L.5.2 RFD 551

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

August 16, 1965

Recent Economic Developments in Canada:
April-August 1965

16 pages

David G. Hayes and Larry Jay Promisel

August 16, 1965

David G. Hayes
Larry Jay Promisel

Recent Economic Developments in Canada, April-August 1965

Summary

The Canadian economy continued its vigorous expansion in the early months of 1965, but accelerated upward price movements and a sharp rise in purchases abroad were clear signs of economic over-heating.[1/] The monetary authorities, concerned over the domestic resource strain and the gathering momentum of inflationary pressure, have been pursuing more restrictive monetary and credit policies since about mid-April; money and credit markets have tightened and the earlier downward trend in interest rates has been reversed. Early in August, Prime Minister Pearson called for restraint in capital investment and announced the postponement or spacing out of some government works projects in order to avoid "excessive demands" on the construction industry. He also called for cooperative efforts at other levels of government to restrain investment outlays.

In the first three months of 1965, further growth in aggregate demand led to a 3.2 per cent increase in industrial production. According to seasonally adjusted national income data for the first quarter of this year, consumer expenditures were up 1.1 per cent and gross business spending on fixed capital was up 4.9 per cent--in real terms--over the final quarter of 1964. Inventory investment was exceptionally large, rising $156 million over the same period.[2/] A moderate rise in exports also contributed to the general

1/ For a review of earlier developments see "Recent Economic Developments in Canada, January-April 1965," dated May 4, 1965.
2/ All data expressed in Canadian dollars unless otherwise specified.

expansion. (See Table 1.) In April and May output levelled out but consumer spending continued to rise--judging from the rise in retail trade--and export sales also increased further.

Table 1. Canada: Main Economic Indicators, 1964-65
(seasonally adjusted)

	1964				1965			
	I	II	III	IV	I	April	May	June
Monthly or monthly average								
Index of industrial production	211	212	213	218	225	226	226	n.a.
Retail trade ($ m)	1,651	1,634	1,673	1,682	1,712	1,761	1,785	n.a.
Exports ($ m)	665	705	725	674	682	715	n.a.	n.a.
Imports ($ m)	613	633	615	635	671	693	n.a.	n.a.
Price index of 30 industrial materials (1935-39 = 100)	258.4	258.4	258.7	257.9	256.1	256.6	258.5	260.4
Quarterly - cont ant (1957) dollars								
Consumer expenditures ($ m)	6,563	6,579	6,703	6,789	6,863	--	--	
Gross business expenditure on fixed capital ($ m)	1,921	1,869	1,840	1,962	2,058	--	--	
Change in inventories ($ m)	111	106	84	52	208	--	--	
Gross national expenditure ($ m)	10,283	10,397	10,454	10,544	10,833	--	--	

Source: Dominion Bureau of Statistics.

Some indications of overheating appeared in the period under review. First, imports rose sharply during the first four months of 1965. In January-April average monthly imports (seasonally-adjusted) were 7.[illegible] per cent above the monthly average in 1964. (See Table 1.) Secondly, price increases accelerated in the first six months of this year. Thirdly, the mid-year government survey of private and public investment plans indicated that total capital spending would reach $12.8 billion by the end of the year--an increase of 18.6 per cent over actual outlays in 1964. Finally, Canadian officials recently acknowledged a severe shortage of skilled and professional manpower, which is expected to endure and which may retard further expansion.

In the light of these developments, the Canadian authorities have moved to slow down the pace of the business expansion. In April, the Bank of Canada adopted more restrictive policies. Money markets tightened: between April 7 and August 5, the average tender rate on 3-month Treasury bills rose by 47 basis points to 4.08 per cent, and long-term government bond yields increased about 25 basis points, to more than 5.25 per cent. In addition, on August 2, Prime Minister Pearson called for a deferment of federal construction projects throughout most of Canada. The Government intends to stretch out completion schedules for some capital projects and to postpone other projects.

The deterioration in Canada's external position in the first quarter of this year--as the customary trade surplus was replaced by a deficit--led to projections of a current account deficit of about $1 billion in 1965, compared with $453 million last year. However, this less favorable projection has now been rendered out-of-date by the announcement, on August 11, of the conclusion of contracts providing for the sale to the U.S.S.R. of Canadian wheat and flour, to an estimated value of $450 million, for the period through July, 1966.

The value of these wheat sales equals roughly 6 - 7 per cent of the value of total Canadian exports in a full year. These deliveries may well reduce the balance-of-payments deficit close to last year's figure; but they will also provide additional income to farmers in the grain producing areas and may thereby add to inflationary strains.

Output rise continues

The rate of industrial output accelerated in the first quarter of 1965: it was 3.2 per cent above the monthly average of the previous quarter, compared to a 6.5 per cent increase for 1964 as a whole. However, output remained stationary in April and May. (See Table 1.)

Part of the first quarter strength reflected an intensification of business inventory demand and consumer spending following the automobile industry strikes in Canada and the United States during the latter part of 1964 and early 1965. According to the Dominion Bureau of Statistics, automotive output reached record levels during the first three months of this year.

The largest single factor accounting for the increased output in the first quarter was the accumulation of business inventories. Between January and March, the rate of inventory accumulation reached $208 million, compared to a quarterly average of $87 million in 1964. (See Table 1.)

Gross business expenditures on fixed capital increased, in real terms, by almost $100 million (4.9 per cent) in the first quarter, to a level of $2,058 million.

Consumer spending, on a national income account basis, also continued to rise. It rose in the first quarter of this year by $74 million (1.1 per cent) to $6,863 million, and remained strong in April and May, judging from the growth of retail trade by $73 million (seasonally adjusted) during these two months. (See Table 1.)

Export sales also moved up in the January-March period--the monthly average of $682 million was 1.2 per cent higher than in the previous three-month period, although it was still below the average of $692 million for all of 1964. (See Table 1.) In April, however, exports rose to $715 million.

<u>Demand for labor still strong</u>

The demand for labor continued to expand throughout the first half of 1965, in response to rising economic activity. Taking account of seasonal factors, total employment reached an average of 6.8 million during the second quarter--an increase of 2.7 per cent over the average for the final quarter of 1964. Because of a nearly equal percentage increase in the labor force, the average unemployment rate for the second quarter was essentially the same as in the fourth quarter of 1964. (See Table 2.)

Much of the growth in employment and in the labor force so far in 1965 took place in the first three months. Employment and labor force totals expanded only slightly in the second quarter, with a somewhat smaller increase in employment than in the labor force. As a result, the second quarter unemployment rate was somewhat higher during these three months than during the January-March period, when it was unusually low because of the government's work program. (See Table 2.)

Table 2. Canada: Labor Market Indicators, 1964-65
(seasonally adjusted; monthly or monthly average)

	1964				1965	
	I	II	III	IV	I	II
Total labor force (th.)	6,884	6,909	6,947	6,955	7,084	7,140
Total employed (th.)	6,570	6,587	6,611	6,654	6,803	6,832
Unemployment as % of labor force	4.8	4.9	4.8	4.4	4.0	4.3
Not seasonally adjusted	6.9	4.7	3.4	3.8	5.8	4.2
Average weekly hours in manufacturing	41	41	41	41	41	a/41

a/ April.
Source: Dominion Bureau of Statistics.

However, these aggregate data tend to understate the tightness in the labor market. Indeed, the government has been trying to persuade European skilled workers to migrate to Canada, because, as Immigration Minister Nicholson recently put it, "Canada is facing a serious, even crucial, shortage of professional and trained workers that could retard her development." Mr. Nicholson pointed out that a survey of 3,391 companies, employing 31.2 per cent of Ontario's labor force, indicated a need for more than 33,000 skilled workers in the next six months. Similar surveys in other provinces revealed the same, almost immediate, need for skilled and professional workers. However, only about 2 per cent of the vacancies can be filled next year through Canada's own technical or retraining school program.

Price rises accelerate

Canadian prices rose sharply during the first half of 1965, in contrast to their more modest movements throughout much of 1964. (See Table 3.)

Table 3. Canada: Price Indices, 1964-65

	Dec. 1963	June 1964	Dec. 1964	June 1965	Percentage change: Dec.'63 June'64	June'64 Dec.'64	Dec.'64 June '65
Consumer prices (1949 = 100)	134.2	135.3	136.8	139.0	+0.8	+1.1	+1.6
Consumer prices, excluding food (1949 = 100)	135.6	136.8	138.6	139.9	+0.9	+1.3	+0.9
Wholesale prices (1935-39 = 100)	245.7	245.4	246.0	252.0	0.0	+0.2	+2.4
30 Industrial materials (1935-39 = 100)	257.5	257.8	256.2	260.4	0.0	-0.6	+1.6
Average hourly earnings in manufacturing ($)	2.02	2.02	2.08	a/ 2.12	0.0	+3.0	a/ +1.9

a/ April.
Source: Dominion Bureau of Statistics; Bank of Canada.

The consumer price index rose 1.6 per cent between December and June, an increase almost equal to the 1.9 per cent rise for the entire year 1964. Most of the increase this year was concentrated in May and June and seems to have been mainly due to the higher cost of food. Over the same period, wholesale prices rose 2.4 per cent, as compared with 0.2 per cent in 1964. In addition, the index of thirty industrial materials rose 1.6 per cent, as compared with a slight decline in 1964. (See Table 3.)

Average hourly earnings in manufacturing rose 1.9 per cent in the January-April period, whereas they were unchanged in the corresponding period in 1964. (See Table 3.)

Leading indicators show continued strength

Selected leading indicators show continued strength in coming months. The value of new orders, unfilled orders, and inventories rose in the first quarter of this year, although considerably less than in the previous quarter. Values were higher again in April, but preliminary data indicate that they began to drop off in May. In January-April, the value of building permits fell off from the high fourth quarter level. (See Table 4.)

External position deteriorates

Canada's continued economic expansion has led to a deterioration in the trade account: the increased demand for imports has outpaced the growth of Canadian sales abroad. In January-March,

Table 4. Canada: Leading Economic Indicators, 1964-65
($ millions; seasonally adjusted; monthly or monthly average)

	1964				1965		
	I	II	III	IV	I	April	May
Manufacturing							
New orders	2,645	2,580	2,583	2,720	2,778	2,828	p/ 2,718
Unfilled orders	2,468	2,545	2,640	2,778	2,852	3,007	p/ 3,007
Owned inventories	4,929	4,971	5,086	5,144	5,218	5,291	n.a.
Building permits	244	231	286	319	274	270	n.a.

p/ Preliminary.
Source: Dominion Bureau of Statistics.

imports (seasonally adjusted) into Canada increased by 5.7 per cent over the fourth quarter of 1964, while exports rose by only 1.2 per cent; as a result, the customary trade surplus was substantially reduced. Both exports and imports recovered in April: exports by 4.8 per cent and imports by 3.3 per cent over first quarter levels. (See Table 1.)

On a balance of payments basis, the trade surplus was replaced by a deficit in January-March, resulting in an increase in the current-account deficit from $169 million in the fourth quarter of 1964 to $408 million in the first three months of this year. (See Table 5.)

Although the surplus on capital account was about unchanged at around $350 million for the past two quarters shown in Table 5, its composition was altered. In 1965, there was a significant reduction in long-term capital inflow from the exceptionally high levels of the preceding two quarters; by contrast, the sizable short-term outflows recorded in the final half of last year were replaced by a net inflow in January-March of this year. (See Table 5.)

Table 5. Canada: Balance of Payments, 1964-65
($ millions)

	1964				1965
	I	II	III	IV p/	I p/
Current account:					
Exports	1,730	2,197	2,183	2,128	1,825
Imports	1,697	2,048	1,827	1,966	1,882
Trade balance	+33	+149	+356	+162	-57
Services (net)	-376	-305	-141	-331	-351
Balance on current account	-343	-156	+215	-169	-408
Capital account:					
Short-term	+337	+111	-277	-106	+188
Long-term	-36	+113	+218	+456	+148
Balance on capital account	+201	+224	-59	+350	+336
Total balance:	-42	+68	+156	+181	-72
Financing:					
Change in reserves	-127	+62	+97	+54	-118
Change in IMF position	+85	+ 6	+59	+127	+46

p/ Preliminary.
Source: Bank of Canada.

The deterioration in Canada's trade position in the first few months had led to projections of a current account deficit of $1 billion this year, compared to $453 million in 1964. However, this prospect has been unexpectedly altered by the announcement on

August 11 of contracts to ship 187 million bushels of wheat to the U.S.S.R. in the period through next July. The value of these and other recent wheat sales to the U.S.S.R. is estimated at $450 million. There have also been large grain sales to other Communist countries, including Red China.

Foreign reserve holdings reduced

Official holdings of gold and U.S. dollars fell by $(U.S.)194.2 million in the first half of this year, to a level of $(U.S.)2,480 million at the end of June. This entire decline represents sales of U.S. dollars; gold holdings have risen throughtout the period. Since the first of the year, gold as a percentage of total official gold and dollar holdings has risen from 38.4 per cent to 43.9 per cent in June. (See Table 6.)

Table 6. Canadian Official Holdings of Gold and U.S. Dollars, 1965
(millions of U.S. dollars)

	Level as of Dec.'64	Change: Dec. '64-March '65	Change: March '65 June '65	Level as of June '65
Gold	1025.7	+ 18.4	+ 45.0	1089.1
U.S. dollars	1648.6	-138.6	-119.0	1391.0
Total	2674.3	-120.2	- 74.0	2480.1
Gold as percentage of Total	38.4	--	--	43.9

Source: Bank of Canada.

Easy credit policies abandoned; money market tightens

During the period under review, the Canadian authorities abandoned their attempts to ease conditions in Canadian money markets which had been in effect since last fall. Instead, in mid-April, the Bank of Canada adopted more restrictive policies; since then, money markets have tightened and the earlier downward trend in interest rates has been reversed. The average tender on 90-day Treasury bills, which reached a low for the year of 3.61 per cent on April 7, had risen by almost 1/2 of 1 per cent to 4.05 per cent by the end of July. Rates for day-to-day money have also risen, from 3.48 per cent on March 31 to 3.98 per cent on July 28. (See Table 7.)

Table 7. Canada: Money Market Indicators, April-July 1965

	March 31	April 28	May 26	June 30	July 28
Interest rates:					
3-month Treasury bills (% p.a.) a/	3.62	3.77	3.90	3.93	4.05
Day-to-day loans (% p.a.) b/	3.48	3.80	3.75	3.48	3.98
Money supply and bank loans:					
Money supply ($ m) c/	17,665	17,921	17,977	18,210	n.a.
Loans ($ m) c/	9,500	9,709	9,762	9,925	n.a.

a/ Weekly tender on Thursday following Wednesday shown; average yield.
b/ Weekly average of daily closing rates.
c/ Seasonally adjusted; average of Wednesdays in month ending with date shown.

The steady tightening of the money market was interrupted briefly in late June following the failure of the Atlantic Acceptance Corporation, a medium-sized sales finance house. Money and credit markets were unsettled at that time, and the Bank of Canada facilitated attempts by the banks to accommodate the extraordinary demand of the sales finance companies caused in part by withdrawals of U.S. funds from Canadian short-term markets. However, conditions had become reasonably settled by early July, and the Bank of Canada reverted to its restrictive policies.

The recent increases in money market rates have occurred in spite of considerable further expansion--though at a slower pace than in the first quarter--in both the money supply and the volume of bank loans. On a seasonally-adjusted basis, the money supply (currency and chartered total bank deposits held by the general public) increased by 3.1 per cent ($545 million) in the second quarter, compared with an increase of 3.6 per cent in the first quarter. Bank loans rose by 4.5 per cent ($425 million) compared to 4.7 per cent in January-March. (See Table 7.)

Conditions in the market for government bonds have also tightened since April. Heavy sales by chartered banks for liquidity needs--particularly in late June and in July--exerted downward pressure on security prices. As a result, yields rose over a range of maturities by an average of 29 basis points in the period under review. Between April 28 and August 4, yields on 3-year bonds rose by 38 basis points (to 5.00 per cent) and yields on 25-year issues rose by 17 points (to 5.26 per cent). (See Table 8.)

Table 8. Canada: Capital Market Indicators, April-July 1965

		March 31	April 28	May 26	June 30	July 28	August 4
Government bond yields:							
5.00%	1968	4.67	4.62	4.81	4.89	4.98	5.00
4.25%	1972	4.95	4.89	5.00	5.12	5.25	5.27
4.50%	1983	5.06	5.04	5.14	5.15	5.30	5.30
5.25%	1990	5.09	5.09	5.15	5.13	5.27	5.26
Stock index:							
Total industrials (1958 = 100) a/		204.1	208.2	209.1	193.9	187.9	n.a.

a/ Figures for Thursday following Wednesday shown.
Source: Bank of Canada, Financial Post.

Because of the relative stability in yields on comparable U.S. bonds throughout the period, yield spreads in favor of Canada widened; by July the differentials exceeded 1 per cent on all the longer term maturities. (See Table 9.)

In the stock markets, the index of total industrials, which had risen in April and May, fell sharply in June and July. From a peak of about 212 on May 20, the index fell 26 points--by over 12 per cent--to about 186 on July 22. At the end of July the index was up slightly to 187.9. (See Table 8.) The decline in this period was attributable in part to downward movements in Wall Street and to less optimistic prospects for continued U.S. prosperity, and in part to the failure of the Atlantic Acceptance Corporation.

Table 9. Canada/U.S. Comparative Bond Yields, April-July 1965

			March 31	April 28	May 26	June 30	July 28	August 4
3-year:								
U.S.	3/68,	3.75%	4.12	4.13	4.11	4.07	4.10	4.14
Canada	10/68,	5.0%	4.67	4.62	4.81	4.89	4.98	5.00
Differential (+ favors Canada)			+.55	+.49	+.70	+.82	+.88	+.86
7-year:								
U.S.	8/72,	4.0%	4.17	4.17	4.18	4.15	4.16	4.19
Canada	9/72,	4.25%	4.95	4.89	5.00	5.12	5.25	5.27
Differential			+.78	+.72	+.82	+.97	+1.09	+1.08
19-year:								
U.S.	78-83,	3.25%	4.14	4.15	4.15	4.16	4.18	4.20
Canada	9/83,	4.5%	5.06	5.04	5.14	5.15	5.30	5.30
Differential			+.92	+.89	+.99	+.99	+1.12	+1.10
25-year:								
U.S.	2/90,	3.5%	4.17	4.17	4.18	4.17	4.18	4.20
Canada	5/90,	5.25%	5.09	5.09	5.15	5.13	5.27	5.26
Differential			+.92	+.92	+.97	+.96	+1.09	+1.06

Canadian dollar strengthens

Between late April and July 15, when the spot rate touched a low of 92.19 (U.S.) cents, the spot Canadian dollar experienced a period of weakness; but since then, the spot rate has strengthened markedly, largely in response to strong commercial demand, particularly on the part of grain interests in anticipation of sales to the Soviet Union. On August 11 the announcement of the size of the Soviet wheat purchases caused the spot rate to jump sharply: on August 12 the spot rate reached a high of 92.79 (U.S.) cents. (See Table 10.)

Table 10. Canada/U.S.: Exchange Rates and Arbitrage Calculations, April-July, 1965

	April 1	April 29	May 27	June 24	July 15	July 29	August 12
Exchange rates:							
Spot (U.S. cents)	92.50	92.70	92.60	92.37	92.19	92.51	92.79
Forward premium on Canadian dollar	+.40	+.30	+.20	+.54	+.14	-.14	+.10
3-month yields and differentials (% p.a.)							
Treasury bills							
Canada (covered)	3.94	3.98	3.98	4.41	4.05	3.79	4.19
U.S.	3.91	3.90	3.86	3.75	3.84	3.78	3.81
Difference (+ favors Canada)	+.03	+.08	+.12	+.66	+.21	+.01	+.38
Finance paper a/							
Canada (covered)	5.10	4.90	4.95	5.22	4.95	4.73	5.19
U.S.	4.25	4.25	4.25	4.25	4.25	4.25	4.25
Differential	+.85	+.65	+.70	+.97	+.70	+.48	+.94

a/ Figures for Friday following Thursday shown.

There have also been large movements in the forward Canadian dollar. The premium on the Canadian dollar fell in April and May, but rose to a high of 0.54 per cent on June 24. (See Table 10.) For a period in July, the forward Canadian dollar fell to a slight discount, but on August 12, after announcement of the large wheat deal, the forward premium reappeared.

Covered differentials on Treasury bills followed movements in the forward rate. The differential in favor of Canada reached a high of 0.66 per cent on June 24, but by the end of July the differential had been virtually eliminated. On August 12 the margin favoring investment in Canadian Treasury paper was back at 0.38 per cent. (See Table 10.)

Prepared by:
David G. Hayes and Larry Jay Promisel
Europe and British Commonwealth Section
Division of International Finance.