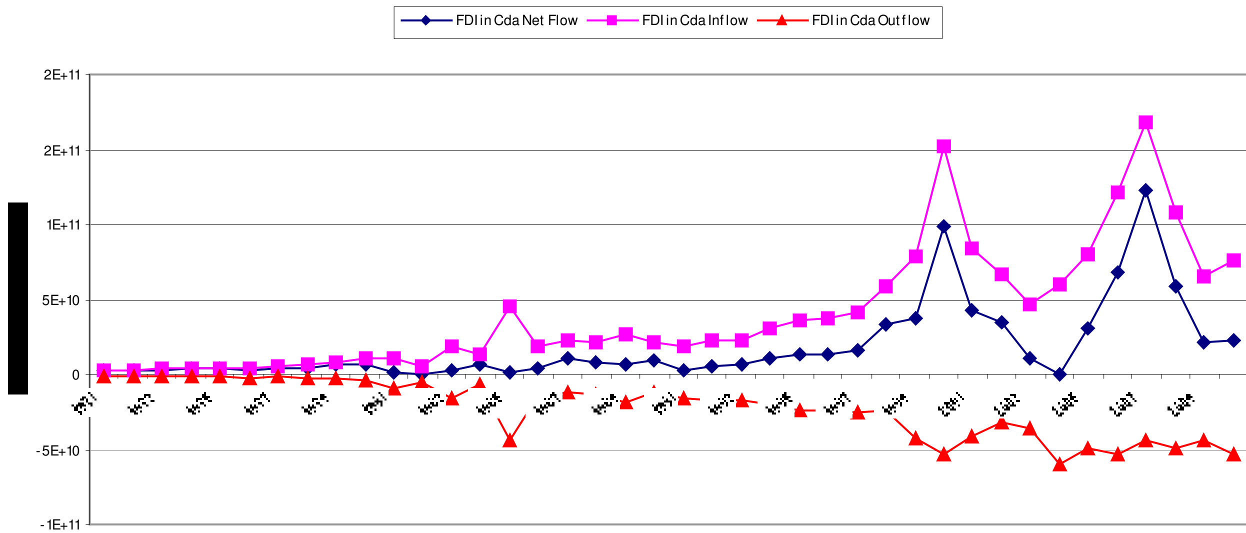
Figure 1 - Canadian Trade Balance



(Source: Statistics Canada data accessed through Cansim2 http://dc2.chass.utoronto.ca.libproxy.stfx.ca/cgi-bin/cansimdim/c2_retrieveManySeries.pl [18 apr 2011.])

Figure 2 allows us to assess the impact of Free Trade on Foreign Direct Investment (FDI) in Canada. Any sign of US branch plants closing should appear as a greater outflow of foreign-owned FDI from Canada (note: this is different from the FDI outflow of Canadians investing abroad.) If Free Trade has made Canada less attractive as a base for economic activity, it would show as declining inflow, increased divestment (outflow), and perhaps even a negative turn for the net flow. Figure 2 does indeed show a steadily growing outflow of FDI (moving downward or negative on this line (red triangles) indicates a growing divestment.) But that trend is more than offset by the Inflow line, thus keeping the Net line in positive territory. Two huge peaks in new FDI can be seen in 2000 (the "tech" boom) and 2007 (a resource-firm acquisition boom.) More will be said about this latter boom in the autonomy section of this paper. Overall it does not appear that Free Trade has made Canada completely unattractive to FDI, which many argue is an important component of future growth. Some business commentators have even fretted as to whether Canada has received its fair share of FDI, blaming Federal government regulation or policy as not being inviting enough.

Figure 2 FDI Flows in Canada



(Source: Statistics Canada data accessed through Cansim2 http://dc2.chass.utoronto.ca.libproxy.stfx.ca/cgi-bin/cansimdim/c2_retrieveManySeries.pl [18 apr 2011.])

From 1996 until 2007 net Canadian FDI abroad outpaced net foreign FDI into Canada (not shown on this figure) but as long as both tend-lines are upward, “Free Trader” pursuers of growth are not worried. Seeing greater openness and globalization as a “win/win” situation, they would remind us that those foreign investments produce future returns in Canada’s Current Account (see below.)

Preserving Canadian Economic Autonomy

Possibly the strongest perspective we could adopt in pursuit of NI 2 would be the traditional Mercantilist position. We could ask, how would an economic nationalist define success? Which components of the Balance of Payments would they seek to maximize?

Unlike the laissez-faire approach of the Free Trader, which expects the market to be self-correcting and tending toward equilibrium, the Mercantilist takes a more pro-active approach. Success is defined in terms of a positive “balance” in virtually every account. Clearly a long-term deficit in the overall balance has been the downfall of many economies; running down reserves, leading to going to the IMF “cap-in-hand,” to be forced into austere SAPs. The successful models to be emulated are the Germans (even today), the Japanese (until the 1990s) and most other Asian Tigers including now in some aspects, the PRC. Historically, the reverse situation, huge indebtedness to foreigners, has been the principle economic challenge to the sovereignty of many small and medium-sized states.

A positive Current Account would be a good place to start. As the name suggests, this account tracks the immediate earnings and expenses of the country related to trade, travel, and returns earned on past investments. For most of the post-WWII era, Canada’s overall Current Account balance was

negative. Mercantilists might compare this to a profligate household: buying more than it sold, traveling more to foreign countries than inviting guests here, being a borrower rather than a lender and thus paying large interest amounts on past debt, and paying out more profits to foreigners than vice versa. And the "Canadian household" paid for this "living beyond its means" by taking on more loans: counted as assets in the counterbalancing Financial Account.[3] Hardly a virtuous cycle in the opinion of the Mercantilist.

Therefore, Mercantilists were pleased to note the change that occurred in about 1998 when the Current Account balance went positive for nearly a decade. To the extent the FTA had any role in this through expanded exports to the US, Mercantilists must concede some merit to it. In the 4th Q of 2008 with the recession and the collapse of exports to the US, the overall balance again went negative and stayed there throughout 2009 and 2010. Early indications are it may recover in 2011 with the end of the recession but it needs be watched closely.

Within the Current Account, the first and most important component is the trade balance. Mercantilists have long championed the virtues of a trade surplus: exports greater than imports shows a strong demand for one's products on global markets. To some extent this measure could also serve as an indicator of the competitiveness and quality of the country's products. While Canada still runs a negative on the services side, since the late 1970s, it has run a goods surplus and the growth in this surplus particularly with the US contributed to the overall Current Account surplus noted above.

One other point would be made by the Mercantilist before leaving the trade account. Trade dependency on one large country certainly threatens autonomy. The need for counterbalancing this dependence on the US market appears historically in Diefenbaker's proposal to divert 15% of exports to the UK and Trudeau/Sharp's Third Option in the 1970s. Mercantilists would therefore list as a negative consequence of the FTA, the rise in the share of exports to the US from about 72% in 1992 to 84% in 1999-2003. Though it had already begun to drop in the middle of the last decade, a recent *Globe and Mail* article highlighted the role of the recession in lowering the US share of Canadian exports to 75%. The report cited "several benefits: it leaves companies less vulnerable to slowdowns by its largest trading partner, and it comes as other currencies, chiefly the euro, are showing less volatility in relation to the loonie than the U.S. currency."[4] Another recent chart in the *Globe and Mail*, showed the UK and PRC as our 2nd and 3rd most important export markets as of 2010.[5]

The another major component of the Current Account is the balance of investment earnings which is further divided into Direct Investment and Portfolio earnings. Mercantilist expectations here are a bit more difficult to sort out given the contradictory short-term versus long-term impacts of investment and debt (see Table 1.) For example, selling a government bond to a foreigner represents an immediate positive inflow of funds in the Financial Account but later must be redeemed in that account and is charged interest as a negative in the Current Account. Therefore overall the Mercantilist would prefer to be a lender rather than a borrower. Profitable overseas investment could be seen as prudent "saving for a rainy day."

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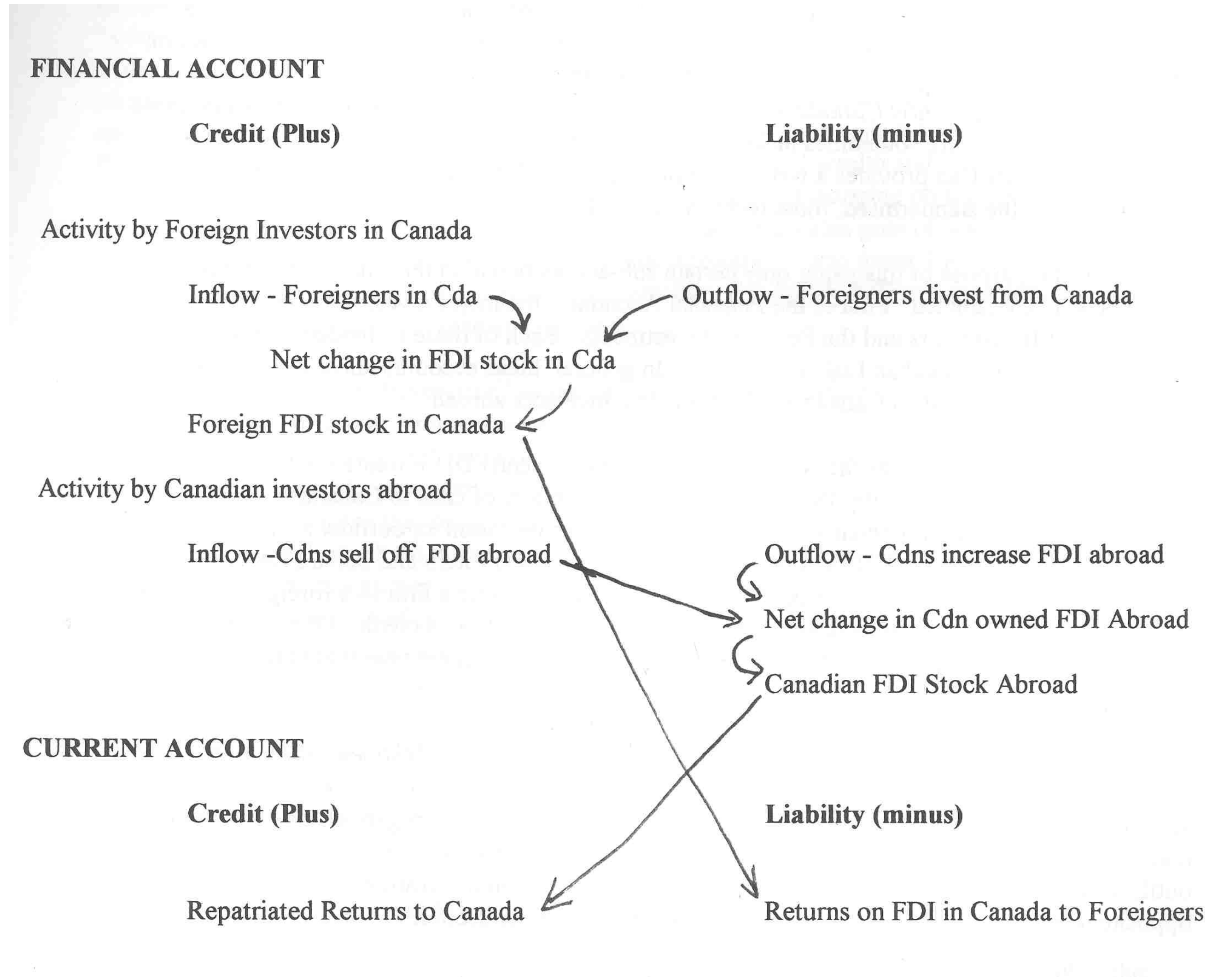
[3] StatsCanada has changed the terminology slightly, so that much of what we used to call the "Capital Account" is now in their "Financial Account."

[4] Tavia Grant, "Exporters lower reliance on US turn to Europe, Asia," *The Globe and Mail*, 8 April 2011, B7.

[5] Bertrand Marotte, "Three charts to start your week," *Globe and Mail*, Apr. 04, 2011, B7.

Table 1 How FDI by Canadian and Foreign Investors is tracked in the Balance of Payments

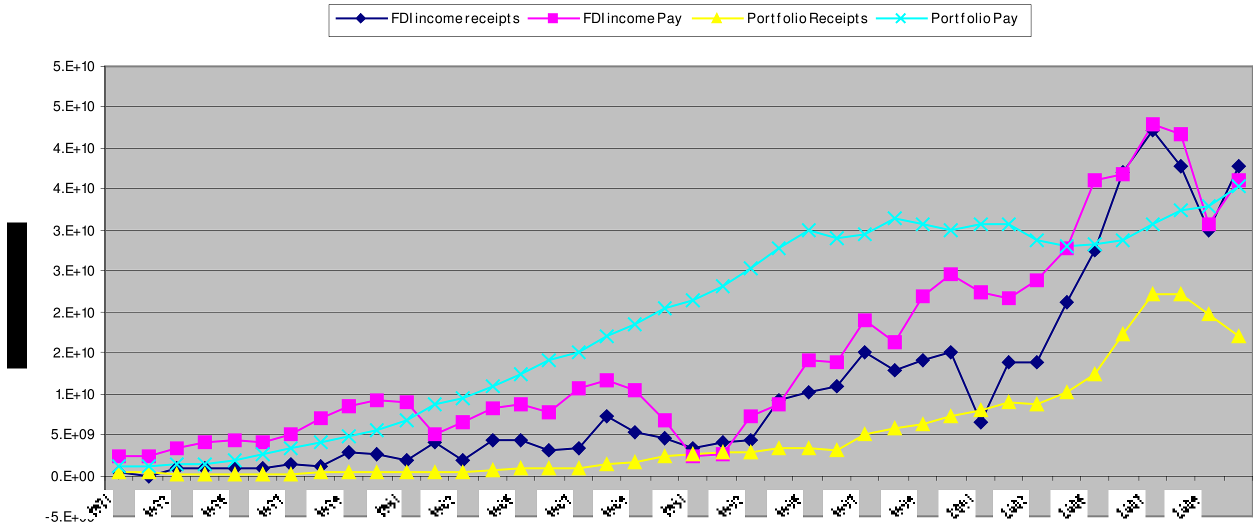


Likewise, concern about foreign ownership of companies has been an important issue for Nationalist and "Sovereigntists" in Canada. Loss of economic decision-making and repatriation of profits are seen as important downsides to FDI in Canada for many in this camp. A Mercantilist might even define certain industries as strategic and use state intervention to prevent dominant foreign ownership in them.

Figure 3 tracks the recent trends for the Current Account balances of FDI and portfolio investments. In the seventies, FDI outflow of earnings (purple squares) far exceeded the returns that Canadian FDI earned abroad (dark blue diamonds) but with the dramatic growth in those Canadian investments abroad, the gap has narrowed recently (even reversed in 1991, 1992 and 2009.) Much more dramatic was the huge gap which opened through the eighties between portfolio earnings (yellow triangles) and payments (light blue x's.) In large part this was due to the huge increase in government debt instruments previously issued by the Federal and Provincial governments. Mercantilists no doubt

approved of the steps taken by the Liberals to curb and shrink the Federal deficit and debt as seen in the flatter line of payments from 1995 on until the return of large deficits with the recent recession.

Figure 3 Canadian Current Account Investments



(Source: Statistics Canada data accessed through Cansim2 http://dc2.chass.utoronto.ca.libproxy.stfx.ca/cgi-bin/cansimdim/c2_retrieveManySeries.pl [18 apr 2011.])

It should be noted that management of the government debt is mostly independent of trade policy. It therefore represents an area of policy where the two interests NI 1 & 2 are not trade-offs and can be pursued independently.

Maitre chez nous

As hinted above, for the Nationalist, there remains the issue of the nationality and type of FDI not immediately to be gleamed from the StatsCan data presented. Though public concern about the Americanization of the Canadian economy by US FDI, has declined since the 1960s and 1970s, the recent action of the Harper government in blocking the acquisition of the Potash Corp by the Australian BHP shows the issue in some form is still alive. As seen on Figure 2, there was a huge influx of FDI in 2007. Let us now examine more closely the nature of that investment. While it shows that NAFTA has not made Canada completely unattractive to foreign investors, there are nonetheless disquieting aspects to the 2007 resources investment boom. 2007 saw some huge foreign acquisitions of iconic Canadian resource giants. The acquisition of Alcan, Canada’s giant in the aluminum industry, by the British company, Rio Tinto, alone was valued at $37.6 billion. Table 2 which is drawn from a list of the top 10 Canadian acquisitions of 2007 shows the five which involved a foreign company taking over a Canadian company. StatsCan reports the total FDI Inflow for 2007 as $167 billion and the five acquisitions here sum to $65 billion or 39% of that total. Acquisitions represent a

very different type of FDI from a green-field, new-asset investment, with far fewer benefits to Canada. This fact was acknowledged in the old FIRA criterion for evaluating FDI.

Table 2: Top Six Acquisitions of Canadian Resource companies in 2007[6]

Target Name	Target Industry Sector	Acquirer Name	Acquirer Nation	Deal Value ($mil)
Alcan Inc	Metal and Metal Products	Rio Tinto PLC	UK	37,629.98
Shell Canada Ltd	Oil and Gas; Petroleum Refining	Royal Dutch/Shell Group	Netherlands	7,640.43
EnCana Corp-Upstream Partnership	Oil and Gas; Petroleum Refining	ConocoPhillips Co-Downstream	US	7,500.00
LionOre Mining Intl Ltd	Mining	OAO MMC Norilsk Nickel Group	Russian Fed	6,286.76
Western Oil Sands Inc	Oil and Gas; Petroleum Refining	Marathon Oil Corp	US	6,185.32

In addition to the questionable economic benefits of a foreign takeover of a healthy Canadian company, there is the clear loss to economic autonomy and the symbolic loss, in the case of Alcan, of an historic crown jewel of the Canadian economy. Such "political" factors at least loomed large enough to convince even the conservative Harper government to block the loss of a lesser jewel, the Potash Corp. That it was a jewel worth saving was reaffirmed in a recent *Globe and Mail* article, heralding potash's rising prices, profits and strategic importance in a looming global food crisis.[7]

Conclusion

In this paper I have tried to show a number of things. First, I have tried again to demonstrate that Balance of Payments data represents a rich mine of information useful to a variety of important IPE research issues. Second, I hope to have shown the utility of a National Interest approach for re-examining and revitalizing older policy debates. Furthermore, I hope to have re-affirmed the legitimacy of "sovereignty" interests, which are sometimes ignored in the rush to achieve the equally important goal of economic growth. Indeed, I have argued that a balance must be found in the simultaneous pursuit of both. Greater openness and globalization can and should be balanced with smart state intervention to serve basic autonomy interests.

Clearly even the Harper government was prepared for such intervention to save the Potash Corp. The pity is that it did not recognize the same urgency to save Alcan. In the immediate aftermath of the action against BHP's bid, many business pundits fretted whether Canada would lose future economic benefits through this "arbitrary" interventionism. But clearly the entire of policy of allowing such mammoth acquisitions needs to be rethought. What economic benefits are gained through the hostile takeover of one giant firm by another? Many Canadian businesses might

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[6] See http://files.newswire.ca/102/KPMGCHART.doc [20 April 2011.]
[7] Bertrand Marotte, "Potash Corp. reaps benefits of rising demand for fertilizer," *Globe and Mail*, 25 April 2011, B3.

appreciate and support tougher hostile takeover regulations for their own protection. Any economic benefits of such takeovers are offset by the restraint of trade, the loss of competition and the monopoly implications they pose. Indeed, by changing the framing of the issue from that of an anti-FDI or Canadianization stance to a non-discriminatory but tougher anti-trust/ anti-combines policy, Canada could finesse challenges at the WTO that it was violating National Treatment: the policy could apply equally to hostile Canadian acquisitions in Canada. Such a rethink of policy would better serve the balancing of all Canadian National Interests and is long overdue.