PRESENTATION TO THE BANK OF CANADA BOARD OF DIRECTORS

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GLOBALIZATION, MANUFACTURING AND BANKING

Thank you for this opportunity….

I will approach the subject by speaking to four issues:

1. Perspective on Globalization

2. Manufacturing – is it different than other parts of the economy and should this difference be reflected in Government and Bank policy?

2. The experience of Palliser

3. My perspective on Canadian banks and Bank of Canada policy.

In 1995 I wrote a speech on the changing nature of our world and titled it "Globalization". My computer spell check rejected the word. It did not exist in any major dictionary and could not be found in recent documents of the World Economic Forum. Ten years ago!

There is a conventional view that the perceived impact of changing global relationships is inevitable and linear. We easily forget the massive and unexpected impact of the fall of the Berlin Wall, the information revolution of the 90's and the tragedy of 9/11. Discontinuities are a reality of history.

The current phase of globalization is really less than a decade old and we should consider the lessons of history as we select winners and losers in this global chess game – and it is more like a chess game than the invisible hand of Adam Smith.

China was linked to Europe for a century after Genghis Khan. There was a tremendous transfer of technology and empires of today had their boundaries set by those events. The link ended when the bubonic plague started in Gangzhou – the same location as SARS - travelled the Silk Road in one year, decimated both China and Europe and cut the linkage for 5 centuries.

One sick cow in Alberta closed the US/Canada border. We insure our homes but place no value on the risk of a possible disruption of the border. What is the risk of locating most of the world's electronic chip production within an hour of the Taiwanese City of Hsinchu – a country not without political risk?

Consider North Korea, Japan/China friction, the Taiwan Straits, the political and regional ambitions of China, an angry Islam, US paranoia. We are creating a global trading pattern as if we lived in a perfect world. We are placing no value on the risks inherent in this structure and we may yet regret that oversight.

Second, I want to speak to the question of manufacturing and how it fits into this emerging global scenario. The ability to produce many products at lower costs in new locations is real and hardly surprising. It is less clear that products and processes will remain rigid and simply shift based on costs. When changes occur too rapidly industries sometimes fail to adjust. When there is more time, companies and industries may metamorphose by adapting their products and processes and even shifting the ground rules of the marketplace.

There is also a current conventional wisdom that we are all more or less equally subject to the forces of globalism. There is a compelling difference between shopping for a product at Wal-Mart or working for a Canadian company that competes with Wal-Mart's Asian supply chain. How many of us as companies or individuals are really in competition with China or the rest of Asia?

Consider sectors or industries that compete locally rather than internationally by virtue of law, regulation, geography or the nature of the product.

- Medical care in Canada
- Pharmaceuticals protected by intellectual property
- Most of education
- Government Services
- Retail and most personal services
- Much of the media with the help of the CRTC
- Many cultural products
- religion
- Agriculture with supply management and massive subsides – plus pseudo-science masquerading as health protection
- Construction and transportation are protected by geography
- Commodities are priced globally but you cannot relocate the tar sands
- Finally - banking and financial services – monopolistic, monolithic and substantially protected from real global competition

What is left? Consumer products that can be transported, certain technical products and services, commodities based on price, international tourism and not much more. The global adjustment is really being handled at best by 20-25% of each economy. The assumption that the current pattern of trade is immutable is dangerous as evidenced by the BSE example. Does this call for a policy of any kind? Our competitors in fact are operating with very clear policies.

Some of our competitors use mercantilist policies reminiscent of the glory days of colonial empires to capture the relocatable parts of the global economy. Manipulating currency, tax holidays, ignoring the environment, restrictive labor policies, irresponsible lending patterns – this creates a cumulative level of cost reduction that swamps international competitors. We too easily forget that the British pre-eminence in textiles was based less on superior cost performance and more on suppression of the industry in North America and the Indian sub-continent.

Does any of this matter? Consumer and industrial products and selected services are industries not necessarily limited by geography. Palliser is located in Winnipeg because that is where my father lived at a time when he needed a job. There was no economic reason whatsoever to base a furniture company in Winnipeg and that is equally true today. It remains because we wish and will it to remain.

Manufacturing and certain industries can be relocated. Since their original positioning was seldom based on economics but more often on personal history – once lost these companies and industries will not return. Manufacturing is an accumulation of capital, competence, product ownership, market relationships and the force of personality. It is no less the wealth of a country or community than nickel or oil in the ground – and it has the tendency to develop rather than deplete.

The European engagement with the aboriginal people of North America was an exchange of land and resources for axeheads and bangles. The exchange in Meso-America was even less generous. Today we give up the accumulated physical and intellectual wealth of our industries in return for lower-cost bangles on the shelves of Wal-Mart. We receive clothing and toys that do not survive the season and electronic bangles that are obsolete within a few years. However, the industries transferred to China will survive all of the gadgets they send and move to the next generation.

Should there be international specialization and the dispersion of production? Absolutely – but we allow it to happen in a mercantilist world with an absence of policy and strategic thinking. History may judge us harshly.

I will now talk about how these global changes affect Palliser and how we are responding. Furniture is a product that has historically been quite regional with significant labor content. The highest-labor items began to move offshore 25 years ago – but today virtually every sector is facing international competition. Although labor in some categories is only 20%, the China price is competitive in spite of a large freight factor. The cost of the entire supply chain is suppressed by a variety of financial, labor, environmental and strategic factors.

The Canadian furniture industry was impacted severely by the FTA of 1989 but the 5-year structured transition allowed the majority of firms to specialize and develop niche markets in the US. Our industry has prospered and outperformed its US counterpart until the currency changes of 2003. We now face the declining 'China Price' in our major market plus the additional impact of currency revaluation. The Canadian Furniture Industry is contemplating requesting the imposition of temporary China-specific Safeguards as allowed by WTO. We will see if our Government has the courage to play by the same rules as China.

Palliser has not been sitting on its Canadian hands. We were among the first to seek technology in Europe in the 50's, sourced components internationally in the 60's and finished goods from Asia in the 80's. We opened our first Asian office in 1986, US showrooms in 1989, Brazilian leather sourcing in 1990, Mexican plants in 1998, Indonesia in 1999 plus many contract suppliers. Our market developed into 65% exports but we were too loyal to Canada and 80% of final production remained here. Most of our competitors have chosen to have a China strategy – we are opting for a contrarian approach based on the cost and time-sensitive possibilities of Mexico but hedging our future with an equal presence in Asia.

2002 was our record year. 2003 was a challenge but by early 2004 we had substantially recovered. The second currency change of late 2004 was more difficult and we had a substantial financial impact on our margins plus the accounting revaluation of assets with a US dollar base. This caused us to miss our ebitda covenants and from the reaction of the banks you would think the world had ended. In spite of all of these setbacks we still broke even in 2004.

Palliser has always opted to use short term funds. We are asset rich with un-financed real estate holdings that are much greater than our equity – but in an ebitda world these suddenly had no value. Without exceptional financial management in our company plus my personal stature, the banking group would have forced us to dis-invest to a degree completely inappropriate to the situation. We would have suffered financially and our employees lost their careers.

Palliser did react. Our largest plant was restructured and sold to family members, one Winnipeg plant has closed and our fourth plant is being opened in Mexico. We source more from Asia, transfer labor to Mexico, change our products, technology and even our customer base. Next we will restructure our banking relationship and there is a high possibility that it will exclude any Canadian banks.

The narrow focus on ebitda with all banks thinking and acting in lockstep will be destructive for Canadian industry during a time of stress. We need a greater variety of banking options that reflect the global possibilities today. Each of you can buy furniture made in Shanghai or Shenzen. An ideal Commercial bank today would have its Information technology in Bangalore, its cost base in Bangladesh, its regulatory environment in Beijing and its Head Office in the Bahamas allowing me a tax-free winter visit. We do not need relationship bankers to buy us golf games in good times.

Our banks suddenly question the collateral value of our real estate, our Mexican assets, our new business ventures and even cash held outside of Canada. They question the value until we request to transfer the collateral to lenders who value those assets more. Nothing would be better for our banking environment than some genuine competition. If we celebrate a new global world – lets at least all be citizens of the same world.

Palliser is moving back into positive territory and will continue to change and thrive but it may well be with new financial partners.

Finally, I promised to make some comments about Canadian Banking and Bank of Canada policy. My feelings about the banks should already be evident.

Canadian banking is both monopolistic and monolithic. The Economist recently reported that Canadian Banking was the most concentrated among major Western economies. In spite of this reality the banks still request permission to merge to reduce competition even more! Furthermore, Commercial Banking has become fringe for Canadian Banks representing less than 10% of their activity.

My best financing experiences were with the Mercantile Bank when they were effective and with Barclays when they were active in Canada. They offered alternative approaches and fresh strategies. I lament their absence. Canadian policy should be directed to the creation of the maximum degree of international competition for financial services within Canada – then allow the banks to merge to one if they want to. At least the rest of us can then choose to go elsewhere.

Reading the daily media about the impact of China and the Canadian dollar on manufacturers and exporters – we can hardly expect the banks to take a high-minded approach to this sector. Given group-think and the absence of real competition they respond as we experienced. If you expect Canadian manufacturers and exporters to survive because of the assistance of banks - that is a faint-hope policy. I suggest that the Bank of Canada explore the reality faced by many of our companies with respect to their banking. Most companies know only a single alternative and assume that the way the five banks deal with them is the total range of possibilities. We may lose more companies and productive assets than is necessary without a greater degree of comprehension and strategic support.

The Bank of Canada has historically stated that inflation was its major concern. I challenge this limited objective. The reality of Canada is that 85% of our trading and financial relationship is with the United States. Any new international investor in any productive industry would observe the recent Canadian experience and the policy or absence of policy of the Bank of Canada with respect to currency values and conclude that Canada represents an unnecessary level of risk. Asia and especially China is strategically mercantilist with respect to most aspects of their economy. The US is less mercantilist but their power in the marketplace allows them to ignore international norms and even treaties when it suits them. Canada does not have that degree of power and needs to be clever and strategic. The Automotive Pact is an excellent example of such a policy. The FTA and NAFTA is a good policy in principle but we note that the US considers the honoring of its obligations as optional.

In conclusion I remind the Board of Directors that the absence of a policy for manufacturing is in fact a policy since our competitors are acting out of a strategic policy framework. Productive asset locations are frequently based on accidents of history and remain based on loyalty to community plus personal commitment. Once disconnected from these emotional attachments these assets will float around the world seldom to return. Manitoba more than most locales represents the power of the human spirit over geography, economics and often the policies of the Canadian center. Take away the human element and Manitoba ceases to exist. We ignore this dimension at our collective peril.

Thomas Friedman recently published a book titled “The World is Flat” and John Ralston Saul is touting his new book titled “The Collapse of Globalism”. They cannot both be right but reflect the fact that there is a place for skepticism.

Canada is enjoying economic prosperity in a global sense but with severe internal tensions. The situation reminds us of the economist whose head is in the fridge and whose feet are in the oven. On average he is comfortable. The strength of commodities plus certain sectors that respond to low interest rates are driving one end of the bargain. When they cease to be drivers we need to make sure that the other end of the economy is still in existence to keep us feeling comfortable on average.

Your deliberations are important to our collective economic health. We wish you much wisdom.