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REVIEW OF FOREIGN DEVELOPMENTS

February 23, 1965

Recent Economic Developments in Canada,
November 1964-January 1965

28 pages

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Summary

Canadian economic activity moved upwards during recent months, after gathering fresh momentum during the third quarter.1/ The present broad expansion--reflecting rising consumer demand, an accelerating pace of non-farm inventory accumulation, government cash expenditures, and construction activity, as well as good levels of exports--has benefited from a notable easing of money and financial markets conditions since late August, and surprisingly strong payments and reserve outturns in the third and fourth quarters of 1964, respectively.

Output rose further in November-December. By mid-December the unemployed formed only 4 per cent of the labor force, the lowest unemployment rate since May 1957.

The present expansion has received a sizable assist from the continued improvement in the Canadian external accounts. During the third quarter, Canada experienced an unprecedented current-account surplus of $219 million, the most favorable outturn since quarterly records first were kept in 1940. The principal development in the capital account in the third and fourth quarters was

Note: All values in Canadian dollars, unless otherwise identified.

1/ Economic developments during the previous three months are summarized in "Recent Economic Developments in Canada, August to October 1964," dated December 2, 1964.

the bulge in deliveries of long-term Canadian bonds to U.S. residents after the signing of the I.E.T. exemption on September 3. Official reserves, adjusted for I.M.F. transactions, rose about \$164 million in the fourth quarter, on top of an increase of \$157 million in the third quarter; about 2/3 of these increases in 1964 were taken in gold. Since October 1964, yield differentials favoring use of the U.S. as compared to the Canadian capital market have been reduced by the Canadian authorities in an attempt to curtail the volume of new issues in the U.S.

The present fast-paced expansion as yet has not noticeably strained resource availabilities. Reasonable price stability still obtains, despite some price creep in recent months. The supply of labor remains about in balance with present needs, partly because of the goodly continued growth in the labor supply.

The expansion resumes in third quarter

During the third quarter, seasonally adjusted real GNP rose almost 1 per cent--or \$360 million at an annual rate in 1957 dollars--as the expansion in aggregate demand regained momentum after a relatively static second quarter. (See Table 1.)

The forces leading the expansion apparently changed considerably during 1964. During the second and third quarters, construction activity, government expenditures, and investment in equipment and machinery fell from their unusually high first quarter levels; however, the acceleration of business inventory

Table 1. Canada: Growth of Real Aggregate Demand, 1963-1964
(millions of 1957 dollars, seasonally adjusted, annual rates)

	Total, IV 1963	Changes from Previous Quarter, During			Quarterly Increases, By Component, as Percentage of Total Increase in G.N.E. 2/		
		I 1964	II 1964	III 1964	I 1964	II 1964	III 1964
Consumption	25,550	492	- 8	472	52	- 4	130
Construction, New	4,100	476	-492	- 20	51	-246	- 5
Equipment, Machinery	2,740	336	- 80	-136	36	- 40	-37
Non-Farm Inventories	350	112	52	256	12	26	70
Exports	8,940	280	532	- 4	30	266	- 1
Government (Goods and services)	6,560	308	- 28	-124	33	- 14	-34
Other 1/	-8,460	-1064	224	- 80	-113	112	-22
Gross National Expenditure 2/	39,780	940	200	364	100	100	100

1/ Comprises farm inventory changes, imports, and residual error of estimate.
2/ Totals may not add because of rounding.
Source: Compiled from Dominion Bureau of Statistics data.

accumulation, together with strong, continued rises in personal consumption--notably on automobiles--lifted total gross national expenditure by 2.7 per cent over the half year between the first and third quarters of 1964. The accelerating rate of non-farm (business) inventory accumulation at least in manufacturing (see page 10) so far appears voluntary and about in line with the rising flow of orders and shipments.

Part of the shift in sectors leading the expansion may reflect temporary or special factors. The lagging growth in construction during the second and third quarters in part is apparent rather than real--the impact of the Government's two year old winter construction program probably is not adequately reflected as yet in seasonal adjustments; thus, the adjusted data shown in Table 1 probably overstate the rise in the fourth and first quarters and understate the level of activity in the middle of the year.

Demand expands further in fourth quarter

The pace of the 47 months old Canadian expansion may have accelerated during the fourth quarter, aided by the jump in construction activity prompted by special government measures, by a continued marked growth in manufacturer's inventories, and by a spurt in central government cash expenditures. Exports and total retail sales at least through November were maintained at fairly high levels.

New construction activity jumped very sharply in November, on top of earlier rises in September and in October. (See Table 2.) These marked increases in seasonally-adjusted construction activity originate in the special government program to increase winter house building, now in effect for the second year.

By November, the number of dwellings under construction was 22 per cent greater than during the third quarter. However, the full effect of the bouyant construction activity is yet to come; the value of new building permits granted, at a total of $426 million in November, was up 51 per cent from the average third quarter level, while the number of new dwelling starts was about 63 per cent greater than during the third quarter. The average number of new dwellings completed in October and November about equalled the average third quarter level.

The rise in construction activity between the third and fourth quarter may even be greater than last year, when the program was regarded as highly successful. The increases in construction during the winter months as yet apparently have not been at the expense of the spring and summer activity levels (see Tables 1 and 2); however, it is too early perhaps to judge the effect of the winter housing bonus on the average level of construction activity.

Federal government cash expenditures[1/] increased during the fourth quarter--mostly reflecting heavier special "below the

1/ Regular budget expenditures, plus special non-budget expenses, excluding exchange-fund and Columbia River Treaty transactions.

Table 2. Canada: Construction Activity, 1963-1964
(seasonally adjusted)

	Monthly Averages 1963 July-Sept.	Monthly Averages 1963 Oct.-Dec.	Monthly Averages 1964 1/2 Jan.-June	Monthly Averages 1964 July-Sept.	Recent Months Sept.	Recent Months Oct. p/	Recent Months Nov. p/
Value of building permits ($ million)	227	180	238	285	359	321	426
Thousands of units 1/							
New dwellings starts 2/	116	148	133	126	124	144	205
New dwellings under construction 3/	64	72	73	69	71	74	84
New dwellings completed 2/	102	119	151	108	107	114	104

1/ Centers of 5,00 or more inhabitants.
2/ Annual rates.
3/ End of month.
p/ Preliminary.
Source: Compiled from D.B.S. data.

Table 3. Canada: Federal Government Expenditures, National Income and Cash Basis
(million dollars)

	Monthly averages 1963 III	Monthly averages 1963 IV	Monthly averages 1964 III	Monthly averages 1964 IV	April 1 - Dec. 31 Cumulative totals 1963	April 1 - Dec. 31 Cumulative totals 1964
Net deficit (-), on cash basis, excluding foreign exchange transactions 1/	-120	—	+33	-47	-240	- 89
(Net cash expenditures) 1/	(616)	(574)	(540)	(658)	(4806)	(5417)
Budget deficit (-)	- 39	+18	+15	+ 9	- 42	+424
Receipts	496	561	573	611	4566	5328
Expenditures	535	543	558	602	4608	4904
Special transactions, net deficit (-), other than Exchange fund transactions 1/	- 81	-18	+18	-56	-198	-513

1/ Excludes transactions with the Exchange Fund Account; and transactions connected with the Columbia River Treaty, which involved an expenditure of $220 million during September 1964; as well as any debt-management operations.

Totals may not add because of rounding.

Sources: Based on monthly data published by the Ministry of Finance, and on the National Accounts data published by the D.B.S.

line" types of expenditures--and averaged almost 22 per cent higher than during the third quarter (see Table 3); in the same period in 1963, net cash spending had fallen. The increases in expenditures during the fourth quarter was only partially offset by the continuing rise in government revenues, so that a cash deficit of about $150 million was registered during the fourth quarter. However, part of this deficit did not affect cash flows: it reflected changes in timing of Bank of Canada profit payments and railway subsidies at the year-end.

From April 1 to December 31 (the first 9 months of the fiscal year), the Federal Government's budget revenues were almost $760 million greater in 1964 than in 1963, largely because of the continuing rise in government revenues generated by the business expansion and the extension in the coverage of the Federal sales tax. The expansion in receipts has yielded a "budget" surplus of over $400 million. On a cash basis, the net deficit declined from $240 million to $89 million over the same period. On a national account basis, a $345 million (annual rate) Federal surplus was registered during the first three quarters of 1964, and a substantial surplus on the national accounts basis--the first since the fiscal year ending in March 1957--is now expected.

Retail sales (seasonally adjusted) during October and November remained about at the unusually high third quarter average of $1607 million, despite special factors which sharply reduced new car sales in October and again in November. Excluding new cars, retail trade to November was up more than 3 per cent over the third quarter average, a distinct acceleration. (See Table 4.) Uncertainty about the impact of the Canadian-U.S. manufacturers' common market in automobiles, then under discussion, and the U.S. and Canadian auto strikes were responsible for the fall in auto sales.

Industrial production up

November industrial output registered its sharpest monthly increase for 1964, rising more than 3 per cent above the third quarter average, after being about stable during September and October. (See Table 5.)

But the large November increase reflected two special factors: (a) durables goods output rose as output of automobiles and parts recovered from the strike-depressed low October levels; and (b) increases in construction activity, and in advance buying of construction materials, helped demand for a range of products, including non-metallic minerals (up 6 per cent) and wood products (up 2 per cent), as well as iron and steel products (up 3 per cent). The recovery during November of automobile and auto-parts production was incomplete and temporary. During December, the auto industry again was adversely affected by strikes, so that the December automotive industry output will be even lower than the October level.

Despite the marked rises in industrial output--up perhaps 32 per cent during the current expansion, compared with an increase in total real G.N.E. of 22 per cent--so far there are few complaints

Table 4. Canada: Retail Sales, 1963-1964
(seasonally adjusted, million dollars per month)

	1963			1964			Recent Months		
	Jan.-June	July-Sept.	Oct.-Dec.	Jan.-June	July-Sept.	Oct.-Nov.	Sept.	Oct.	Nov. p/
Retail sales, excluding automotive	1290	1321	1337	1374	1389	1422	1388	1411	1432
New car sales	162	168	195	192	218	188	251	201	175
Total	1452	1489	1532	1566	1607	1610	1639	1612	1607

p/ Preliminary.
Source: Based on data published by D.B.S.

Table 5. Canada: Industrial Production, 1961-1964
(deseasonalized index, base 1949=100)

	relative weights	INDICES							Rise, March 1961 Nov.'64 (%)
		1961 March	1964 I	II	III	Sept.	Oct.	Nov.	
All industry, total 1/	100	166	211	212	213	213.4	214.2	219.6	+32
Manufactures, total	85	148	187	187	189	190.0	188.4	194.0	+31
Durables	39	142	193	192	196	196.3	191.5	198.6	+40
Autos	3	179	307	290	313	321.4	218.8	255.5	+43
Auto parts	1.5	135	215	214	238	238.2	217.1	222.2	+64
Non-durables	46	154	181	183	184	184.6	186.6	190.0	+23
Mining, total	10	244	326	324	313	308.1	319.9	334.2	+37
Electrical and gas utilities, total	5	302	391	399	411	416.1	426.9	418.7	+39

1/ Industrial production accounts for about one-third of G.N.P.
November data preliminary.
Source: Dominion Bureau of Statistics.

of a developing shortage of plant capacity. Only in the case of steel--and there particularly for certain finishing mill products--are there indications of strain on plant capacity.

Favorable orders position

The quite favorable September-November manufacturers' orders, inventories and shipments data, together with the bouyancy in building permits, suggest that the underlying demand trend still is strongly upwards.

New orders for manufacturers, rising by 9 per cent between July and November, reached an all-time peak of $2,775 million. (See Table 6.) Despite large increases in shipments the level of unfilled orders continued to rise, and at $2,800 million now equals that reached in May 1957 during the previous expansion; however, unfilled orders remain below the peaks reached in the two previous cyclical expansions.

Inventories in manufacturing (including raw materials, semi-finished, and finished goods) rose almost 1 per cent from October through November, suggesting a continuation of the upwards trend in non-farm business inventories, which on a national accounts basis have swung from a decumulation (seasonally adjusted annual rates) of $60 million in the second quarter of 1963 to rates of accumulation of $620 and $816 million in the second and third quarters of 1964, respectively.

Table 6. Canada: Leading Indicators, 1963-1964
(deseasonalized, millions of Canadian dollars)

	1963		1964						
	Aug.	Nov.	Jan.	March	May	July	Sept.	Oct.	Nov.p/
Manufacturing									
New orders	2421	2501	2676	2699	2507	2555	2603	2623	2775
Unfilled orders	2321	2450	2481	2468	2546	2633	2660	2742	2793
Inventory/shipments (ratio)	2.05	1.97	1.88	1.82	2.00	2.03	2.00	2.01	1.89
Owned inventories									
Raw materials	2121	2149	2166	2163	2195	2209	2245	2243	2250
Semi-finished and finished goods	2726	2695	2787	2720	2777	2838	2885	2865	2902
Total	4847	4884	4953	4883	4972	5047	5130	5108	5151
Shipments	2362	2479	2633	2687	2483	2489	2572	2541	2742
Building permits	224	320	250	244	211	235	359	323	426

p/ Preliminary.

Source: Compiled from data published by the Dominion Bureau of Statistics.

Table 7. Canada: The Labor Force and Unemployment, 1964
(seasonally adjusted)

	1964						Rise, June '64-Dec. '64 (%)
	Jan.	June	Sept.	Oct.	Nov.	Dec.	
Civilian labor force (000)	6857	6929	6914	6937	6963	6967	+ .5
Total employment (000)	6522	6596	6605	6593	6667	6691	+ 1.4
Average weekly hours in manufacturing	41.3	40.9	41.1	41.0	n.a.	n.a.	--
Index of unemployed (1956=100)	170	183	157	175	150	140	-23.5
Unemployed as per cent of labor force	4.9	5.2	4.5	5.0	4.3	4.0	-23.1
Average hourly earnings, manufactures	1.99	2.02	2.06	2.05	n.a.	n.a.	1/+ 3.5

1/ Through September, 1964 - n.a. Not available.
Source: Based on data published by D.B.S.

But the November level of manufacturers' inventories, while high, is not out of line--and may even be low--given the current increase in manufacturing activity. The rise in owned inventories in recent months has more than been matched by the rise in shipments, so that the inventory shipments ratio had fallen back by November to 1.89, about the level touched last January after a five or six months long surge of economic growth; further, the backlog of unfilled orders continues to rise, suggesting that the inventory accumulation is voluntary.

Labor force up, unemployment down

The rapid expansion of output during the third and fourth quarters has taken up much of the slack in the labor market, even though the labor force has continued to expand. By December, the number of persons unemployed (seasonally-adjusted) had decreased by more than 23 per cent from the high mid-summer level. (See Table 7.) Unemployment as a percentage of the labor force had fallen between June and December by 1.2 percentage points to 4.0 per cent--the lowest unemployment rate since perhaps May 1957--while the total labor force grew by 0.5 per cent.

Present and prospective labor supplies appear consistent with the Government's target for a 5 per cent growth in real output during 1965, given some continued growth in productivity. The unemployment rate at 4 per cent leaves a good margin; unemployment rates of 3 per cent and less were touched during the previous cyclical peaks of 1953 and 1956. Further, labor force growth during

1965 is expected to be even higher than the 1.9 per cent growth achieved during the year ending in December 1964. The rest depends on productivity changes. Substantial investment in machinery and equipment took place in 1964, and during the year ending in the third quarter 1964, real gross national expenditure per employed person rose about 2.7 per cent, an increase well above that of recent years, but well below that achieved in the first post-war decade, and not out of line with the goals set by the Economic Council of Canada for these next five years.

Prospects for achieving substantial continued economic growth during 1965, without bumping up against excessive wage strains, are enhanced by the recent reductions in the structural elements (seasonal, occupational, and regional) limiting the reduction in the unemployment rate. Government policies aimed at reducing winter unemployment have also reduced the "seasonal" element in structural unemployment. Provisions encouraging the location of new plants in depressed regions also are helping to reduce the regional element in structural unemployment. Finally, the quite large accessions of young newcomers to the labor force (the byproduct of the postwar baby boom) may increase the responsiveness of the work force to new types of job opportunities.

<u>1965 Investment prospects good</u>

The prospects for continued expansion of investment in 1965 are proclaimed with unusual unanimity. Minister of Trade and Commerce Sharpe has reported that "known" business plans call for a rise of 10-15 per cent in capital investment; the Minister of Resources has forecast an increase in electrical generating capacity of triple the 1964 increment; the President of the Canadian Construction Association expects a 12 per cent rise in construction outlays, with all provinces except Newfoundland and Manitoba contributing to that outcome; a member-company survey conducted by the Canadian Association of Purchasing Agents indicated that none expected sales in 1965 to decrease, whereas 83 per cent forecast increased sales; while the Canadian Good Roads Association estimates that all government entities will spend 5 per cent more on streets and roads in 1965 than in 1964; and construction began in 1964 on more than 9 pulp mills in British Columbia with the result the pulp capacity in that province will be at least 45 per cent higher in 1967-68 than in 1963. Moreover the increase in productive capacity undertaken in 1964 will improve the domestic supply of structural steel and steel plate, presumably at the expense of imports.

Price creeping up

After quite remarkable stability earlier in 1964, consumer and wholesale price indices began creeping up during the three months, November through January. (See T ble 8.)

The consumer price index in these three months has risen more than 1 per cent, although over the same period in recent years it has tended to fall. The increases are broadly distributed, only the clothing index declining. This recent jump brings the total

Table 8. Canada: Price Developments, 1963-1965

	Percentage increases during					Indices (recent months)			
	1963		1964						
	Jan.-June	July-Dec.	Jan.-June	July-Sept.	Oct.-Dec.	Oct.	Nov.	Dec.p/	Jan.p/
Consumer prices (1953=100)	.7	1.1	.8	.3	.9	117.4	117.7	118.4	118.6
Wholesale prices (1953=100)	1.4	-.2	--	-.4	.7	110.7	110.9	111.5	111.7
30 Industrial materials (1935-39=100)	2.9	1.0	.1	.4	-1.0	258.9	256.7	256.2	n.a.
Import prices (1948=100)	3.5	.7	2.4	n.a.	n.a.	(132.7 July)	n.a.	n.a.	n.a.

p/ Preliminary.
n.a. Not available; none
Source: Based on OECD Main Economic Indicators and Dominion Bureau of Statistics data.

Table 9. Canada: Indicators of Prices and Costs in Manufactures, 1963-1964 (seasonally adjusted)

	Changes (per cent) during				
	1963		1964		
	Jan.-June	July-Dec.	Jan.-June	July-Sept.	Oct.-Dec.
Wholesale price index manufactures (1935-39=100)	+1.2	+ .4	+ .4	- .4	-.1
Labor cost per unit output in manufactures	+1.1	- .1	+1.2	+1.0	--
Average hourly earnings in manufactures	+1.6	+2.0	+2.0	+2.0	1/ -.1
Corporate profits in manufacturing before taxes	+2.9	+9.5	+5.1	-6.9	n.a.

1/ November 1964 over September.
n.a. Not available.
Source: D.B.S.

increase over the year ending in January 1965 to almost 2 per cent, compared with an increase of slightly more than 1 per cent in the U.S. index.

The wholesale price index increase of about 1 per cent from October 1964 to January 1965, also broadly distributed by commodity, is roughly twice the average increase during this period in the previous five years. However, the recent increases leave the wholesale index still below its January 1964 level; over the past year, U.S. wholesale prices have remained about flat.

So far, there is little evidence of upwards wages pressure on wholesale prices of manufactured goods. The increase in average hourly earnings in manufactures has accelerated slightly from about 0.8 per cent per quarter in the first half of 1963 to perhaps 2 per cent during the third quarter of 1964, but labor costs per unit output seem to have risen substantially less, at least through the third quarter. (See Table 9.) The continuing rise in average hourly earnings and in wage costs per unit output in the face of a fall in the manufactures wholesale price index may have been a factor in the 7 per cent decrease in the before-taxes profits of manufacturing corporations. The decline in the pace of the business expansion also probably affected third quarter earnings.

Fiscal and monetary posture

Encouraged by the relative price stability maintained in 1964 and by the improvement in the external payments position, Canadian fiscal and monetary policy now are directed at prolonging the roughly 47 months long business expansion into 1965. Finance Minister Gordon recently noted that ". . . we must do everything we possibly can do to ensure a rapid and a sustained rate of growth of the Canadian economy this year . . . .",1/ after estimating that real G.N.P. rose about 6 per cent in 1964. On the fiscal side, the Minister hinted broadly at the Government's readiness to reduce taxes during 1965, should the present expansion weaken. He commented in effect that with substantial unemployment, the Federal Government in 1964 had experienced a good surplus on a national accounts basis (the first since the fiscal year ending in March 1957); as a result, there was room to reduce taxes if needed.

On the monetary side, current policy is aimed at keeping financial conditions moderately easy, in marked contrast to the trend towards tight money evident in the first half of 1964. From early September 1964 through early February 1965 interest rates have declined considerably, and now are below their end-1963 levels. (See Table 10.) After August, bank liquidity eased: the liquid assets ratio rose from 16.35 in August to 17.37 in January and 17.42 in early February. Currency outside banks and chartered bank deposits held by the general public (seasonal adjustment estimated) have risen about $700 million or over 4 per cent in the five months from August through January, after slowing down during

1/ Speech delivered January 4, 1965, before the Canadian Club of Toronto. (mimeo) Page 6.

the summer. Over the same period, general loans of the banks rose about $400 million.

The rise in liquid assets, and the continued easing of financial markets in part reflects the inflow of foreign (mainly U.S.) funds and in part the lower central government new cash requirements. The government was able to meet its cash needs out of the seasonal rise in the sales of non-remarketable Canada Savings Bonds, and still retire some $250 million of marketable debt over the year. The current ease of money and financial market conditions is aimed at putting Canadian financial markets in position to finance the expected further expansion of business activity, and to encourage more resort to Canadian rather than U. S. sources of funds.

The current easing of money and financial conditions was interrupted only briefly by market responses to the uncertainties generated by the "token" 1/4 percentage point increase in the Bank of Canada discount rate, effective last November 24. By early December vigorous official intervention had steadied money and financial markets, and by early February 1965, interest rates on bonds had fallen 7 to 20 basis points below their November levels. (See Table 10.)

Earlier, to mid-August financial conditions had been permitted to tighten considerably as commercial banks met the heavy demands for business loans by selling off central government securities at declining prices. Bank liquidity fell steadily to a fairly low

Table 10. Canada: Financial Indicators, July 1964 through early February 1965

	Changes during				Rate, week of	
	July 8-Sept. 16	Sept. 16-Nov. 18	Nov. 18-Dec. 2	Dec. 2-Feb. 4	Dec. 31 1963	Feb. 11 1965
A. INTEREST RATES	(basis points)				(per cent)	
Short-term						
Day-to-day	+ 68	- 25	+17	-17	3.63	3.53
3-month Treas. bills	+ 28	- 15	+19	-14	3.78	3.70
6-month Treas. bills	+ 26	- 14	+22	-22	3.99	3.80
Government of Canada bonds						
3-years (5%-'68)	+ 10	- 15	+ 9	-29	4.75	4.56
7-years (4-1/4%-'72	+ 7	- 18	+14	-17	4.96	4.88
25-years (5-1/4%-'90)	- 1	- 19	+ 2	- 9	1/ 5.30	5.06
	(million dollars)				Amount ($000,000) as of Jan. 27	
B. COMMERCIAL BANKS					1964	1965
General loans	+115	+ 70	+99	2/ -115	7063	8137
Treasury bills, govt. securities	-200	+123	-21	+92	4009	3777
"Cash" assets	+ 39	- 3	-63	2/ +113	1250	1356
Total deposits, including float	+153	+130	+310	2/ +85	15114	16320

	Changes (million $) during					Amount in January	
	June-Sept.	Oct.	Nov.	Dec.	Jan.	1964	1965
C. MONEY SUPPLY AND BANK LOANS (seas. adj. avge. of Wed.)							
Public holdings of currency and bank deposits	+166	+89	+149	+199	+157	15993	17207
General loans of chartered banks	+273	+69	+121	+ 44	+ 53	7246	8324

1/ May 27, 1964--first available quote.
2/ As of January 27.
Sources: Nesbitt, Thomson; Bank of Canada.

level in August, and the seasonally adjusted volume of general Canadian loans rose at a slower pace.

Bond yield differential down

The yield differential in favor of Canadian over comparable U.S. securities across a range of maturities narrowed noticeably from mid-September (1964) to early February (1965), mostly reflecting the 20-35 basis points decline in Canadian bond yields. (See Table 11.) Over roughly the same period the U.S.-Canadian yield differentials narrowed by about 20 to 33 basis points on the issues selected.

The trend toward lower Canadian yields and narrower U.S.-Canadian yield differentials was only briefly interrupted by the financial market uncertainties about the implications of the international round of discount rate changes in late November. Vigorous Bank of Canada intervention steadied the market, and in early December the downwards trends of the yield differentials resumed.

The Canadian authorities recently have taken other steps to reduce the attractiveness of the lower-cost U.S. financial market. The mid-January Federal refinancing has been placed in the shorter-dated end of the Canadian market to free longer-term funds for provincial and municipal financing. The Federal government reportedly has also pointed out to local government officials that excessive bond issues in the U.S. market might endanger the Canadian new security issues exemption from the U.S. interest equalization tax.

Table 11. Market Yields and Differentials on U.S. and Canadian Bonds, 1964-65
(per cent per annum, plus favors Canada)

	Rates and yield differential					Changes,
	Sept. 23	Nov. 18	Dec. 2	Jan. 6	Jan. 20	Sept. 23-Jan. 20
I. CENTRAL GOVERNMENT SECURITIES						
3-years, issued in:						
Canada (5%-'68)	4.95	4.80	4.89	4.68	4.60	-.35
U.S. (3.75%-'68)	4.04	4.04	4.13	4.06	4.03	-.01
Difference	.91	.76	.76	.62	.57	-.34
25-years, issued in:						
Canada (5.25%-'90)	5.29	5.10	5.12	5.03	5.03	-.26
U.S. (3.5%-'90)	4.19	4.16	4.20	4.20	4.18	-.01
Difference	1.10	.94	.92	.83	.85	-.25
II PROVINCIAL OR PROVINCIAL GUARANTEED						
Ontario, issued in:						
Canada (5.5%-'81)	5.41	5.20	5.30	5.27	5.19	-.22
U.S. (4.75%-'84)	4.59	4.58	4.59	4.59	4.59	--
Difference	.82	.62	.71	.68	.60	-.22
III. GOVERNMENT OF CANADA						
10-years, issued in:						
Canada (5.5%-'75)	5.20	5.02	5.05	4.97	4.92	-.28
U.S. (2.75%-'74)	4.50	4.51	4.46	4.55	4.55	+.05
Difference	.70	.51	.59	.42	.37	-.33

Sources: Bank of Canada; Federal Reserve; and Nesbitt, Thomson.

Money market yields fall

From early December through late January, covered yields favoring Canadian over U.S. Treasury bills and finance paper decreased by about 27 to 37 basis points. From January 22 through early February the covered yield on 3-month bills was 45 points in favor of New York, the highest net U.S. incentive in over a year; while the covered yield in favor of Canadian over U.S. finance paper had fallen to insignificant levels. (See Table 12.)

These movements in favor of New York reflect both a marked easing in yields on Canadian short-term paper, and some widening in the discount on the forward Canadian dollar. The strengthening of the short-term bill market primarily reflects greater demand by the banks for liquid assets as their deposit liabilities rose; after December 16, there was little net change in the overall supply of Treasury bills outside the government accounts and the Bank of Canada. The decrease in Canadian finance paper rates after year-end in part is a seasonal phenomenon.

Spot Canadian dollar strong

After early December the spot Canadian dollar regained most of the ground lost in the unsettled markets following the discount rate change; during the week of January 22, the spot Canadian dollar remained within .04 to .07 cents of its ceiling of 93.24 U.S. cents. (See Table 13.) This strength reflected the continued take down of Canadian new security issues in New York.

Table 12. U.S. - Canadian Money Market Arbitrage, 1964-1965
(per cent per annum, plus favors Canada)

	Sept. 18	Nov. 20	Dec. 24	Jan. 8	Jan. 22	Feb. 8	Changes Nov.20 Dec.4 2/	Changes Dec.4 Feb.8
3-MONTH PAPER								
Treasury bills								
Canadian, New York quote basis	3.75	3.60	3.76	3.71	3.63	3.63	.17	-.14
U.S.	3.52	3.59	3.84	3.75	3.81	3.88	.17	+.12
Net, favor Canada	.23	.01	-.08	-.04	-.18	-.25	—	-.26
Forward discount on Canadian dollar	-.20	-.13	-.07	-.14	-.27	-.20	—	-.07
Equals: Hedged Incentive in Favor of Canadian Bill	.03	-.12	-.15	-.18	-.45	-.45	—	-.33
Finance paper, prime								
Canadian, fully hedged	4.26	4.20	4.50	4.00	4.15	1/4.15	+.20	-.25
Less: U.S. prime paper	3.75	3.88	4.12	4.12	4.12	4.00	+.12	—
Equals: Hedged Incentive in Favor Canada	.51	.32	.38	-.12	.03	.15	.08	-.25

1/ For Friday, February 5.
2/ Week of Canadian, U.S., and U.K. discount rate hikes.
Sources: Based on data supplied by Federal Reserve and Morgan Guaranty Trust.

Table 13. Canadian Dollar Quotations, September 1964-January 1965

	Changes during Sept.16-Nov.20	Nov.20-Dec.4	Dec. 4-Dec.28	Dec.28-Jan.21	Jan.21-Feb.8	Rates Jan. 8	Jan. 21	Feb. 8
Spot rate: U.S. cents per Canadian dollar	+.24	-.30	+.30	-.05	-.13	93.07	93.20	93.07
3-months Forward Premium (+) on Canadian over U.S. dollar, in per cent per annum	+.14	—	+.06	-.16	—	-.14	-.23	-.20

Source: Based on New York inter-bank quotations.

The spot rate weakened after the last week of January, again reflecting the dropping off of deliveries of Canadian new issue activity in New York and more recently, the Canadian dollar settled back down to a range of a few points around the 93.0 level, perhaps reflecting uncertainties about the meaning for Canada of the U.S. Balance of Payments message. The forward Canadian dollar in late January stood at a discount of .27 per cent per annum, a decline of perhaps 13 basis points since early December.

Payments, trade and reserves strong

The Canadian external position strengthened considerably in the third and fourth quarters, partly because of temporary factors.

During the third quarter Canada experienced an unprecedented current account surplus of C$219 million--the most favorable outturn since quarterly records first were kept in 1948. The bulk of the sharp improvement reflected the bulge in wheat deliveries during the quarter. The $120 million current account deficit with the U.S., while much lower than the average $530 million deficit registered during the first half of 1964, still was about double the third quarter 1963 current deficit.

The composition of the capital account also improved during the third quarter, reflecting the continued increases in new Canadian bond issues in the U.S. The balance on long-term capital and current account during the third quarter was $411 million--a "surplus" sufficient to finance a very large short-term capital outflow (mostly to the U.S.), which took place in connection with the international currency disturbances; to repay $59 million to the IMF, and to increase official reserves by about $100 million. (See Table 14.) The Canadian payments surplus apparently continued into the Fourth quarter, as adjusted official reserves rose roughly $160 million, supported by high export levels and very large deliveries (payments basis) of new securities sold to U.S. residents. The less than seasonal decline of U.S. $9 million in official reserves during January 1965 is considered a sign of continued strength. Much of the recent strengthening in Canadian reserves has been taken in gold--thus in 1963 and 1964, approximately 80 and 65 per cent, respectively, of the improvement in adjusted reserves was taken in gold, compared to the 50 per cent average ratio of March 1962.

The payments balance now may be receding from its recent unusually strong position. Wheat exports now are tailing off. Also, the unusual bulge in Canadian securities flotations in U.S. markets now may be ebbing, as a good part of the pent-up needs of the larger Canadian borrowers were satisfied by the flotations contracted after the September 3 confirmation of the Canadian exemption from the I.E.T. The "overhang" of sold but undelivered securities fell from $218 million at the end of the third quarter to perhaps $50-$75 million at the end of the fourth quarter following deliveries in excess of $400 million during the fourth

Table 14. Canadian Balance of Payments, 1963 to 1964
(million dollars per quarter)

	With United States				With World				
	1963		1964 p/		1963		1964 p/		
	I-II	III-IV	I-II	III	I-II	III-IV	I-II	III	IV
A. CURRENT ACCOUNT, NET 2/									
Merchandise	-144	-100	-281	- 83	- 74	+178	+ 90	+359	n.a.
Other	-206	-142	-250	- 37	-300	-230	-340	-140	n.a.
Total deficit (-) 2/	-350	-242	-531	-120	-226	- 52	-250	+219	n.a.
B. CAPITAL MOVEMENTS, NET									
Long-term inflow (+)									
New Canadian bonds	+381	+ 71	+195	+ 93	+401	+ 83	+208	+109	n.a.
Other long-term	- 50	+ 17	- 74	+119	-109	- 69	+161	+ 83	n.a.
Total long-term	+331	+ 88	+121	+212	+292	+ 14	+ 47	+192	n.a.
Short-term inflow (+) 1/	+ 2	+ 53	+165	- 20	+ 23	+ 24	+215	-254	n.a.
Total capital inflow (+)	+333	+141	+286	+192	+315	+ 37	+262	- 62	n.a.
(BALANCE ON CURRENT AND LONG-TERM CAPITAL)	(- 19)	(-154)	(-410)	(+ 92)	(+ 66)	(- 38)	(-203)	(+411)	n.a.
OVERALL (A+B) SURPLUS (+)	n.a.	n.a.	n.a.	n.a.	+ 88	- 16	+ 12	+157	+164
D. FINANCING: (increase-)									
Official reserves	n.a.	n.a.	n.a.	n.a.	- 88	59	+ 33	- 98	- 54
IMF position	n.a.	n.a.	n.a.	n.a.	--	- 43	- 45	- 59	-110

1/ Total short-term flows between U.S. and Canada are not available.
2/ Current account reflects merchandise gold available for export, which conventially is credited to the U.S.
p/ Preliminary.
n.a. Not available -- none.
Source: Based on Dominion Bureau of Statistics data.

Table 15. Canada: Sales and Deliveries of New Canadian Bonds to U.S. Residents, 1963-1964
(million dollars per quarter)

	1963			1964			
	Jan.-June	July-Sept.	Oct.-Dec.	Jan.-March	April June	July-Sept.	Oct.-Dec.
NEW SALES CONTRACTS	321	16	42	111	189	278	n.a.
DELIVERIES OF NEW AND PRIOR SALES	381	92	51	145	245	93	e/425
CARRY-OVER FOR LATER DELIVERY OF							
New sales	175	125	120	61	4	20	n.a.
Prior sales	158	7	3	28	29	198	n.a.
Total	333	132	123	89	33	218	e/50-75

Totals may not add because of rounding.

e/ Estimate.
Source: Compiled from the D.B.S., Quarterly Estimates of the Canadian Balance of Payments.

quarter. (See Table 15.) In response to the U.S. President's Balance of Payments message, the Canadian Minister of Finance on February 10, 1965 noted that "our policies will continue to be directed towards general stability in our foreign exchange reserves. It is not our desire or intention to increase our reserves through the proceeds of borrowing in the United States under the exemption." A further element of uncertainty is added by the status and effects of the U.S.-Canadian auto-part treaty; during 1963 net imports of autos and parts--mostly from the U.S.--exceeded $500 million.