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U.S. ECONOMIC POLICY VIEWED BY A FRIENDLY PARTNER

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It is a pleasure to be here and, as a Canadian, let me add my word of welcome to you from the States who are here today. I just hope that you feel as much at home in Canada as I have felt in the U.S. on a number of occasions visiting that country and studying and teaching there. It is also a pleasure to be able to discuss North American economic relations in a period of relatively favorable relations between our two countries. I think we have essentially gotten through a potentially dangerous period of an election in both countries, in particular in the United States. The growing pressure of protectionism that is always present in an election campaign seems to have been deflected to a degree that appeared unlikely six months ago. In Canada we have a new Prime Minister whose promise of improved relations with the United States in his election campaign has not generated the traditional nationalistic backlash that sometimes occurs in this country. He is therefore in a position to consider new, outward-looking policies that will both benefit Canada and will, in addition, I believe, be easier for Canada's trading partners to live with. Before I begin, let me say I'd like to keep this as informal as possible. I'll try to take a break, if time permits, partway through to entertain some questions or comments you may have. What I'd like now is to turn to my first topic, to my basic topic, which is an examination of recent U.S. economic policies, as evaluated by a friendly critic.

As one looks at the United States from a distance, one problem the U.S. faces stands out. It's not easy being the world's largest economic power. When you make a mistake, it hurts you and it hurts everyone else. On the flip side, when you generate an economic recovery, as indeed you are now doing in a most remarkable way, to some degree you bring the whole world along. That's not the case in Canada, of course, where we have the luxury of being able to make mistakes that hurt only ourselves or mostly ourselves, mistakes indeed that others may not even notice, although we have discovered in the last five years that it is becoming more and more difficult to remain unnoticed. When our officials go to international conferences, they don't give lectures on the size of the Canadian deficit, even though it is in relative terms, relative to domestic GNP, roughly twice as large as your American deficit. Those lectures are reserved for U.S. officials because the U.S. deficit is of such huge absolute size that it dominates the world financial scene. And it raises a number of problems for other countries and this will be one of my major topics I want to talk about this morning — the pressures generated by that U.S. deficit, not just on the United States, but in particular on other countries as well.

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Secondly, I'd like to spend some time looking at the trade scene. Once again, the U.S. story is that the U.S. dominates this, especially when one looks at Canada-U.S. economic relations. Trade for Canada with the U.S. is far more important than is trade for the U.S. with Canada. It puts one in mind of the chicken and pig who are passing the ham and eggs sign and the chicken said, "What do you think of that?" And the pig, after a moment's reflection, said, "I think the suggestion is a more serious one for me than it is for you. All they are asking from you is a token contribution. From me they seem to want some form of long-term commitment." Trade relations with Canada are important for the U.S. but they are enormously important for Canada — so important that they become one of our national preoccupations, for two reasons: we trade more in Canada than you do, as a percentage of our GNP; and secondly, when one looks at the trade we do our trade is more heavily concentrated with the U.S. Yours is more spread out amongst a lot of other countries. True, you trade with Canada more than with any other single country, by a large margin, but still you do a lot of trade with other countries. We do about 70% or so of our trade with you. The result is that one percent of U.S. GNP is generated by U.S. exports to Canada. Sixteen percent of Canadian GNP is generated by Canadian exports to the United States. If we spend a moment thinking about this, we'd realize it must be so. We have two countries, a balanced flow, roughly equal flows of trade between the two in both directions — one country 14 times the economic size of the other. It therefore follows that trade must, relatively speaking, be roughly 14 times as important for the small country than as for the large. So this imbalance then has nothing to do with Canada at all. We'd get the same imbalance if we were to split California off from the rest of the United States. It is a simple phenomenon of relative size. And the result is, if you can consider now each country imposing a protectionist measure on trade that cuts our trade with the other partner in half, let's suppose, then your protection will have sixteen times the impact on Canadian GNP and employment as our protectionist measures will have on you. Another corollary is if you introduce protection designed to hurt the Japanese, then if it is nondiscriminatory, applied to all countries, it may well hurt Canada even more. The result then is a key policy question in Canada -how do we avoid being side-swiped by U.S. protective policies aimed at others. I think that, in that regard, the really interesting development that has arisen is a possibility that the two countries who have been considering sectoral free-trade arrangements will now take a further additional step and begin to consider a general, across-the-board industrial free-trade arrangement. You're also contemplating this possibility with Israel.

Trade between Canada and the United States is by far the largest trade flow that now exists anywhere in the world or has ever existed in history. If paradoxically these two countries are two of the three industrialized countries that are not part of a common market or free-trade arrangement, (Japan is the third) this type of arrangement would be extremely beneficial for Canada and would also be beneficial for the United States, not only in economic terms - terms of increasing the market size (the market access) to U.S. manufacturers by 7 to 8%, which may not sound like much but it's an awful lot for companies that don't reach their break-even point until a point close to 100% - but also because it would mean a creative and positive arrangement of mutual benefit to two countries could be undertaken by the Americans in a world in which, unhappily, a lot of our dealings with our neighbors in this hemisphere can best be regarded as damaged limitation exercises.

So this, I think, is something well worth watching. If this possibility does develop it could make it a very exciting decade.

Another topic which I now propose to address is the topic of U.S. policies which are now being introduced which do not directly have a great impact on Canada, but which we have a great interest in for obvious reasons — policies of deregulation of industries which date back before this present administration, which have been carried out by your current administration, and policies of welfare reform. They don't directly affect us but we are very interested in seeing how these experiments in the U.S. develop because we have to address the same questions should we deregulate, should we reform our welfare system. On the one hand, if we look at deregulation, we've had substantial moves toward letting the private market work. We've come a long way, indeed, from several decades ago when planning was popular, in particular French planning was popular. Even the words themselves were reassuring. Planning suggested some intellectual content. French suggested something romantic. That was a great combination but you can't sell it today. As a comic has put it in France the private sector is the sector under government control and the government sector is the sector under no control. The French good news/bad news story. The good news is the economy is in a mess. The bad news is they're planning to do something about it.

I don't want to dwell on the subject of deregulation and planning and so on, but I do want to look at welfare reform, because I think it is indeed very important.

We've had an extremely interesting attempt by the U.S. in the last four years to get a handle on the welfare system, to tailor it and get it under control. And almost all would agree that was long overdue. At the same time, all would agree there must be a safety net in the system. Assistance must be provided to children, for example, in fatherless families. The real issue then is, how far do we go in supplementing income of the poor by government transfers. And the basic problem here is that when you start transferring income, there is a waste. And the more you transfer, the greater the waste becomes of transferring each additional dollar. You can think of the process as taking a dollar of income from the rich and transferring it to the poor in a bucket that leaks. The key question is, "How much of that dollar leaks out as waste en route?" This question was first posed by Arthur Okan, an ex-chairman of the Council of Economic Advisors in Washington, and it is now I suppose in perhaps the worst pun of the decade, referred to as the Okan bucket. The best estimate looks like the following; our estimates are still not great on this, but this is the way the picture looks. You take a dollar from the rich. There's a dead weight loss of something like 30 - 35 cents. The rich, in response to their higher taxes, work less. A lot of accounting and legal services are wasted in the attempts to find lower tax opportunities for these people. So there's a dead weight loss of about 35 cents at that point, so the total cost to society of extracting this dollar from the income stream runs something like \$1.30, \$1.35. The full dollar that is collected doesn't all, however, go to the poor. There are administrative costs. We're now in the range of something like 85 cents to 90 cents left. There's another difficulty here and that is when you grant this to the poor you don't increase their income by this amount, because some of the poor work less as a consequence, so that what you're doing is increasing their income by something like 65 cents. So that the best information we now have, and it's still a bit murky, is that's a bucket with something like a 50% leak. It's costing society $1.35 to raise the income of the poor by 65 cents, and there are other problems. The more you transfer, the greater the leak becomes per dollar of benefit delivered. The more income you distribute to the poor, the closer you bring them to the income they could earn if they continued to work. The less incentive they then have to continue to work, the greater the leak at this last stage then becomes.

Some transfer programs have a bigger leak than others. The simple transfer program I've been talking about assumes you tax only the rich and give only to the poor. But most tax systems involve taxing the rich and the middle class and most granting programs involve granting income to the poor and to the middle class to some degree, as well. So the transfer is no longer a clean one from the rich to the poor. A lot of the transfer is now occuring within the middle class, far less as a result then from the rich to the poor and you're spinning your wheels to some degree and you've got a bucket with a larger leak. It doesn't take much imagination to find buckets with leaks of 80-90%. You can sit down and on the back of an envelope scratch out a taxation welfare program in which you're dealing with a bucket that has no bottom in it at all, indeed, in which the leak may be more than 100%, if you can grasp that analogy.

The more we study this, the greater the leak seems to be. This doesn't mean that we abolish welfare. It doesn't necessarily mean we cut back on it an awful lot. But it does mean that we have a realistic view of its cost. We're watching the U.S. attempts to cut back on this with a great deal of interest and as we do we watch the U.S. poverty statistics.

As you tailor a welfare program and tighten it up, what happens to the percentage of the population that are in poverty? If you look historically at this percentage you find that it has fallen. It fell secularly and continuously until the late 1960's. In the 70's there was little change, although you could argue that because of non-cash benefits, like food stamps and medical services that were not included in the official statistics, we were still making progress. However, in the early 80's the situation here really took a turn for the worse. A 9% poverty rate in 1979 increased to 13% in 1983. That's adjusted for these non-cash benefits. That's very disquieting. And it was due to, first of all, the tightening up of the welfare system under the current administration; secondly, the worst recession since the 1930's, which meant that the Reagan administration, as it was reducing the reach of the welfare programs and tailoring them back, was nonetheless still making even larger welfare payments because of the increased demand for these due to the recession; and thirdly, the secular growth in problems that cause poverty, and in particular the break-up of the family unit.

Now let's just look at a couple of numbers here to give you a picture of what's going on. We've got 13% of the population in poverty in the U.S. We get what we expect when we look at the racial figures. The percentage for whites is just over 10%; the percentage for blacks almost 30%; and for Spanish origin 25%. There's a surprise when we come to look at family type. Persons in married-couple families -less than 8% of people in this situation are below the poverty line. Persons in fatherless families — almost 35% below the poverty line. So we've got a problem here with the type of family the individual is in. And when we put both of these together, the racial and the family problem, we get the proportion of the population in black, fatherless families, over 50% in the United States and this is a segment of the population which has been growing rapidly.

For an individual couple, some people have always viewed divorce as a luxury good and I leave with you the question, for society, is the family breakdown that's going on something we can any longer afford. Alice Rivlan, who followed Arthur Okan, made the comment that our higher income has provided us with the luxury of no longer having to live with our relatives. Is that a luxury we can still afford?

The second major issue I want to talk about is the distrupting effects on the world's financial system of the U.S. deficit. Perhaps I should take a break here for just a moment and see if there are any pressing questions or observations you want to make before pursuing this question.

MR. ROBERT MYERS: How do you define welfare? In other words, do you include the social insurances in welfare and if you do, I very much question the leak being that large because the leak in at least the Social Security program is only of the order of 1 1/2% for administrative expenses.

PROF. WONNACOTT: Social Security is included in these poverty statistics. Social insurance programs are indeed one of the major reasons why the poverty rate isn't even higher. When I talk about a leak in a bucket, I am talking not about that, I'm talking about increasing on the margin welfare payments by some form of taxation on the wealthy and distributing the income to the poor. So this is related to one of the observations but not the other.

MR. ROLAND DIETER: In the front page of our Saturday Toronto paper there was something very disturbing to me. I wanted you to comment on what our politicians would say in rebuttal. Reagan's administration is saying that they will not buy strategic metals for our stockpiles from Canadian producers, it has to be from the U.S., which of course hurts Canada.

PROF. WONNACOTT: You want my reaction to that? I guess if you're going to buy strategic things you want to buy them domestically, and yet in this case I can't see really the difficulty. Once you've bought them, you have them and if you're going to be stockpiling them I don't see how we have any control left of them. I'll leave you as the judges of whether we would be the people that would be high on your list or low on your list. I think we should be high on your list but there we go.

Let me get on with this deficit question, because it is a very important one. There's a lot of controversy now about the U.S. fiscal deficit and a lot of controversy about how it should be defined. How big is it? When you take account of adjusting it for inflation, adjusting it for cyclical recession and so on, how big is it? But the thing that must never be forgotten is that all $175 billion of it is still there, no matter how you define it. All that $175 billion is still there and it has to be financed and that financing has many real effects. It's not just a financial phenomenon. It has many real effects on the U.S. economy and on other economies. I'd like to turn to those.

First of all, it raises interest rates in the U.S. There are people in the U.S. current administration who would like to pull your leg with the suggestion that it doesn't raise interest rates. They know better. If you dump a truckload of government bonds on the market, as you must to finance this sort of deficit, it will do to bonds what the same activity will do to anything else; it will lower their price. And when you lower bond prices you're raising interest rates.

I'm not claiming that that's the only reason why interest rates, real interest rates, discounted for inflation, are now very high, but that's one of the important reasons. The real effect, of course, that everybody understands is that real interest rates reduce domestic investment and private investment by businesses who just don't undertake investment activities because of the high interest rates that they face. So there's a cutback then in domestic investment, more than there would be otherwise, although domestic investment now in the U.S. is looking good because of a number of tax breaks.

This crowding out is not one-to-one. Nobody suggests it is, but there is still some crowding out, some reduction of domestic investment that takes place, and this means that the additional consumer spending is now occurring in the United States because of the tax cut. The additional government expenditures on military equipment and so on —these are not coming free. The cost is in terms of the lower level of capital expenditure and a less effective capital stock in the U.S. than would otherwise occur and a lower level of capital investment in capital stock elsewhere in the world.

That brings me then to the second form of crowding out, which is not so well understood and that's crowding out on the international scene. Now the interest rate rise in the United States is moderated by an inflow of capital from abroad. This capital is being attracted by those high U.S. interest rates and it means that some of the U.S. deficit, a large part of the U.S. deficit, is being financed by foreign funds. This reduces the crowding out, the pressure on U.S. domestic investment, but it raises another problem — the large capital inflows lead to a rise in the value of the U.S. dollar.

Again, there are other influences at work on the U.S. dollar at present but this is one of the important pressures. This deters exports and increases imports. U.S. firms have difficulty in competing because U.S. goods are now more expensive as the value of the U.S. dollar rises. The result is the sheer $120 billion projected trade deficit. A trade deficit of staggering proportions for any country, and especially so for a country which normally runs a trade surplus.

If we recap then, we have a deficit which raises interest rates, which attracts capital from abroad and in response to this capital inflow the U.S. dollar keeps rising until a trade deficit is created sufficient to offset that capital inflow. So the U.S. dollar is not up there, is not elevated, as some people suggested, by some form of black magic. It won't be cured as others have suggested by a trade deficit. Instead it's caused by the capital inflow and in turn, the high value of the U.S. dollar creates the offsetting trade deficit.

So the result then is a crowding out from the U.S. deficit on trade account. And the crowding out then (the pressure on U.S. internationally competing industries - their inability to compete) is going to be something like, measured by the size of the trade deficit, $120 billion this year. With a total U.S. deficit of $175 billion, you can see that we're talking about a situation which the trade crowding out is more important than the domestic investment crowding out.

So the brunt then of this deficit is now falling on these industries like steel and so on, that are facing this tough foreign competition because of the elevated value of the U.S. dollar. This raises a clamor for protection, industries asking how can we compete. And the Reagan administration's record on this in dealing with protectionist pressure has essentially been good. Although it must be recognized that this was in dealing with a problem that was in some degree created by its own deficit policies. You've got to be running this trade deficit. And the problem here is that we need a liberal trading system. The U.S. has been and is the natural leader in the world for that trading system and yet pressures for protection, very serious pressures for protection, are being generated in the U.S.

There are other problems that can be attributed to the deficit and these problems can be attributed indirectly to the deficit and more particularly to the high interest rates that have followed. The debt-ridden third world problems, of course, are high on that list. High interest rates raise three problems for these countries. First a softening of commodity prices. High interest rates bring that. The case of Mexico is perhaps the most disasterous in this regard, since loans were granted to Mexico on the assumption that the price of oil would continue to rise and that's just not happening. In real terms the price of oil is falling. And probably in nominal terms, in any terms, it may continue to weaken somewhat. That's an open question. Secondly of course a high interest rate increases the carrying cost of these countries on the debt they have incurred. And thirdly, the high interest rates, by elevating the value of the U.S. dollar, have increased the denomination in which a lot of this debt is set so that the burden of the debt increases in that respect as well.

I had a lot more to say here about trade and I can talk about it, trade between the two countries. On the trade topic, again I mentioned that the major problem for Canada, if the U.S. does become more protectionist, and our current policy has been very much designed as an attempt to insure secure future access to the U.S. market. That's what brought the Canadian government to Washington, to arrange some sort of sectoral or other type of free-trade arrangement. Great advantages from the Canadian point of view of a broad free-trade arrangement with the U.S. are traditional, mutual benefits for both countries from liberalizing trade that comes from comparative advantages. We've all learned about these in our basic course in economics.

Much more important are advantages that will come to Canada from economies of scale, cost reductions that are possible in Canadian manufacturing as volume increases as our market size is expanded. Our manufacturers now in Canada have access to a domestic market of 20 million people. All our industrial competitors, in the United States, in Japan, in Europe, have access to a domestic market of 100 million people or more. In an increasingly competitive world many industries can't be competitive without unimpeded access to this sort of very large market and the ability to exploit economies of scale.

So our interests then are not only in protecting our very high and important level of present trade against U.S. protection, but in expanding these opportunities, in a sense making the domestic market the market of both countries in North America the domestic market of each, and thus expanding our access to much higher volume activities.

The problems with the sectoral approach we're now talking about in Washington is first of all, it's small potatoes. One of the sectors they're talking about is agricultural implements. We already have free trade in most agricultural implements. The addition here would be more cosmetic than real. Some of the other sectors are more interesting. Secondly, we violate our international agreements in GATT, the Geneva Agreement on Tariffs and Trade, which restrict countries from engaging in industrial programs that are preferential, that don't include the rest of the world. We can't open our trade between two countries if we're not opening it to other countries as well. The more ambitious alternative of a broad free-trade arrangement is consistent with GATT, as long as it covers most industries it's consistent with Article 24 of GATT. Incidentally Article 24 was required by the United States when GATT was being set up, because of the possibility at that time that Canada and the United States would be using that provision to be forming a free-trade arrangement.

There has been an enormous historical reluctance in Canada to engage in closer economic relations with the U.S. That process has now been, in large part, overcome. Our business community is now either neutral or in favor of such an initiative because the only opposition to a free-trade arrangement is going to come from business or labor. They're the ones who run the risk from tougher import competition, until they conclude that the value of access to the foreign market is more important to them than the increased competition from imports from the partner will be damaging. At that point the case is made, because every other group in Canada has an interest in liberalizing trade in this way. Consumers get a lower price. Resource sectors get lower input cost. Service industries get lower input cost. The gains to Canada have been estimated at something like 5-10% of GNP and that's a very large slice of income indeed. And the fact that because Canadian industry would be tested in the international marketplace, it would find it easier to adjust to the even more severe shocks that are going to occur in the future that we've got to learn to deal with, such as the increased imports from the newly industrialized countries. So it may indeed be an exciting decade if this development bears out.

QUESTION FROM THE FLOOR: The comment you made about the large deficit -- what should the United States do to reduce our budget deficit, in particular, should we increase taxes?

PROF. WONNACOTT: I'm not going to stand up here and pass judgement on that, but there are a number of programs that could be tried...First of all, no one is going to try to cut the deficit in half overnight, and there would indeed be problems if an attempt was made of that kind, because the deficit does generate aggregate demands. That is, in part, responsible for this rapid recovery in the United States. So you want to get your deficit under control, but you've got to be talking about a five or ten-year program for doing so and a really tough, responsible program over that period. But there are expenditure cuts that would be possible. Let's forget about taxes for the moment. Expenditure cuts would be possible. The enormous increase in government outlays to agriculture, for example, in the last five years, look at those — those are really incredible. Read the latest reports of study groups who work on military procurement. If you try to force a tremendous amount of money through any given pipe, as has been attempted by the U.S. administration in the last four years, then you're going to find there's an awful lot of waste. And the more you try to force, the larger the margin of waste becomes, in the newspapers yesterday, $7,000 for a coffee-making machine; $75,000 for a ladder — a good ladder, a great ladder, a high-tech ladder.

QUESTION FROM THE FLOOR: I have a question about comparing the 1979 poverty percentage of people under the poverty level in 1983. It doesn't seem like a valid comparison to compare a year in which you're at your top economic growth in a relative boom, to a year in which you're at the bottom of the worst recession since the 30's. Wouldn't a more valid comparison of progress against poverty compare, let's say the bottom of the 1975 recession to the bottom of the 1983 recession, or conversely, shouldn't we wait until we get to the top of the current expansion to compare to the top of the previous expansion in 1979?

PROF. WONNACOTT: Yes, indeed, that's why I was very explicit in saying that one of the reasons for the increase was because of the unemployment. But if you do compare from '75 to '83 you find a big increase as well. And if you do look at the recessions in 1970, '74, '75, you do find the recessionary impact, but it's less than 1%. If we talk about a recession impact of being perhaps greater or maybe even double the recession impact in '70, '74, '75, we've still got a big component left unexplained. Your point is very well taken. The only reason for comparing those two years is because '79 was the year things started to go really bad.