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Robert M. Dunn

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Recent Economic Developments in Canada:
May-November 1966

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The Canadian economy is experiencing a pause in its five-year advance in business activity. Since spring, indicators of physical output--industrial production, deliveries and orders in manufacturing, and construction--have been on a plateau. This slowdown has been accompanied, however, by accelerating rises in costs and prices.

The moderation in the pace of business expansion after the first quarter can in part be related to the restrictive monetary and fiscal steps taken by the Canadian authorities earlier in 1966.[1/] An unusual first-quarter advance in business activity was also assisted by heavy anticipatory retail sales prior to a March rise from 3 to 5 per cent in the Ontario sales tax. Industrial production, which had risen by 7.1 per cent during 1965, rose at an annual rate of only 3.4 per cent during the first eight months of 1966, and actually declined by 1.2 per cent between April and July. At an annual rate, GNP in real terms rose by 12.4 per cent in the first quarter but slowed down to 2.6 per cent in the second.

With new orders lagging and unemployment rising during the spring and summer months, demand pressures within the economy are not as strong as they were earlier in 1966. (See Table 1.) There were signs of a slackening in the rate of expansion throughout the economy,

1/ For a review of earlier Canadian developments, see "Recent Economic Developments in Canada: March-May 1966," dated June 3, 1966.

and particularly in automobiles, steel and construction. From their March peaks, both new orders and deliveries have declined irregularly, so that order backlogs have not been reduced. But with the ratio of inventories to shipments in manufacturing up noticeably to the highest level since mid-1963, further slackening in demands could induce firms to cut back operations in order to work down inventories.[1/]

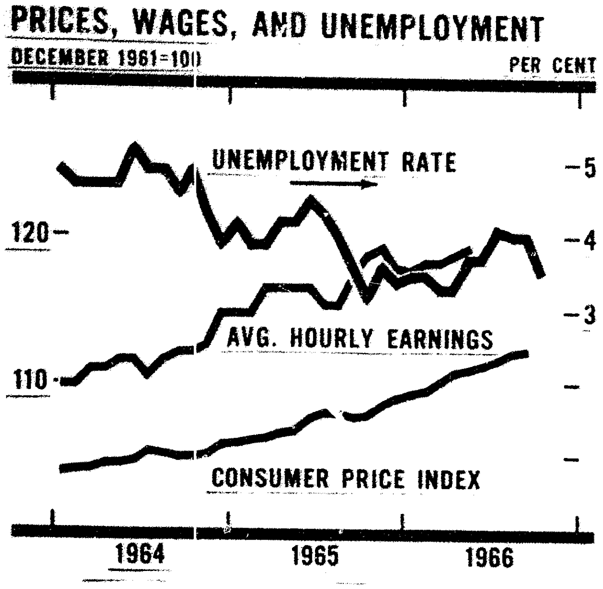
By contrast to these developments, the export position has been particularly favorable this year, and investment activity is also continuing to expand--in resource development, in the government sector and, to a lesser extent, in manufacturing. Despite the recent slowdown, however, there are signs of strain on physical capacity in some sectors.

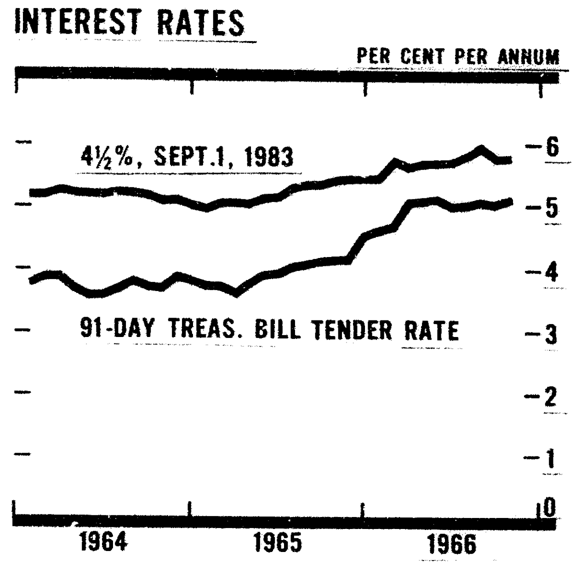
Partly as an outgrowth of the earlier period of business advance, Canadian wages have been rising at an accelerated rate, despite recent signs of softness in the labor market. (See Chart 1.) During the first half of 1966, Canadian average hourly earnings in manufacturing rose 50 per cent faster than a year earlier. During the same period, American manufacturing wages rose approximately half as fast as Canadian wages. Since June (the last month for which Canadian wage data are available), there have been a number of contract settlements with large wage increases.

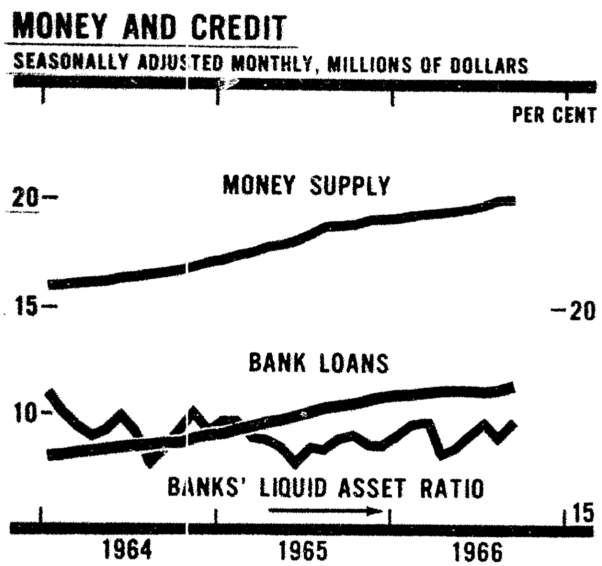
1/ Another sign of weakness in the economy is a sharp decline in a diffusion index of leading indicators which is published by a major Canadian bank. This index reached a peak of 70 in January, and fell to 25 by May. It has since held around the 25 level. This diffusion index is considered expansionary when above 50, and contrationary when below. The sharp and sustained fall in the index during the first five months of this year was the largest since the recession of 1960. However, a diffusion index ought not to be regarded as reliable evidence that the Canadian economy has in fact experienced a cyclical turn.

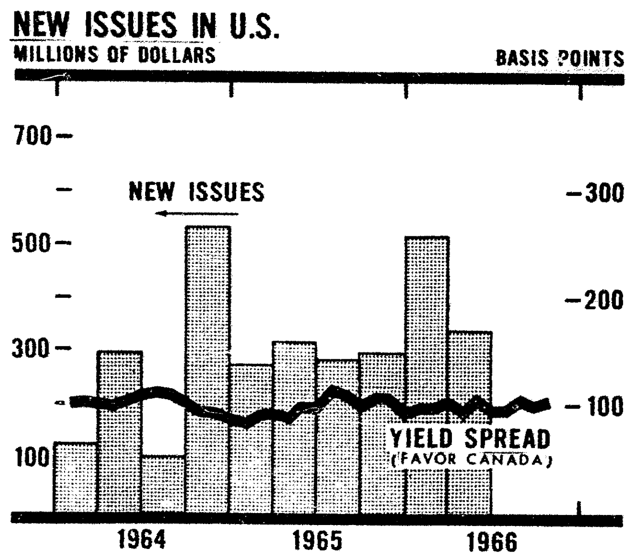
CHART 1

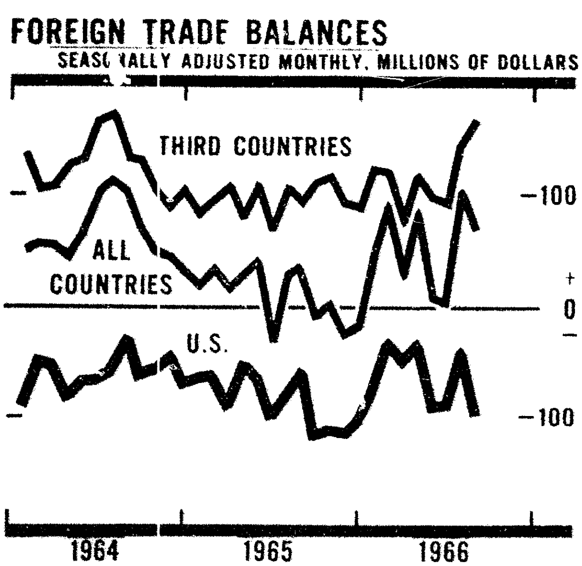
CANADA: MAIN ECONOMIC INDICATORS

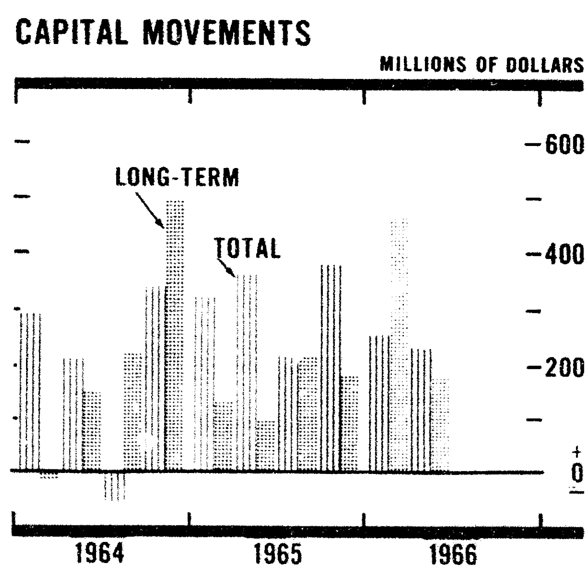












Two strikes were settled for 30 per cent in two years, after intervention by the Dominion Government. Because consumer prices have been rising twice as fast during the first nine months of 1966 as in the same period of 1965, the Canadian authorities are particularly concerned about the threat to price stability from the recent pace of wage settlements. The continued rise in wages and prices despite signs of softening demand suggests that the Canadian inflation has shifted to a cost-push variety.

Table 1. Canada: Main Economic Indicators 1965-1966[a/]
(seasonally adjusted)

	Industrial Production 1949=100	New Orders ($ mil.)	Inventory Shipments Ratio	Unemployment Rate	Avg. Hourly Earnings in Manufacturing	Consumer Price Ind. 1949=100
1965:						
I	250.6	2,870	1.89	3.9	2.10	137.3
II	251.6	2,829	1.91	4.3	2.11	139.0
III	260.2	2,897	1.96	3.6	2.14	139.1
IV	268.6	3,103	1.87	3.4	2.15	140.8
1966:						
I	273.8	3,141	1.91	3.3	2.20	142.4
II	273.1	3,086	1.96	3.6	2.23	143.8
Monthly:						
April	274.1	3,092	1.95	3.3	2.21	143.2
May	273.8	3,088	1.97	3.6	2.22	143.4
July	270.9	3,030	2.04	4.1	n.a.	144.3
August	274.4	3,038	2.09	4.0	n.a.	144.9
September	n.a.	n.a.	n.a.	4.0	n.a.	145.1
October	n.a.	n.a.	n.a.	3.5	n.a.	n.a.
November	n.a.	n.a.	n.a.	3.7	n.a.	n.a.

a/ Quarterly figures are for the last month of the period.

The contrast between the pause in the growth in output and the rapid wage-price advances has created some uncertainty about the appropriate emphasis for economic policy in Canada. On the monetary side, the banks continue under liquidity pressures, and bank loans have grown less than a third as rapidly in 1966 as they did in 1965. Recently, long-term bond yields have risen sharply and have returned to about the recent August peak, the highest point since World War I. In the short-term sector, the Treasury bill yields have not eased along with U.S. bill yields but have held stable at 1966 highs, and costs of Canadian finance paper are well above 6 per cent, the highest in the post-war period. The particularly high level of finance paper rates is partially related to problems of investor confidence which have been caused by the failure of two large finance companies.

The uncertainties about Canadian policy actions are perhaps best seen in the long postponement by the authorities of a special interim (so-called "mini") budget. During the summer, the Finance Minister had indicated that such a budget would be presented in the early fall to restrain inflationary pressures. In October, it was indicated that the budget would be announced in November and then in December. The budget was in fact announced on December 19 by the Finance Minister, and has only the modest aim of providing $290 million in new taxes to cover increased social security payments of $280 million which are to start in January, and provides no additional fiscal restraint. To the extent that the pensioners may spend a much higher percentage of their added income than the population at large, the package may prove to be slightly expansionary.

On the external side, the surprising strength of Canadian exports has been mirrored in a significantly better trade balance this year. (See Chart 1.) Exports grew particularly rapidly during July and August. The 1965 automobile agreement with the U.S. and the wheat sales to the eastern bloc have been major factors in this growth. Increased exports of automobiles and parts and wheat accounted for about one-half of Canada's export growth during the first eight months of this year. Both exports and imports with the United States grew somewhat more rapidly than total trade during this period, and Canada's trade deficit with the U.S. declined slightly from the same period of last year.

Despite the improved trade account, Canada's balance of payments deficit increased during the first three quarters of this year; although long-term capital continued to flow into Canada, sizable outflows of short-term capital and dividend and interest payments produced an increased deficit in the official settlements balance of payments.

Even with the favorable export picture, however, the Canadian dollar has weakened during the last two months; the spot rate has fallen from over 93.0 U.S. cents in late August to below the 92.5 cent parity during November, and has recently been as low as 92.25 cents. Movements of short-term funds seem to be the main reasons for this decline. The Canadian trade account is sound, and long-term capital has continued to flow into Canada. Balance of payments data for the first three quarters of 1966, however, show a sizable deficit in short-term account; it appears that, during the summer months, Canadian banks lost U.S.-dollar deposits of non-residents and they attracted new U.S.-dollar deposits from

Canadian residents by offering more favorable terms on U.S.-dollar than on Canadian-dollar deposits. Tight conditions in the United States financial markets, together with the shortage of working capital in U.S. businesses, are also encouraging American firms to move cash balances out of Canada. The exchange rate decline has been orderly, however, and there have been no signs of speculative selling or of reserve losses to indicate official Canadian activity to support the rate.

Within the agreement to hold Canadian official reserves at the $2.6 billion ceiling, Canadian residents have borrowed more in U.S. capital markets this year than in 1965: some $1,100 million compared with $742 million a year earlier. (See Table 2.) Two-thirds of the 1966 volume, however, took place in the first four months of the year and represented in part deferrals from 1965 borrowing programs of some Canadians. The new flotations diminished steadily to a low of $10 million in August; but we expect fourth-quarter placements to approach $200 million.

Table 2. Canada: Bond Flotations in the U.S. and Foreign Exchange Reserves 1965-1966

	Bond Flotations in U.S. ($ mill.)	Foreign Participation ($ mill.)	Foreign Exchange Reserves ($ mill.) (end of period)
IV Q 1965	--	--	3017.9
I Q 1966	365.4	39.5	2751.2
II Q 1966	271.9	2.7	2595.1
III Q 1966	197.4	2.0	2516.3
IV Q 1966	168.8 (forecast)	0.9 (forecast)	2509.6 (Nov.)
Total	1103.5 (forecast)	45.1 (forecast)	

Industrial demand weakens

Softening of demand pressures in the Canadian economy can be seen in three sets of indicators: orders and inventories, industrial production, and gross national product. Shipments and new orders, which rose sharply from the third quarter of 1965 to a peak in March 1966, then turned down. (See Table 1.) There were minor month-to-month fluctuations in this series in the second and third quarters, but the backlog of unfilled orders effectively ceased to grow in mid-1966. The flattening out of the order backlog was also accompanied by a rise in the ratio of inventories to shipments in Canadian manufacturing from about 1.91 for the first quarter to 2.04 for July and 2.09 for August. (See Table 1.)

At the same time, industrial production, which had risen rapidly from the second quarter of 1965 to a peak in the first quarter of 1966, then proceeded to flatten out. (See Table 1.) By June, the index was fractionally below the end-March level and fluctuated around that level in July and August. The April-August sluggishness in the index reflected a downturn in output of durable goods but there was also a general easing in activity throughout manufacturing and mining.

During 1966, GNP (in real terms) also flattened out. After rising sharply during the first quarter, GNP remained about unchanged during the second and third quarters. (See Table 3.) At a seasonally-adjusted annual rate, GNP rose 12.4 per cent in the first quarter, 2.6 per cent in the second and actually receded marginally in the third quarter. During the third quarter, private fixed investment, which had risen steadily during the preceding five quarters, dropped back. This decline has come at a time when the Canadian press had suggested a slower rate of growth in 1967; in addition, seasonally-adjusted profits declined during the second and third quarters. Some observers are concluding from this range of evidence that the investment boom of the last few years has already lost a good deal of steam and may be coming to an end.

Table 3. Canada: Gross National Product
(seasonally adjusted annual rates; billion $; constant 1957 prices)

	1965				1966		
	I	II	III	IV	I	II	III
Consumption	27.6	28.1	28.8	29.3	29.5	29.3	30.2
Government Expenditures	7.4	7.6	7.6	7.7	7.8	8.1	8.4
Private Fixed Investment	7.9	8.0	8.5	8.9	9.1	9.3	9.0
Net Change in Inventories	1.3	1.2	.7	.6	.9	1.3	.6
Exports	9.6	9.9	10.1	10.4	11.2	11.0	11.2
Imports (-)	-10.2	-10.5	-10.8	-11.5	-11.6	-11.6	-12.1
Residual Error	.1	0	.2	.1	.1	0	- .1
Gross National Product	43.7	44.3	45.2	45.6	47.0	47.3	47.2

Source: Dominion Bureau of Statistics.

Labor market softens

The Canadian unemployment rate rose sharply during the spring and summer, and brought at least a temporary end to a four-year continuous improvement in the labor market. (See Table 1 and Chart 1.) The recent higher unemployment resulted from a slower growth of total employment accompanied by a continued rapid increase of the labor force. Despite increased unemployment, however, Canadian wages have been rising at an accelerating rate.

The rapid growth of the Canadian labor force has been one of the striking characteristics of the boom of the last five years. Between August 1961 and August 1966, the labor force expanded at an average annual rate of 3 per cent, well in excess of the natural population growth. The entry of those born in the World War II baby boom and a rise in immigration contributed to this expansion. Some 147,000 immigrants entered Canada in 1965, a 30 per cent increase over the previous year, and the government expects 200,000 in 1966, an increase of 36 per cent over 1965. This flow will add a full one per cent to the Canadian population. The age distribution of the immigrants is such that one-half of them are immediate members of the labor force; by contrast, the participation rate for the population as a whole is about 37 per cent. Consequently, for the purpose of the labor force, this year's probable immigration could be considered equivalent to a 1.35 per cent growth of the population.

Despite the recent slowdown in the rate of growth of the industrial sector of the Canadian economy, upward pressures on wages have increased. In the period between December of 1965 and June of last year, Canadian average hourly earnings in manufacturing rose at an annual rate of 7.4 per cent, compared with a rate of only 4.9 per cent in the same period of the previous year. (See Table 1 and Chart 1.) A similar comparison for the United States shows an annual rate of growth of wages of 3.8 per cent in the first half of 1966 and 3.1 per cent in 1965.

Since June, a number of union contracts have been signed in Canada which included somewhat larger wage increases. A national railroad strike was settled for 24 per cent in two years. Steel and packing-house workers received similarly large increases, and an Air Canada strike of 5,200 was just settled for 12 per cent immediately and another 8 per cent over 26 months. The Canadian Government intervened in two other strikes during the summer which were settled for 30 per cent in two years, and later granted raises of 14 per cent in two years to the armed forces and the mounted police.

Unit labor costs in Canadian manufacturing turned up in 1964 after a four year decline, and have risen particularly rapidly since mid-1965; the total increase since the 1964 trough is about 5 per cent.

Press reports suggest that the labor movement intends to continue to press for wage increases well in excess of productivity growth in an attempt to reverse the trend in income distribution which has accompanied the boom of the 1960's. From 1961 to 1965, corporate profits before taxes increased by 51.7 per cent while labor income grew by 37.1 per cent. Current wage trends represent an obvious problem for the maintenance of price stability in Canada. The recent rise in Canadian manufacturing unit labor costs, after the decline of the early 1960's, and the easing of demand pressures suggest that the Canadian inflation may be shifting from a "demand-pull" to a "cost-push" variety.

<u>Durables and food lead consumer price index rise</u>

The seasonally-adjusted consumer price index rose at an annual rate of 2.3 per cent between December 1964 and September 1965, and 4.1 per cent in the same period of 1966. (See Table 4 and Chart 1.) The recent increases have been concentrated in food and services; the index of prices of non-durables other than food has remained unchanged since April. An index of the prices of thirty industrial materials shows a contrasting pattern. It rose unevenly during 1965 and reached a peak in February; during the next seven months, it declined by 3.1 per cent.

Table 4. Canada: Wholesale and Consumer Prices 1964-1966
(changes from the previous period)

	Consumer Price Index 1949=100	Consumer Durables 1949=100	Food 1949=100	Wholesale Price Index 1935-9=100	30 Industrial Mat. 1935-9=100
Level on:					
December 1964	136.8	115.2	133.2	246.0	256.2
March 1965	+ .5	- .6	+ .1	+ .8	+ .1
June 1965	+ 1.7	0	+ 4.3	+ 5.2	+ 4.1
September 1965	+ .1	- .2	- 1.3	- 1.0	0
December 1965	+ .8	+ .2	+ .4	+ 4.3	- 1.5
March 1966	+ 1.6	- .5	+ 3.8	+ 2.7	+ 3.3
June 1966	+ 1.4	+ 1.2	+ .8	+ 1.5	- 1.6
September 1966	+ 1.3	- .4	+ 2.9	+ 1.2	- 4.1

Fiscal restraint expected in interim budget

The Canadian Government indicated in late summer that fiscal policy would be used to restrain excessive demand pressures in the economy. Finance Minister Sharp announced in August that the medicare program and certain other planned expenditures would be put off for a year. Later the Finance Ministry indicated that an interim budget would be presented in the fall with the purpose of curbing inflation. Early press reports suggested that it would involve a large tax increase. As signs of a pause in the economy have appeared, financial commentators have suggested that less restraint is needed than had been thought in August.

The budget, which finally was presented in December, proposed tax increases to yield $290 million, or almost exactly the amount required to pay for new social security benefits which began in January. The Finance Minister said that the package was intended to have a neutral fiscal effect, and suggested that the current state of "delicate balance" in the economy should not be disturbed by any major policy shifts.

Money and bond markets revive slightly from August lows

Financial markets were very tight during the second half of 1966; after rising unevenly since early 1965, bond rates rose sharply in late July and early August; at the mid-August peak, long-term interest rates were higher than they have been at any time since World War II.

The bond markets recovered in September and October, and softened again in November; government bond yields were slightly below their August peaks at the end of November. (See Table 5 and Chart 1.)

Table 5. Canada: Money and Capital Market Indicators, 1966
(change from previous period)

	Short-Term Rates			Government Bond Rates				Stock Mkt.
	30-day Comm. Paper[a]	90-day Finance Paper[a]	91-day Treas. Bills[b]	5.0 % 1968	4.25% 1972	4.5 % 1983	5.25% 1990	Industrials[c]
Level on:								
May 4	5.81	5.88	5.10	5.39	5.67	5.67	5.69	167
June 1	0	+.25	0	-.07	-.01	+.02	0	- 6
July 6	-.06	+.12	-.04	-.05	+.04	+.14	+.05	0
Aug. 24	+.25	0	+.02	+.77	+.43	+.24	+.28	-11
Sept. 14	+.13	+.12	-.01	-.41	-.31	-.14	-.16	- 4
Oct. 19	0	0	+.07	-.08	-.03	-.06	-.10	- 3
Nov. 16	+.12	+.12	+.06	+.22	+.10	+.13	+.10	+ 3
Nov. 30	0	0	-.05	0	+.09	+.07	+.08	- 1
Level on:								
Nov. 30	6.25	6.50	5.15	5.77	5.98	5.97	5.94	145

a/ Friday data.
b/ Thursday data.
c/ Toronto stock exchange index.

Interest rates at the short end of the market showed a less clear pattern. Treasury bill rates rose sharply during the spring, and since then have fluctuated between 5 and 5.25 per cent. The sharp rise in U.S. Treasury bill rates during August and early September was not reflected in the Canadian market, and consequently U.S. rates were as much as a half a percentage point higher than those in Canada during September. Commercial and finance paper rates in Canada have continued to rise since August.

The difference in the behavior of short- and long-term rates in August is the result of a number of factors; the extreme tightness of monetary conditions in the United States and the failure of a large Canadian finance corporation undoubtedly drove up the finance and commercial paper rates. The fall of long-term rates in September, when shorter maturities were not declining, was probably caused by the late August announcement that an interim budget would be presented in the fall. The expectation of increased reliance on fiscal policy suggested that monetary policy might be eased at the end of the year and encouraged a speculative demand for long-term bonds. The hesitency and delays in the presentation of this budget later discouraged these expectations and bond rates rose during November.

Stock market declines

The Canadian stock market, which has declined during most of 1966, suffered its sharpest losses during the summer. (See Table 5.) Industrial stocks declined by 6 per cent between February 1 and July 6, and by another 9 per cent by mid-September. The market was relatively stable during the next two months. The summer decline can be attributed in part to the greatly increased attractiveness of long-term bonds to investors seeking either higher rates of return or possible future capital gains. In addition, the weakness in equity prices has been attributed to investor uncertainty growing out of recent rapid wage increases and the large number of important wage contract negotiations in the offing.

The percentage decline in U.S. stock prices during 1966 was somewhat greater than that in Canada, and undoubtedly encouraged some of the softness there. The limited recovery in American stock prices during the fall was not matched in Canada, however, and the market there remained stagnant through November.

Bank loan and money supply expansion slows

Tight monetary policy in Canada has reduced the growth of the money supply and bank credit in 1966. The seasonally adjusted growth of the publicly held money supply fell from $566 million per quarter during the first three quarters of 1965 to $324 million per quarter in the next four quarters. (See Table 6 and Chart 1.) The decline in the rate of growth of total bank loans took place one quarter later, and was even more striking. Bank loans grew at a seasonally adjusted quarterly rate of $447 million during 1965, and $133 million during the first three quarters of 1966.

During 1965, the banks had sufficient liquidity positions to expand loans faster than deposits, primarily by selling off government securities. During most of 1966, in contrast, their liquidity positions have been much more strained, and they have been able to expand loans much less rapidly. The "more liquid asset ratio" of the private banking system was below the customary minimum of 30 per cent from late March to September but has recovered somewhat since then. The improvement of September and October is only a slight easing of the banks' shortage of liquidity, but does suggest that the serious pressures of the early summer have been reduced somewhat.

Table 6. Canada: Selected Banking and Money Supply Data, December 1963-September 1966
(millions of dollars; seasonally adjusted)

	Money Supply a/	Demand De-posits	Personal Savings Deposits	Total Loans b/	Personal Loans c/
Outstanding:					
1963 - December	15,889	4,114	8,529	7,926	1,448
Changes:					
1964 - March	+ 290	+ 165	+ 100	+ 320	+ 93
June	+ 203	+ 15	+ 89	+ 241	+ 82
September	+ 240	- 14	+ 208	+ 209	+ 88
December	+ 437	+ 102	+ 139	+ 376	+ 100
1965 - March	+ 564	+ 54	+ 168	+ 430	+ 88
June	+ 543	+ 87	+ 144	+ 439	+ 104
September	+ 593	+ 69	+ 214	+ 467	+ 115
December	+ 349	+ 57	+ 282	+ 452	+ 89
1966 - March	+ 245	+ 97	+ 101	+ 168	+ 83
June	+ 260	+ 36	+ 125	+ 93	- 32
September	+ 440	+ 152	+ 143	+ 139	+ 71
Outstanding:					
1966 - September	20,053	4,934	10,200	11,251	2,335

a/ Money supply held by the public.
b/ Excludes day-to-day loans, call loans, and loans for the purchase of Canadian savings bonds at time of issue.
c/ Unsecured.
Source: Bank of Canada *Statistical Summary*.

Trade account in surplus

A continuing strong point in the Canadian economy during 1966 has been the foreign trade performance. As would be expected in a period of prosperity, Canadian imports have grown significantly; the total for the first eight months of last year was 15.8 per cent above the same period of 1965. Exports, however, grew by 19.5 per cent over 1965, and produced a trade surplus of $398 million during these eight months, which was more than double that of 1965; the export surplus was particularly large during July and August. (See Table 7.)

Table 7. Canadian Foreign Trade, 1965-1966
(millions of Canadian dollars; seasonally adjusted)

	1966				1965	1966	%-age
	I-Q	II-Q	July	August	8-month Total	8-month Total	Growth 1965-66
Exports	2521.7	2481.4	863.1	896.1	5660	6763	19.5
Imports	2383.3	2391.7	762.5	826.9	5497	6365	15.8
Balance of Trade	+138.4	+ 89.7	+100.6	+ 69.2	+163	+398	144.2
Exports to U.S.	1482.9	1542.2	504.3	481.8	3262	4011	23.0
Exports to U.K.	319.7	271.2	87.2	106.2	786	784	- .3
Exports to Other Countries	719.1	668.2	271.6	308.1	1601	1868	16.7
Imports from U.S.	1653.2	1775.4	546.9	581.8	3832	4558	18.9
Imports from U.K.	182.6	139.8	47.3	64.9	397	436	9.8
Imports from Other Countries	547.5	495.0	168.3	180.2	1233	1291	4.7

Source: Canadian Statistical Review.

Canada's strong export performance has been encouraged by three major factors; strong demand pressures in the United States, the 1965 automobile trade agreement with the United States, and large wheat sales to the eastern bloc.

During the first eight months of 1966 Canada's exports to the United States were 23 per cent higher than in the same period of 1965; this is almost exactly the rate of growth for all U.S. imports during this period, meaning that Canada maintained an unchanged share of the U.S. import market. Canadian imports from the United States also grew more rapidly than those from other countries, although Canada's trade deficit with the U.S. declined slightly. (See Table 7.)

The 1965 automobile trade agreement with the United States created free trade between the two countries in automobiles and parts. The excess of Canadian imports over exports in this area has been reduced by the agreement but remains sizable. During the first three months of 1966 Canada's imports of automobiles and parts totaled $379 million, or almost 1/6 of total imports, while her exports were $209 million. The agreement began operating in early 1965, and its effects can be seen most clearly in a comparison with 1964. Canadian exports of automobiles and parts grew by 498 per cent between the first quarters of 1964 and 1966, while imports rose by only 74 per cent, making clear that the agreement has worked overwhelmingly to Canada's advantage thus far.

Exports of wheat, resulting from agreements with eastern bloc countries, have been another source of Canada's trade surplus. During the first six months of this year Canada exported $417 million in wheat, compared to $295 million in the same period of 1965. It is unlikely that this flow will continue to grow, since Canada's capacity to ship and load wheat is currently strained, and USSR, Argentina, and Australia all have had much larger crops this year than last.

The automobile and wheat agreements do not account for all of this year's growth in Canadian exports; out of an export growth of $768 million in the first half of this year, $368 million represents growth in automobiles and parts, or wheat. Canadian exports during the first six months of this year were 19 per cent over last year's level; if exports of automobiles, parts, and wheat had remained unchanged, the growth would have been 10 per cent. Canada's export performance was greatly aided by the automobile and wheat agreements, but would have been good even without them. Given the growth of imports, however, Canada's balance of trade would have deteriorated badly without the aid of these two factors.

Short-term capital outflow causes balance of payments deficit

During the three quarters of 1966, an outflow of short-term capital was responsible for an increase of $496 million in Canada's official settlements deficit over the same period of 1965. (See Table 8.)

Canada's current account was significantly better in the first nine months of 1966 than in the same period of 1965. An increased deficit in the services item was more than offset by a $220 million improvement in the trade account. The increased services deficit was caused by an increased flow of interest and dividends out of Canada and by an increased travel deficit.

The payments deficit of the first three quarters of this year was caused by a decline in the capital account; the flow of long-term capital into Canada rose by $414 million but was more than offset by a large outflow of short-term capital.

The outflow was partially brought about by a large withdrawal of non-resident U.S. dollar accounts from the chartered banks. Tight monetary conditions in the United States caused the outflow and encouraged the banks to replace these funds with Canadian resident U.S. dollar deposits rather than call in U.S. dollar loans. Consequently, the banks raised the interest rate paid on deposits which are swaped into U.S. dollars; the result of this set of transactions was a net capital outflow of $295 million, which accounts for almost all of the deficit in the short-term capital account during the period. The deficit in the balance of payments was exceeded by a reduction of Canadian short-term liabilities to foreigners (bank accounts), and consequently a liquidity balance for this period would probably have shown a slight surplus. The deficit was the result of tight money in the United States and the fact that American firms may have withdrawn funds from Canada to meet domestic needs. Both the increased flow of profits and interest from Canada, and the withdrawal of U.S. bank deposits there were probably related to monetary conditions in the United States rather than to any basic change in the attitude of the market toward the Canadian dollar.

Table 8. Canada: Balance of Payments, 1965-66
($ million)

	1965					1966		
	I	II	III	IV	Year	I	II	III
Current account:								
Exports	1,825	2,189	2,262	2,461	8,737	2,212	2,586	2,685
Imports	1,867	2,217	2,107	2,445	8,636	2,218	2,606	2,354
Trade balance	- 42	- 28	+ 155	+ 16	+ 101	- 6	- 20	+ 331
Services (net)	- 353	- 333	- 125	- 387	-1,201	- 398	- 332	- 203
Balance on current account	- 395	- 360	+ 30	- 361	-1,100	- 404	- 352	+ 128
Capital account:								
Short-term	+ 128	+ 134	+ 212	+ 232	+ 713	- 165	+ 56	- 434
Long-term	+ 195	+ 227	- 26	+ 131	+ 527	+ 430	+ 179	+ 221
Balance on capital account	+ 323	+ 361	+ 186	+ 363	+1,240	+ 265	+ 235	- 213
Total balance:	- 72	+ 1	+ 226	+ 2	+ 157	- 139	- 117	- 85
Financing:								
Change in reserves	- 118	- 92	+ 144	+ 55	- 11	- 166	- 181	- 105
Change in IMF position	+ 46	+ 93	+ 82	- 53	+ 168	+ 27	+ 64	+ 20

Source: Dominion Bureau of Statistics.

The balance of payments deficit of the first three quarters of 1966 was financed by a reduction of official reserves. (See Table 9.) An agreement with the United States was announced in late 1965 under which Canada is to maintain her foreign exchange reserves and net position at the IMF at $2.6 billion or less, in exchange for unrestricted access to the U.S. capital market. The deficit of the first half of 1966 reduced Canadian reserves to $2,595 million. The decline continued through the summer, and reserves fell to $2,509.6 million by the end of November.

Table 9. Canada: Official Foreign Exchange Holdings and International Monetary Fund Position, 1966
($ U.S. millions)

	Level	Change from Previous Period						Level end
	Dec. 30	May	July	Aug.	Sept.	Oct.	Nov.	of Nov.
Foreign exchange								
Gold	1,150.8	- 90.1	- 74.5	+10.5	+12.0			
U.S. dollars	1,513.7	-162.2	- 22.3	-44.9	-48.7			
Total	2,664.5	-252.3	- 96.8	-34.4	-36.7	-21.1	+18.9	2,242.1
IMF position								
Super gold tranche a/	215.9	+ 47.9	- 8.5	+ 6.5	+10.2	+ .1	- 4.6	267.5
Total	2,880.4	-204.4	-105.3	-27.9	-26.5	-21.0	+14.3	2,509.6

a/ Net IMF sales of Canadian dollars.
Source: Bank of Canada, Statistical Summary and Federal Reserve System.

Canadian dollar declines

The market for the Canadian dollar was strong during the summer, but has softened noticeably since early October. The spot exchange rate has fallen below the par of 92.5 U.S. cents and was as low as 92.25 cents in November, after being over 93 cents during July. (See Table 10.) The exchange market has generally been quiet during this period of decline, and there has been little, if any, official intervention.

The reasons for this fall are not completely clear, but press reports suggest a combination of seasonal factors and the effects of tight money in the United States. The usual fourth quarter flow of profits and interest payments out of Canada may have been greater than usual in 1966 due to a desire of U.S. firms to repatriate any available funds for use here. Recent data show that Canadian commercial banks continued to increase their non-resident U.S. dollar positions through October. A small increase in foreign deposits was more than offset by increased loans to foreigners during October.

Table 10. Canada/U.S.: Exchange Rates, 1966

	May 19	July 21	Sept. 22	Oct. 20	Nov. 17
Exchange rates					
Spot (U.S. cents)	92.88	93.11	92.91	92.65	92.35
Forward discount on Canadian dollar (per cent per annum)	.13	0	- .39	- .41	- .41

The fall in the exchange rate during October and November does not represent a basic weakening of confidence in the Canadian dollar. The decline was steady and gradual, and there were no signs of heavy speculative selling. The Canadian dollar went to a premium in the forward market during the summer, and maintained that premium during the decline. The trade account remains sound, and long-term capital continues to flow into the country. A need for working capital arose in the United States and American firms have apparently used bank accounts and subsidiaries in Canada as sources of funds, leading to pressure on the exchange rate.