The Role of Foreign Exchange Control

By R. W. Lawson

INTERNATIONAL finance is a subject that most people would prefer not to think about. Nevertheless, during the past few months public interest in Canada's international financial relations has grown rapidly. The reason is, of course, that there is developing in Canada a serious foreign exchange problem which promises to have in the near future an unpleasant effect upon our standard of living.

Unfortunately no amount of thinking about the Canadian foreign exchange problem is likely to reveal a painless solution to it. Our ills are primarily the product of widespread external economic dislocation, of the almost chaotic state of affairs in so many important areas of the world, and we are being squeezed whether we will or not. We are much too vulnerable to world economic developments to be able to escape unscathed. We are, however, free to choose how we will react to this unhappy situation. We must decide, for example, to what extent and by what means we wish to continue to contribute to the economic recovery of Europe and Asia, and in what manner we wish to distribute among ourselves the sacrifices being forced upon us by external economic dislocation. These are unpleasant problems for none of the alternatives look very attractive, but they cannot be avoided. Because Canada is so closely tied to the world economy and because, therefore, our collective welfare is so deeply involved it is particularly important that our decisions be carefully thought out and widely discussed.

It is not intended in this article to argue what Canadian policy in these circumstances ought to be. Nor will an attempt be made to survey all the important relevant considerations. The aim is in fact much more modest: it is to comment on one technique which is being used to deal with our foreign exchange problem. That technique is foreign exchange control. Because of its nature, foreign exchange control permits a much more selective distribution of the incidence of foreign exchange difficulties than is possible under alternative procedures. How such selectivity is achieved and what its usefulness is in the Canadian situation are the matters to be examined.

Cause of Our Difficulties

The general nature of Canada's present foreign exchange difficulty is fairly widely appreciated. We are sending great quantities of goods to Europe (mainly to the United Kingdom) on credit whereas most of our external purchasing is being done in the United States for cash. The means of payment internationally acceptable today are gold, U.S. dollars and currencies freely convertible into U.S. dollars and, because exports on credit do not yield such means of payment, we are spending more of such means than we are receiving. Consequently our reserves are being drawn down steadily. The Canadian problem is, then, that a shortage is threatening in our supply of internationally acceptable means of payment.

To state this matter more precisely it is advantageous to use some balance of payments terminology. International financial payments and receipts are usually classified as on either current account or on capital account. The most common transactions considered to be on current account are payments and receipts in settlement for goods imported and exported, for transportation, business, tourist and other services rendered by foreigners or to foreigners, for income on capital invested in the country and abroad by residents, and for benevolent remittances to foreig-

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EDITOR'S NOTE: R. W. Lawson is an economist with the Statistics and Research Section of the Foreign Exchange Control Board in Ottawa. The article was written before the announcement on November 17th of the Canadian Government's new external financial policy. This does not impair in any way the value of the article which illustrates some of the reasons which necessitated the new policy.

The opinions are the writer's and not necessarily those of the Foreign Exchange Control Board.

current account payment. But if for some reason the goods are not imported and the funds are used instead for the purchase of a foreign security the original transfer turns out to have been on capital account. Because the final effect of transfers is thus not immediately apparent the selective restriction of transfers requires that all of them be scrutinized. It is for this reason that foreign exchange controls require information about international transfers of types which the controls are not intended to restrict.

Priorities

The advantage that may be gained through the allocation of scarce foreign exchange on the basis of the purpose for which it is to be used depends, of course, on the extent to which it is felt that some purposes should have priority over others. If no schedule of priorities commends itself the power to control distribution is of little value. The question therefore arises—are there some purposes for which foreign exchange may be wanted that are clearly less essential than others?

There can be no doubt that some of the purposes for which United States dollars are used, are absolutely vital to our national welfare. Without imports of coal, petroleum and steel—to select only a few examples—the Canadian economy could scarcely function. The question must then be—are there other uses of United States dollars less essential than these?

Most people would agree that the answer should be in the affirmative. There is, for example, widespread agreement that of all the possible calls on international cash those for some types of capital transfers have the least claim for satisfaction. This is particularly so in the case of what is often called "hot money." "Hot money" is capital in liquid form (bank balances and readily marketable securities) which moves about from country to country in search of security or speculative profit, or both. The international flows of such funds, if permitted, tend to produce erratic and violent changes in exchange rates or in foreign exchange reserves which do not accord in any way with the basic realities of the situation.

The potential drain on Canada's United States dollar resources from this type of movement is very great. It is estimated that at the end of 1946 the total foreign investment in Canada was of the order of $7,000 million of which more than two-thirds was held by residents of the United States. Undoubtedly much of the United States investment in Canada is of a kind that cannot be easily liquidated, but a very large part of it is in fairly liquid form. A small part of this liquid investment is represented by bond and other contracts which require that the investor's capital be returned to him in United States dollars at a specified time. For the rest of it (and for the part covered by such contracts until the times specified arrive) we are under no obligation to provide United States dollars; nevertheless the owners could, in the absence of exchange control, withdraw their investments in United States dollars simply by selling them to Canadians for Canadian dollars and then using those Canadian dollars to purchase United States dollars in the foreign exchange market. If for one reason or another the owners of only a relatively small part of this investment should suddenly decide and were permitted to do this, they could easily divert much of the available foreign exchange away from far more essential purposes.

The use of scarce foreign exchange resources to increase Canadian investment abroad is a somewhat similar case, though not quite so simple. Some of such investment may well be in the Canadian interest; it might, for example, open up an important export market to Canadian manufacturers. But some of it may be nothing more than the acquisition of foreign assets for purposes of exchange speculation. With foreign exchange control it is possible to require the would-be investor to provide evidence indicating the real purpose of his project before the funds are made available.

When one turns to current account payments the advantages of selective distribution of exchange resources are not quite so clear. This is particularly so in the case of payments for goods. Probably no one would deny that there is a great difference in our need for different imports that, for example, our need for imports of anthracite coal is enormously greater than for imports of boxed chocolates. But even if foreign exchange was denied for non-essential imports they might continue to enter the country, the supplier prefering to provide them on credit rather than lose the market. The disadvantage of imports so financed would be that they would increase Canada's international indebtedness for non-essential purposes. For this reason many of the countries which have felt it necessary to apply selective import restrictions have not used exchange control techniques but have taken direct action to stop banned goods at their borders.

In the face of a sufficiently serious foreign exchange shortage exchange control techniques might be useful in dealing with current account payments other than for goods. There are, for example, various kinds of payments on account of travel, of some other services and of gifts which many people would consider to be less essential than those for many goods. There is, however, a very real difficulty in that individual assessments of the need for many of these payments vary enormously. However, to the extent that any widespread agreement to treat any of these payments as non-essential could be reached the foreign exchange control technique would allow it to be made effective.

Evaluation

Perhaps sufficient has now been said to indicate that the alternative procedures of a free foreign exchange market and foreign exchange control yield quite different results in coping with inadequate supplies of international cash. Neither system performs miracles; if there is not enough foreign exchange to go around, some would-be purchasers must go without. The important differences lie in who gets what there is and what price is paid for it. The more serious the exchange shortage is the greater will these differences be. In a free exchange market no preference can be given to buyers for essential purposes. Their demand can be satisfied only if they outbid other would-be purchasers, and the price to the Canadian consumer of essential imported goods and services must be correspondingly high. With foreign exchange control it is possible to give preferred treatment to the buyers of exchange for essential purposes. The demand of other would-be purchasers is neutralized with the result that essential imported goods and services are made available to the Canadian consumer in greater volume and at a lower price. One's opinion on which of these two systems is preferable for Canada will depend upon how he evaluates the different results against the background of our foreign exchange position.