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"CANADIAN DEVELOPMENT AND CAPITAL FORMATION"

REMARKS BY IAN D. SINCLAIR, PRESIDENT, CANADIAN PACIFIC RAILWAY COMPANY TO THE CANADIAN CLUB, TORONTO, OCTOBER 17, 1966.

I have chosen as the topic for my remarks "Canadian Development and Capital Formation". A number of factors conditioned this selection.

First, the Canadian economy is currently in transition. There are many disturbing elements in the short-term outlook, and a situation not unlike that in the mid-1950's has developed.

Secondly, the long-term outlook for the Canadian economy has attracted a great deal of optimism and, in my view, that outlook has not deteriorated in recent months.

Thirdly, our capital requirements and the manner in which they are to be financed are currently being debated with renewed vigour.

These three elements form a common problem.

Canada has been experiencing an almost uninterrupted economic expansion since early 1961. The duration of the expansion and its magnitude have indeed been remarkable. Gross National Product per Capita in real terms has risen by over 18% since 1961, or at a compound annual rate of 4%. Industrial production in real terms has increased by close to 50%, while over one million new jobs have been created. Business gross investment and exports have both increased by over half. Unemployment has fallen from the 7% which prevailed in 1960 and 1961 to about 4% currently.

By any measure of economic well-being, the past several years have been most prosperous for Canada. It has, however, become increasingly clear that it will be difficult to sustain upward momentum in the economy during 1967. Several key economic indicators have recently shown signs of hesitancy, and some, such as housing starts and new auto sales, have declined substantially. Quarterly estimates of the Gross National Product have, in recent quarters, confirmed that sluggishness has developed. The state of financial markets currently is, to say the least, hardly such as to encourage confidence in the near-term economic outlook.

Of particular concern is the accelerating spiral in wages and prices.

The pattern of wage increases is most alarming. In 1966, hourly earnings in the manufacturing industries have been increasing at an annual rate of close to 6%, hourly earnings in mining at a rate of 7%, and hourly earnings in the construction trades at a rate of over 11%. Largely as a result of this, the rate of price increase has greatly accelerated - from an annual rate of increase of one percent at the outset of the present expansion to a current rate of some 4%.

Wage increases of the current magnitude cannot be absorbed by the economy without increases in the prices of goods and services. The inflationary spiral which is generated reduces the purchasing power of all those who have a fixed income, as well as the value of all fixed income securities. Also, it makes Canadian exports less and less competitive in foreign markets, while at the same time induces increased imports into Canada. Reasonably full employment in these circumstances can only be maintained by currency devaluation. In an internationally exposed economy, such as Canada, excessive wage increases can only lead to unemployment or devaluation, or both.

Only through increased productivity can improved living standards be achieved. In recent years, productivity in the economy has increased at an average rate of some 3% annually. Wage increases in excess of this rate can lead only to higher prices or a serious squeeze on corporate profits which leads to reduced investment and, thus, to unemployment.

Has the share of profits in our economy been excessive? The record refutes any such claim. In the immediate post-war years, corporate profits before tax accounted for some 16% of Canada's national income. During the economic boom of 1950-51, this ratio approached 18%. In the expansion of 1955-56, the share of corporate profits never exceeded 14.5%. The most recent national account statistics indicate a share of 12.5%, well below historical standards and substantially below the levels of even 1964 and 1965.

In view of the huge investment requirements of the Canadian economy, corporate profits are undoubtedly too low.

The wage price spiral presently under way is not unique. The experience in Canada at the peak of the boom of the mid-1950's was very similar, with wage increases of the same general magnitude as those presently being experienced. I need not remind you that the boom of the mid-1950's was followed by a prolonged recession extending over four years and only in these circumstances were wage demands purged of the air of economic unreality. It has been said that those who do not learn from history are condemned to repeat it. I sincerely hope that we are capable of learning.

What of the longer term? The potential for Canadian development remains very bright, provided that moderation can be accepted, the problems of wage-price stability overcome, and our capacity to compete internationally assured.

For many years, the agricultural sector of the economy was virtually stagnant. In recent years the situation has changed radically, as we have had a glimpse of the vast potential demand for foodstuffs in a world in which population is expected to double in the next 35 years, and little virgin land remains. By the end of this century, our population experts forecast that we will need the capacity to feed another 3 billion people, with no improvement whatsoever in living standards. Since the present population of the world is some 3 billion, this implies duplicating, in the next generation, the ability to produce what man has achieved since the dawn of history.

Can this challenge be met? Tremendous scope exists for improving output by the accelerated application of capital and technology to land now under cultivation. When one compares the record wheat yield this year in the Prairie provinces of some 27 bushels per acre with normal yields in Western Europe of 48 bushels per acre, one realizes the potential which can exist in Canada for increased production.

Our forest-based industries have the unique advantage of abundant low-cost raw materials - particularly in

British Columbia. The demand for these products can only increase, while our capacity for increased production is capable of very large expansion. The tremendous forest products development presently under way in British Columbia is a preview of the future, although it is clear that the path of expansion will have its ups and downs - its periods of surplus and price pressures.

Our oil and gas industry, again centered in Western Canada, is a relatively new one, dating only from the post-war period. It is becoming clear that we have substantial underdeveloped oil and gas reserves, and that our basic problem will continue to be one of markets rather than of production. Long-term growth in energy requirements, however, will ensure a growing market into the foreseeable future, particularly as other North American reserves become depleted. I need only mention the vast potential of the Keg River formation, the exploratory work being carried out in the Arctic and the heightened interest in off-shore drilling off both coasts of the country.

There has also been substantial growth in oil and gas by-products. In 1957, Canada produced a negligible amount of elemental sulphur. In 1966, it will produce over two million tons and rank fourth in world production. Canadian sales of elemental sulphur today are limited by production and not by market potential. Canada is also about to become a major exporter of liquefied petroleum gas to Asian markets. Canadian Pacific is proud to be playing a leading role in the transportation of both these products to Tidewater.

Mineral production in Canada has grown at an average rate of approximately 12% since 1950, a very impressive record. Among the more spectacular developments were the commencement of large scale iron-mining in Northern Quebec and Labrador, the production of nickel in Northern Manitoba, the bringing into production of the rich lead and zinc properties in the North-West Territories, and the more recent base-metal discoveries in the Timmins area of Northern Ontario.

Perhaps most spectacular of all has been the recent emergence of Saskatchewan as an important world producer of potash. Although production only commenced in 1959, output in 1970 will be about 10 million tons, the result of an existing and planned investment of some $500 million. Saskatchewan has about half the world's known potash reserves, which have been described as sufficient to fertilize all the arable land on earth for five centuries.

Although considered a fuel of a bygone age, few people realize the growth potential which Western Canadian coal can have. Western Canadian coal reserves are many billion tons, and substantial growth in production for thermal power plants is anticipated. It is probable that exports of coking coal to Japan will increase substantially as a result of current investigations and studies.

I have spoken at length regarding the resource-based sectors of our economy as I believe that their importance cannot be over-emphasized. Canada is often disparagingly referred to - mostly by Canadians - as a "hewer of wood and drawer of water". So long as Canada is efficient in the hewing of wood and drawing of water, and these pursuits are economic, there should be no complaint. A visit to an iron-ore pelletizing mill, a potash mine, a natural gas processing plant, or a pulp mill should rapidly dispel the thought that Canada's resource-based industries are technologically backward. On the contrary, the technology is most sophisticated and, of particular importance, capital investment requirements are staggeringly large. Furthermore, an increasing degree of secondary processing is being attained in most of our resource-based industries.

Canadian Pacific is vitally interested in Canada's resource-based activities, from both the standpoint of transportation and of investment. From a transportation standpoint, a railway has very substantial inherent advantages in the transportation of most bulk materials.

The portfolio of Canadian Pacific Investments reflects interest in the resource-based industries, as shown by our control of Cominco, our large holdings in Trans-Canada Pipe

Lines Ltd., and MacMillan Bloedel, as well as major equity investments in Canadian companies in the oil and gas and mining industries. In addition, Canadian Pacific Investments has wholly-owned operating subsidiaries in the oil and gas and forestry fields.

One cannot, of course, dismiss Canada's manufacturing industries, particularly in view of their size and the rapid development in recent years. Indeed, in the past four years, exports of manufactured goods have grown at a rate of over 20% annually, and exports now account for some 14% of total manufacturing output. This reflects the prolonged domestic economic expansion, improved technology, the dynamic growth of international trade in such products, and the substantial improvement in the competitive position of Canadian industry, resulting from devaluation in the Canadian dollar in 1962. Also of critical importance was the agreement recently reached for free trade in motor vehicles and parts between Canada and the United States.

The future of Canada's manufacturing and resource industries can be bright, but we will have to work hard for that future. No one owes Canada a living. Other places in the world can produce resource-based products and manufactured goods. In particular, attention will have to be concentrated on restraining wage demands in excess of productivity improvement and fostering a commercial policy which allows Canadian manufacturing to expand in areas in which it should compete internationally.

The development potential I have outlined will require substantial capital investment. Traditionally, Canada has required vast sums of capital to finance its development needs. The share of Gross National Product devoted to capital formation in Canada, about 20% throughout the post-war years, has been substantially higher than in the United States, or other developed countries.

There are several reasons for these high capital requirements. These include the higher construction costs imposed by our climate, the formidable geographic features of the country, and the heavy transportation and communications investment in relation to population which are necessary to overcome the vast distances. More important, the industrial mix of the Canadian economy is concentrated in activities requiring unusually high capital investment in relation to output, and correspondingly lengthy capital payout periods. The development of Canada's mineral resources and forest products, as well as the large expenditures for power generation and transportation, fall into this category. Canada is still very much a resource frontier, and requires a rate of capital investment appropriate thereto.

Fixed capital investment in Canada in the post-war period has totalled approximately $135 billion, some 23% of Gross National Product. Some 83% of this investment has been made by the private sector, with non-residential construction and machinery and equipment accounting for more than three-quarters of the private investment, and housing the remainder. Investment by all levels of government in the post-war period has only amounted to 17% of total capital formation.

The financing of this huge investment program has placed, and will continue to place, tremendous strains upon the

Canadian economy. It is perhaps not always realized that the savings rate in Canada has consistently been higher than the savings rate in the United States. The unique problem faced by Canada has, thus, not been so much a comparative inadequacy of savings, but rather the very large investment program.

In view of the proximity of the United States capital market, the relative absence of impediments to capital flows over the border and the fact that a substantial portion of Canadian investment is in projects which have their major market in the United States, it is not surprising that substantial sums of money have flowed across the border. In the post-war period, over 8% of gross capital formation has been financed by non-residents, excluding re-invested earnings of foreign-controlled companies.

Although this may not sound like a high percentage, I would point out that it is the highest ratio for any major Western country. In addition, much of this foreign investment has been concentrated in certain key sectors of the economy, and in certain time periods, which exaggerate its overall magnitude. The structure of the Canadian economy is such that in periods of rapid economic expansion such as was experienced in the mid-1950's and is being experienced at present, investment requirements in Canada grow more rapidly than in the United States, and the inflow of foreign funds quickens. This is a pattern which has been evident since the turn of the century and shows no signs of changing appreciably.

The Economic Council has projected that, if the rate of economic growth which is necessary to provide jobs for our rapidly growing labour force is to be attained, private domestic investment in 1970 must increase by 42% over its level in 1965, and be almost one and one half times its level as recently as 1960. It is most unlikely that investment requirements of this magnitude can be financed domestically. Indeed, the Economic Council has projected an annual inflow of foreign capital of some $1.7 billion in 1970, equal to approximately 10% of the investment program.

It should be the policy of our government to do its utmost to encourage domestic savings, and I would suggest that the area in which the government can contribute most is in fiscal policy. Savings levels can only be increased at the expense of current outlays for goods and services. A careful review of many aspects of governmental expenditures is warranted, to compare the benefits to be attained from such expenditures with the alternative of increasing the flow of saving. Certainly, one cannot stop the "March of the Welfare State", but one is legitimately entitled to question the pace of the march, if we are truly concerned about the domestic flow of saving in Canada and of foreign investment and the control which it can bring.

Taxation policy is also of critical importance. Unreasonable levels of succession duties, sharply increasing marginal personal tax rates, and corporate tax rates of over 50% do nothing to encourage the saving needed to finance our demand for investment funds. The imposition of a capital gains tax, as is being discussed currently, can only worsen matters. In fact, we should be discussing a tax credit for investment in Canadian equities.

Imposition of constraints on public expenditures, coupled with a careful revision of the tax structure, could go a long way to encouraging individuals and corporations to save a larger portion of their incomes.

Canadian Pacific has reason to be proud of its role in Canadian capital formation. In the post-war years, gross capital investment by our Company has totalled some $1.5 billion, equal to more than 1.5% of total domestic capital formation, exclusive of housing and governmental investment. Furthermore, over 97% of this investment has been internally financed so that Canadian Pacific has not added significantly to the imbalance between saving and investment in Canada.

Moreover, Canadian Pacific has played an active role in repatriating substantial foreign holdings of Canadian securities. From 1957 to 1965, Canadians repurchased equity securities of Canadian Pacific from foreigners, having a present market value of approximately $250 million, and today over 55% of the equity capital in Canadian Pacific is owned in Canada. Furthermore, the recent expansion of our investment portfolio has involved the repatriation of substantial foreign holdings in Canadian companies on more than one occasion.

It is important that Canadian based corporations with investment portfolios and Canadians with growing disposable income to have the largest stake they can in Canada. That stake is best evidenced by equity investment. This attitude of investing in equities must be fostered by government tax policies. Even aggressive policies to foster investment by Canadians in equities will not wholly meet the need. We must recognize that the investment phase in Canada for many years requires the importation of large sums of foreign capital. We should welcome it and encourage it to enable our development to proceed in line with its potential. Encouragement of foreign investment does not mean limiting it or channelling it only into debt securities. It means the foreign investor should not be prohibited by government decree or influence from securing part of the action. He must have the right to equity participation.

Preoccupation with nationalism, whether in economic terms or in other aspects, is, I suggest, particularly inappropriate for a resource frontier such as Canada. Also, our resource orientation at times of cost push and demand pull cycles such as are evident now requires more than normal resistance to wage and price excesses. As Canadians we must recognize the facts that objective analysis clearly indicates; we must provide an encouraging investment climate for Canadians and for foreigners; we must accept the disciplines that our economic resource environment imposes.

Undoubtedly, to develop our economic potential will involve strains and pressures that cannot be met by an emotional approach. If Canadian business leaders, labour leaders and those in government are not prepared to meet the facts, serious monetary and employment problems, in my view, are a certainty.
