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THE CANADIAN TREATMENT OF FOREIGN BANKS:
A CASE STUDY IN THE WORKINGS OF
THE NATIONAL TREATMENT APPROACH

John F. Chant

This paper contains preliminary findings from research work still in progress and should not be quoted without prior approval of the author.

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IN SERVICE INDUSTRIES:
U.S.-CANADIAN BILATERAL AND MULTILATERAL PERSPECTIVES

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preparing this study.
On June 28, 1984, the Canadian House of Commons gave third reading to a bill to raise the ceiling for foreign banks operating in Canada to 16% from 8% of the Canadian dollar assets of the banking system. This move represented a measured step toward the resolution of a continuing dispute between the American and Canadian governments with respect to the treatment of the other nation's banks participating in domestic banking activity. Despite the reception of approval accorded this step, many questions remain unanswered. Is the removal of the ceiling adequate in itself to signal a changed attitude by Canadian authorities to foreign banks? Or is it merely one stage in a hard fought battle to strengthen the competitive position of foreign, most notably, American banks, in the Canadian market which will continue without abatement.

The purpose of this paper is to explore the workings of Canadian-American relations with respect to the Canadian policy toward the operations of foreign owned banks. One aspect of the study consists of a documentation of the issues which have generated controversy and disagreement between the two countries. In addition, as a case study it assesses the usefulness of the principle of "national treatment" adopted by the United States as its policy to multinational banking and evaluates the degree to which this
policy permits two countries which pursue substantially different approaches to the regulation of banking institutions to achieve agreement with respect to their treatment of the participation of each other's banks in domestic banking.

While this paper concentrates on the Canadian treatment of foreign banks and only considers the American treatment of foreign banks tangentially, the treatment of foreign banks in Canada has considerable relevance for the American treatment of Canadian banks seeking to extend their activities in the United States. Senator Jake Garn, Chairman of the Senate Banking Committee, has proposed legislation which would require American banking authorities to consider "the treatment of U.S. banks in the home country of any foreign bank applying for a national branch or agency in the U.S." While this legislation is not supported by Treasury Secretary Donald Regan, he is sympathetic to the purpose of the legislation, making a statement to the effect that "he would not hesitate to take vigorous action to protect U.S.
interests if attempts to persuade offending countries to loosen their regulations for U.S. banks are unsuccessful."^2

The reaction of U.S. banking authorities to the Canadian banking policy is especially relevant at the present time when the senior executives of several of the major banks have expressed the intention to expand their activities within the United States^3 and, in particular, the Bank of Montreal has taken over the Harris Bankcorp of Chicago, the 33rd largest bank in the United States.

The assessment of the national treatment approach which is embodied in this paper is directed at the problems in its application between two countries which have substantially different approaches to regulation. Section I of this paper outlines the distinctive features of the Canadian system of banking regulation which are revelant to this assessment and contrasts them to the features of the American system.

Section II traces the evolution of the attitudes of Canadian banking authorities toward foreign banking activities in their country and describes those elements of Canadian

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3 See, for example, Annual Report of the Canadian Bank of Commerce, 1982, which states "expansion in the U.S. continues to be a major thrust (p. 10)"; and 1983 which reiterates "our international activities - especially those in the United States - remain important to our overall planning and progress (p. 15)".
policy which would be interpreted as antithetical to the national treatment approach. Finally, the national treatment approach to multi-national banking is assessed in Part III.

I The Regulation of Banking in Canada

In order to understand the basis of disagreements between Canadian and American authorities over Canadian treatment of foreign banks, it is important to recognize the distinctive features of the Canadian approach to the regulation of banking. For this purpose, it is useful to make a distinction between regulation by "rule" and regulation by "discretion", a distinction which parallels that made by Friedman with respect to monetary policy. Regulation by rule implies that the authorities responsible for regulating some activity establish a set of rules to govern the behaviour of the regulated and only intervene when the violation of one of the underlying rules has become apparent. In contrast, regulation by discretion involves much less clearly defined powers for the regulated. Rather the regulator determines the acceptability of certain types of actions on a case-by-case basis. Much of the analysis which follows is directed toward demonstrating the strong emphasis placed historically by the Canadian banking
authorities on regulation by rule.

The Locus of Regulation. Section 92 of the British North America Act of 1867, which delineates the powers of the federal government in Confederation, placed matters of banking and currency under the authority of the federal government. While the scope of this delegation of powers has been questioned, federal control over the regulation of the chartered banks has been virtually unchallenged.4 This situation contrasts sharply with the dual system of regulation which exists in the United States. There, the regulation of banking is split between state and federal authorities. Some banks, if they choose to opt out of membership in the Federal Reserve system and protection for their customers under the federal system of deposit insurance, can be wholly state regulated. At the other extreme are national banks which are regulated primarily by federal authorities but which must conform to the basic requirements of the state within which they operate. Finally some state banks must follow the requirements of federal regulations as a

4 Interestingly one potential challenge occurred within the past year. One chartered bank wished to advertise its so-called Green Line service by which it made the services of an independent discount broker available through its branches. The Ontario Securities Commission questioned this practice. In doing so the Commission claimed to be exercising its authority over the operations of securities markets. Although the Commission eventually approved the Green Line service, it seems almost certain that any decision to disapprove would have been met by a challenge to the Commission's authority over the federally chartered banks.
result of their membership in either deposit insurance or the Federal Reserve. To the extent that American banks are subject to state regulation, they may have substantially different powers because the rules governing banks differ markedly among states.

**Approach to Regulation.** The activities of the chartered banks in Canada have been governed by successive versions of the Bank Act, a piece of federal legislation. This act is quite distinctive in that it has always incorporated a finite duration of 10 years in each successive version from the time of its initial passage in 1871. This provision encourages the reevaluation and revision of banking legislation at a regular interval. It means that the opportunity exists for change on a periodic basis but it also tends to discourage consideration of change between revisions.\(^5\)

The Bank Act has been the embodiment of a rules approach to banking regulation. It defines the powers of the banks but, more importantly, it sets the conditions which must be met to become a bank. Until recently, it defined the powers of the chartered banks consistently with the "commercial loan" theory of banking or the "real bills" doctrine. Banks were to make self-liquidating loans by financing primarily the production and distribution of goods. Up to 1980,

\(^5\) Indeed the raising of the eight per cent ceiling on foreign bank activity is the only notable instance of change between scheduled renewals of the Bank Act.
sections 86 and 88 of the Bank Act defined the banks' lending powers with respect to financing the production and distribution of goods. More important, however, were the omissions from the Bank Act. The number and location of branches was neither limited nor even controlled. Branching was solely a concern of the bank management. Similarly, though initial capital requirements were an important element of entry requirements, any required relationship between subscribed capital to borrowings or deposits has been absent in Canadian banking legislation.

Discretionary control of banking behaviour is only one among several approaches to attaining the goals of banking regulation. As a substitute, the Canadian government developed a system of prudential regulation which was directed to limiting the activity of banking to assuredly dependable enterprises. The main element of the Canadian approach was a stringent qualification for entry into commercial banking which was built around i) the need to acquire a charter and ii) high capital requirements. To give some further indication of the role of regulation by rule in Canada can be determined by examining the restrictions on bank entry and the powers of the Inspector-General, the regulator of Canadian banks. Finally, a recent departure from the principle of regulation by rule is noted.
i) Restricted entry. Until the 1980 revision to the Bank Act, a charter for a new bank could only be obtained through a special act of Parliament. As Bond and Shearer note:

Such a bill must be introduced as a private member's bill and must be passed in a private member's hour. Under Parliamentary rules it is comparatively easy for a few members to hold up the procession of the bill. Once passed second reading, the bill must be referred to a standing committee, where the sponsors of the bill may be cross-examined and asked to "show their capacity to carry on the banking business" before the bill is reported to the House for third reading. Once the act of incorporation is passed and the charter granted, the sponsors of the new bank must still obtain a certificate from the government entitling them to commence business. Before issuing this certificate, the government must satisfy itself that all legal requirements have been met.  

Possibly, the most significant aspect of this approach was the requirement that the bank charter be obtained through a private member's bill. These bills can best be characterized as relating to issues of concern to a private member as distinct from the party in power. Bank charters were required to compete with all special concerns of private members in the very limited time available for these bills.

The second element of the restriction to entry into Canadian banking has been the high initial capital requirement. As early as the Bank Act of 1871, the first after Confederation, any new bank was required to have a subscribed capital of $500,000. At the time, the comparable requirement in the United States was only $50,000 for national banks and as low as $10,000 for state banks in some states.

An indication of the effectiveness of this restrictive approach to entry can be seen through examining the rate at which new chartered banks succeeded in completing the process and in actually becoming active. From Confederation in 1867 until 1925, seventy-two banks gained charters and of these, thirty-seven became active. Most striking, however, is the following period from 1925 to 1968 during which a total of five bank charters were issued and only three of these emerged as active banks. Together with five mergers, the total number of active banks fell from eleven to nine over this forty-three year period. Finally, during the


8 The data which follow are from K. Buckley and M.C. Urquhart, Historical Statistics of Canada (Toronto: Macmillan Company of Canada, 1965) cited in Bond and Shearer (1972).

9 During this same period, thirty-three chartered banks disappeared through mergers and twenty-eight banks failed. The total number of banks dropped from thirty-five to eleven.
period between the Bank Acts of 1967 and 1980, another six banks gained charters and all six became active. The total number of banks increased only by three because of the merger of two of the new banks with existing banks and another merger of two of the established banks.

ii) the role of the Inspector General of Banks. The office of Inspector-General of Banks was only created in 1924 in reaction to the failure in the year before of the Home Bank, Canada's last bank failure. Jamieson notes

the government had always been opposed to assuming any responsibility in connection with bank inspection" (65-66).

and

that the principal objections to government inspection had always been that it would require too large a staff and cost too much to make it effective, also that the work performed would be largely a duplication of that done by the banks' own inspectors and latterly the shareholders' auditors (66).

These sentiments were followed in the legislation establishing the office. One witness before the Banking and Commerce Committee of the House of Commons argued "that an effective system of government inspection or supervision could be adopted with a very small organization and practically no duplication of effort."10 In an amendment to the Bank Act in July 1924, the Office of Inspector-General of Banks was

10 Jamieson, p. 65.
created. The present powers of the Inspector-General with respect to examination and inquiry are essentially unchanged from the original statement and are contained in 246(2) of the Bank Act:

The Inspector, from time to time, but not less frequently than once in each calendar year, shall make or cause to be made such examination and inquiry into the business of each bank as the Inspector shall deem necessary or expedient, and for such purposes may take charge of the premises of (sic.) the assets of the bank or any portion thereof, if the need should arise, for the purposes of this Act having reference to the safety of the interests of the depositors, creditors and shareholders of the bank and other provisions of this Act and being duly observed and that the bank is in sound financial condition, and at the conclusion of each examination and inquiry shall report thereon to the Minister.\footnote{11}

Indeed in testimony before the Finance, Trade and Economic Affairs Committee of the House of Commons, the current Inspector-General stated that his total staff consisted of only twenty-one people and that the annual inspection could be best described as a "management audit of the banks."\footnote{12}

The role of the Inspector General can be contrasted with that of the supervisors and examiners of banks within the United States. Some flavour of the difference between the two approaches can be seen from a study by the American

\footnote{12} Canada, \textit{House of Commons, Standing Committee on Finance, Trade and Economic Affairs, Minutes}, Issue No. 84 (May 10 and 18, 1982), p. 31.
Enterprise Institute of proposals to deregulate depository institutions which describes the duties of the controller of the currency:

The controller of the currency must approve applications for the formation of new national banks..., the establishment of branch offices by these banks, and mergers and consolidations that produce a national bank. He arranges the examination of these banks to determine their financial soundness, quality of management, and compliance with laws and regulations. He regulates and supervises the trust activities of these banks and is responsible for the disclosure reporting proxy requirements and securities activities under federal securities laws.13

Similarly, the discretionary powers appear quite broad in the same study's description of the Federal Reserve's power with respect to bank holding companies:

The FRB determines which activities can be performed in bank holding companies or in non bank subsidiaries of such companies under the statute's authorization of their performance of activities determined by the board to be closely related to banking or to managing or controlling banks (p. 7).14

iv) The Bank Act of 1980. Section 315 of the Bank Act of 1980 represented a substantial departure from the traditional rules approach to bank regulation by declaring:


14 Emphasis added.
The Governor in Council may make regulations generally for carrying out the purposes and provisions of this Act and, without restricting the generality of the foregoing, may make regulations prescribing anything that, by virtue of any other provision of this Act, is to be prescribed by regulation (p. 326).

This section permits the Inspector General to make regulations about, among other things, the adequacy of liquidity and capital and also a variety of powers of foreign banks. It will be argued later that this change does not represent any major redirection of banking policy but rather was necessitated by the prospect of the entry of foreign and other schedule B banks which had not met the stringent tests traditionally required for entry into banking.

II Policy toward foreign banking

The formalization of the policy toward foreign banking in Canada can be traced to the Bank Act of 1967 which incorporated for the first time a limit to the degree of foreign ownership to less than twenty-five percent of the shares of any chartered bank. This change, which was motivated by the take-over of the Mercantile Bank, a small specialized bank owned by Dutch interests, by the First National City Bank of New York in 1964. This change represented a major reversal of policy. Not only had the
Mercantile Bank been foreign owned since its chartering in 1953, at least three other Canadian chartered banks had been foreign owned in the past.\textsuperscript{15}

The Background for Restrictions on Foreign Banks. While the prohibition on foreign-owned banks was only formally introduced in response to the take-over of Mercantile Bank in 1964, the growth of sentiment favouring a restriction on foreign banking in Canada can be traced prior to this event. Walter Gordon, the Minister of Finance at the time of the take-over, had been Chairman of the Royal Commission on Canada's Economic Prospects (the Gordon Commission) which had made its final report in 1957. The Report of the Commission was unequivocal:

...We believe it to be most important that Canadian control be maintained of our principal financial institutions - the chartered banks and the life insurance companies incorporated in Canada.... These institutions form the very core of our financial and business sector and together they control a considerable proportion of the savings of Canadians....The Commission suggests that appropriate action be taken to prevent any substantial measure of control of

\textsuperscript{15} The other three were British owned and included the original Bank of British Columbia (absorbed by the Canadian Bank of Commerce in 1900), the Bank of British North America (absorbed by the Bank of Montreal in 1918) and Barclays Bank (absorbed by the Imperial Bank in 1953). The Mercantile and Barclays are each significant in that they were the only foreign owned banks chartered between Confederation and the 1980 Bank Act.
these institutions from coming into the possession of non-residents.  

The Commission argued as an elaboration that foreign control of major financial institutions would be detrimental to the conduct of monetary policy where there should be a reasonably close and preferably informal relationship between the officials of the central bank on one level, and the officials of the commercial banks on the other (p. 397).

Apparently more significant to the Commission was domestic control over financing:

the role of banks and insurance companies in financing economic activity in Canada might be adversely affected, if control of these important institutions were in the hands of non-residents with major interests in other countries to consider (p. 397).

The theme of the Gordon Report was continued with the Royal Commission on Banking and Finance (the Porter Commission), appointed in 1961 to make recommendations for the next Bank Act revision scheduled for 1964. Despite a strong commitment to measures to enhance and support competition in Canadian financial markets, the Porter Commission expressed a number of serious concerns about

foreign ownership and control in the Canadian banking sector. First, they had a general concern about the relation between foreign ownership and the concentration of ownership within banking. On the other hand, they saw individual ownership of bank stock by non-residents as a force which countered concentration of shareholder power. On the other hand, they feared the "large concentration of economic and financing power which are sometimes centered in large foreign banks." 17 Second, the Commission felt that foreign-owned banks, especially those controlled in the United States - might be in a position to obtain the business of firms whose parent companies already deal with the parent bank, without offering better or cheaper service in our banking market (374).

Finally, though they recognized the Gordon Commission's concerns about the possibility that foreign banks might be less sympathetic to Canadian monetary policies, they also realized foreign-owned banks would be under the same set of controls as domestic banks and would not necessarily have any more favourable access to foreign funds.

The Porter Commission did recognize benefits which could accrue from a foreign presence in Canadian banking. The approach suggested by the Commission would permit foreign banks to establish agencies "which would be

free to conduct all phases of their business, other than the acceptance of deposits in Canada (373)." The agencies would be limited in their number of offices but licenses for additional offices would be granted if the foreign bank could demonstrate them to be necessary for their business and "a useful addition to Canada (374)." While the presence of such agencies was viewed as being beneficial in improving banking facilities available to Canadians, it should also be noted that the Commission also argued that

it might reduce the pressure on foreign banks, particularly American banks, to acquire ownership in Canadian financial institutions.... (374).

In conclusion, the Commission expressed its views on the desirability of the ownership and control of banks operating in Canada. Here the Commission was clear and unequivocal:

a high degree of Canadian ownership of financial institutions is in itself healthy and desirable, and that the balance of advantage is against foreign control of Canadian banks (374).

The Bank Act of 1967 reflected the Canadian concerns which were precipitated by the First City take-over of the Mercantile Bank. Two restrictions were added to the Bank Act which serve to preclude foreign ownership. The first, the more explicit, prohibited the transfer of bank shares to non-residents if the transfer increased total non-resident
holdings in that bank to more than 25 per cent of outstanding shares. The other, though not explicitly directed toward the problem of foreign ownership, limited the holdings of a bank's share by any one interest to no more than ten per cent of the outstanding shares of the bank. The effects of this latter restriction by itself in limiting foreign bank entry should not be underestimated. Any foreign bank would have two alternative ways to enter Canadian banking. The foreign bank could join a consortium of at least nine other parties or it could attempt to attract subscriptions for dispersed shareholders - Canadian or foreign - to complement its maximum ten per cent. As will be seen later, neither of these alternatives could be expected to be attractive.

The restrictions on foreign banking which were incorporated in the 1967 Bank Act prevented only formal establishment as a chartered bank and did not preclude the undertaking of other types of financial activity by foreign banks. Several American banks gained a presence by acquiring substantial interests in existing Canadian trust companies. Others established subsidiaries to specialize in activities such as leasing, factoring and term finance while still others established representative offices. In assessing the scope of foreign bank activity in Canada, the Economic Council of Canada stated,
Various estimates have been produced regarding the extent of foreign bank activity in Canada. One of these estimates indicates that there are over one hundred foreign banks operating in Canada. Others claim a more modest number of about fifty that carry out any substantial banking activity.\textsuperscript{18}

The restrictions on foreign banks quickly became one of the main items on the agenda when the imminent revision of the Bank Act started to be discussed in the mid 1970's.\textsuperscript{19} Several factors focussed attention on this one aspect of the then current Bank Act. First, a number of the Canadian banks with extensive activity in the United States were concerned with the policy proposals made in that country regarding foreign banking activity. Any requirement of reciprocal treatment imposed in the United States or other countries might jeopardize the continuation of their operations. Second, as already seen, the failure to recognize foreign bank subsidiaries as "banks" did not prevent them from entering in other guises. Some of Canadian bankers argued that the then current treatment permitted foreign banks to


\textsuperscript{19} The Bank Act was scheduled for renewal in 1977 but was extended several times on a short-term basis. The revised Bank Act was not proclaimed until 1980.
carry on activities which they themselves could not carry on. For them, the removal of the prohibition on foreign banks in Canada would provide an opportunity for controlling the activities of foreign banks and limiting them to no more than the powers available to Canadian chartered banks.

Prior to the impending revision of the Bank Act scheduled for 1976, the Economic Council of Canada prepared a report Efficiency and Regulation: A Study of Deposit Institutions as an independent input to the deliberations on banking legislation. The Council's recommendations regarding foreign bank entry can be best understood in the context of its concern with the existing limitations on entry into banking by any enterprises, whether foreign or domestic. The Council recognized that the limitation to equity holdings by any one interest in ownership in a chartered bank constituted a major obstacle to entry into banking. Not only did it limit the formation of new banks by entrepreneurial interests, it also prevented any movement of domestic new banks further into banking activity through creation of subsidiaries. The Council apparently accepted the principle of the ownership ceiling for large banking concerns but made proposals for easing it in the case of new and smaller banking institutions. In particular, the Council argued
...Any Canadian institution currently carrying on deposit activities should be eligible to receive a bank charter, either in its own name or on behalf of a subsidiary company. Under this scheme there would be no ownership restrictions for new Canadian-owned banks during an initial period unless they became larger than a designated size. The legislation should state explicitly the latitude of the Supervisor of Deposit Institutions in determining the size limitation and the transition period. After the transition period, a bank could remain wholly owned by any Canadian or eligible group of Canadians, on condition that the number of branches and the size of the bank, measured by the current value of assets, be limited to that allowed during the transition period. If the bank wanted to expand beyond this designated size after the transition period, the major founding interest could retain more than 10 per cent (possibly 25 per cent) of the shares, the maximum presently allowed for shareholders of banks. If an institution became sufficiently large, however, the 10 per cent maximum should apply to all shareholders, after a designated divestiture period (p. 77).

The Council applied essentially the same principle to entry into banking by foreign banks, with one exception. The Council proposed a Foreign-Owned Banks Act which would provide for the entry of foreign-owned banks under the same conditions proposed for the entry of new domestic concerns. The only difference was that during an initial stage "a foreign bank entering the Canadian banking would have its power to branch and expand restricted (p. 95)." The Council suggested this difference so as to allow new Canadian banks to have an opportunity to take advantage of easier entry
into banking activities. After the initial period of transition, the foreign-owned banks would have essentially the same options as domestically owned banks. Each could operate on the same basis as the initial stage or it could obtain the same powers as domestic banks on divestiture of shares (with retention of up to 25 per cent by the parent) and an overall size limit. Once the foreign-owned bank reached a large size, it would be subject to the same restrictions as large Canadian banks in that any ownership interest would be limited to 10 per cent of total equity.

The Federal government's initial proposals with respect to foreign banking were contained in the *White Paper on the Revision of Canadian Banking Legislation* issued in August, 1976, by the Minister of Finance, Donald S. Macdonald. The proposals were similar in many ways to those of the Economic Council but differed in a number of important respects. The *White Paper* stressed the need for dispersed ownership of major banks, stating

> A basic rule for Canadian banks denies any shareholder or associated shareholders a controlling interest in a bank. This rule ensures that a chartered bank does not become

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captive to a person or associated persons who have business interests other than banking, thus avoiding a potential for significant conflicts of interest or possible risks to the bank's depositors (p. 27).

The White Paper recognized only two categories of banks: widely held and controlled. By definition "widely held" banks could not be foreign owned because this category would be subject to both the 10 per cent ceiling to ownership by any one interest and the 25 per cent ceiling on foreign ownership. Foreign bank subsidiaries would "be subject to such limitations on growth and size in relation to the authorized capital of the bank as may be approved by Governor in Council (p. 28)." In addition, the incorporation of a foreign bank subsidiary would be subject to the following major provisions:

i) its size would be limited to 20 times its authorized capital,

ii) the maximum authorized capital for any foreign bank would be limited to $25 million,

iii) increases in authorized capital beyond a minimum level would be contingent on the performance of the bank subsidiary,

iv) the foreign bank would be limited to one place of business but could open up to five branches with the approval of the Minister of Finance with respect to number and location,
v) a parent foreign bank would not be permitted affiliates in Canada other than those permitted to the subsidiary under banking law,

vi) the total operations of foreign banks would be limited to 15 per cent of total commercial lending in Canada,

vii) the subsidiary would be required to have assets in Canada at equal to at least its Canadian liabilities,

viii) a foreign bank subsidiary would be permitted only when favourable treatment for Canadian banks is reciprocated in the jurisdiction of the parent bank (*White Paper*, pp. 28-9).

The proposals of the Minister of Finance differed from those of the Economic Council in two notable respects. First, the Minister of Finance did not acknowledge the Council's proposals for an intermediate category of bank with more tightly held ownership and with more limited powers than permitted large banks but by the same token with greater powers and less concentrated ownership than the new category proposed by the Minister.21 Second, and more significant, the Minister added the further restriction,

21 Admittedly, under the Economic Council proposal, the new category would come into effect only after 10 years. Still, incorporation of the category into the act, or even a statement of intent, might have served to encourage foreign banks.
absent in the Economic Council proposals, that the total size of foreign bank affiliates be limited to fifteen per cent of the total lending of the banking system.

The resulting legislation, embodied in the Bank Act of 1980, followed the White Paper proposals in most respects. A distinction was created between schedule A banks, which conformed to the limits to concentrated ownership, and schedule B banks, which did not. Necessarily foreign bank subsidiaries must seek incorporation as schedule B banks.

Schedule B banks are subject to a different set of requirements than the schedule A banks, many of which were foreshadowed in the White Paper. The major difference between the Bank Act and the White Paper was that the ceiling on the operations of all foreign banks in Canada was established at eight per cent of total domestic assets of all banks in Canada rather than 15 per cent of total commercial lending.

The Foreign Bank Reaction. Foreign banks responded quickly to the opportunity to participate in the Canadian banking market, albeit subject to the restrictions imposed on them as schedule B banks and the further restriction on the total size of foreign banks as a group. By mid 1984, the
total number of foreign-owned banks had reached 58, with some operating as many as 11 branches.

Despite the substantial response in number of banks seeking status as schedule B banks, the foreign banks have substantial criticisms of their treatment in Canada which they have put forward in a series of submissions to the Inspector General (1982, 1983). The criticisms are directed toward their change in status as a result of the 1980 Bank Act and their treatment subsequent to qualification as schedule B banks.

The first paper notes that "Prior to November 1980, 17 U.S. banks operated in Canada through subsidiaries with provincial business corporation charters and had aggregate assets totalling C$5.5 billion..." and states that on this basis the foreign banks had the freedom to conduct a broad financial service business across Canada. It asserts that all these foreign banks would have preferred "a banking license without restriction" to the status quo but that most would have chosen their previous status to "a bank charter with restrictions". It continues to argue that the latter choice was not available to them. Not only did they lose some of their current powers (e.g., the right to issue

commercial paper with parental guarantees), the Inspector General's office informally told several banks --

'if you do not volunteer, you'll be drafted', i.e., if you fail to apply for a bank charter we will think of new ways to compel you to do so and on less favourable terms than if you do so voluntarily.

The White Paper notes that all except one of the U.S. banks operating in Canada chose to accept a bank charter voluntarily.

The U.S. banks also criticized the various restrictive measures applied primarily to foreign-owned banks such as the ceiling on the foreign bank sector, the ceiling for individual banks, the need for license renewal, the need for approval for branches, and the restrictions on offshore activities which have been discussed above.\(^{23}\) The White Paper concludes that despite the characterization of the 1980 Bank Act as a positive step toward easier entry for foreign banks,

viewed from the perspective of those U.S. banks operating in Canada prior to November 1980 the Bank Act did not represent a step forward but instead the imposition of "protectionist" restrictions that will seriously curtail their growth and increase significantly the cost of doing business. The Canadian position on this point should be regarded as extremely self-serving and only applicable to those U.S. banks not operating in Canada prior to November 1980 (p. 2).

\(^{23}\) Some but not all of these restrictions apply to those schedule B banks that are domestically owned.
For present purposes, a more significant issue raised by the foreign banks has been the exercise of discretionary power by the Inspector-General with respect to the foreign banks operating in Canada. In their White Paper of February 1982 the foreign banks outline the instances of discretionary measures taken by the Inspector-General which do not apply to domestic banks. These measures include

i) limit to offshore funding,
ii) prohibition against sale of bearer paper to offshore borrowers,
iii) prohibition of the sale of assets by foreign banks to their parent banks,
iv) instructions from the Inspector-General to concentrate on loans to small-and-medium sized businesses,
v) suggestion to maintain a 20:1 asset ratio,
vi) request to new foreign banks to locate their head offices outside of Toronto.

The White Paper of 1982 subsequently served as a basis of discussion between the Inspector-General's office and the foreign banks. As noted in the paper of February 1983,

The Inspector-General decided to address all the points raised in the White Paper and has
redefined his position on several of them. In several instances he has ruled in favour of the foreign banks, in some cases he softened his position but did not change its basic thrust and, in others, he refused to budge and reiterated his position.

By 1983, the emphasis of the foreign bankers' concerns had shifted from that of the year before. The rapid growth of the foreign banks combined with the slow growth of the rest of the banking system threatened to push the foreign bank assets to the 8 per cent limit of bank system assets. While the focus of the foreign bank's second paper appears to be directed toward the pressing problem of the eight per cent ceiling, the brief reaffirms the view of the first paper that the overall treatment of foreign banks differs from that of domestic banks in Canada. Indeed the second paper states,

On a long-term basis the foreign banks would like to achieve a goal of "national treatment" in the Canadian banking community. It is our opinion that this could be facilitated more judiciously by allowing the establishment of foreign branches in Canada rather than foreign subsidiaries (p. 4).

Such a step would mean that foreign banking operations in Canada would be totally integrated with the operations of the parent companies and that many of the binding restrictions on schedule B banks such as borrowing to deposit ratios, limits to size of loans relative to capital
and restrictions on sources of funds would no longer apply. As will be shown later, this step would go well beyond the present treatment of foreign banks and would require a fundamental change in the Canadian approach to bank regulation.

III National Treatment: An Assessment

Since the passage of the International Banking Act of 1978, the United States Government has been pursuing a policy of national treatment with respect to the regulation of foreign banking activity in the United States. This policy has been proposed as a device to achieve greater scope for international banking at the same time as permitting individual countries to maintain their own approach to regulation. The Honourable M.E. Leland, Assistant Secretary of the Treasury for International Affairs, in testimony before the Senate Banking subcommittee on International Finance and Monetary Policy, characterized the benefits of national treatment in the following way:

The International Banking Act of 1978 enunciated the principle of national treatment as the U.S. Government's policy in the field of international banking. Foreign banks are permitted to operate under the same general conditions as domestic financial institutions. Internationally, our objective has been to secure national treatment for American banks operating abroad, namely that they be able to compete in foreign markets on the basis of
equality with local banks. We believe this is a workable principle, it removes discrimination and, handled in the context of regulatory issues and prudential considerations, is fair and pragmatic (p. 6).

A major virtue claimed for national treatment implicit in this statement, which should be stressed, is that it is intended to avoid the problem of "extra-territoriality". Each country supposedly can maintain its own approach to banking legislation as long as it permits the opportunity for foreign banks to compete on a fair basis.

I National Treatment Compared to Reciprocity

National treatment is not the only approach the United States authorities could have chosen at the time of the International Banking Act. Mutual reciprocity appears also to offer the same advantages of fairness and even-handedness. Each of two countries would agree to extend to the other's banks the same powers that the other country extended to its banks.

Mutual reciprocity would appear to involve many more practical difficulties than national treatment. Each pair of countries would have to develop a set of powers which they could mutually agree to extend to each others' banks. Moreover, it is not obvious that country A would agree upon the same list of reciprocal powers with country B as it would with country C. National treatment literally applied
reduces the need for the detailed bilateral bargaining which would be required for mutual reciprocity.

National treatment and mutual reciprocity also differ in theory with respect to their implications for the national system of bank regulation. If the two banking systems are relatively similar, the extension of powers to foreign banks in each case could be dealt within the context of existing regulation. In contrast, with two diverse banking systems, the application of mutual reciprocity would likely lead to foreign banks having different powers than purely domestic banks. It would be difficult to imagine any country extending greater powers internationally to foreign banks than to domestic banks. Rather reciprocity for banks would in these circumstances appear to be dictated by the provisions of the most stringent banking law. In this case, any country would need to have a variety of rules applying to the banks within its jurisdiction. The most liberal powers would be extended to indigenous banks with differentiated powers accorded to foreign banks according to their nationality.

24 Some claim that foreign banks in the United States have been given greater powers than domestic banks in that they can acquire a bank without raising questions either about the state of competition in some circumstances or about inter-state operations when American banks could not.
II National Treatment in Practice: A Case Study

The application of the principle of national treatment to Canadian-American banking questions provides an informative case study of the effectiveness of the concept as a device for extending international competition in banking services. The Canadian-American case tests the usefulness of the concept under quite difficult conditions. Despite the closeness and general openness of the two economies, they have chosen distinctly different approaches to the regulation of banking. In Canada, the jurisdiction for banking is centered solely on the federal government whereas in the United States this jurisdiction is divided between the federal and state governments. Moreover, each country approaches banking regulation in a different way. As has been already shown, Canada historically has restricted entry into banking but, at the same time, applied a relatively laissez-faire approach to existing banks. The United States, in contrast, has permitted easier entry but has maintained a greater degree of oversight and supervision for operating banks. This case study provides an opportunity to determine whether the national treatment approach can accommodate these differences in reaching a fair treatment of foreign banks.

The approach to be followed in this assessment involves an evaluation of particular features of the Canadian and
American systems of bank regulation with respect to the degree to which they either do or could serve as obstacles to national treatment. The only feature of the American system to be considered is the division of powers among federal and state authorities. In contrast, three features of the Canadian system will be assessed: i) the ceiling to total foreign bank assets, ii) the 25 per cent limit to foreign ownership, and iii) the "rules" approach to regulation. It will be argued that, although the ceiling to total activity of foreign banks and the limit to foreign ownership appear to be the major obstacles to the achievement of national treatment, their elimination would still leave the Canadian system of regulation fundamentally incompatible with national treatment.

i) Division of Powers. Canada and the United States differ markedly regarding the division of powers with respect to banking. In Canada, federal legislation governs banking throughout the country whereas in the United States, federal legislation interacts with state legislation in each of the states. Does this difference in approach to legislation affect the applicability of national treatment to the banking activities between the two countries?

The division of powers among jurisdictions makes the concept of national treatment ambiguous in a very fundamental way. In an obvious sense, no single definition of
national treatment emerges with several jurisdictions. A very weak definition would imply that the federal legislation accord national treatment to foreign banks in all the respects to which it applies. Yet by such a definition, national treatment would be an empty gesture should, for example, a majority of state regulators choose to discriminate against foreign banks. A stronger definition of national treatment would require that both federal and state jurisdictions accord equal treatment to domestic and foreign banks in their jurisdiction.

While the United States fares well with respect to the narrow definition of national treatment, it fares less well with respect to the broader definition. As of mid 1984, some 33 states maintain explicit prohibitions against foreign banks, though with the exception of Texas these states are generally not of interest to foreign banks.

The problem of divided jurisdiction thus shows up one of the limitations of the concept of national treatment. It is a concept designed for nation-to-nation bargaining with respect to the terms for foreign bank entry. Implicit in the concept is that the national authorities have full jurisdiction over banking regulation. The concept loses some of its appeal when it is applied to any nation in which subnational governmental units have jurisdiction over
banking. Fortunately, in most countries - the United States as the prime exception - the jurisdiction for regulation of commercial banking rests with the federal authorities. The problem may also arise in a different form with respect to countries in which the functions traditionally identified with commercial banking are split up among a variety of institutions. In these cases, some activities may be under federal jurisdiction whereas others may not.

ii) The Ceiling to Assets of Foreign Banks. The current 16 per cent ceiling to the share of foreign banks in the Canadian system appears initially to be one of the more serious obstacles to achieving the standard of national treatment. While the ceiling certainly symbolizes the differential treatment of the foreign banks in Canada, it is certainly not the sole obstacle, as will be demonstrated below. Moreover it does not appear to be even an essential element of Canadian banking policy. Prior to the adjustment to the ceiling in June 1984, the Finance Committee of the House of Commons called for its complete elimination. Similarly the Minister of Finance referred to the adjustment as an interim measures and proposed that consideration be

25 This point appears to have been recognized by the Swiss. In the past, they have threatened to confine the operations of Americans banks to only one canton.
given to its elimination in the future.

iii) The Ceiling to Foreign Ownership of Schedule A Banks. The twenty-five per cent ceiling to the foreign ownership of any bank wishing to qualify as a schedule A bank, like the asset ceiling, appears to be a major obstacle to equal treatment of foreign banks. Yet its elimination without any other changes, would change only the apparent treatment of foreign banks but would not alter effectively their status at all. Each of the foreign banks operating in Canada is the fully owned subsidiary of a foreign bank and as a result would still be unable to qualify as a schedule A bank because of the constraint on concentrated ownership through the ten per cent limit to shareholding by any common interest. While, under these circumstances, a bank which is fully foreign owned could technically qualify as a schedule A bank if its ownership were spread among at least ten separate interests, it is unlikely that this approach to entry into Canadian banking would have any appeal. Multinational banking is generally explained as a device to gain advantage from specialized skills or knowledge of parent banks. The form of organization required to qualify for a schedule A bank would lead to benefits from these advantages being shared with the other interests.

26 See Richard Caves, "Discussion" in Federal Reserve Bank of Boston, Key Issues in International Banking, Conference Series no. 18, pp. 87-90.
iv) The Canadian Approach to Regulation. The Canadian approach to banking regulation, at least up to 1980, could be characterized as a system of regulation by rule with minimum discretionary intervention in the conduct of banking.\textsuperscript{27} It is important to recognize that such a system could be successful only if accompanied by a number of other factors to ensure that the banks function prudently. Historically in Canada, the device chosen to achieve this end was an extremely selective approach to entry intended to ensure only "solid" enterprises were permitted to participate in banking. Subsequently, this approach was supplemented by the ten per cent limit to ownership by any interest which was intended to make it more difficult for any party to "capture" a bank and use it for its own purposes at the expense of depositors. These elements, it could be argued, comprise a consistent and, by experience, an effective means of prudential regulation.\textsuperscript{28,29}

\textsuperscript{27} Considerable intervention did occur through moral suasion by the Bank of Canada for monetary policy reasons. For present purposes, regulation of banking is considered separate from the achievement of credit targets, whether aggregate or sectoral. For a discussion of the use of moral suasion, see Keith Acheson and John Chant, "The Choice of Monetary Instruments and the Theory of Bureaucracy", \textit{Journal of Money, Credit and Banking} (Spring, 1972), pp. 13-33.

\textsuperscript{28} The last bank failure in Canada occurred in 1923. It has been suggested that some bank mergers have been arranged by banking authorities in face of imminent failure.

\textsuperscript{29} This statement leaves open the question of the costs of the system in terms of a lack of competition. The present purpose is not to assess the desirability of the system but rather to identify its qualities.
In their policy toward foreign banks, Canadian authorities face a dilemma between maintaining their long standing approach to regulation and the need to conform to the national treatment approach. Treatment of foreign banks on the same basis as schedule A has the potential to jeopardize the system of regulation which has built up over the years. Some foreign bank entrants would come from countries where many of prudential rules integral to the Canadian system are absent or, at least, weaker. For example, few other countries prohibit the sole ownership of banks. In cases when substantially different standards of regulation are applied to banks, even the required "letter of comfort" from the bank's parent may not be adequate reassurance for the Canadian authorities.

A strict interpretation would appear to make the Canadian differentiation in the treatment of schedule A and schedule B banks incompatible with national treatment. Indeed, it could be argued that both the creation of the schedule B category and the explicit provision for discretionary changes to regulations were directed primarily at providing a basis for foreign entry in a manner which would not jeopardize the existing approach to regulation. Some support for this view is given by the evidence that the discretionary approach has been directed primarily, though solely, at the Schedule B banks.
The other alternative open to the Canadian authorities would require them to alter the treatment of domestic banks so as to make it consistent with the present treatment of schedule B banks. As should be clear, such a step would require a complete reversal of the philosophy of Canadian banking regulation. Rules would be supplanted by discretion. If the Canadian authorities followed this approach, it would mean that the strict application of national treatment has resulted in a loss of control by domestic authorities over the types of rules and regulations governing its banks.

Conclusions

The justification for national treatment is the fair treatment of American banking interests in foreign countries. Assistant Secretary Leland spoke, unabashedly and legitimately, of national treatment as a plan "to support U.S. banks and financial firms' interests overseas (p. 1)." The continued acceptability and success of the national treatment approach will in large measure depend on its perceived contribution to the success of the international operations of U.S. banks in foreign markets.

As already seen, it seems quite possible that by a valid interpretation of national treatment, the Canadian
authorities can quite consistently maintain essentially the status quo. They would only have to eliminate the limitation on foreign ownership. As the two White Papers demonstrate, such an outcome would be unacceptable to the American banks with established subsidiaries in Canada. To them, fairness means more than having the same powers as schedule B banks and being subject to the accompanying discretionary approach to regulation. Their goal is no less than the ability to operate under the rules approach applied to the schedule A banks. The national treatment approach will be acceptable to American banks only as long as it supplies progress toward this goal and will likely be supplanted when it cannot.

The treatment of foreign banks operating in Canada has been and will likely continue to be a source of friction between the United States and Canada in future years. The movement from an eight to sixteen per cent ceiling on foreign bank activity appears to have alleviated the proximate cause of the friction for the present. Moreover the adoption by the United States of a national treatment approach to negotiations over powers of foreign banks has been acclaimed as a workable formula to achieve mutual agreement. In face of these developments, can the current calm be projected far into the future or is it merely a transitory pause reflecting the glow of recent successes?
The analysis suggests the latter interpretation to be more likely for three reasons. Least of all, Canada will in all likelihood maintain its foreign ownership limitations rather than symbolically adopt national treatment. But, even if Canada did drop its foreign ownership limitation and became, at least arguably, consistent with national treatment, it would not alter the effective status of foreign banks. Other features of Canadian banking regulation would constrain their operations. Finally national treatment will promise much more to foreign banks about their prospects in Canada than they are likely to receive. Inevitably, their view of fairness will lead them to expect more than the Canadian authorities will, or need, give them to be consistent with an interpretation of national treatment. It is the case of an irresistible force meeting an immovable object – the pressures for multinational banking against the Canadian approach to regulation.
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