QUEBEC'S SOVEREIGNTY MOVEMENT AND ITS IMPLICATIONS FOR THE AMERICAN ECONOMY

BY EARL FRY

It is not certain that Quebec will separate from Canada. Quebec voters may become disenchanted with Quebec's lackluster economic and fiscal performance and decide to boot out the incumbent government. Or, even if reelected, the PQ may face defeat once again in a referendum campaign because polls have consistently shown that the vast majority of Quebeckers would like to remain a part of Canada, albeit with greater autonomy for their provincial government.

Nevertheless, there is perhaps a 25-percent probability that a referendum will be held in or before the year 2000 and that the sovereignty option will capture a majority of the votes. If this were to occur, what would be the implications for the American economy?

THE SOVEREIGNTY ISSUE AND THE AMERICAN ECONOMY

The uncertainty surrounding the sovereignty issue has already cost the United States billions of dollars in economic growth and tens of thousands of jobs. Over the past five years, the value of the Canadian dollar has decreased by 19 percent vis-à-vis its American counterpart. Part of this drop is attributable to the heavy indebtedness of the federal and provincial governments and their chronic budget deficits. Ottawa's total debt is now approaching 600 billion dollars and a much higher percentage of its budget must be devoted to annual interest payments on this debt than Washington's interest payments on its five trillion dollars in cumulative debt. Moreover, the fiscal position of the provincial governments is much worse than that of the American states.

Nevertheless, over the past three years, Ottawa has made a concerted effort to pare its budget deficits and it is quite conceivable that Canada's national government will balance its budget before the United States national government does. Most of the provincial governments have also moved toward balanced budgets and the overall fiscal outlook at the federal and provincial levels has improved dramatically, with total deficits declining from 66 billion dollars in fiscal year 1992-93 to 32 billion dollars in the current fiscal year. Moreover, these deficits are expected to be cut in half again during the 1997-98 fiscal year.

With this in mind, why does the Canadian dollar continue to languish in the 72 to 74 percent range? The chief explanation is the political and economic uncertainty associated with Canada's unity crisis and the future status of Quebec within North America.

Absent the Quebec crisis, Canada's currency would probably be in the mid-80-cent range today and headed toward 90 cents or more. In 1996, for the fifth year in a row, Canada will experience a lower inflation rate than the United States. Exports have skyrocketed, and during the second quarter of 1996 Canada experienced its first current account surplus since 1984. The Bank of Canada has also cut its bank rate 16 times over the past 16 months, and Canada's short-term interest rates have now fallen below comparable rates in the United States. About 500,000 new jobs have been created since the beginning of 1994, a credible performance when one takes into account that tightened government budgets at the federal and provincial levels have decreased the number of personnel in the public sector.

On the other hand, a rapid rise in exports, directed primarily at one foreign market, the United States, accounts for almost all of Canada's recent economic growth. Consumers have not been spending, in part, because of employment concerns and, in part, because of Canada's unity crisis. Investors have also hesitated to put their money in Canada and businesses have hesitated to expand because of weak consumer spending and the prospects of yet another referendum in Quebec.

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Why has this uncertainty already cost the United States thousands of jobs and may threaten to cost additional jobs in the future? This is easy to explain. If the Canadian dollar were above the 85-cent range and if Canadian consumers were spending their money, billions of dollars in additional American exports would have poured into Canada during the 1990s. Even at 72 or 73 cents, American exports to Canada are at record levels, but Canadian exports into the American market have also become much more attractive, helping to account for Canada's $20.5 billion merchandise trade surplus and $8.4 billion current account surplus with the United States in 1995.

In addition, a stronger Canadian dollar would have dramatically increased cross-border shopping and tourism by Canadians in the United States. In the period since the Canadian dollar peaked at 89 cents in late 1991, cross-border shopping excursions by Canadians have dropped literally by millions, leading to huge revenue losses for retail outlets in communities such as Burlington, Vermont; Plattsburgh and Buffalo, New York; Detroit, Michigan; and Bellingham, Washington. The drop in the Canadian currency has also severely dampened Canadian tourism in the United States. In 1991, 19.1 million visits were made by Canadians south of the 49th parallel, compared with an estimated 13.7 million in 1995, a drop of almost 30 percent. Furthermore, spending by these Canadian visitors in the United States decreased by more than two billion dollars from the end of 1991 through the end of 1995.

Undoubtedly, both Canada's and Quebec's economies have suffered significantly because of the possibility that Quebec's voters will eventu-

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ally support the sovereignty option. However, within the highly integrated North American economy, American businesses, workers, and those seeking work, have also been adversely affected by Canada's political uncertainty, resulting during the 1990s in the loss of billions of dollars in potential revenues and tens of thousands of jobs.

The Canadian domestic market would shrink by one-quarter with the loss of Quebec, and the massive Canadian territory would be split into two distinct and geographically remote sections, conditions which are not conducive to sustained economic growth.

These losses more than offset any gains which might be attributable to the Quebec issue because of (a) a diversion of foreign direct investment from Canada to the United States, (b) an expansion by Canadian businesses into the United States instead of Canada, and (c) a transfer of assets by Canadian citizens into the United States.

THE ECONOMIC CONSEQUENCES OF A PRO-SOVEREIGNTY VOTE

The short-term and medium-term economic consequences for the United States of a pro-sovereignty vote in Quebec are overwhelmingly negative. If patterned after the 1995 referendum, a "Yes" vote would result in up to one year of negotiations between Quebec City on the one hand, and Ottawa and the nine provincial capitals on the other. If the negotiations were fruitless, then the Quebec government would issue a unilateral declaration of independence.

This period following the pro-sovereignty vote would be fraught with additional uncertainties and dangers. For example, would Ottawa accept a unilateral declaration on the part of Quebec and, if not, would it be prepared to send in military forces? Would Quebec be allowed to separate with its current boundaries intact? Would native groups remain a part of Canada or Quebec? What would happen to the anglophone and allophone (those who speak neither French nor English as a first language) communities in Quebec? How would the national government's debt and assets be divided between Quebec and the Rest of Canada (ROC)? Would Quebec allow unimpaired access between ROC East (New Brunswick, Nova Scotia, Prince Edward Island, and Newfoundland) and ROC West (Ontario, Manitoba, Saskatchewan, Alberta, and British Columbia)? Would there be widespread civil strife?

Unless terms of separation had been worked out prior to the referendum, a highly unlikely possibility, both Canada and Quebec would be moving into uncharted territory. As soon as the referendum results were known, the Canadian dollar would fall precipitously on international exchange markets. If the Canadian currency were to fall below its historic low of 69 cents vis-à-vis the American dollar, and if the Bank of Canada's reserves were exhausted in a vain effort to slow this devaluation, Washington might be asked to put together a rescue package which could be much more expensive than the controversial package rescuing the Mexican peso in early 1995. American exports to Canada would plummet as a result of the devalued Canadian dollar and the drying up of consumer spending. Ottawa might also be forced to raise interest rates in an effort to restore confidence in the Canadian dollar and to entice international investors to venture back into the domestic market. Higher interest rates, in turn, would be another impediment to a rebound in economic activity within Canada. American banks and other financial institutions would begin to worry about the ability of the federal and provincial governments to repay their massive loans with perhaps 50 billion dollars or more of these loans financed in the United States. The Canadian domestic market would shrink by one-quarter with the loss of Quebec, and the massive Canadian territory would be split into two distinct and geographically remote sections, conditions which are not conducive to sustained economic growth.

In the medium to long term, the nine remaining provinces would make a valiant effort to keep the ROC intact. Nonetheless, the new confederation would face massive challenges. Would the eight provinces, and especially Alberta and British Columbia, be willing to participate in a political system in which Ontario would have almost one-half of the population and over one-half of the gross domestic product? If a compromise were reached that would result in a highly decentralized federal political system, would the ROC be able to maintain its economic union at peak efficiency, or would provincial barriers to economic activity grow profusely? Would Ontario, Alberta, and British Columbia be willing to continue the billions of dollars in annual equalization payments to the four poorer provinces east of Quebec? With the drop in their standard of living, which is certain to occur for at least a few years after Quebec's separation, would groups in the Atlantic and Far West regions begin to explore the possibilities of creating their own separate nations or even petitioning to join the United States?

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Washington would face a situation unknown since Canada became a confederation in 1867. Its leading trading partner would suffer significant economic setbacks after the Quebec referendum, and Quebec would suffer an even greater downturn because it is poorly prepared economically and fiscally to assume the burdens of political independence. American retail businesses along the border that cater to a Canadian and Quebec clientele would face a major drop in sales. American exporters would face the same predicament, and tourist destinations, especially near the border and in sunbelt states such as Florida, South Carolina, Hawaii, California, and Arizona, would face major revenue losses far beyond what has already occurred during the 1990s. A small part of this revenue drain might be compensated for by a transfer of the assets of Canadian citizens to the United States prior to the referendum, in anticipation of a drop in the value of the Canadian dollar and major economic turmoil. Such a transfer, however, would do little to bolster confidence in Canada's political and economic system and would place downward pressure on the Canadian currency even before the referendum were held. Moreover, Washington and other G7 nations, along with the leading international financial institutions, would likely be forced to dig into their treasuries in an effort to refloat the Canadian economy, and the United States should expect a hefty rise in immigration applications from Canadian citizens. The economic underpinnings of NAFTA would also be shaken for a considerable period after the referendum, and North America as a region would be hesitant to proceed with the creation of the FTAA and less prepared to compete effectively against the growing economies in Asia and other parts of the world. In addition, the United States, which has entered into hundreds of agreements and accords with Canada, might be required to reexamine the utility of the 1965 Auto Pact and other long-standing institutional arrangements with the revamped ROC and Quebec.

OPTIONS AVAILABLE TO THE UNITED STATES IN THE PRE-REFERENDUM PERIOD

In spite of the negative economic repercussions which the United States will face in the aftermath of a pro-sovereignty vote in Quebec, this is strictly a domestic affair for the citizens of Canada to resolve. United States' leaders should continue to emphasize that the United States is quite content to have a united Canada north of its border and prefers to see Canada remain united in the future, but fully recognizes that this is a domestic issue to be decided exclusively and democratically by the Canadian people.

On the other hand, Washington could clarify its conditions for entry into NAFTA for new members. The PQ Government has told the Quebec people that the new sovereign nation would quickly join NAFTA and this would cushion any economic downturn resulting from Quebec's separation from Canada. In other words, Quebec would achieve political autonomy and could still rely on the huge American marketplace to offset any losses in trade and investment flows with the ROC. Indeed, all recent Quebec Governments, and the Parti Québécois in particular, have historically been among the most ardent supporters in Canada of the FTA and NAFTA.

Quebec's citizenry must recognize, however, that entry into NAFTA could be a difficult and time-consuming process. As an original member of NAFTA, Ottawa would arguably have the right to veto Quebec's entry into the North American trade organization. Moreover, trade groups in Washington have worried from time to time about Quebec's policies linked to government procurement, agriculture, textiles and clothing, government subsidies, state-owned enterprises, construction industries, and other economic and business activities.

If Quebec were to separate, the most likely candidates to join the United States would be the three Maritime provinces of New Brunswick, Nova Scotia, and Prince Edward Island, and less likely, the most eastern Atlantic province, Newfoundland.

In rather concrete terms, the United States government should emphasize its position on each of these issues so that Quebec and any other applicants would be aware of what would be expected before they could join NAFTA or enter into bilateral free trade arrangements with the United States (an option which remains available to the United States even with its membership in NAFTA). If an independent Quebec nation, which would rank as the eighth or ninth largest trading partner of the United States, is willing to satisfy Washington's concerns, then it should eventually be permitted to join NAFTA or at least a bilateral free trade accord with the United States. Furthermore, if and when the troublesome issues surrounding separation have been resolved between Quebec and the ROC, Washington should be willing to support Quebec's membership in the World Trade Organization (WTO).

Finally, a few comments should be made about the oft-repeated assertion that the United States can benefit economically from the break-up of Canada and the eventual absorption of one or more provinces into the American union. Above all, Canadians are a proud and independent people and would strongly resist annexation to the United States. Many would never want to join the United States and others would join only if they perceived that their economic prospects would remain dismal within a fragmented and contentious ROC structure.

If Quebec were to separate, the most likely candidates to join the United States would be the three Maritime provinces of New Brunswick, Nova Scotia, and Prince Edward Island, and less likely, the most eastern Atlantic province, Newfoundland. These provinces are also home to a proud people, but unless the richer Western provinces in the ROC agree to some revenue transfers, parts of the Maritime area might explore annexation to the United States. However, such an endeavour would be expensive for Washington because Eastern Canada would become the poorest region within the United States and would require a substantial transfer of revenues. In addition, the political priorities of most Canadians are appreciably to the left of those of most American citizens, with Canadians far more accepting of government interference in

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The United States, working with international financial institutions and major allies, should be prepared to refinance Canada's international debt, to allow it to continue to service debt while Quebec's contribution is uncertain or under negotiation. This will reassure bond markets that the United States will not permit the collapse of the Canadian economy in the aftermath of Quebec independence and will further discourage other provinces from abandoning Ottawa.

The Clinton administration took American policy on Canada partially into the daylight, by strengthening its statements in support of a united Canada and hinting at some of the consequences of Quebec separation. Unfortunately, this shift has left American policy exposed to misinterpretation by Canadians on all sides of the unity debate.

The United States should be prepared to lead an international effort to support the Canadian dollar, which is important in the short run to Canadians and Quebeckers, who will continue to hold Canadian dollars in the days after independence.

WHY CHANGE NOW

The traditional American position kept United States' policy in the shadows. Some will argue that it was better for the United States to operate in this way, as we have in the past. The Clinton administration took American policy on Canada partially into the daylight, by strengthening its statements in support of a united Canada and hinting at some of the consequences of Quebec separation. Unfortunately, this shift has left American policy exposed to misinterpretation by Canadians on all sides of the unity debate. Today, the United States faces a strategic choice between a retreat to the shadows and taking a step further into the light of day by clarifying the core of the American position should Quebec separate.

Retreat to the shadows of our former position is probably impossible. United States officials' statements during the referendum clearly reflected American interests and constraints on our policy options. To suggest now that we are truly indifferent, or to attempt to withdraw our concerns over trade agreements, would render the rest of the infrastructure of the United States-Canada relationship not credible in Canada.

Of course, it is also possible to attempt to continue the current balancing act in the hope that we can escape paying a price when Canadians misunderstand our intentions. The problem with this option is that its weakness will not become widely apparent until we are once again faced with a crisis of Canadian unity, and then our policy options will be limited. Our current position leaves American interests vulnerable to being misunderstood.

The fact is that something profound happened during the 1995 Quebec referendum. The United States, for the first time, became publicly engaged in the Canadian unity debate. Canadians, especially Quebeckers, began to debate the American role in resolving this crucial question. If we fail to articulate our interests and the goals of our policy on this matter, Canadians and Americans will be forced to guess, and may assume the worst—that the United States cannot be relied upon in this crisis—and they, and the international financial markets, will act accordingly. When that happens, every American who works for a company that does business in Canada, and every American with family and friends there, will share in the suffering, all of it unnecessary.

We have nothing to fear if we will be forthright. Canadians are our friends, whether they live in Quebec or elsewhere, whether they vote for the independence of Quebec or not. The future of Canada is for Canadians to decide. Our obligation to them, and to the American people, is honesty about both our intentions and our limitations.

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the private sector, extensive cradle-to-grave social welfare and health systems, and a very circumspect and limited role for their nation in world affairs. The "fit" between Canadians and American residents would be strained at best and, quite frankly, each side would be better off if current national boundaries were to remain intact.

In conclusion, the economic interests of the United States are best served by Canada remaining united as a nation-state and maintaining its national economic union. Some concessions can certainly be made by Ottawa and the nine other provinces to the citizens of Quebec, especially to the French-speaking majority which wants greater guarantees in terms of the preservation of its language, culture, and distinctive civil code. However, these concessions must not be so drastic that they result in a highly decentralized federal system which would jeopardize Canada's economic union and hamper Canada's competitiveness regionally and globally.

It is to be hoped that Canadians will find an equitable solution to their unity problems within the next few years, because the sooner this issue is resolved and national unity preserved, the brighter the economic prospects will be for American businesses and workers.

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