

**WHAT IF
SEPARATION WERE
NOT FEASIBLE?**

Notes for a
Conference
by

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I would like to begin by thanking you for inviting me as your guest speaker. It is always an honour to speak to such a distinguished audience. I wish I could address a different topic than the one I chose, for the problem we all face, as Canadians, with the constitutional quandary, is definitely not conducive to rejoicing, and speaking on this subject is definitely not an uplifting exercise.

There is an old trick that Toastmaster International probably teaches to its students in public speaking 101. First, choose a question as the title of your speech. Second, make sure that your audience agrees with you on the answer to the question. This I have done. But I must admit to you that I deliberately went one step further in the application of good Toastmaster principles. I chose an easy question: What if the separation of Québec were not feasible?

I would like today to talk about the economic impacts of separation on the Québec economies and on the Canadian economies. That should lead to an agreement on the answer to that question. The impacts would be so large and negative, that the political process, in its great democratic wisdom, will prevent separation from happening. The costs are much higher than what our society can accept. I would also like in conclusion to briefly analyze where the demise of this second attempt at convincing Québecers to separate could lead this country, that is in what direction the impetus generated by the current constitutional crisis will lead the governance system of this country.

In recent weeks, there has been a flurry of analyses released publicly which concluded that the separation of Québec would be far from the neat process imagined by Mr. Parizeau, and that this messiness is likely to derail it. Patrick Monahan, a professor at Western University, Gordon Gibson, a well-known political commentator from Vancouver and Tom Kierans, of the C.D. Howe Institute, have all indicated recently that to the extent that the Québec separatist project rests on the negotiation of several complex issues with the rest of Canada, and in particular, an economic association, it is unlikely to be achieved in the timetable proposed by Mr Parizeau, namely within one year after a victory of the

separatist option in a Québec referendum. These experts have correctly pointed out that what is conveniently called the Rest of Canada would not conduct swift negotiations with a renegade Québec.

The roadblocks would be numerous. Problems of political legitimacy in Ottawa would arise, since neither Mr Chrétien nor any other federal prime minister for that matter would have a mandate to sit down and negotiate with Jacques Parizeau. Divergent political interests throughout the rest of Canada would soon arise and temporarily derail and delay any negotiations with Québec. If Québec announced that it wants to pull out of Canada, the priorities of most Provinces would not be to negotiate an economic association with Québec. Indeed, such a association would be a very complex and politically unattractive issue to their electorate. Their priority would be to renegotiate a restructuring of what is left of Canada. As the French said it, "Le Roi est mort, vive le Roi". The economic association issue would be on the back burner. More important questions would be whether the new Canada should centralize or decentralize, whether Ontario should control 50% of the House of Commons, as its share of population calls for, whether aboriginal sovereignty should be recognized, whether we should have a Triple E Senate, etc.

These legitimate priorities of various Canadian constitutional players are far different from those on Mr Parizeau's agenda and will take precedence. But unfortunately for Mr Parizeau, the particular rules of Canadian constitutional politics, and in particular the requirement for unanimity, preclude any sensible agreement on these issues for several years. Meanwhile, Québec would be waiting for its economic association, an agreement which we can roughly characterize as ten times more complex than the Free Trade Agreement, which took three years to be negotiated and approved and did not require unanimity. For Mr Parizeau to believe that the negotiation of such a complex agreement would be a priority for the rest of Canada and could be finalized within one year is to dream in technicolor. Any significant delay would seriously erode support for separation. Thus, two essential conditions for a strong support of the separatist

option in Québec, namely an orderly parting and an economic association, are for all practical purposes, unachievable, given the constraints of Canadian constitutional politics and the limits of an electoral mandate.

But that, in my opinion, is not the main reason why separation will be derailed by the inherent wisdom of the democratic process. The cost of divorce, for the two parties involved, are way beyond what they can afford. As soon as the population realizes it, the idea of divorce will be relegated to where it belongs, that is, to university seminars, the appropriate forum for discussing theoretical options.

This may sound surprising or somewhat arrogant to some of you. How can I say this, in light of the open support for the separatist option by numerous economists, including Mr Parizeau, and of the numerous studies which supported the economic feasibility of Québec separation? Political correctness makes the public analysis of the costs of separation difficult in Québec. A central element of the Parti Québécois' strategy for leading Québec to independence is to sugarcoat its economic difficulties. Not only is it claimed that there will be a economic agreement negotiated with the rest of Canada, but also that the separation itself will be no more painful than a visit to the dentist, if I may borrow a familiar metaphor once used in this room.

I dispute this assertion. Canada might have a toothache, and it might be a good idea to visit the dentist. But pulling out not one, not two, not three but several large teeth, without any local anaesthesia, is not the way toothaches are taken care of in today's society. Separation is harsh and cruel medicine, indeed, totally unacceptable medicine for our constitutional toothache.

The separation of Québec would unleash three types of economic forces on Québec and to a lesser extent, on the rest of Canada, creating pressures to a degree unheard of in our history. First, there would be real adjustments to the economy. The "rules" would be changed and people and corporations would adapt. The most important of these real shocks would affect the Montréal

economy, where 50% of Québec's gross domestic product is generated. Montréal is 25% anglophone. The percentage of anglophones who would elect to leave this new country of Québec is a topic not really discussed in Québec, for it is not politically correct to assume that a significant number of anglophones would leave. What could that number be, in light of the fact that Québec would also be hit by a depression more severe than anything we have ever witnessed in Canada, a recession as severe as the ones which have hit the Eastern European countries during their recent visits to the dentist? The break-up of countries is generally accompanied by massive migration of minorities. There would be one such migration out of Montréal, and for a few years, it would cripple that city's economy.

A second economic shock would be felt in the Hull region, across the river from Ottawa, which leads in terms of income per capita in Québec and whose economy is totally dependent on the federal government. Ten to fifteen thousand jobs would be lost within a year or two in that region, a social experiment that only blind ideologists can wave off as "something that will be taken care of". But a more significant shock would be felt in rural Québec, with the withdrawal of the Canadian milk marketing plan. One third of Québec milk, or roughly 12 % of Québec agricultural output, would suddenly lose its market. As you probably know, Canadian milk prices are about twice the world prices, a protectionist measure which resisted the last GATT renegotiation, and whose benefits are somewhat skewed towards Québec. Canadian consumers would not be in the mood to subsidize Québec farmers the day after separation, especially when milk is the only major agricultural commodity which is the object of such a cross-provincial subsidy by consumers. The industrial jobs associated with that production would also drop, a \$1 billion real shock to the Québec rural economy. This would have severe ripple effects throughout Québec's rural economy.

There would be other real shocks as the economy adapts to the legal discontinuity that results from the existence of two countries, the break-down of traditional government procurement patterns, the emergence of trade barriers,

petty harassments and discrimination, and the temporary suspension of NAFTA as it applies in Québec. Indeed, Québec admission into NAFTA would be contingent upon numerous conditions dictated by Canadian and American politics, One such condition is likely to be a satisfactory agreement with Québec aboriginals, who have sovereignty plans of their own.

These real shocks would induce a recession not only in Québec, but in Central and Atlantic Canada. This is also not sufficiently realized. Canadians and Québécois behave with regard to separation as patients who believe that they will be able to walk scot-free the day after a major open-heart surgery. That would not be the case. The divorce would be painful for the real economy, on both sides.

The second type of economic forces would be monetary. Canadian governments owe close to \$800 billion, nearly three hundred of which to non-Canadians. We are paying a premium of nearly 1% in interest rates, (amounting to \$8 billion), to entice lenders to stick with our debt. The possibility of Québec separating would force the Bank of Canada to pursue an even tighter monetary policy, and a bigger premium, deterring investments which otherwise would have been undertaken. All Canadians would be losing in the process. But if it were to separate, Québec would face an even more important problem. The Parti Québécois' common currency scheme, that is keeping the Canadian dollar as the currency of an independent Québec, does not pass any reality check. So-called convergence criteria for assessing whether a common currency can be used would not be met. In particular, an independent Québec would face a large current account deficit, resulting mainly from its indebtedness to the government of Canada, as a result of picking up its share of the federal debt. This deficit would point to the long term instability of the common currency area, precipitating preemptive capital outflows by investors. The household sector in Québec holds over \$100 billion in liquid assets. In the age of electronic currency, no government, however smart, can prevent a stampede of capital if basic confidence in the currency is not present. There are enough sceptical Québécois at the moment on this issue to make any common currency scheme simply impossible.

The Québec economy would go through a particularly difficult time when its government would attempt to set up a new currency. There is an old law in economics, Gresham's Law, that says that bad money chases away good money. Québec businesses would have to go through a period of severe liquidity shortage, forcing them to curtail activities, thus fuelling deflationary pressures in the economy.

The third type of hostile forces pressuring the Québec economy would be the severely restrictive fiscal policy that the government would have to pursue. On day one, the government would have to reduce its deficit and curtail its borrowings. In 1991, economists sympathizing with Québec's independence calculated that even if there was no recession and if Québec would assume only 19% of the federal debt, it would still face a deficit in the \$14 to \$15 billion range. Four years later, the public debt to be borne by Québec after independence has increased by \$50 to \$60 billion, and real interest rates, by 2%. Disregarding facilitating but unrealistic assumptions, such as Québec not picking its fair share of the federal debt or no traumatic recession, the estimated deficit of the government, before any cuts in programs or tax increases, looms in the \$20 to \$25 billion range, or 12% to 14% of the GDP. This would be unfinanceable.

The government of a newly independent Québec would be forced to tax and cut at rates unprecedented in the history of Canada. The deflationary impact of such a drastic deficit reduction exercise would have major macro-economic effect, specially since Québec would not benefit anymore from the stabilizing effect of the Canadian fiscal federalism.

The convergence of real shocks, such as the losses of markets for Québec milk, the restrictive monetary policy and the shortage of liquidity, and the deflationary would sent the Québec economy into a tailspin This is not good news for Québécois, nor Canada as a whole, as the impact would be swiftly transmitted to the rest of the country. We would all suffer from these follies.

The fact of the matter is that the 1995 Québec economy is characterized by a significant macro-economic disequilibrium in its government sector. It copes with it by borrowing abroad. Belonging to the Canadian federal fiscal system also helps, to the extent of \$3 billion per year in net transfers and more in lower borrowing costs. Québec is just not strong enough to walk away from that support system and face the challenges of a post-secession trauma, without risking a severe crisis. The high levels of deficit and indebtedness are the major factors. Indeed, if Ontario were to separate, it would face the same problems.

Do Québecers know that? To a certain extent, yes. The committed separatists believe that the costs are not that high and that achieving independence is worth it. After all, aren't small countries doing quite well in Europe? A divorce is not the end of the world. Such views, which you heard from Mr Parizeau, are prevalent among the supporters of the Parti Québécois. Carried away by their enthusiasm, they also tend to overlook many of the practical problems I alluded to.

But the majority of Québecers do not share their optimism. They are wary of the costs of independence, and indeed, the referendum will be won or lost on this issue. As one expects, the PQ strategy calls for down playing these costs and difficulties. Their proposal calls for negotiating an economic association and a common currency and asserts that Québecers will benefit from dual citizenship, in fact keep their Canadian passport. Those that question the realism of such assertions are quickly branded extremists. As a consequence, the Parti Québécois has had a certain success in silencing economists and in getting experts and commentators to put in their analysis assumptions which are overly generous toward the Parti Québécois positions, so as to ensure that their views are not instantly dismissed as simplistic fearmongering. Thus nobody dares to say that separation will create an unmitigated economic disaster. Political correctness is alive and well in Québec when it comes to this issue.

But no matter how clever that strategy is, the costs are too big to be hidden. They will be publicized. The federalist forces in Québec are active. I will do my share,

with a book on the subject in a month from now. I also had the pleasure of working with David Johnston, on an English version of the book, which will also be available in mid March.

There is a segment of Québécois, about a third of the population, who are ambivalent about their nationhood. Although they are nationalists and are unsatisfied with the status quo, they also want to keep the benefits of Canada. Thus they are longing mainly for a rearrangement, not a messy divorce. These ambivalent Québécois are likely to turn down Mr Parizeau's invitation in the upcoming referendum. The costs are just too big.

It is thus difficult to see how the separation of Québec could be achieved in the foreseeable future, since the cost of the divorce will remain fairly high for a certain time. If Canada and Québec were in good fiscal shape, with twin surpluses, in the budgets and in the current accounts, and if public indebtedness was not so high, one could see how Québec could finance the trauma of separation and bear the costs of the real shocks that it entails. It would not be at the limit of its international credit and could increase its deficit. The monetary arrangement would appear as stable. But Canada and Québec's public finances are a long way from returning to good shape. Consequently, Québec is bound to Canada for quite a certain time, no matter how impatient Mr Parizeau is.

But we will still be suffering from that toothache. Alain Dubuc, who preceded me last week suggested that decentralization, that old Québec buggy horse, was the best way of curing the toothache. Not only do I agree on the remedy for the toothache, but decentralization could also do wonders for our fiscal shape. Our public finance crisis has stimulated a critical review of the way our federal government operates, leading many Canadians to share this view. In that regard, there are two fundamental questions, closely related, which we should address in the aftermath of a defeat of the separatist option in the referendum.

The first question may appear overly simple, but is fundamental: how much

central government do we need to hold this country together? Is it necessary for Ottawa to regulate birds, cows, cheese, and wetlands, and tell people in Rimouski and Swift Current how to operate their hospital? Why do most federal politicians and federal bureaucrats believe that a country needs national standards and that Canadians have to do things in one particular way, if we are to be a country. Do we really? Sometimes, I wonder how Canada managed to stick together when there was no environmental regulations and no federally funded social programs.

The second question is trickier, and has to do with fiscal federalism. Through federal taxation and spending, about \$20 billion are transferred every year from the have provinces to the have-not provinces. The net amount is not big, 2.5% of GDP. But the system does not work anymore and has become a political hot potato. The "haves" are tired of paying, and the "have-nots" are too dependant. Is this country more than a giant welfare system? The answer is yes. We should start thinking about reforming it.

Modern society is not kind to radical politics. We have learned it in our youth. Politicians may have dreams, but politics is common sense, and not too many steps at a time. We may not like the inertia of the political realm. "Plus ça change plus c'est la même chose". But this is the wisdom of democracy. The rejection of the separatist option should be seen as an invitation to be sensible and stop putting off that visit to the dentist.