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An often-heard quote is "If you will have peace, prepare ye then for war". That seems to be the basic outlook of a lot of people here. They're just saying to those of us who are naïve enough to believe that Canada can survive intact that all we're doing is looking towards the future possibilities. We're already planning how foreign countries are going to relate to a split Canada, and how we're going to deal with the military, and how we're going to deal with the economy, even though these things are only conjecture. If we're already doing this, doesn't it show some lack of will to keep the country together and doesn't it send a very negative message? Would we not be better off turning our energies towards preventing separation rather than planning for it?

PATRICK GRADY

THE FINANCIAL AND ECONOMIC DIMENSION

Joel Sokolsky

Our first speaker this morning is Dr. Patrick Grady. Dr. Grady received a PhD in economics from the University of Toronto. He has lectured at the University of Toronto, the University of Regina, and he was a visiting scholar at the University of Guelph. He has written widely on economic policy, macroeconomics and public finance; his writings have appeared in the *Canadian Journal of Economics*, *The Canadian Tax Journal* and *Canadian Public Policy*, among others.

From 1972 until 1981 Dr. Grady held various civil service positions in Ottawa. In 1981 he resigned from the public service to establish his own economic consulting firm, Grady Economics and Associates and from 1981 to 1986 he practised as a private consultant. In July 1986 Dr. Grady accepted a two-year term appointment to serve as the first director of the new Economic Analysis and Forecasting Division of the Department of Finance. Following completion of this service he returned to consulting and was a co-founder of Global Economics Limited.

Patrick Grady

Yesterday we spent the day "thinking the unthinkable", as Herman Kahn said in reference to nuclear war. What we heard was indeed frightening. So far, with respect to nuclear war the approach seems to have worked and the cataclysm of the nuclear holocaust has been avoided. This seminar will un-

derline the high risks involved in breaking up Canada, in military and security as well as economic terms, and convince Canadians and Quebecers to come to a mutually satisfactory accommodation that will keep the country together. If not, at least perhaps it will help us to avoid some of the more mutually-destructive approaches to breaking up the country.

I would like to now turn to the scenarios. I find myself largely in agreement with them; I think that it is certainly correct that sovereignty association is a non-starter, not only because acrimony would prevent it from being a viable long-term objective, but also because I don't think it would be in the interest of the rest of Canada. I say this for two reasons: primarily because the structure of trade in this country provides a rather high degree of protection to certain industries such as textiles and clothing and dairy which are concentrated in Quebec. It would not be in Canada's interest to continue that sort of preferential access to Canadian markets, we don't have to be acrimonious to see that. And then there is the question about whether or not it would be advantageous for us to continue to have them use our currency; it would certainly present some difficulties in the conduct of macro-economic policy, although there would also be some offsetting advantages.

My usual presentation on this whole question of the economic dimension of these constitutional options involves beating the horse which I characterize as "the Belanger-Campeau sovereignty association view". However, for this audience, and in view of the earlier presentations, this horse appears to be already dead, so beating it further would not serve much of a purpose.

Turning to the status quo option, I am not as sure as Roger Gibbins appears to be that this is unlikely. Many speakers have indicated the broad popular support for the status quo; the central provinces would be against, perhaps, the Triple-E Senate; there are some concerns about the economic proposals, there are other concerns about distinct society status, so status quo does have a lot of support and if there is no agreement, then perhaps there would be a referendum in Quebec. It's not a foregone conclusion that a referendum would lead to sovereignty. It could lead to more years of the status quo. I don't see that as being terrible. It would be nice to resolve the constitutional issues but I think that it's better that the country stay together than that it break up just for the sake of tidying up the constitutional issue. So we could very well end up muddling through in the Canadian fashion.

Scenario one is the current constitutional proposal. This is obviously the option that I would favour. There is a reasonable possibility that agreement can be reached. I was encouraged by a poll that appeared in the *Globe and Mail* on 4 November 1991 which showed that, while there is not overwhelming support for the package of proposals as such, the individual components seem to have more solid support. In particular, the "distinct society" now seems to be causing a lot less trouble than it did before the government clarified what it means in terms of language and civil law. Now that the concept has been made more specific it is less worrisome to people in the rest of Canada. The support of Premier Clyde Wells of Newfoundland, who was the champion of the anti-Meech force, is also encouraging. But the Triple-E Senate, which has seemed to gain a lot more momentum in the West and even in Newfoundland, could be a stumbling block if Quebec and Ontario dig in their heels.

The proposals for a strong economic union seem to have attracted the most attention and objection. There has been some discussion recently about the need to clarify what this means. I think that the proposals have been quite misunderstood. They have been interpreted, particularly in Quebec, and even in some of the other provinces, as a power grab. I don't think that the part about the free movement of services, capital and people under Section 121 has attracted opposition, but Section 91A for the strengthening of the provision of federal powers to legislate for the efficient functioning of the economic union presents a problem. It should be emphasized that there is the opting-out provision for the provinces. There is also the requirement that it be approved by seven provinces with 50 percent of the population. That is a pretty severe restraint on the federal government. As an economist I support the federal government's proposal for strengthening the economic union and I think that it would go some way towards making the Canadian economy more competitive and more efficient. However we have to be careful that we don't oversell the benefits to be derived from these proposals. The quantified estimates, even those of the federal government, of what the possible gains to the country would be are in the neighbourhood of one percent of GDP. So we have to be careful that, in trying to make everything totally efficient, we don't throw out the whole constitutional proposal and end up in the separation scenario where the costs would be much

greater than the benefits to be derived from improving the efficiency of the economic union at the margin.

I'm a little discouraged by the statements made by the Quebec Minister of Intergovernmental Affairs which described the proposals as "unacceptable". Premier Bourassa has been much more careful about this, but it would be very helpful if Quebec would come out and lay its cards on the table and say exactly what aspects of the government proposals it finds unacceptable and in what ways the proposals could be improved. It is really impossible to arrive at an agreement that's going to be acceptable to Quebec if Quebec doesn't participate in the process. This is not to say I don't understand why Premier Bourassa doesn't want to get involved in participating in the process, but he's going to have to take some risks.

The second scenario, Quebec independence and decentralization, is very unlikely in my view. I disagree with Professor Gibbins' 50-50 odds on scenario two versus scenario three. I take considerable encouragement from the Spicer Commission report which really did canvass the opinions of Canadians outside of Quebec. It was probably the deepest probing of the Canadian psyche we have had for quite some time and it found a strong undercurrent of Canadian nationalism outside of Quebec with support for centralized government, sharing across regions, social programmes such as medicare, strong support for CBC and even VIA Rail, which might be a questionable economic advantage given the high costs of moving passengers by rail transport, support for the equality of provinces and the Charter of Rights and even aboriginal self-government. I don't see the tendencies out there for the country to balkanize. I think there is still very strong glue to keep Canada together even if Quebec decides to go its own way.

The third scenario, of Quebec independence and a revitalized Canada, is the one that I spent the most time analyzing. The Fraser Institute just published my book, *The Economic Consequences of Quebec Sovereignty*. It deals entirely with the third scenario and the economic impacts of it, not because I think that this is the most probable scenario, but because I think that this is the scenario we have to understand if it is to be avoided.

I don't have time to go into all the details of my analysis, but allow me to summarize some of my conclusions from that book. The economic costs of separation would be very high for Quebec, and while they would be lower

for the rest of Canada they would still be quite important. The estimates that I developed in this book suggest that in the short run the costs for Quebec could be as high as ten percent of GDP. That's a very high number; it would be something like four times the decline in output that we had in the current recession, or twice as bad as the 1981-82 recession. There's nothing that the Quebec government could do to offset it; it would just have to accept that great a loss in the short run. In the longer run I think there would be some room for recovery; cuts in investment would cause the economy to decline more in the short term, while maybe in the longer run Quebec would be worse off by only about five percent.

If Quebec were to start to separate, it would cause a tremendous crisis of confidence in the international financial community and, understandably, people would wonder what was going to happen to the Canadian dollar, and to Quebec. If there was going to be a Quebec currency, or if there was just going to be a Canadian dollar for Quebec assets, that currency would go down as well. Money would be withdrawn from Canada. The Bank of Canada would react to this by raising interest rates and this would have a severe impact on the financial sector, causing investment to be cut and housing to decline. If it was severe enough it may even mean financial institutions being called into question. This would be more probable in Quebec than in Canada because of the likely greater risk of capital loss in keeping money in Quebec, so that there would be cutbacks in investment and interest-sensitive spending. In all likelihood there would also be a fairly significant outflow of people from Quebec. Over the last fifteen years 200,000 anglophones have left. Polls conducted in April 1991 showed that approximately one in two anglophones said they would leave if Quebec were to become independent. If the Quebec economy were thrown into severe recession others, including francophones, might leave as well because people tend to go where the work is.

Trade is obviously where the disruption would be most evident in a structural sense. If Canada negotiated a free trade agreement with Quebec there would be industries where Quebec would certainly not be able to supply the goods any more. These include industries such as textiles, clothing and footwear which are protected by either high tariffs or quotas or both and the dairy industry, which is under supply management. There would definitely be significant trade disruptions. There could also be trade disruptions caused by Quebec moving to its own currency, because that would make it more cost-

ly to trade with Canada. It would also make it more costly to go the other way, but the bigger partner is always the one that loses less from these sorts of disruptions.

It's not only trade relations with Canada that would be disrupted in the case of Quebec (I should note that Quebec is much more dependent on trade with Canada than vice-versa — in 1984 26.5 percent of Quebec manufacturing shipments went to the rest of Canada while only 6.8 percent of the manufactured shipments from the rest of Canada went to Quebec), there would also be disruption in trade with the US. It is not apparent to me that in the event of separation Quebec would continue to be covered by the free trade agreement. I would suspect that it would have to negotiate its own free trade agreement with the Americans, and if it did so there are a lot of issues that would have to be resolved. Provinces have been shielded from the full range of demands made in trade negotiations in the past, mainly because the federal government doesn't have any control over them. But with regard to the traditional sorts of issues such as the sale of alcoholic beverages, supply management, cultural industries — the US would probably want to raise these issues with Quebec and Quebec would have to respond. There are also new issues that have come to the fore lately, such as "Quebec Inc." and the degree of support that Quebec would provide to its industries that probably the Americans would want to examine. There are also the environmental concerns related to James Bay, and these have been raised in the context of the North American free trade agreement with Mexico, and probably the Americans would want to raise them with Quebec. If Quebec were a separate country, not only the US, but Canada, too, would have to look at some of these issues to make sure that there was a fair basis of competition between Canada and Quebec.

In terms of fiscal issues, there would certainly be very significant implications for Quebec if it were to become sovereign. If Quebec were to assume the federal government's expenditures and revenues in the province the deficit would probably be something in the \$10-15 billion range, which would be very high. If Quebec were to assume the debt, which raises the question of what the appropriate share of the debt would be, but say it was to assume its population share, it would certainly put Quebec in the position of being one of the most highly indebted countries in the world. It would raise its debt as a share of GDP from 35 percent to 95 percent. That would be higher than

all the G-7 countries except Italy, and looking at the smaller countries of the OECD, only Belgium and Ireland would be higher. An independent Quebec, then, would certainly be a highly indebted country. This would have implications for interest rates that it would have to pay on its debt, so there could be a costly premium built in. Of course the deficit that would result from assuming the federal government expenditure, and taxes and the newly-acquired debt would result in a need for Quebec to increase tax burdens substantially.

Quebec would lose on emigration. Consider the issue of head offices. Many Canadian financial institutions such as Montreal Trust, Imasco, and Power Corp. have head offices located in Montreal and one would not expect to see the owners of Canadian financial institutions residing outside the country. There would be the same problems in areas such as telecommunications with BCE and Bell and Teleglobe in Montreal; and in transportation there are Air Canada and CN. Quebec would lose a lot.

Next are treaties and their restructuring. Over the 124 years that we have been a country we have developed a very complicated network of international treaties; Quebec doesn't have any of these and would have to negotiate them. With the US it would have to negotiate a free trade agreement, and there would be many others. It would be costly to negotiate all these treaties. I estimate that the it cost Canada around \$30 million to negotiate the free trade agreement. I should say that even though Quebec would be very hard hit, it would still be viable, I wouldn't deny that. In terms of the size of its GDP, Quebec would be a little bit smaller than Austria and higher than some of the Scandinavian countries, but I don't think that's a relevant question. The relevant question is whether Quebec would be better off as part of Canada or separately, not whether or not it would be viable.

It is more difficult to quantify the impact on the rest of the country because the impacts are not as obvious and there are some offsetting advantages. For example, if Quebec is going to receive less in fiscal transfers, currently estimated to be in the range of two percent of GDP and \$2.8 billion according to the Belanger-Campeau commission, obviously the rest of the country is not going to be paying that money so it's going to be better off. Also, if people leave Quebec they're going to go out to the rest of the country. But the recession would certainly hit both parts of the country and the trade flows

would be disrupted. Trade disruptions would be greatest in the regions that are the most dependent on Quebec, obviously Ontario and the Atlantic provinces. The trade links are less direct in the West. The Atlantic provinces would be hit by the so-called "Pakistanization" of Canada. Their shipments across Quebec would be disrupted by administrative controls on trans-shipments. But I think that the fear in the Atlantic provinces need not be as great as some have suggested because, without Quebec, the costs of the transfers to the less-well-off provinces would drop substantially so that the federal government, debt-strapped as it is, would be in a much better position to afford to continue to pay the transfers to the Atlantic provinces.

The big cost would be the institutional restructuring that would be required in the rest of the country. Federal laws would have to change, we would need treaties with Quebec covering a whole range of areas that are now covered in our treaties with the United States, and that would occupy the time of some of the most highly talented brain power in this country over the next ten or twenty years. It was mentioned yesterday that this would detract from the national security agenda; in fact it would detract from almost everything — we're spending our time on that and virtually no time on anything else. I would just make two further comments. In scenario two, in which the rest of the country decentralized, the economic impacts on the country would be much greater than they would be under scenario three where the rest of the country is revitalized. I don't think that everybody would be hit as badly as Quebec, but certainly the greater the decentralization, the worse off all would be.

Finally, I would just like to make a point on the issue of the Reform Party. Professor Gibbins seemed to suggest that it was a foregone conclusion that the Reform Party would be the new government if the country were to fall apart. This is not obvious at all to me. I would expect it to be more likely to be an NDP government that would be formed. We have seen three NDP governments win recently, and although the Liberals and Conservatives would be decapitated to a certain extent, I don't think that they would completely disappear. So that would mean that the votes on the right to centre would be divided, and the votes on the left would be unified. Certainly under an NDP government there would be strong support for nationalistic-type policies and I think that this is good, since this is the glue that keeps the country together. On the other hand there would be a risk of resorting to interventionist and protectionist policies which governments to the left have

been more likely to do, and to the extent that we did that we would worsen the cost of the break-up of the country.

I have been asked to say a few words on the costs of Quebec defence. Jocelyn Coulon said yesterday that 12,000 of the Canadian troops are based in Quebec and he pointed out that this could easily form the basis of a Quebec military force. The hardware and supplies needed by these troops could also be provided if military assets were split between Canada and Quebec, but this would be a much more sensitive issue. In the longer run there could be problems of assuring continued access to the supply of military materiel, unless and until Quebec became integrated into the defence, development and production sharing arrangements. It has been said by Quebec, even by the PQ, that a sovereign Quebec would retain its membership in NATO and NORAD; certainly Quebec is not going to want to antagonize the Americans so that the Americans would probably be favourably oriented towards bringing them into a defence production agreement. But this is not going to happen overnight, and I would think that this would be a fairly low-priority item from the Quebec point of view. There would be many other things that it would have to resolve before it would ever get around to looking at defence production sharing.

How much would it cost Quebec to assure its own defence? Quebec currently contributes 23 percent of government revenues — so you could say that's its share of the country's defence expenditures, currently around \$11 billion. This would amount to about \$2.5 billion that Quebec could spend on defence and still be in the same position it's in now. If relations with Canada were relatively harmonious, by that I mean that there are no insurrections such as we saw last year with the aboriginal people in Quebec, that should be more than adequate. In fact Quebec could even cut back on its defence expenditures and get a free ride on US and Canadian expenditures much in the same way that we shelter free under the US defence umbrella. But on the other hand, if some of the disaster scenarios occurred, Quebec could end up having to spend a fair amount of money.

Turning to defence production, there are quite a few significant defence producers in Quebec, firms like Canadian Marconi, Canadair, Oerlikon Aerospace, and others. We have to wonder what would happen to these firms and to defence production if Quebec were to separate. Looking at the

defence development and defence production sharing arrangements, trade has been roughly in balance over the longer run from 1959 to 1980. In 1987 Canada imported \$1.8 billion and exported \$1.3 billion in defence goods to the US for a deficit of \$500 million. I was unable to find a breakdown on how much of the exports would go from Quebec. If Quebec became sovereign, clearly there would be a big impact in both Quebec and the rest of Canada until Quebec became integrated in the North American defence production agreement. There would also have to be a defence production agreement between Quebec and Canada. The big contracts such as the patrol frigate that went to the MIL Group and the CF-18 maintenance contract with Canadair would come into question. Production under the defence agreement with the US would be at risk but, as I said, as long as Quebec was playing on the same team I don't think that in the long run it would end up being completely shut out, even though it may be shut out for a while until the dust settled.

Just to put this in perspective, defence production is not trivial for Quebec in terms of the amount, but if you look at it in terms of the lost output and potential it's much smaller than the other issues I talked about such as textiles and clothing or even dairy industries. Nevertheless these are high-tech industries involving a lot of R&D and people see them as industries of tomorrow, so I don't think Quebec would like to lose out on them.

I would like to conclude by reiterating that the stakes involved in breaking up our country are extremely high and that it's to everyone's advantage to try and reach an agreement that will keep the country together. I think that the current set of constitutional proposals is a good basis for coming to an agreement.

FORUM

Mr. Dan Robertson

You touched on the implications of the second scenario. Could you discuss that further, specifically what would be Ontario's economic situation and what options would Ontario have regarding its economic relations with other provinces if the country were to break up?

Dr. Grady

I think of all the provinces the one that's best placed to go it alone is Ontario. It is the largest, it has the largest population and production. But Ontario also traditionally had specialized in manufacturing goods that were exported to the rest of the country under significant tariff protection. As the Canada-US free trade agreement came into effect the degree of protection decreased so the advantages for Ontario of that strategy becomes less and less all the time. If the country were to break up Ontario would lose to a certain degree its guaranteed access to a significant part of its markets and this would be costly. If we were to have an Ontario dollar and a Quebec dollar, we would lose the advantages of having a common currency. The larger the currency area the greater the advantage for having a common currency. But I really don't see this total break-up scenario to be plausible.

Mr. Frank Cicerio

You mentioned that Quebec would have to negotiate a free trade deal with