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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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# REVIEW OF FOREIGN DEVELOPMENTS

May 11, 1966

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Recent Economic Developments in Canada:
March-April, 1966 25 pages

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# Recent Economic Developments in Canada: March-April, 1966

## Summary

Fresh evidence of mounting inflationary strain induced the Canadian authorities to take both monetary and fiscal measures during the month of March to slow the growth of total spending.[1/] The pace of aggregate demand during the final quarter of 1965 and the early months of the current year was more rapid and the pressures on domestic resources more intense than a year earlier. A continuing rise in investment spending provided the main source of strength in the current phase of the Canadian boom. By March, it had become clear that the Canadian economy was experiencing the largest wave of investment activity since the 1955-57 massive expansion in resources development. In these circumstances, the Bank of Canada raised discount rate on March 14 and the Finance Minister introduced new tax measures on March 29 in the budget for the 1966-67 fiscal year.

Basic economic indicators, as they became available during the period under review, demonstrated the strength of the business advance and the narrowing margin of resources available for further gains in real output. During the fourth quarter, extraordinary levels of investment spending (up 22 per cent above year-earlier levels), higher consumer spending (up 9.7 per cent) and heavier government outlays (up 11.3 per cent) pushed Canadian prices and wages to new highs. Import purchases

1/ For a review of earlier Canadian developments, see "Recent Economic Developments in Canada: October, 1965-March 1966.

also showed further gains. A quickening of the rate of price increases and low levels of unemployment during the early months of 1966 suggested that the pace of the business advance was being maintained, and plans for investment spending in 1966 indicated that demand pressures would increase as the year advanced. (See Table 1.)

Table 1. Canada: Main Economic Indicators, 1964-66

| | 1964 | 1965 | | | 1966 | | |
|---|---|---|---|---|---|---|---|
| | IV | I | II | IV | Jan. | Feb. | Mar. |
| Monthly indices a/ | | | | | | | |
| Industrial production (1949=100) | 218 | 225 | 226 | 239 | 243 | -- | -- |
| Inventory/shipments ratio | 1.88 | 1.92 | 1.90 | 1.89 | 1.85 | -- | -- |
| Total labor income ($m) | 2013 | 2084 | 2133 | 2265 | -- | -- | -- |
| Total employment (th.) | 6674 | 6790 | 6837 | 6950 | 7044 | 7107 | -- |
| Unemployment rate | 4.4 | 4.0 | 4.3 | 3.4 | 3.5 | 3.5 | 3.3 |
| Retail trade | 1697 | 1716 | 1778 | 1862 | 1865 | -- | -- |
| GNP components b/ | | | | | | | |
| Consumption ($m) | 30.4 | 30.7 | 31.6 | 33.3 | -- | -- | -- |
| Investment ($m) | 9.7 | 11.0 | 11.2 | 11.9 | -- | -- | -- |
| Government ($m) | 8.9 | 9.2 | 9.5 | 9.9 | -- | -- | -- |
| Other ($m) | -0.5 | -0.7 | -1.0 | -1.3 | -- | -- | -- |
| Total ($m) | 48.5 | 50.2 | 51.3 | 53.8 | -- | -- | -- |

a/ Seasonally adjusted monthly averages.
b/ Seasonally adjusted annual rates in current prices.

In this environment, the Canadian authorities decided to strengthen their stabilization effort on a broad front. The rise in the Bank of Canada's discount rate from 4-3/4 to 5-1/4 per cent on March 14 was accompanied by a further tightening of bank liquidity and by increases in short-term interest rates. The central bank's monetary management was designed to allow chartered bank lending to grow at the expense of a reduction in the banks' ratio of "more liquid assets" to total assets; in the first two weeks of April, this ratio fell to 29.3 per cent from 31 per cent at the end of January. Preliminary estimates suggest some reduction in the growth of bank loans in the first two months of 1966; they had risen by 20 per cent in 1965 and a 14 per cent rise in the preceding year. (See Chart 1.)

On March 29, the effects of more intense credit stringencies were reinforced by new tax measures introduced in the 1966-67 fiscal year budget. Largely as a result of these measures, the Treasury's revenue surplus (on a national accounts basis) for the current fiscal year was estimated to be \$615 million compared to \$494 million in 1965-66. (See Table 2.) The major measures included in the new budget were:

a. Higher personal income taxes (on average and above-average income);

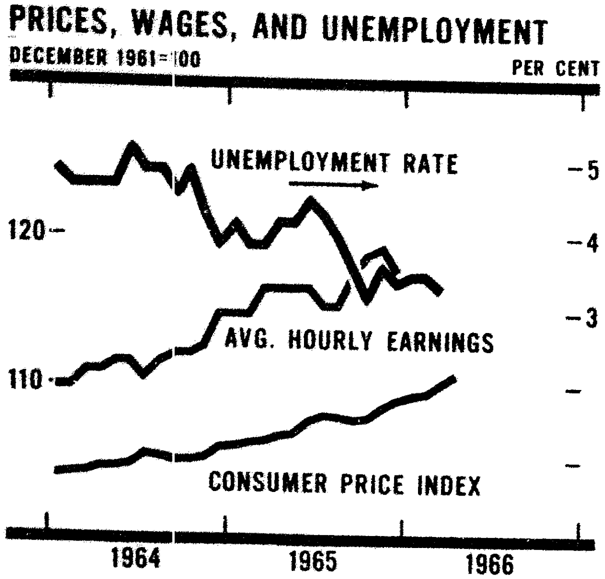
b. Reduced investment allowances on selected capital spending; and

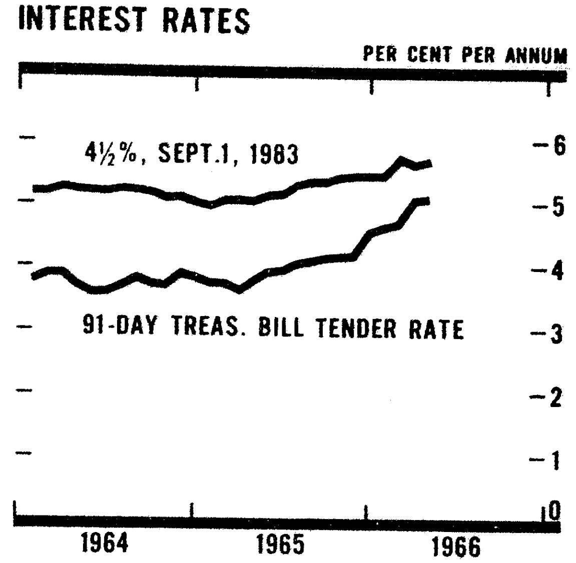
c. A new tax of 5 per cent on corporate cash flow (defined as total income, including depreciation and depletion allowances, minus the regular corporation income tax) in excess of \$30,000.

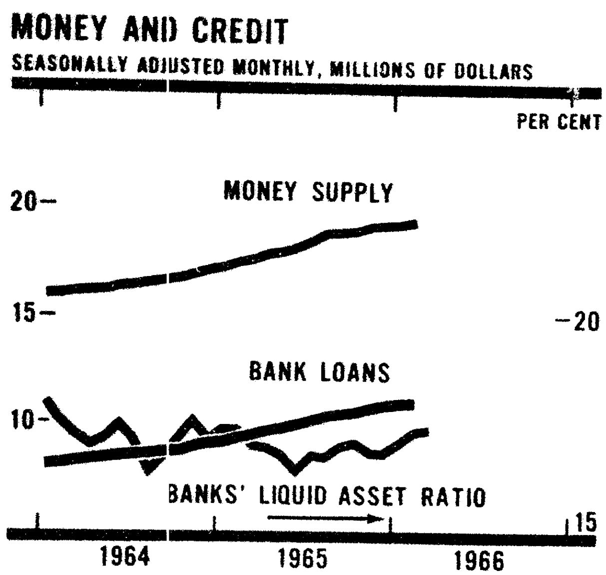
The cash-flow tax, however, is merely a temporary withholding of corporate funds: the payments are to be returned to the taxpayer after 18 months (if economic conditions warrent their release) with a 5 per cent rate of interest.

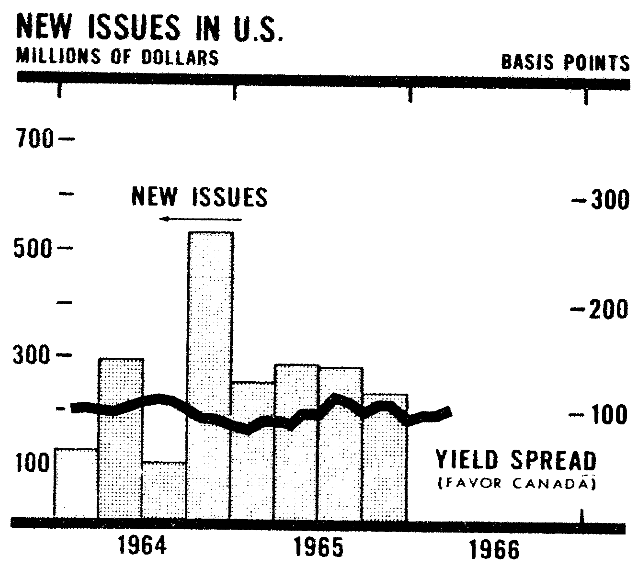
CHART 1

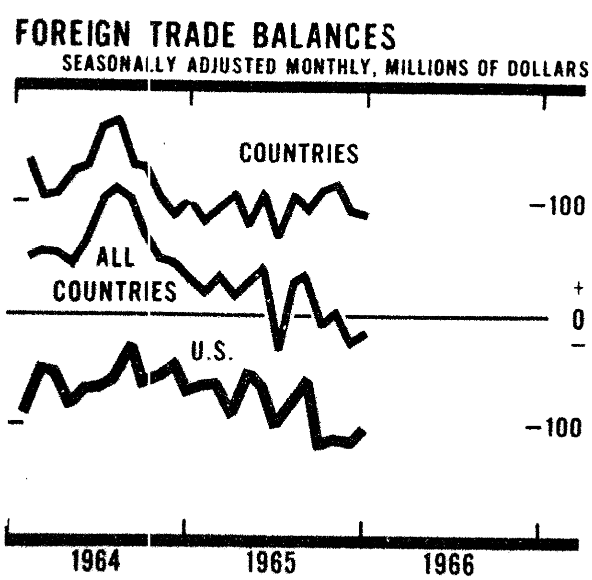
# CANADA: MAIN ECONOMIC INDICATORS



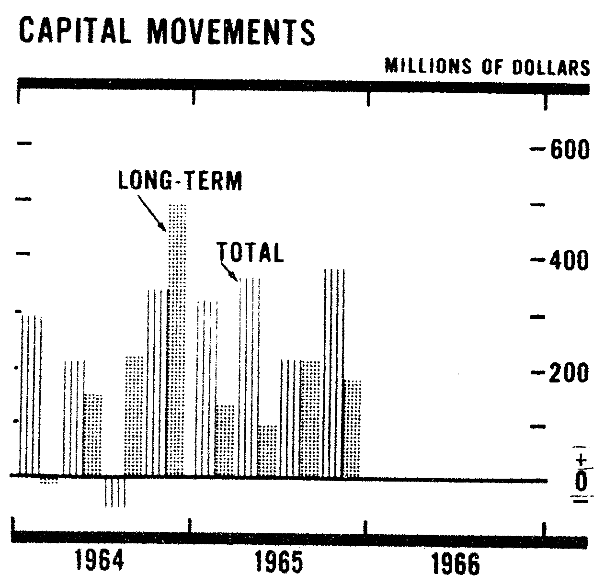



Table 2. Canada: Federal Government Revenue and Expenditure on National Accounts Basis (millions of dollars)

| | 1965-66 estimate | 1966-67 forecast after tax changes | Percentage change |
|---|---|---|---|
| **Revenue** | | | |
| Direct taxes, persons | 2758 | 3045 | +10.4 |
| Direct taxes, corporation's 1/ | 1624 | 1770 | + 9.0 |
| Refundable tax | -- | 160 | 2/ |
| Withholding taxes | 170 | 178 | + 4.7 |
| Indirect taxes | 3341 | 3564 | + 6.7 |
| Investment income | 630 | 758 | +20.3 |
| Insurance and pension funds | 607 | 662 | + 9.1 |
| Total revenue | 9130 | 10137 | +11.0 |
| **Expenditure** | | | |
| Goods and services: defense | 1565 | 1634 | + 4.4 |
| Goods and services: other | 1794 | 1944 | + 8.4 |
| Transfers to persons | 2345 | 2553 | + 8.9 |
| Interest on public debt | 1057 | 1174 | +11.1 |
| Subsidies | 325 | 347 | + 6.8 |
| Capital assistance | 84 | 69 | -17.9 |
| Transfers to other levels of Government | 1466 | 1801 | +22.9 |
| Total expenditure | 8636 | 9522 | +10.3 |
| Surplus (+) or deficit (-) | +494 | +615 | +24.5 |

1/ Excludes taxes on government business enterprises.
2/ Not meaningful.

These measures of restraint will be reinforced by the Canada Pension Plan, which became operational on January 1, 1966. The funds accumulated in the Account will eventually be on-lent to the provinces, but there will be some delay between receipt of funds by the account and actual spending by the various provincial agencies.

On the international side, the fourth-quarter balance of payments showed that a large current account deficit was approximately matched by capital inflows. Official holdings of gold and foreign exchange increased by about $50 million, but Canada's net creditor position at the International Monetary Fund declined by almost the same amount.

For the year as a whole, Canada's current-account deficit increased from $433 million in 1964 to $1,136 million in 1965, almost entirely because of the deterioration in the merchandise trade account. The trade surplus fell from $700 million in 1964 to only $101 million last year. With the growing investment boom taking up more and more of the slack in the economy, imports rose much more rapidly than exports. From 1964 to 1965, imports rose by 14.5 per cent and exports by only 6 per cent. For the fourth quarter alone, imports rose by 24 per cent on a year-to-year basis. During these three months, the capital inflow which financed the current account deficit came about equally from long-term and from short-term borrowings.

Industrial output higher

Industrial production rose sharply during the period under review. The seasonally-adjusted index rose by 3.3 per cent between the third and fourth quarters and was 8.2 per cent higher in January (1966) than in the same month a year earlier. (See Table 3.)

At the same time, manufacturers reported that their shipments were rising more rapidly than their inventories. Between the end of

Table 3. Canada: Industrial Production, 1965-66
(1949=100; seasonally adjusted)

| Index | 1964 IV | 1965 I | 1965 II | 1965 III | 1965 IV | 1966 Jan. |
|---|---|---|---|---|---|---|
| Manufacturing | | | | | | |
| Durable | 195.5 | 206.3 | 209.6 | 214.9 | 223.1 | 227.9 |
| Non-durable | 190.3 | 190.0 | 191.2 | 196.0 | 201.2 | 204.1 |
| Total | 192.7 | 197.5 | 199.6 | 204.7 | 211.3 | 215.0 |
| Electricity and gas utilities | 427.6 | 436.3 | 433.7 | 445.3 | 478.3 | 489.9 |
| Mining | 335.3 | 346.4 | 339.4 | 351.6 | 355.4 | 349.0 |
| Total industrial production | 219.0 | 224.7 | 225.6 | 231.8 | 239.4 | 242.6 |

Source: Bank of Canada, Statistical Summary.

September and January (1966), manufacturer's owned inventories rose by $276 million and shipments by $269 million. (See Table 4.) As a result, the ratio of inventories-to-shipments declined from 1.93 to 1.85, the lowest level for this economic indicator since the Korean War years.

New and unfilled orders climbed appreciably during the fourth quarter but receded slightly during the month of January. (See Table 4.) Nonetheless, in January new orders were 11.6 per cent higher and unfilled orders were 16.4 per cent higher than they were a year earlier.

## Continued growth in employment

Total civilian employment exceeded 7 million workers in January for the first time in Canadian history. (See Table 5.) Because of an

Table 4. Canada: Manufacturing Orders, Inventories, and Shipments, 1965-66
($ millions; seasonally adjusted, monthly or monthly average)

| | 1964 | 1965 | | | | 1966 |
|---|---|---|---|---|---|---|
| | IV | I | II | III | IV | Jan. |
| New orders | 2742 | 2782 | 2830 | 2885 | 3041 | 2987 |
| Unfilled orders | 2601 | 2807 | 2946 | 3040 | 3245 | 3170 |
| Owned inventories 1/ | 5134 | 5227 | 5347 | 5465 | 5645 | 5741 |
| Shipments | 2722 | 2729 | 2809 | 2828 | 2989 | 3097 |
| Inventories/shipments ratio | 1.91 | 1.92 | 1.90 | 1.93 | 1.89 | 1.85 |

1/ Includes raw materials, goods in process, and finished goods.

unusually large growth in the total civilian labor force between the fourth quarter of 1965 and January-February 1966, however, the rate of unemployment was nudged up from the fourth-quarter average of 3.4 per cent to 3.5 per cent for the first two months of this year. (See Table 5 and Chart 1.) Nonetheless, the 3.5 per cent figure was significantly below the 3.9 per cent annual average for 1965 and 4.7 per cent annual average for 1964. Furthermore, the expansion in non-agricultural employment in March brought the preliminary estimate of the unemployment ratio down to 3.3 per cent for the month.

Three sources account for most of the gains in the labor force: more women are available for employment; teenagers are dropping out of school earlier because jobs are available; and immigration of qualified workers is proceeding at a high rate. Although all branches of the Canadian economy are attracting new workers, the service and durable goods manufacturing sectors increased their work forces at faster rates than did the construction, mining, and non-durable manufacturing sectors. (See Table 5.)

Table 5. Canada: Labor Market Indicators, 1965-66
(seasonally adjusted; monthly or monthly average)

| | 1965 I | 1965 II | 1965 III | 1965 IV | 1966 Jan. | 1966 Feb. | 1966 Mar. |
|---|---|---|---|---|---|---|---|
| **Labor force status of population** | | | | | | | |
| Civilian labor force (th.) | 7075 | 7138 | 7146 | 7196 | 7303 | 7362 | |
| Annual rate of change | +2.6 | +3.2 | +3.0 | +3.1 | +3.5 | +4.1 | |
| Total employed(th.) | 6790 | 6837 | 6867 | 6950 | 7044 | 7107 | |
| Annual rate of change | +3.3 | +3.8 | +3.9 | +4.4 | +4.2 | +4.7 | |
| Non-agricultural employed (th.) | 6176 | 6227 | 6282 | 6383 | 6495 | 6539 | |
| Unemployment rate | 4.0 | 4.3 | 4.0 | 3.4 | 3.5 | 3.5 | 3.3 |
| **Employment in selected sectors (1949 = 100)** | | | | | | | |
| Manufacturing | | | | | | | |
| Durables | 135.2 | 136.7 | 139.1 | 143.8 | | | |
| Non-durables | 118.0 | 118.6 | 120.4 | 121.5 | | | |
| Total | 125.8 | 126.9 | 128.9 | 131.7 | | | |
| Mining | 121.0 | 123.2 | 124.5 | 125.6 | | | |
| Construction | 140.6 | 138.9 | 141.9 | 148.5 | | | |
| Services | 196.7 | 202.4 | 206.2 | 212.9 | | | |
| **Unemployment rates by region** | | | | | | | |
| Atlantic provinces | 7.9 | 7.8 | 6.9 | 6.1 | 7.1 | | |
| Quebec | 5.5 | 5.7 | 5.4 | 5.0 | 4.5 | | |
| Ontario | 2.6 | 2.8 | 2.6 | 2.1 | 2.4 | | |
| Prairie provinces | 2.6 | 2.9 | 2.6 | 1.9 | 2.3 | | |
| British Columbia | 4.4 | 4.5 | 4.3 | 3.6 | 4.4 | | |

Geographically, higher unemployment levels were concentrated in the Atlantic Provinces (7.1 per cent), Quebec (4.5 per cent) and British Columbia (4.4 per cent). By contrast, unemployment averaged 2.3 per cent in the prairie provinces and 2.4 per cent in Ontario.

Press reports suggest that the Federal Government's labor mobility program announced in December, is beginning to reduce regional pockets of high unemployment. Persons unemployed for four months or more have begun to take advantage of their options under the program to: (a) obtain resettlement grants of as much as $1,000 and (b) take retraining courses. Ottawa officials reportedly believe that, under present conditions of high aggregate demand, the combination of a high rate of labor force growth, accelerated retraining programs, and increased labor mobility will make a substantial contribution to increasing Canadian real output in 1966.

Wages and prices continue to rise

Despite the increase supplies of labor on the one hand and output on the other, Canadian wages and prices continued on a strong upward trend during the period under review, giving further evidence that serious strains are developing on Canadian resources for the first time since the mid-1950's. (See Table 6.)

On the wages front, average hourly earnings in manufacturing (seasonally adjusted) rose 5.2 per cent between the fourth quarter of 1964 and 1965. Labor income in the fourth quarter of 1965 was also boosted by an increase in the number of actual hours worked--up 0.4 per cent from a

Table 6. Canada: Prices and Wages, 1964-66
(annual rates of change)

| | 1964 | 1965 | | | | 1966 | | |
|---|---|---|---|---|---|---|---|---|
| | IV | I | II | III | IV | Jan. | Feb. | Mar. |
| **Prices** | | | | | | | | |
| Consumer | | | | | | | | |
| Total excluding food | + 1.9 | + 2.3 | + 2.3 | + 2.5 | + 2.4 | +2.1 | +2.3 | +2.4 |
| Food | + 0.9 | + 1.2 | + 2.5 | + 2.5 | + 4.4 | +6.1 | +7.1 | +7.6 |
| All goods (1949=100) | + 1.6 | + 2.0 | + 2.3 | + 2.5 | + 2.9 | +3.1 | +3.6 | +3.7 |
| Wholesale (1935-39=100) | - 0.4 | + 0.2 | + 1.6 | + 2.7 | + 3.6 | +4.3 | +5.3 | +4.6 |
| 30 industrial materials (1935-39=100) | + 1.1 | - 0.9 | 0 | + 0.6 | + 0.8 | +3.4 | +5.7 | +4.1 |
| **Labor income** | | | | | | | | |
| Goods 1/ | | | | | | | | |
| Manufacturing | + 7.9 | + 8.8 | +10.1 | + 9.6 | +13.2 | | | |
| Other | +11.2 | +14.4 | +15.5 | +17.0 | +19.4 | | | |
| Services | | | | | | | | |
| All governments | + 6.1 | + 7.1 | + 6.8 | + 8.6 | + 7.4 | | | |
| Other | + 9.8 | +10.3 | +11.0 | +11.2 | +11.6 | | | |
| Total labor income | + 8.9 | +10.0 | +10.8 | +11.0 | +12.5 | | | |
| Average hourly earnings 2/ | + 3.0 | + 4.7 | + 4.6 | + 4.3 | + 5.2 | | | |
| Average hours worked per week 2/ | + 0.5 | - 0.2 | - 0.3 | - 0.6 | + 0.4 | | | |

1/ Includes construction and public utilities.
2/ Hourly rated employees in manufacturing.

year earlier. These two factors, combined with a larger working population, raised total labor income (seasonally adjusted) to an annual rate of $27.2 billion in the last 3 months of 1965, 12.5 per cent higher compared to October-December 1964. (See Table 6.) By contrast, labor income rose 8-1/2 per cent during calendar 1964 and about 11 per cent in 1965.

On the prices front, the rises in both consumer and wholesale prices accelerated sharply during the first quarter of 1966. This acceleration led the Bank of Canada to note that:

> "Although the principal measures of final prices were affected during the year by some special factors, it seems clear...that prices were responding to influences of a more general nature and were beginning to rise more rapidly over a wide range of goods and services." 2/

On a year-to-year basis, the consumer price index for all goods (1949=100) moved up at annual rates exceeding 3 per cent per annum during the first three months of 1965. Sharply rising food prices contributed to the acceleration in the index during February and March.

Wholesale prices moved up even more sharply during the first quarter than did consumer prices. In January, higher prices for copper, copper products, and tin ingots contributed substantially to the rise in the general wholesale price index (1935-39=100) to a level 4.3 per cent higher than a year earlier. In February, non-ferrous metal prices remained at their high January levels, and higher prices for animal and vegetable products boosted the index 5.3 per cent above the year earlier level. In March, a decline in the prices of animal and vegetable products brought about a moderate reduction in the index.

<u>Slowdown in growth of bank credit</u>

The Canadian banks found themselves under increasing liquidity pressures during the period under review and there was evidence that the rate of expansion in bank loans proceeded at a somewhat slower pace during the first quarter of 1966 compared with a year earlier. (See Table 7.)

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2/ Bank of Canada, <u>Annual Report</u>, 1965, p. 13.

Table 7. Canada: Money and Credit, 1964-1966 [a]
($ million)

| | 1964 | 1965 | | | | 1966 | | |
|---|---|---|---|---|---|---|---|---|
| | IV | I | II | III | IV | Jan. | Feb. | Mar. |
| Currency and chartered bank deposits of the general public | 16,862 | 17,432 | 17,975 | 18,670 | 19,035 | 19,140 | 19,298 | |
| Chartered bank deposits of general public | | | | | | | | |
| Personal savings | 8,982 | 9,133 | 9,274 | 9,460 | 9,747 | 9,868 | 9,910 | |
| Demand | 4,329 | 4,402 | 4,510 | 4,633 | 4,617 | 4,649 | 4,767 | |
| Non-personal term and notice | b/ 1,487 | ( 1,729) | ( 2,098) | ( 2,343) | ( 2,369) | ( 2,273) | ( 2,264) | ( 2,328) |
| Bank loans: | | | | | | | | |
| Total bank loans | 8,910 | 9,353 | 9,772 | 10,284 | 10,681 | 10,912 | 10,944 | |
| of which: | | | | | | | | |
| Business | ( 4,944) | ( 5,042) | ( 5,293) | ( 5,614) | ( 5,623) | ( 5,516) | ( 5,611) | |
| Personal | ( 2,305) | ( 2,350) | ( 2,560) | ( 2,723) | ( 2,793) | ( 2,786) | ( 2,766) | |
| Farm | ( 708) | ( 670) | ( 718) | ( 797) | ( 819) | ( 771) | ( 760) | |
| Non-bank consumer credit | ((3,024) | ( 3,037) | ( 3,126) | ( 3,227) | ( 3,317) | ( 3,346) | | |
| Non-farm residential mortgage loans | ( 176) | ( 104) | ( 143) | ( 160) | ( 155) | | | |

a/ All figures are seasonally adjusted except those in parenthesis.
b/ November and December only.

During 1965, total loans of the chartered banks rose by 20 per cent, compared to 14 per cent in 1964. However, the cash management of the Bank of Canada after April 1965 concentrated on ensuring that the continued strong loan expansion would bring about a further reduction in the ratio of their "more liquid" assets[3/] to total assets. As a result, the chartered banks found that their more liquid asset ratio declined during 1965 from 32.9 per cent in January to about 30 per cent in December. Continued central bank pressures brought this ratio down to about 29.3 per cent in the first two weeks of April (1966). (See Chart 1.)

Seasonally adjusted currency and chartered bank deposits held by the general public changed little in December and January but advanced appreciably in February. The $158 million increase in total holdings of the general public in February consisted mostly of demand and personal saving deposit accounts; by contrast, more than half of the 11 per cent increase in the general public's currency and chartered bank deposit holdings in 1965 was placed in the less liquid non-personal term and notice deposits, rather than in demand and savings deposits.

This latest large rise in demand and personal savings deposits may indicate a further preference for increased liquidity on the part of the general public. During all of 1965, funds were shifted to the banks' term and notice accounts from finance company paper, partly in response to the collapse of the Atlantic Acceptance Corporation.

3/ Bank of Canada, Annual Report, 1965, p. 25. More liquid assets include: cash reserves, money market loans, Treasury bills, government securities and net foreign assets.

Discount rate raised again in March

The desire of the monetary authorities to slow the pace of bank loan expansion, as the slack in the Canadian economy continued to diminish, led the Bank of Canada to increase its discount rate from 4-3/4 to 5-1/4 per cent on March 14. Earlier, on December 6 (1965), the Bank of Canada had raised discount rate by 1/2 per cent, following the rise in U.S. discount rates.

Short-term rates advanced sharply after the latest rise in discount rate. (See Table 8.) By the end of March, the Treasury bill rate was 37 basis points above its mid-March level.

Table 8. Canada: Money and Capital Market Indicators, February, 1966-April, 1966
(per cent per annum)

| | Actual Feb. 24 | Change from the preceding date to March 11 | March 30 | Apr. 20 | Actual Apr. 20 |
|---|---|---|---|---|---|
| A. Interest rates | | | | | |
| 30-day commercial paper | 5.69 | 0.0 | +0.12 | -0.12 | 5.69 |
| 90-day finance paper | 5.75 | 0.0 | +0.13 | -0.13 | 5.75 |
| 91-day Treasury bills | 4.69 | 0.0 | +0.37 | +0.04 | 5.10 |
| Government bonds | | | | | |
| 4.50% 1966 | 5.02 | -0.10 | +0.22 | +0.06 | 5.20 |
| 5.00% 1968 | 5.38 | -0.03 | +0.07 | -0.01 | 5.41 |
| 4.25% 1972 | 5.70 | -0.02 | -0.06 | +0.06 | 5.68 |
| 4.50% 1983 | 5.71 | -0.01 | -0.08 | +0.07 | 5.69 |
| 5.25% 1990 | 5.65 | 0.00 | -0.02 | +0.09 | 5.72 |
| B. Stock index | | | | | |
| Total industrials (1958=100) | 202.8 | -2.4 | +1.4 | a/ +3.6 | a/205.4 |

a/ April 14.

In April, however, commercial and finance paper rates receded to their end-February levels while Treasury bill and short-term bond rates continued to move up.

There were only limited changes in Canadian bond yields after the discount rate action. In fact, bond yields on April 20 for intermediate and longer maturities were close to the late February levels. (See Table 8.)

U.S.-Canada bond yield differentials widened

With the relative stability of long-term Canadian bond yields in March and April, differentials on Government bond yields between the United States and Canada widened as rates on U.S. Governments declined. (See Table 9.) Between February 23 and April 20, the uncovered spread between Canadian and U.S. Governments widened from 6 to 29 basis points on one year maturities and from 93 to 108 basis points on 24-year bonds. (See Chart 1 and Table 9.)

Fiscal policy anti-inflationary as national accounts budgetary surplus increased

Shortly after the Bank Rate rise, the Canadian authorities brought fiscal policy into step with monetary policy. On March 29, the Government introduced its budget for 1966-67 which contained new tax measures to restrain the growth of domestic demand. With these taxes, the budget position for 1966-67 was expected to show a $615 million surplus (on a national income accounts basis) an increase of 25 per cent over the previous year. (See Table 2.)

Table 9. Canada/U.S. Comparative Bond Yields, December, 1965-April, 1966

| | Dec. 29 | Jan. 26 | Feb. 23 | Mar. 30 | Apr. 20 |
|---|---|---|---|---|---|
| 1-year: | | | | | |
| U.S. 11/66, 4.0% | 4.88 | 4.89 | 5.08 | 4.80 | 4.91 |
| Canada 12/66, 4.5% | 5.08 | 4.81 | 5.02 | 5.14 | 5.20 |
| Differential (+ favors Canada) | +0.20 | -0.08 | +0.06 | +0.34 | +0.29 |
| 2-year: | | | | | |
| U.S. 3/68, 3.75% | 4.93 | 4.92 | 5.14 | 4.86 | 4.96 |
| Canada 10/68, 5.0% | 5.35 | 5.25 | 5.38 | 5.42 | 5.41 |
| Differential | +0.42 | +0.33 | +0.24 | +0.56 | +0.45 |
| 6-year: | | | | | |
| U.S. 8/72, 4.0% | 4.71 | 4.78 | 5.04 | 4.82 | 4.92 |
| Canada 9/72, 4.25% | 5.37 | 5.40 | 5.70 | 5.62 | 5.68 |
| Differential | +0.66 | +0.62 | +0.66 | +0.80 | +0.76 |
| 17-year: | | | | | |
| U.S. 78-83, 3.25% | 4.51 | 4.47 | 4.73 | 4.59 | 4.71 |
| Canada 9/83, 4.5% | 5.45 | 5.45 | 5.71 | 5.62 | 5.71 |
| Differential | +0.94 | +0.98 | +0.98 | +1.03 | +1.00 |
| 24-year: | | | | | |
| U.S. 2/90, 3.5% | 4.50 | 4.51 | 4.72 | 4.56 | 4.64 |
| Canada 5/90, 5.25% | 5.44 | 5.45 | 5.65 | 5.63 | 5.72 |
| Differential | +0.94 | +0.94 | +0.93 | +1.07 | +1.08 |

Sources: Bank of Canada, Weekly Statistical Summary; Federal Reserve System.

On the assumption of no change in taxes, Canadian officials had expected a Treasury surplus (on a national economic accounts basis) of $370 million for 1966-67 and expected the Canadian gross national product would increase by "over 9 per cent." With the Government's new revenue proposals, however, a national accounts surplus of $615 million was predicted, which is expected to limit the increase in gross national product to "something over 8-1/2 per cent." Emphasizing the counter-inflationary purpose of the revenue measures, the Finance Minister commented that "we hope and expect that most of this reduction would consist of a smaller increase in costs and prices," rather than of real output.

To slow down investment spending, the Minister of Finance announced the introduction of a 5 per cent refundable tax on corporate cash flow (income including depreciation and depletion allowances but excluding the corporate income tax) in excess of $30,000. This measure is expected to reduce corporate investment spending by $250 million per year.

To dampen consumer demand, the Government introduced a revision of the personal income tax structure, effective June 1. The change is expected to lower the taxes of households with "below average" incomes, but to raise taxes of households with "above average" incomes. In addition, capital cost allowances for capital spending are to be withdrawn and replaced in some cases with grants to encourage investment in chosen areas. However, the capital cost allowance granted to promote expenditures for the prevention of water polution was retained.

The government also revised downward its own construction expenditures for the present fiscal year.

The Budget Speech also proposed that interest on bonds and debentures of the federal and provincial governments and agency bonds guaranteed by these governments should be exempt from the Canadian 15 per cent non-resident withholding tax on interest. This change will increase the incentive of non-residents to purchase Canadian government issues.

The measures to curb investment spending were made against the background of the Government's January survey of Canadian capital spending intentions for 1966. The survey suggested that investment spending during this year would continue to be a strong expansionary force in the Canadian economy. Rising interest rates, lengthening order backlogs, and the Government's proposed levy on corporate cash flow will modify some of these intentions; however, both higher prices and larger imports may be expected as a result of investment spending, which is still expected to be quite heavy.

The Canadian economy is in the midst of the "largest wave of investment activity in Canada since the mid-fifties."[4/] Capital outlays for 1966 reportedly would total $14.5 billion, up 14 per cent over 1965. By contrast, investment increased 16 per cent in 1964 and 17 per cent in 1965. Construction expenditures were expected to increase 12 per cent while spending on machinery was estimated to rise by 17 per cent. Durable goods purchased for personal use and outlays for defense equipment were both excluded from the report.

With the construction and capital goods industries believed to be operating at or very close to capacity at the present time, further increments to spending in these areas can be expected to encourage the inflationary trends which emerged in 1965. Although much of the impetus to price indices in 1965 can be traced to rising food costs, upward

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4/ Bank of Canada, *ibid.*, p. 14.

pressure was clearly evident in non-food sectors. The non-food component of the consumer price index moved up by 2.3 per cent during the twelve months ending in February 1966. More specifically, construction costs moved up 6-1/2 per cent in 1965 after increasing 4 per cent per year in 1963 and 1964. With skilled labor shortages already widespread in the industry, further spending on construction projects will contribute to the momentum of inflation in the industry in 1966. Similarly, spending on machinery and equipment could further enlarge the sizable volume and backlog of unfilled orders already on the books of Canadian machinery producers and might well lead to increased imports as sources of supply are sought abroad.

On the other hand, rising interest rates and tighter credit availabilities during the coming year should reinforce the effects of the 5 per cent temporary tax on corporate cash flow in holding down the rate of expansion of investment activity.

Foreign capital inflows exceed 1965 current account deficit

A deteriorating balance of payments position also formed part of the background for the more restrictive monetary and fiscal posture. Sharply higher merchandise imports in 1965 substantially reduced Canada's trade account surplus and brought about a large increase in the current account deficit. However, short- and long-term capital inflows more than offset the deficit and made possible an increase in Canada's international reserves. (See Table 10.)

Table 10. Canada: Balance of Payments, 1965
($ million)

| | 1964 | 1965 | | | | |
|---|---|---|---|---|---|---|
| | Year | I | II | III | IV | Year |
| **Current account:** | | | | | | |
| Exports | 8240 | 1825 | 2189 | 2262 | 2461 | 8737 |
| Imports | 7540 | 1867 | 2217 | 2107 | 2445 | 8636 |
| Trade balance | + 700 | - 42 | - 28 | +155 | + 16 | + 101 |
| Services (net) | -1133 | -359 | -339 | -145 | -394 | -1237 |
| Balance on current account | - 433 | -401 | -367 | + 10 | -378 | -1136 |
| **Capital account:** | | | | | | |
| Short-term | - 57 | +121 | + 90 | +214 | +183 | + 608 |
| Long-term | + 853 | +208 | +278 | + 2 | +197 | + 685 |
| Balance on capital account | + 796 | +329 | +368 | +216 | +380 | +1293 |
| **Total balance:** | + 363 | - 72 | + 1 | +226 | + 2 | + 157 |
| **Financing:** | | | | | | |
| Change in reserves | + 86 | -118 | - 92 | +144 | + 55 | - 11 |
| Change in IMF position | + 277 | + 46 | + 93 | + 82 | - 53 | + 168 |

Source: Dominion Bureau of Statistics.

Merchandise imports rose by $1,096 million in 1965 and exports by only $497 million: the surplus on merchandise trade fell from $700 million in 1964 to $100 million in 1965. The deficit for services and non-merchandise transactions widened by $104 million to $1,237 million. Consequently, the current account deficit widened to $1,136 million in 1965 from $433 million in 1964. The current account deterioration related to Canadian trade with its major trading partners, especially the United States and the United Kingdom.

The net capital inflow for 1965 amounted to $1.3 billion, and was divided about equally between short- and long-term funds. New issues of Canadian securities in foreign countries (essentially the United States) and direct investment in Canada (largely from the United States) amount to $1,517 million. In addition, foreign-currency operations of the Canadian chartered banks appear to have contributed another $426 million of capital inflow to cover the overall current account deficit. Capital outflows from Canada included net purchases of common and preferred stocks abroad ($241 million), direct investment abroad ($115 million), and retirements of Canadian securities ($373 million).

Because of the large capital accounts surplus, Canada's official reserves position improved by $157 million. Gold and dollar reserves declined by $11 million but Canada's "super gold tranche" position in the International Monetary Fund improved by $168 million.

Wheat exports to mainland China to increase

Canadian exports will benefit over the next few years because of large wheat sales to mainland China. As expected, the Communist Chinese obtained in early April (1966) an increase in the amount of wheat purchases which the Chinese can make from Canada during the years 1966-69. The agreement should add an average of $150 million to Canada's exports in each of the three crop years beginning in August, 1966.

Under the new contract, grain shipments to mainland China could reportedly increase Canada's merchandise exports by as much as $550 million in the thirty-six month period beginning July 31, 1966. The agreement calls for credit terms of 25 per cent cash and 75 per cent in 18 months. Beginning August 1, 1966, the Communist Chinese will also be allowed to export to Canada goods valued at $10 million per year.

The reported inability of Argentina and Australia to fulfill their quota of grain exports to Red China apparently may provide Canada with additional opportunities to sell wheat to that country. Poor crops in Argentina and Australia will reportedly leave Red China with a grain import deficit of one to two million metric tons of wheat. Nevertheless, Canada's order books for wheat are reported to be so full that the Canadian Wheat Board is reluctant to contract additional sales to the Communist Chinese.

Canada's reserves continue to fall

Canada's international reserves (including the super gold tranche position with the IMF) declined by $156.3 million in the first four months of this year and reached $2,723.9 million. (See Table 11.) A $195.4 million decline in gold and U.S. dollar holdings was partially offset by $38.9 million rise in Canada's super gold tranche position.

Particular significance was attached to the super gold tranche position in early December when Canadian exemption from the United States' Interest Equalization Tax was reportedly made contingent upon Canada's maintaining a level of international reserves, including gold, dollars and super gold tranche position in the IMF, of approximately $2.6 billion.

Table 11. Canada: Official Foreign Exchange Holdings and International Monetary Fund Position, November, 1965-January 1966
($ U.S. millions)

| | Level on Nov. 30 | Change during the month of Dec. | Jan. | Feb. | Mar. | Apr. | Level on Apr. 30 |
|---|---|---|---|---|---|---|---|
| Foreign exchange | | | | | | | |
| Gold | 1137.5 | +13.3 | - 38.0 | -36.3 | + 9.1 | n.a. | n.a. |
| U.S. dollars | 1543.6 | -29.9 | - 64.1 | +21.5 | -46.9 | n.a. | n.a. |
| Total | 2681.1 | -16.6 | -102.1 | -14.8 | -37.8 | -40.7 | 2469.1 |
| IMF position | | | | | | | |
| Super gold tranche a/ | 225.9 | -10.0 | + 60.5 | -30.2 | - 4.8 | +13.4 | 254.8 |
| Other countries transactions b/ | | | | | | | |
| Repayments | -- | 10.0 | 53.0 | 30.2 | 72.3 | n.a. | -- |
| Drawings | -- | -- | 113.5 | -- | 67.5 | n.a. | -- |
| Canadian transactions b/ | -- | -- | -- | -- | -- | n.a. | -- |

a/ Net IMF sales of Canadian dollars.
b/ Transactions in Canadian dollars with IMF.
Source: Bank of Canada, *Statistical Summary*.

The April level is about $100 million above this target. Under the exemption-reserve level agreement, which reportedly attaches more significance to the trend of Canadian reserve than their month-to-month variations, the Canadian authorities stand ready to buy Canadian federal government bonds from U.S. residents in order to reduce the Canadian reserve level, to about $2.6 billion.

## Spot Canadian dollar stays above parity while forward discount narrows

During March and April the spot Canadian dollar remained well above parity, and the discount on the forward Canadian dollar largely disappeared.

Table 12. Canada/U.S.: Exchange Rates and Arbitrage Calculations, February, 1966-April, 1966

| | Feb. 24 | March 17 | March 31 | Apr. 21 |
|---|---|---|---|---|
| **Exchange rates** | | | | |
| Spot (U.S. cents) | 92.88 | 92.94 | 92.84 | 92.90 |
| Forward discount on Canadian dollar (per cent per annum) | -0.45 | -0.15 | -0.04 | -0.13 |
| **3-month yields and differentials** | | | | |
| Treasury bills | | | | |
| Canada (covered) | 4.07 | 4.49 | 4.84 | 4.90 |
| U.S. | 4.66 | 4.62 | 4.50 | 4.65 |
| Differential (+ favors Canada) | -0.59 | -0.13 | +0.34 | +0.25 |
| Finance paper | | | | |
| Canada (covered) | 5.53 | 5.74 | 5.94 | 5.94 |
| U.S. | 4.88 | 5.13 | 5.13 | 5.25 |
| Differntial (+ favors Canada) | +0.65 | +0.61 | +0.81 | +0.69 |

Source: Federal Reserve System.

Covered differentials between U.S. and Canadian Treasury bills moved markedly in favor of Canada in February, March and April, reflecting both rising interest rates in Canada and the narrowing of the discount on the forward Canadian dollar. Between February 24 and April 21, the covered Treasury bill yield moved from 59 basis points in favor of New York to 25 basis points in favor of Canada. In the finance paper markets, the narrowing of the forward discount on the Canadian dollar was largely offset in April by a rise in U.S. finance paper rates. The covered incentive favoring Canada moved up from 65 basis points on February 24 to 69 basis points on April 21.