

Speech

**“What Kind of Canada
Do We Want?”**

by

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CHECK AGAINST DELIVERY

Thank you, Mary Anne.

It will come as no surprise to you that I am going to talk today about the proposed merger of Bank of Montreal with Royal Bank of Canada. But I am going to do that by talking about the merger in the context of a much bigger and more important national issue and challenge. Obviously, by doing so I hope to show that the merger is both a positive development and an important initiative, one that is consistent with helping Canada cope with one of our most serious tasks today.

For over eight months now we have been debating how the merger will affect different constituencies: rural and remote areas, small businesses, and bank employees, to name only three of the most high-profile among many.

All these issues are important. All of them, and more, will be dealt with in the process of review by government agencies, parliamentary committees and public hearings that is now well under way. But it is unlikely that the process will discuss what, to my mind, may be the single most crucial issue facing Canadians today.

The proposed merger can be seen as a proxy for the much broader question of whether Canada will have the companies, the industries, and the general high level of productivity needed to compete with the most productive and competitive companies in the world.

Banks everywhere are merging for one and the same reason, to achieve higher productivity.

In our case at Bank of Montreal, we know that becoming more productive is the only way we can give Canadians what they expect of a big Canadian bank: nation-wide, full-service banking, available through both a vast branch network and the latest electronic access channels.

We know improving our efficiency is the only way we can continue to give Canadians that level of service, and at the same time, be able to compete here in Canada with the most productive U.S. and overseas financial institutions.

But this is not a challenge unique to the financial services industry. Canada itself urgently needs to achieve higher productivity as a nation. We expect a lot of our country. We want a full-service nation, yet we haven't been winning the kind of productivity gains we need to afford one.

For twenty-five years or more, the sluggish productivity growth of the nation has been a debilitating economic virus. Year after year and decade after decade, the gap grows larger between what one Canadian produces on average and what one American on average produces. This is the root cause of the stagnation of our real after-tax incomes.

For the last eight months, the merger debate, it could be argued, has been focused on just two trees and not the forest. In one way that is understandable. The issues raised by the proposed merger involve the public interest, and it is right they should be thoroughly debated. But we should be spending much more time looking at the forest, that is, at the extent to which the merger, if allowed, contributes to advancing Canada down the path of preparing for the 21st century.

Ladies and gentlemen, the contours of that forest have been dramatically shaped by events. Toward the end of the last century, Sir John A. MacDonald launched a new economic strategy for Canada which he named the National Policy. Its purpose was to create a unified and protected Canadian market, in which Canada's infant industries could learn to compete. Today, at the close of the twentieth century, I believe government, business and the public must work together to create an International Policy, one that will enable Canada's industries to compete with best-in-class competitors in any market, with top priority for serving our Canadian customers. That is why whatever the merger decision proves to be, it will not and cannot be just a decision on the future of two banks. It will be one step, taken in the private sector, toward shaping the kind of Canada we will have in the new century that now lies just ahead.



Canada is already a very different place from the Canada I first saw as a young immigrant just over thirty years ago. In those years we have all lived through an economic revolution. The old Canadian economy has gone. We are still constructing its replacement.

In 1967 Canadians were prospering in an economy that could be compared to a three-legged stool. We had a large and growing public sector, buoyant natural resource exports, and protected manufacturing, transport, and communications industries. Output, incomes, and productivity were rising substantially. Canada was a major trading nation, but much of the economy enjoyed a significant degree of natural or legislated protection from the full force of international competition.

In the 1970s signs of trouble appeared. The long-running growth in Canada's productivity slowed dramatically. The three-legged economy was beginning to wobble. Expanding government began to run up against fiscal and constitutional constraints. The GATT rounds lowered protectionist barriers. Information technology reduced natural barriers by making space and distance increasingly irrelevant. Not least, the growing sophistication of Canadian consumers made them more and more reluctant to pay the higher prices or accept the lower standards that a protectionist regime inevitably entails.

Canada's signatures of the FTA in 1988 and of NAFTA in 1992 meant that the comfortable, protected past was irretrievably gone. Now Canada found itself naked and exposed, unequivocally part of a North American and global economy where both legislative and natural barriers had disappeared and there was no place to hide.

Geography reinforced the impact. In many ways living beside the American leviathan is an immense opportunity, giving Canadian companies access to the largest and richest market in the world. Joining NAFTA was a good move for Canada, and I applaud it, but there are two sides to the NAFTA coin, as the debate that raged at the time clearly demonstrated. The flip side of the export gains was and is that Canada is only one hour away from an economy with more powerful, competitive, best-in-class companies than any other place on earth.

For a physically contiguous nation with only 30 million people, spread over a land area larger than all of Europe, meeting such a competitive challenge has meant taking hard choices. Those choices were especially hard because through the 1980's Canada's rate of productivity growth had been less than half that of the United States.

Companies operating in a protected economy could safely ignore such a gap, since they could simply raise their prices to cover their higher costs and assure themselves of a reasonable return on investment. Now this option was not available.

If a Canadian company wanted to survive, it now had to become productive enough to compete head-on with the best in class in North America or the world.

If Canadians as a nation wanted to preserve their high standard of living, they had no choice but to become steadily more productive and competitive.

These problems have not gone unnoticed. Canada's sluggish productivity growth was recognized in the Government's "Purple Book" of 1994¹. Just over two weeks ago the Prime Minister, addressing an audience in New Brunswick, said that the government's over-riding objective will be to do whatever it takes to produce more jobs, higher incomes and a higher standard of living for Canadians, and that to do that we must enhance our productivity.² Yet so far, accurate diagnosis has not brought a cure. Canada's productivity growth rate in the 1990's has continued to lag that of the U.S. by as much as a third.



¹ "As well, the growth of productivity, roughly a measure of the value of what we get out of production compared with what we put in, has also been a concern. During the period of gradually increasing unemployment levels since the 1970s, productivity growth sputtered and then stopped, causing growth in our standard of living to stall. We cannot improve real incomes unless we improve productivity". Canada, Department of Finance: *Agenda, Jobs and Growth*, November 1994.

² Quoted in Giles Gherson, "PM Targets Standard of Living", *The Vancouver Sun*, October 3, 1998.

So far in the 1990s we have seen Canada move half-way toward a new economy. Happily, we have some successes to report. Exports have been very strong. Manufacturing has been revitalized and includes a growing knowledge-based industry sector. Several companies, once bastions of the old economy, have successfully adapted to the much more demanding conditions of the new.

Canada's railroads, for example, have made remarkable progress toward becoming more efficient, although their productivity is still somewhat lower than that of the U.S. railroads. Canadian National has been responding to this challenge by growth through acquisitions, most notably its recent purchase of Illinois Central as a long step toward building an integrated North American rail system.

Retailers have experienced a series of threats, first from a high Canadian dollar which forced down their margins by encouraging cross-border shopping, then from formidable competition in their home market from the likes of Wal-Mart and Home Depot. Traditional department stores faced a choice: either they could achieve the size needed to make the large investments in sophisticated inventory control, ordering, selective distribution and sales tracking systems (as Hudson's Bay has done), discontinue certain lines of business as Eaton's has done, sell the business to a powerful competitor as Aikenhead's did, or even exit the business altogether as Woolworth's did. What none of them could do was choose the status quo.

Auto parts manufacturers have their own version of this choice. They can make the investments necessary to become not just parts makers, but auto systems developers and integrators. They can become second-tier suppliers, or even be forced out of the industry. Many have already suffered the latter fate. A few, notably Magna, have successfully made the transition and are growing rapidly through both internal growth and acquisitions.

For many companies, the struggle to adapt continues to be hard. In the information-intensive industries, of which financial services is one, the transition from a high level of effective protection to an open international market has been especially sharp. Not so long ago, the heavy regulation of television and radio broadcasting, or the possession of a nation-wide, bricks and mortar bank branch network virtually guaranteed market share and acted as a powerful barrier to entry by new competitors. Now, the competition is as far away as your telephone, your PC or the satellite dish on your roof. Even more than most Canadian industries, information industries know they are playing in an entirely new and tougher league.



The intense and protracted study the government and its agencies are putting into the future of the financial services industry recognizes the national importance of an industry that can hold its own and make a smooth transition to the new, borderless world.

Financial services are the lifeblood of all advanced economies. They are part of every transaction from the largest to the smallest, and their price is included in every other price. Their efficiency, or lack of it, affects the efficiency and the competitiveness of the whole economy.

In many respects Canada's financial institutions have served us well. We have safe, sound institutions that offer a remarkably wide range of products and services and perform billions of transactions with remarkable speed and accuracy. All the same, we have not escaped the broader national problem. Banks measure productivity by calculating the ratio of non-interest expenses to revenues. For the major Canadian banks, that ratio is consistently worse than that of the best United States and international financial institutions. Canadian banks spend from 60 to 65 cents of every dollar earned on non-interest expenses. For the best U.S. banks the figure is 53 to 55 cents – in some cases, even lower. As the MacKay Report points out, this difference has if anything tended to widen in recent years.³

Our productivity is relatively low because while our costs are high, as the MacKay Report acknowledged our service charges are lower than those in the U.S., our spreads – the difference between the interest we pay on deposits and the interest we charge on loans - are narrower than those in the U.S, and our taxes, which of course add to the cost of everything we do, are very significantly higher than those in the U.S.

Our costs in turn are high because we have increasing difficulty in funding both the massive investment required by new technologies, and the continuing high costs of maintaining our traditional bricks-and-mortar branch distribution network alongside the new channels.

Yet we must do both. We live in Canada, not in the United States, and Canadians both expect and deserve a lot from their big banks. Very few customers use only our branches, or only the new electronic channels. We find ourselves building and maintaining two major delivery systems, supported by the same customers whom we used to be able to serve through the branch system alone. Many customers want face-to-face service, and resent feeling pushed to use banking machines or telephone banking. We want to be able to serve them in the way they want to be served.

The problem of funding adequate investment in technology is perhaps most acute. While the cost of a single electronic transaction may be very low, the cost of the investment needed to make that transaction possible is enormous and rising. As the MacKay Report notes, the three largest banks in the United States spent US\$5 billion on technology in 1996, while the three largest in Canada spent only US\$1.6 billion.⁴ A gap in productivity-enhancing investment as large as this one, in a key industry, raises troubling questions about Canada's future in a knowledge-based world.

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³ MacKay Report, Background Paper #1, p. 115.

⁴ MacKay Report, p 55.

To repeat, in a borderless world productivity gaps matter. They cannot be safely ignored, nor will they go away by themselves. And there are really only two ways to close the gap — two that are broadly comparable to those available to railways, retailers and auto parts manufacturers.

The first is growth. The second is specialization.

By growing our business we can expand our customer base, achieving economies of scale and scope and improving our productivity by increasing revenues relative to costs. In a mature and fiercely competitive market like the Canadian financial services market, however, this is not easy to do.

By far the quickest, most cost-efficient way of growing our business is to seek a merger with another Canadian bank. It is also the most visionary way, allowing us to make the changes required to be competitive without shortchanging our customers, without massive layoffs and without exiting marketplaces or lines of business.

By merging with Royal Bank of Canada, we can achieve significantly higher productivity through more efficient investment in technology and larger scale in lines of business. As I suggested at the outset of these remarks, higher productivity in turn will pay for:

- a full-service bank, with both electronic access channels and branches nationwide;
- a Canadian-based, Canadian-controlled world-class bank in Canada, with all that that means for well-paid Canadian jobs, orders for hundreds of Canadian businesses, and decisions taken in Canada for Canadian purposes;
- a bank whose productivity and efficiency contributes to raising the productivity of the Canadian economy as a whole, and not least
- a bank with the resources to re-invent the range and quality of customer service at a level beyond anything experienced before.



Growth by merger is thus our first and preferred choice. The second is specialization, a decision to concentrate on those businesses we do best.

Let me emphasize, along with every other observer of the sector, that the status quo is not a third choice, however appealing it may seem. As I have already said, at their present size Canadian banks are finding it increasingly difficult to fund both the massive costs of operating thousand-branch national networks, and the huge investments in technology, training, research and development needed to give Canadians state-of-the-art services and keep Canada competitive abroad.

Sooner rather than later, something is going to have to give. Pressure from our shareholders will ensure that. I know very well that shareholders are not the only people who have a legitimate interest in the merger issue. But in an era of pension-fund capitalism, it is not wise to ignore the interests of the shareholders indefinitely. And I remind you all that one out of every two Canadian households is either directly or indirectly a shareholder in our banks.

The pressure to produce acceptable rates of return means that Canadian banks will have strong incentives to drop lines of business altogether, as all of them have already dropped payroll processing and most have already dropped global custody. We would increasingly concentrate on strong, profitable businesses – or in other words, we would not continue to invest in those businesses which were not profitable and not expected to become so.

As I told the House of Commons Finance Committee on September 25, Bank of Montreal would emerge from the specialization option much smaller, much more productive, much more able to invest in our chosen businesses. We would also no longer be a nation-wide, full-service bank with an ubiquitous community presence, nor active as we now are in more than thirty different lines of business. I did not become chairman of this bank to preside over an era of the remarkable shrinking bank. The proposed merger, in my view, is a textbook example of true conservatism: preserving what is best from the past, by intelligent adaptation to change.



I have spoken at some length of Canada's productivity problem and its counterpart challenge at Bank of Montreal. In different ways all Canadian industries face the same challenge, the need to adapt to living in a world where your competitor is never more than a step behind you.

Very often, meeting that challenge has been acutely painful. Many thousands of jobs have been lost, many companies have merged, been sold or gone out of business. Adapting has been especially difficult for government, the biggest service industry of all, with tens of thousands of jobs gone for good and sharply reduced standards of service delivery.

This record, is of course, one reason why the proposed merger has aroused such widespread public interest and concern. Yet to me it is reasonable to expect that in the case of the banks, the transformation will be relatively painless, if we can make it soon, and not be forced to wait until our backs are to the wall.

Take the future of our employees. We have a strong track record of redeploying staff as jobs change. Over the past 10 years, 60% of Bank of Montreal employees have been trained for new jobs and moved into them. This capacity to retrain and redeploy, in combination with our normal rate of turnover, is what makes us confident that the merger can be accomplished without mass layoffs. That is why we can realistically adopt as our objective that there will be no involuntary layoffs as a result of the merger.

Again, since the whole purpose of this merger is to grow our customer base, not to shrink it, it is only reasonable to expect that we will share its benefits through such things as better access, lower service fees, and more targeted services for our retail and small business customers. That's what we have promised to do, and that's what we will do because it will make good business sense to do it.

It will make good business sense, in turn, because increasing competition in financial services will leave us little choice. There has been widespread concern that the merger will increase the degree of concentration in the financial services industry and thereby lead to less competition, higher prices and poorer service. This, with all respect to those who believe it, is not merely simplistic, it is just plain wrong.

In the first place, intense competition can and does exist in industries with a high degree of concentration. Think about Coke and Pepsi. In the second place, as the MacKay Report indicates, concentration in Canadian financial services is much less than in many other Canadian industries, with the six major banks together having less than half the total assets of the industry. Moreover, the degree of concentration is steadily decreasing and - if the recommendations of the MacKay Report are implemented, as I hope they will be - it will decrease still further.

Finally, if relatively small countries like Canada are to have corporations that can compete, some at least are going to have to be large corporations, with the human and financial resources to do the job. Some of the largest banks in the world are in small countries like the Netherlands and Switzerland, whose governments encouraged them to achieve the scale needed to compete and prosper at home and abroad.



Let me touch very briefly on the question of timing. It has sometimes been said in recent months that Bank of Montréal and Royal Bank of Canada were "too early" in our merger proposal. Personally, I fear just the opposite is true. It has been well said that you may not know when you're too early but you find out quickly if you're too late. In my view the writing has been on the wall for some time, and I don't believe we should simply watch passively from our towers while one business line after another gets eaten away far below.

Ladies and gentlemen, as I've said it is right and proper that the proposed merger should be subject to intense review and public debate. It is also important that we do not lose too much time in shaping our response to forces that will not wait for us to set our house in order. You may have seen that the Citibank/Travelers merger, creating the world's largest financial institution, is expected to be approved less than six months after its announcement, even though it involved a major policy change for the United States government. There is a lesson here. In today's financial services universe, the readiness is all.



Finally, does all this matter for ordinary Canadians? Why should they care, why should you care whether or not the banks are allowed to make their option for growth?

I believe it matters a great deal to everyone living in this country. It matters so much, in fact, that it is too important to be left to bankers or even to politicians. It is a question on which all Canadians should become informed and involved.

It matters because improving our productivity is ultimately the only way we can raise our living standards and leave our children a richer country and a better way of life than the one we inherited

It matters because improving our productivity is ultimately the only way we can be sure of creating and retaining well-paid jobs in Canada.

It matters because creating those jobs is the only way we can keep our well-trained young people in Canada, instead of exporting them to the United States to work for Bill Gates.

It matters because improving our productivity is the only way we can be sure of having powerful, competitive, Canadian-based and Canadian controlled companies and industries, with all that that means for our ability to shape our own economic destiny.

Finally, our option for growth matters, to repeat, because in some measure it will help to determine what kind of country we are. For too long and too often in Canada, nationalism was expressed in negative terms, in attempts to exclude all that came from outside. The time for that negative nationalism is now long gone. We need a new and positive nationalism, strong in the self-confidence of a country that knows itself able to match the best in the world.

That is the real issue before us. That is the choice I hope Canada will make.