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REVIEW OF FOREIGN DEVELOPMENTS

November 21, 1950

Germany - EPU Deficit and Transit Trade  
By Gordon B. Grimwood

6 Pages

Recent Canadian Exchange Developments  
By Edward Marcus

18 Pages

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## GERMANY - EPU DEFICIT AND TRANSIT TRADE

Gordon B. Grimwood

German trade statistics for September for the first time break down import statistics by "country of origin" and "country from which shipped," thus providing an opportunity to examine a German claim that one of the reasons for Germany's unfavorable position vis-a-vis the European Payments Union has been an increase in the transit trade through other EPU countries, particularly the Netherlands and the United Kingdom. Since the statistics are presented as a total for September and a total for the first three quarters of 1950, there is no opportunity to trace the development of the transit trade during the year. However, since the September deficit was the largest of the third quarter, a percentage comparison of transit trade in relation with total trade for that month with the three-quarter totals would seem a logical basis upon which to make some assumptions regarding Western Germany's present predicament. First, however, a quick glance at developments in the German position during the first three quarters of 1950 would be advantageous.

Development of EPU deficit

Since German officials contend that the present situation is the result of payments difficulties rather than a structural distortion in the trade pattern, Table I sets forth a comparison of the balance of trade, the service account, and the balance of payments. The first quarter reflects the impact of trade liberalization on German imports; the trade deficit, however, in contrast to the second and third quarters, differs only in a minor degree from the payments deficit. During the second quarter a small surplus with the Continent was unable to overcome a deficit on trade account with the sterling area; the payments account, however, shows a large surplus with the non-sterling OEEC countries. This surplus has been explained by German authorities as the result of credits extended to Germany by other European countries and as the result of pre-payments for German exports. It has been estimated that these advances were in the magnitude of \$50 million.

Developments in the third quarter, which have received considerable publicity because of the size of the German deficit with EPU, show a payments deficit over twice as large as the deficit on trade and service accounts. The spread between trade and payments with non-sterling OEEC countries can be partly explained by the extensive over-payments which occurred in the second quarter. The spread in the sterling area deficit, which accounts for three-fourths of the total trade deficit and more than half of the payments deficit, is primarily the result of two factors: (1) increases in prices of food and raw material imports, which are mostly paid for in cash and therefore affect immediately the balance of payments, relative to the increase in the price of German exports, which are largely sold on credit and will be reflected in the balance of payments at a later date; and (2) a rumor that sterling would be appreciated, which caused

importers to hasten payment of their accounts and exporters to hold balances in sterling beyond the normal lag period. The Germans have advanced a third reason - that other EPU countries have taken advantage of Germany's liberalized trade policy to transship goods from other countries into Germany. The remainder of this paper will deal with an examination of this claim.

#### Magnitude and direction of transit trade

Table III shows the transit trade of all EPU countries with Germany, plus that of the United States, which was the only country outside the EPU which shipped more goods to Germany than originated in the country. The total transit trade during the first three quarters of 1950, including the United States, amounted to about 20 per cent of total imports; excluding the United States, the total was about 16 per cent. In September, the month of Germany's largest payments deficit, these percentages increased to about 24 and 20 per cent, respectively.

Table IV groups the countries which show an excess of "goods of origin" over "goods shipped" according to currency areas through which these accounts may be assumed to be cleared. These amounts are subtracted from the "mother countries'" totals, and any remainder is listed as "unexplained". During the first three quarters of 1950 the "unexplained" transit trade amounted to \$67 million, or less than 4 per cent of total imports. The comparable figure for the month of September is less than 8 per cent.

#### Conclusions

It appears reasonable to assume that the "unexplained" transit trade, i.e., goods which may have been transshipped into Germany through "alien" currency areas, played a minor part in producing Germany's EPU deficit although the importance of such trade increased somewhat during the month of September. At first glance it might seem that the spread between Germany's balances of trade and services and its balance of payments with the EPU countries for the first three quarters of 1950 might be due to the "unexplained" transit trade, since the magnitude of the latter is somewhat larger than the total spread for the period. A breakdown of the balances for September by currency areas (see Table II) shows, however, that there is no correlation between the two figures: in that month, the spread between balance of payments and the balances of trade and services was \$83 million while the "unexplained" entrepot trade was only \$18 million. The spread must therefore be primarily explained by the normal and speculative lags between import and export payments. If this explanation is correct, the spread should disappear and even be reversed in the near future.

TABLE I  
Germany's Balance of Trade and Payments  
with EPU Countries and DOT's, 1/1950  
(millions of dollars)

Area	(1) Imports	(2) Exports	(3) Balance of Trade	(4) Balance of Services	(5) Balance of Payments	(6) Capital Transactions (5-3+4)
Non-Sterling EPU (inc. DOT's)						
1st Quarter	295.4	244.9	-50.5	- 0.6	-76.8	-25.7
2nd Quarter	252.7	282.5	+29.8	- 5.5	+78.6	+54.3
3rd Quarter	351.2	335.8	-15.4	-13.1	-79.4	-50.9
Total	899.3	863.2	-36.1	-19.2	-77.6	-22.3
EPU and non-EPU Sterling						
1st Quarter	90.8	37.5	-53.3	- 1.0	-52.8	+ 1.5
2nd Quarter	88.1	38.4	-49.7	- 1.9	-17.1	+34.5
3rd Quarter	94.8	51.3	-43.5	- 3.0	-102.8	-56.3
Total	273.7	127.2	-146.5	- 5.9	-172.7	+20.3
Total EPU and Sterling						
1st Quarter	386.2	282.4	-103.8	-1.6	-129.6	-24.2
2nd Quarter	340.8	320.9	- 19.9	-7.4	+ 61.5	+88.8
3rd Quarter	446.0	387.1	- 58.9	-16.1	-182.2	-107.2
Grand Total	1,173.0	990.4	-182.6	-25.1	-250.3	-42.6

Sources: Trade Statistics - Der Aussenhandel der Bundesrepublik Deutschland  
Service and Payment Statistics - Report by German Minister for the  
Marshall Plan, November, 1950.

1/ Dependent Overseas Territories

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TABLE II  
Germany's Balance of Trade and  
Payments with EPU Countries  
and DOT's, Sept. 1950  
(millions of dollars)

Area	(1) Imports	(2) Exports	(3) Balance of Trade	(4) Balance of Services	(5) Balance of Payments	(6) Capital Transactions (5-3+4)
Non-Sterling EPU (inc. DOT's)	131.2	110.8	-20.4	-5.6	-77.6	-51.6
EPU and non-EPU Sterling	<u>36.6</u>	<u>13.3</u>	<u>-23.3</u>	<u>-0.7</u>	<u>-55.8</u>	<u>-31.8</u>
Total EPU and Sterling	167.8	124.1	-43.7	-6.3	-133.4	-83.4

Source: Der Aussenhandel der Bundesrepublik Deutschland, Sept., 1950.

TABLE III  
Germany's Transit Trade, 1950  
(millions of dollars)

Area	(1) Import by Country of Origin		(2) Import by Country from which shipped		(3) Transit Trade (2-1)		(4) Exports		(5) Balance of Trade (2-4)	
	Sept.	Jan.-Sept.	Sept.	Jan.-Sept.	Sept.	Jan.-Sept.	Sept.	Jan.-Sept.	Sept.	Jan.-Sept.
Belg.-Lux	10.3	61.7	11.4	77.4	1.1	15.7	13.4	108.1	+ 2.0	+30.7
Denmark	10.7	77.1	10.9	77.6	.2	.5	9.0	54.1	- 1.9	-23.5
France (inc. Saar)	25.2	135.8	34.6	198.2	9.4	62.4	14.7	128.0	-19.9	-70.2
Greece	.9	7.1	.9	7.0	-	0.1	2.2	21.7	+ 1.3	+14.7
Great Britain	11.3	70.3	35.9	194.8	24.6	124.5	5.2	60.3	-30.7	-134.5
Iceland	.4	.9	.1	.2	.3	0.7	-	0.7	- .1	+ 0.5
Ireland	.3	1.7	.3	1.7	-	-	.4	2.9	+ .1	+ 1.4
Italy	10.8	71.4	10.8	69.9	-	1.5	9.6	81.9	- 1.2	+12.0
Netherlands	26.0	211.0	35.4	267.4	9.4	56.4	23.2	191.4	-12.2	-76.0
Norway	4.2	36.9	4.2	35.5	-	1.4	1.6	18.7	- 2.6	-16.8
Austria	4.4	25.7	4.4	26.3	-	0.6	5.8	52.0	+ 1.4	+25.7
Portugal	.7	2.5	1.8	7.9	1.1	5.4	.7	6.1	- 1.1	- 1.8
Sweden	14.8	106.1	16.0	115.6	1.2	9.5	11.7	75.4	- 4.3	-40.2
Switzerland	7.1	57.2	7.3	64.6	.2	7.4	12.6	76.6	+ 5.3	+12.0
Turkey	2.8	23.6	2.8	23.3	-	0.3	4.8	38.9	+ 2.0	+15.6
Total EPU Area	129.9	889.0	176.8	1167.4	47.2	282.4	114.9	916.8	-61.9	-250.4
(excl. DOT's)					- .3	- 4.0				
U.S.	21.8	295.0	32.0	373.0	10.2	78.0	10.7	53.8	-21.3	-319.2
Rest of World	87.4	606.7	30.3	250.3	57.1	-356.4	40.1	323.2	+ 9.8	+ 72.7
Grand Total	239.1	1790.7	239.1	1790.7	+57.4	+360.4	165.7	1293.8	-73.4	-496.9

Source: Der Aussenhandel der Bundesrepublik Deutschland, Sept., 1950.

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TABLE IV  
Germany's Trade with Dependent  
Overseas Territories and Countries Clearing  
Through Major Currency Areas  
(millions of dollars)

Countries with Transit Surplus	Total Transit Trade (1)		"Normal" Transit Trade (2)		Unexplained Difference (1)-(2)	
	Sept. 1.1	Jan.-Sept. 15.7	Sept.	Jan.-Sept.	Sept.	Jan.-Sept.
Belgium						
Belgian Congo			2.5	14.2	- 1.4	1.5
France	9.4	62.4	9.4	53.7		
African franc area			-	.3		
Indo-china			-	2.3		6.1
French America						
Great Britain	24.6	124.5	7.9	46.7		
African Sterling Area			1.3	44.7		
Asian Sterling Area				.1		
Ireland				.6		
Iceland				1.5		
American sterling area				19.7	13.6	11.2
Australian sterling area						
Netherlands	9.4	56.4	6.5	40.2	2.9	14.7
Indonesia				1.5		
Neth. America				1.5		
Portugal	1.1	5.4	.9	3.7	0.2	1.7
Portuguese West Africa						
United States	10.2	78.0				
Canada			.5	4.0		
Cuba			5.9	19.0		
Mexico			-	1.2		
Rest of Latin America			5.1	39.8	- 1.3	14.0
Other EPU countries	1.6	18.0				
Totals	<u>57.4</u>	<u>360.4</u>			<u>1.6</u>	<u>18.0</u>
Source: Same as Table III					<u>18.3</u>	<u>67.2</u>

November 21, 1950

RECENT CANADIAN EXCHANGE DEVELOPMENTS

Edward Marcus

For the third time since the end of the Second World War Canada has altered the foreign exchange value of its currency. As a result of speculative capital inflows amounting to about half a billion dollars in three months, induced, in part, by rumors that the recent improvement in Canada's current position would lead to appreciation of the Canadian dollar, dealings at the former fixed rate of exchange were suspended on September 30, 1950, and since then the currency has had a fluctuating value. Immediately after the freeing of the rate, the Canadian dollar rose from US\$0.909 to about US\$0.945, around which it moved for the next two weeks. Toward the end of October the rate began to move upward, though somewhat irregularly, reaching an average of US\$0.962 in the week ended November 18. Most observers believe that the speculative capital inflow has ended, or, at least, has diminished greatly, but that the movement has not reversed to become an outflow.

Throughout the war the Canadian dollar had been pegged at US\$0.909, a nine per cent discount from its value just prior to the outbreak of hostilities. Then, in an effort to lessen the inflationary effects of the U. S. price rise, the Canadian dollar was raised to equality with the U. S. dollar over the 1946 July Fourth week-end. This change, however, tended to hurt the balance of payments on current account, particularly vis-a-vis the United States; Canadian gold and U. S. dollar holdings declined from US\$1,624 million at the end of June 1946 to US\$502 million at the end of 1947. Import controls were instituted towards the end of 1947, and holdings of gold and U. S. exchange rose, reaching US\$987 million at the end of August 1949 <sup>1/</sup>. The September 1949 devaluations in Europe prompted the Canadians to follow, their dollar then being lowered to the wartime rate. This rate was maintained until September 30, 1950.

Future Alternatives for Canada

Canada is now faced with these alternatives: to let the rate remain unpegged for a considerable period of time, or to return to a fixed value for its currency, either to the pre-September (lower) rate or to a higher (appreciated) rate.

A fluctuating rate.--The current experimental policy gives the Canadian authorities an opportunity to test the intentions of those who have been speculating on the value of the Canadian dollar. It enables them also to try out the effects, upon Canada's imports and exports of goods and services, of a moderate appreciation without commitment as to the permanence of the new rate.

<sup>1/</sup> In addition, there developed a legal market for Canadian dollars below the established par--usually at US\$0.95 equals C\$1.00--for purchases by U. S. tourists visiting Canada and for certain types of capital transfers. Cf. the (Canadian) Foreign Exchange Control Board Report for 1948, pp. 18-21.

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If speculators continue to believe that parity with the U. S. dollar is inevitable, fluctuations in the rate may cause substantial capital movements, which in turn, may come to dominate the rate. Maintenance of the current 95-97 cent level should tempt speculators to send additional funds into Canada. If the rate rose strongly toward parity, however, the reverse movement might at some stage occur as profits were realized. Since the estimated average volume of transactions in the foreign exchange market, apart from speculative capital movements, is about C\$15 million a day, while the amount of existing hot money which might move out is perhaps of the order of magnitude of C\$500 million, the potential dominance of the latter in setting the level of the Canadian dollar is quite evident; to keep the rate from depreciating again, active intervention by the Foreign Exchange Control Board would be necessary, selling U. S. dollars as speculators sold Canadian dollars. If, while speculative capital were rapidly moving out, the current account were also weakening because of the previous appreciation of the Canadian dollar <sup>1/</sup>, Canada might suffer a double drain of reserves.

On the other hand, speculators may become convinced that further appreciation is not in the cards. In this event a gradual withdrawal of hot money over a considerable period might conceivably occur. Such a withdrawal of capital, accompanied by a gradual depreciation of the Canadian dollar back toward the 90.9 cent level, would help establish the psychological groundwork necessary for a return to a fixed rate at the pre-September level. Canada might possibly retain some of the U. S. dollars it gained last summer, since the new depreciation would tend to increase the supply of foreign exchange earnings on current account. Such an improvement in the current account might, however, merely offset the adverse effects of the recent de facto establishment of a higher rate and in any event, in view of the magnitude of the potential outflow of capital, it is doubtful that more than a very small fraction of such outgoing capital could be offset by any improvement in the current account.

Revaluation upward.--An outright revaluation upward from current market levels, like a further strong appreciation of the present floating rate, would probably cause speculative capital to flow out of Canada, having realized its exchange gain, and would probably result in a weakening of the current account. This potential double drain of reserves would duplicate the 1947-49 experience, when the earlier appreciation had to be followed by import controls and then by devaluation.

Upward revaluation might tend to diminish some of the upward pressures on prices in Canada. Since so many commodity prices are set in world markets--e.g., wheat under the International Wheat Agreement--

<sup>1/</sup> For a discussion of this possibility, cf. below, pp. 6-7.

any appreciation of the currency would lower selling prices in terms of the Canadian currency. Unless the Canadian sellers could raise prices sufficiently to offset this decline 1/, appreciation would dampen recent price and income upswings **in** these exposed segments of the economy.

In considering the effects of any early reestablishment of a fixed exchange rate, the most important unknown is the reaction of the speculators whose actions induced the original capital inflow. If the rate were fixed below what they thought would be the ultimate level, a further inflow of hot money might result, requiring additional purchases of U.S. dollars by the Foreign Exchange Control Board. On the other hand, should they become convinced that the rate which had been set were the final one, an outflow of capital would occur, draining out some of the previously acquired reserves. The ultimate scale and timing of such an outflow would remain uncertain, depending on how long it took the speculators to become convinced that further appreciation was no longer a possibility.

Canada's current account balance of payments since the war

In the post-war period, as before the war, Canada had large current account surpluses with the United Kingdom and other areas, except the United States, with whom a deficit was the rule. In order to sustain exports to Europe, it was necessary for the Canadian Government to extend aid—a C\$1,250 million loan to the United Kingdom, and more than C\$500 million to other countries. In addition, off-shore purchases from Canada under the (U. S.) European Recovery Program amounted to about US\$875 million in the two calendar years 1948 and 1949. Since total exports (other than to the United States) in these last two years averaged almost C\$1,500 million, whereas imports averaged just under C\$800 million, the Canadian foreign position was highly vulnerable to unfavorable developments in Europe, such as import or exchange restrictions.

Since last year, there has been a marked improvement in the structure of the Canadian current account, in the direction of bilateral balancing. The visible deficit with the United States has been reduced, while, simultaneously, the surpluses with "soft-currency" areas have also decreased. The former overall surplus has disappeared and given place to a virtual balance. Requirements for official financing of surpluses with non-dollar countries have been reduced. The dollar position, while adversely affected by a decline in ERP off-shore purchases, seems nevertheless to have been improved.

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1/ As might be possible for newsprint and nickel, since Canada furnishes so large a proportion of world supplies.

Canadian Visible Trade Balance 1/  
(In millions of Canadian dollars; excludes gold)

	<u>With U. S.</u>	<u>With U. K.</u>	<u>With All Others</u>	<u>Total</u>
1947	-918	+564	+592	+238
1948	-284	+389	+368	+473
1949	-428	+402	+287	+261
1950 <u>2/</u>	- 95	+ 74	+ 6	- 15

Partly as a result of the improvement in the trade balance with the United States, partly because of large inflows of investment funds, rumors began to circulate that the Canadian dollar would return to a 1-to-1 ratio with the U. S. dollar. As a result, the speculative influx began, culminating in the recent freeing of the Canadian dollar.

Capital movements

Although a net capital exporter 3/ since the end of the Second World War--and, in fact, since 1932--Canada has tended to be a net capital importer from the United States.

Net Long-Term Capital Imports from the United States  
(In millions of Canadian dollars)

1946	107
1947	144
1948	130
1949	59

Through the end of 1948 most of our long-term capital went into direct investments, especially into manufacturing and petroleum refining. Including growth through retention of earnings, our direct investments rose from C\$2,304 million at the end of 1945 to C\$2,829 million at the end of 1948 (1949 data unavailable). Of this increase, C\$145 million went into wood and paper products manufacture, C\$74 million into iron manufacturing, and C\$96 million into non-metallic mineral manufacturing (probably petroleum refining). In the other direction, there was a movement of Canadian direct investment into the United States, amounting to C\$235 million from the end of 1945 to the end of 1949, practically all into commercial and industrial concerns, particularly distilleries.

1/ Includes exports of foreign goods.

2/ January-September, annual rate. For quarterly data, cf. Appendix A, Table 1.

3/ Mainly through the repatriation of foreign-held Canadian obligations.

For the four years 1946-1949 net capital inflows from the United States (small net inflows from a few other countries can be neglected) were less than 10 per cent (C\$440 million) of the C\$4,638 million net domestic investment.

With the rest of the world, particularly the United Kingdom, Canada was a net capital exporter mainly through intergovernmental aid and debt repatriation.

Canadian Long-Term Capital Account  
(Outflow -; Inflow +) (In millions of Canadian dollars)

	<u>1946</u>	<u>1947</u>	<u>1948</u>	<u>1949</u>
Canadian Government Aid to Other Countries <sup>1/</sup>	-758	-557	-126	-107
Net New Issues (+) or Retirements (-) of Canadian Securities	-315	-275	+ 37	- 42
Net Sales (+) or Purchases (-) of Outstanding Securities	+214	- 4	- 17	+ 22
Other Long-Term Capital Movements <sup>2/</sup>	+129	- 58	+146	+ 84
Total Long-Term Capital Outflow (-) or Inflow (+)	+730	-894	+ 40	- 43

Recent capital flows.--During the three months July-September 1950, the capital inflow from the United States increased greatly, as a strengthened current account position gave rise to rumors of an upward revaluation of the Canadian dollar. Reported official Canadian holdings of gold and U. S. dollars rose from US\$1,255 million at the end of June to US\$1,789 million <sup>3/</sup> at the end of September, of which US\$285 million came in September. Thus, something like half a billion dollars U. S. capital entered the country during the quarter, or more than in all the four post-war years. The forms this movement took are discussed in Appendix B.

Outlook for the Canadian current account

For the next twelve months (October 1950-September 1951), it seems probable that Canada will have an over-all current account deficit of about C\$200 million, compared with surpluses in 1948 and 1949. In line

<sup>1/</sup> Includes export credits.

<sup>2/</sup> Includes changes in the external short-term assets of Canadian commercial banks.

<sup>3/</sup> Excludes US\$50 million borrowed in New York in September and US\$50 million set aside from reserves to redeem a Dominion issue due October 1st.

with recent trends, the surpluses with non-dollar areas will be diminished, while the deficit with the U. S. is expected to remain below both 1948 and 1949. The U. S. deficit, however, is not likely to fall below the level reached in the first three quarters of 1950. This forecast is made on the assumption that import controls will be ended 1/.

The estimates, details of which are shown in Appendix A, are based on the pre-September exchange rate of C\$1.00 = US\$0.909. This is not to be understood as a prediction of the expected rate, and, in fact, the rate has been 4-6 cents higher in October and November. Since the ultimate level is still indeterminate, and since the impact of United States and Canadian rearmament programs on availability of supplies, as well as the repercussions on the price level, cannot as yet be estimated with even reasonable accuracy, the hypothetical balance of payments given in the Appendix must be accepted only with these various qualifications. Any marked change as a result of these uncertainties may alter the actual trade figures materially.

Should the Canadian dollar remain long at its present level or settle at a higher rate, the current account balance might be more unfavorable than indicated by a projection based on the pre-September rate. The higher rate, and thus the higher cost of Canadian goods to foreigners, would tend to hurt exports, especially since competitor nations would not be raising the external value of their currency. At the same time, the Canadian dollar price of imports would be less, thus leading to replacement of domestic products by imports; an elasticity of demand for imports greater than one would increase the Canadian dollar value of imports.

A clue to the possible effects on imports can be obtained from the July 1946 revaluation. During the six months January-June 1946 imports from the United States were the same as in the first half of 1945. In the second six months (following the appreciation of the Canadian currency), they rose almost 30 per cent, whereas during the second half of 1945 they had dropped 5 per cent. As a result, the Canadian dollar value of imports for the year August 1946-July 1947 exceeded that of the previous corresponding year by 50 per cent. Of course part of the rise was attributable to increased availability of supplies and rising U. S. prices following the end of OPA.

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1/ In his statement of September 30, 1950, the Minister of Finance indicated that import restrictions on other than capital goods will have been removed by January 2, 1951, restrictions on tourist spending abroad would be relaxed immediately, and that restrictions on capital goods would probably be relaxed, too.

Since most prices are set in the United States (and other world) markets, it might be thought that a given volume of Canadian exports would have a constant value in U. S. dollars, any upward revaluation of the Canadian dollar lowering internal prices. On the other hand, recent price increases in the Canadian newsprint industry indicate that the U. S. dollar price of leading Canadian exports would be raised to prevent a drop in domestic prices, the current tightness in world (and particularly U. S.) markets permitting such action. Hence, for these commodities, it would be more correct to predict a constant Canadian dollar value for a given volume of exports and an increased U. S. dollar value.

On balance, we can expect some rise in the Canadian dollar value of imports as a result of appreciation, and either a fall, or at best, no change in the Canadian dollar value of Canada's exports. Hence the conclusion that the appreciation which has already occurred may, if maintained or allowed to go further, result in a current account balance more unfavorable than that indicated by a projection based on the pre-September rate.

Over the long-run the current account should strengthen. Petroleum developments in the Province of Alberta and titanium and iron ore in Quebec and Labrador <sup>1/</sup> should improve the visible trade position, as domestic production replaces imports, and perhaps, yields exportable surpluses <sup>2/</sup>. Most estimates for the next five years foresee at best, a 50 per cent reduction in petroleum imports--a savings from 1949 of C\$125 million, plus a C\$50 million iron ore export. Thus, for several years ahead, the Canadian current account will be unlikely to show a large surplus.

The state of the current account cannot be taken as the only indicator of the position of the Canadian dollar, since capital movements are also an influence. A diminution in Canadian Government aid to Europe plus the recently increased inflow of U. S. direct investment funds into iron ore mining and petroleum refining might well result in an over-all net capital inflow, and offset the current account deficit. The ending of Canadian Government aid and an increase in the net inflow of private long-term capital to about C\$200 million (as compared with C\$64 million in 1949 and C\$166 million in 1948) would be necessary to balance the total account without a fall in official holdings of gold and dollars.

#### Canadian foreign exchange policy

According to the official announcement, the reasons for freeing the exchange, as a result of the recent speculative capital inflows, were: (i) "An influx of funds on this tremendous scale would, if it continued, be likely to exercise an inflationary influence...", (ii) "...the accumulation of foreign exchange as a result of

<sup>1/</sup> Much of this year's inflow of U. S. capital has been for these developments.

<sup>2/</sup> Although, as a partial offset, interest and dividends paid to foreigners would rise.

this inflow<sup>7</sup> ...would mean that Canada was in effect incurring a substantial increase in its gross foreign debt and annual service charges without any corresponding increase in its productive resources or ability to export." <sup>1/</sup>

This statement raises two questions: (1) how serious a consideration, in the decision to let the rate go, was the increase in Canada's annual service charges? (2) could the inflationary influence of the influx of capital have been neutralized without disturbing the foreign exchange rate?

The objection to adding to debt costs could hardly have been paramount in determining the final policy. Thus, Dominion long-term yields in the third quarter averaged 2-3/4 per cent. If foreigners purchased high-grade Canadian securities in order to get funds into Canada the net annual addition to Canadian interest charges on an inflow of C\$500 million would be less than C\$14 million, which is less than 1 per cent of Canada's current account debits. If foreigners bought higher-yield securities the cost might be somewhat more; but if they took interest-bearing deposits or advances to affiliated Canadian companies the cost might be less. It is difficult to believe, therefore, that this balance of payments consideration was influential.

If the Canadian authorities had not wished to disturb the foreign exchange rate in order to combat the effects of the inflow they could have resorted to large-scale open-market sales of securities during the period of heavy inflow--in fact this was probably done. (For a discussion of the available information on this see Appendix B.) An alternative means of sterilization might have been to raise the banks' reserve requirements sufficiently to neutralize any expansionary effects from the inflow. This would have required Parliamentary legislation, but, in view of the present administration's large majority, that would not have been an obstacle. The Canadian banking system is highly concentrated, so that such a change could have been effected quite easily, the individual banks tending to maintain quite comparable positions; the difficulties that the United States faces, because of its unit banking system, would not be a problem. The desirability, however, of using so drastic an instrument for a temporary need may be questioned. Still another possibility was the reimposition of more stringent controls over the trade in outstanding securities, the main destination of speculative capital <sup>2/</sup>. Legitimate long-term investment, direct or via the purchase of new security **issues**, would have been unaffected. Since the pressure has been to get capital into Canada, any "leaks" in the controls would mean that some capital came in through uncontrolled channels; this part could

<sup>1/</sup> Since this statement is somewhat ambiguous, the reader is referred to Appendix B for clarification.

<sup>2/</sup> Article VI, Section 3 of the International Monetary Fund Agreement permits such intervention.

be sterilized easily. Such controls over speculative capital would not be a retreat from multilateralism, since all "legitimate" movements would be untouched. Moreover, the main objections to controls are the possibility of evasion in order to export capital and the use of controls to sustain an unrealistic foreign exchange rate above its "free" value; these objections would obviously have been inapplicable in the Canadian case.

It is clear that alternative courses of action might have been found to prevent the inflationary consequences of a speculative inflow of capital. One must therefore look beyond the official announcement for the underlying reasons for the decision to free the rate. It is impossible to say whether the rate was freed in the expectation that a permanent appreciation of the Canadian dollar would result, or whether the Canadian authorities, in allowing the rate to fluctuate, aimed not only to stop the speculative flow but to reverse it and, if possible, to discourage such movements in the future.

Appreciation would of course tend to lessen the internal price rise as a result of the upward movement in the United States, while Canadian prestige would be enhanced the closer the Canadian dollar came to parity with the U. S. dollar. On the other hand, appreciation involves a danger of impairment of the current account balance of payments.

The possible effects of a floating rate upon speculative capital movements have been discussed in an earlier part of this paper. It is too early to forecast the actual outcome.

APPENDIX A

CANADIAN CURRENT ACCOUNT PROJECTION, OCTOBER 1950 - SEPTEMBER 1951  
(ASSUMING EXCHANGE RATE OF C\$1.00 = U.S. \$0.909)

Table 1  
Canadian Visible Trade - Annual Rates by Quarters 1/  
(In Billions of Canadian Dollars)

Period	With U. S.		With U.K.		With All Others		Total	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
1947 - I	0.9	1.8	0.6	0.2	0.9	0.2	2.4	2.2
II	1.0	2.2	0.8	0.2	1.1	0.4	2.9	2.8
III	1.0	1.9	0.8	0.2	0.9	0.5	2.7	2.6
IV	1.2	2.0	0.8	0.2	1.1	0.5	3.1	2.7
Year	(1.1)	(2.0)	(0.8)	(0.2)	(0.9)	(0.4)	(2.8)	(2.6)
1948 - I	1.2	1.7	0.7	0.2	0.8	0.4	2.7	2.3
II	1.3	1.8	0.7	0.3	0.9	0.6	2.9	2.7
III	1.6	1.8	0.6	0.3	0.8	0.5	3.0	2.6
IV	1.9	1.9	0.7	0.3	1.1	0.7	3.7	2.9
Year	(1.5)	(1.8)	(0.7)	(0.3)	(0.9)	(0.5)	(3.1)	(2.6)
1949 - I	1.4	1.9	0.6	0.3	0.7	0.5	2.7	2.7
II	1.4	2.1	0.8	0.3	0.9	0.6	3.1	3.0
III	1.3	1.8	0.8	0.3	0.8	0.6	2.9	2.7
IV	1.9	1.9	0.7	0.3	0.8	0.5	3.4	2.7
Year	(1.5)	(2.0)	(0.7)	(0.3)	(0.8)	(0.5)	(3.0)	(2.8)
1950 - I	1.7	1.8	0.4	0.3	0.5	0.5	2.6	2.6
II	2.0	2.2	0.5	0.4	0.7	0.6	3.2	3.2
III	2.1	2.1	0.4	0.4	0.7	0.7	3.2	3.2
1950-51 Projection	2.3	2.3	0.5	0.4	0.6	0.7	3.4	3.4

1/ Exports include re-exports of foreign goods. Excludes gold.

APPENDIX ACANADIAN CURRENT ACCOUNT PROJECTION, OCTOBER 1950 - SEPTEMBER 1951  
(ASSUMING EXCHANGE RATE OF C\$1.00 = U.S. \$0.909)

Table 2  
Canadian Current Account  
(In Millions of Canadian Dollars)

	<u>1948</u>	<u>1949</u>	<u>Projection</u> <u>1950-51</u>
U.S.- Credits	2247	2261	3125
Debits	2640	2855	3350
Balance	-393	-594	-225
U.K.- Credits	922	890	600
Debits	436	447	550
Balance	+486	+443	+ 50
Other- Credits	978	919	700
Debits	619	588	725
Balance	+359	+331	- 25
Total- Credits	4147	4070	4425
Debits	3695	3890	4625
Balance	+452	+180	-200

APPENDIX A

CANADIAN CURRENT ACCOUNT PROJECTION, OCTOBER 1950 - SEPTEMBER 1951  
(ASSUMING EXCHANGE RATE OF C\$1.00 = U.S. \$0.909)

Table 3

Canada

Projected Balance of Payments

October 1950 - September 1951

(In Millions of Canadian Dollars)

	<u>U.S.</u>	<u>U.K.</u>	<u>Other</u>	<u>All</u>
1. Exports	2300	475	575	3350
2. Gold	150	-	-	150
3. Tourism	275	Neg.	Neg.	275
4. Interest and Dividends	50	Neg.	25	75
5. Freight and Shipping	175	50	75	300
6. All other Current Credits	175	75	25	275
7. Imports	2325	375	650	3350
8. Tourism	175	25	Neg.	200
9. Interest and Dividends	350	50	Neg.	400
10. Freight and Shipping	225	50	25	300
11. All other Current Debits	275	50	50	375
Total: Current Credits	3125	600	700	4425
Current Debits	3350	550	725	4625
Current Balance	-225	+ 50	- 25	-200

Note: All estimates are rounded to the nearest C\$25 million.

Discussion of Table 3

1. The leading Canadian exports to the United States are non-ferrous metals (mainly aluminum, copper, lead, nickel, and zinc); pulpwood, wood pulp, and newsprint; lumber and lumber products; and food products (cattle, fish, and meat). Based on U. S. consumption trends and the expected level of industrial production for the next year, it is assumed that the physical volumes will rise somewhat over the January-August monthly rate. In view of the concentration of armament orders on U. S. metal industries, the monthly volume of non-ferrous metal exports to this country is projected at 20 per cent above the first eight months. All other exports are increased 5 per cent, except lumber, which is projected at an unchanged average level in view of the recent restrictions on construction in the United States, plus the fact that the first eight months (actual) shipments included a seasonally higher period than for the year as a whole. In line with the recent agreement with the United States C\$100 million rearmament orders were then added to the total.

The resulting volume figures are then adjusted for price changes. It is assumed that the next twelve months would see the average price level at about that ruling in September 1950. Hence, the January-August values were adjusted by the excess of September 1950 prices for each major category over the average for the first eight months of this year.

Estimated Canadian Exports to the United States (October 1950-1951)  
(In Millions of Canadian Dollars)

Non-ferrous Metals	333
Pulp and Paper	720
Lumber and Its Products	241
Selected Food Products	425
All Other	<u>581</u>
Total	2300

In line with the recent agreement with the United States, an estimate of C\$100 million sales to that country has been added and is included in the "All Other" exports.

Exports to the United Kingdom and "Others" are assumed to remain at the rate for January-August 1950.

2. Gold production during the first seven months of 1950 exceeded the corresponding period of 1949 by 12.0 per cent. It is assumed that net gold production 1/ in 1950-51 will be 12 per cent above net gold

1/ After deducting the proportion used for domestic arts and industry.

production in the full year 1949. With gold valued at C\$38.50 per ounce, this yields an estimated value for 1950-1951 of C\$157 million available for export.

(The rates of bonus paid to gold mines have been changed twice during 1950 and will be changed again at the beginning of 1951. Following the September 1949 devaluation the bonus was reduced at the beginning of 1950. On October 1, following the freeing of the rate, the bonus was restored to the pre-devaluation rates. Changes in the formula for setting bonuses to go into effect in 1951 will make the bonus amounts intermediate between those paid before September 1949 when the price of gold was C\$35, and those paid in January-September 1950 when it was C\$38.50. If it is assumed that bonus rates will be adjusted to future changes in the value of the Canadian dollar, it may be assumed that projections of Canadian gold production, in ounces or in U. S. dollars, would be the same at any exchange rate. In Canadian dollars, however, the sale value would be lower at a rate above \$0.909.)

3. January-August 1950 entries into Canada of foreign (practically all U. S.) autos exceeded January-August 1949 by 3.2 per cent. This increase is applied to 1949 U. S. tourist expenditures in Canada. Earnings from other areas are assumed unchanged.

(It is difficult to assess the influence on tourist expenditures of a change in the external rate of the Canadian dollar--either that of September 1949 or the recent one. Thus, it could be argued that a higher Canadian dollar rate would cut foreigners' expenditures, since in terms of their own currency prices are higher. On the other hand, 10 per cent is not a great addition; the average U. S. tourist spent less than C\$150, so that a 10 per cent shift alters his total cost by but US\$15. Moreover, since his major spending is on room and food, he is probably more inclined to accept whatever the prevailing price is, rather than seek to economize, to offset a currency shift. Hence, it is assumed that the expenditures in Canadian dollars would be unaffected by currency changes of the past two years' magnitude.)

For tourists from other than the United States, it is assumed that exchange restrictions will not permit an increase, nor force a decrease, in travel.

4. Total dividends paid by U. S. corporations for the first eight months of 1950 rose 6.7 per cent over the comparable period for 1949. It is assumed that Canadian dividend receipts in 1950-51 will be 6.7 per cent higher (in U. S. dollars) than in 1949. The valuation in Canadian dollars takes account of the 10 per cent depreciation in September 1949. Interest receipts are raised over 1949 only to correct for the exchange rate change of September 1949. The proportion of total Canadian

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holdings of U. S. securities invested in fixed-interest obligations is estimated at 10 per cent, and the adjustments of the 1949 dividends and interest receipts are allocated accordingly. Receipts from other areas are assumed the same as for 1949.

5. The 1949 proportion of freight and shipping earnings with each area to the exports to that area is used in calculating the 1950-51 estimate.

6. As for 1949.

7. In estimating imports for the next twelve months, several unknowns must be established, since the assumptions regarding them will be the major determinants of the projected volume of trade. The main uncertainties concern; (i) the availability of supplies, as a result of rearmament in the United States and abroad; (ii) the effect of the proposed removal of Canadian import restrictions; (iii) the effect of Canadian rearmament on domestic spending, as modified by the recent increases in internal taxation.

Imports from the United States may be divided into two groups: capital goods and all others. The Canadian import classification "Iron and Its Products" is selected as representative of the former, since it covers almost all capital and consumers' durable goods. Including recent increases as a result of post-Korean rearmament, it is estimated that gross investment within Canada in 1950-51 will rise about 7 per cent over 1949 <sup>1/</sup>. Imports of iron and iron products from the United States are accordingly estimated at 7 per cent over the post-devaluation eleven months (October 1949-August 1950) (adjusted to an annual rate). This implies that the ratio of such imports from the U. S. to gross investment (excluding inventories) will be only 27 per cent, compared with 30-35 per cent prior to the imposition of import restrictions in 1947. Implicitly assumed is the expectation that the removal of import restrictions, which would tend to raise the proportion of capital goods imports to Canadian home investment would be offset, in the case of imports from the U. S., by the substitution of either home-produced or competing foreign items as a result of the 1949 devaluations <sup>2/</sup> and by the shortages of U. S. supplies resulting from rearmament.

Because of import restrictions, the ratio of "other imports" from the United States to Canadian personal consumption dropped from 13.7 per cent in 1947 to 10.8 per cent in 1948 and 1949. The expected

<sup>1/</sup> Cf. the Hon. Douglas Abbott (Minister of Finance), Budget Speech, September 7, 1950, House of Commons Debates (3rd Session, 21st Parliament, vol. 91, no. 9), pp. 418, 419-420.

<sup>2/</sup> Actually, the only marked shift within the iron products category since September 1949 has been a rise in imports of automobiles valued under C\$1200, British supplies rising from C\$15 million for January--August 1949 to C\$44 million for January-August 1950. This item has been omitted from the capital goods import estimate.

removal of such restrictions would tend to raise the ratio back toward the 1947 figure, unless offset by supply shortages in the U. S. or by the purchase of competing foreign and Canadian-produced items. Because of these latter qualifying factors, it is assumed that the rise in other imports from the United States over the October 1949-August 1950 average would be only 15 per cent. This is only about half the increase which would be needed to restore the 1947 ratio of other imports to Canadian personal consumption.

Imports from the United States  
(In millions of Canadian dollars)

	<u>Projected</u>	<u>October 1949-August 1950 (annual rate)</u>
Iron and Its Products	823	767
All other	<u>1402</u>	<u>1220</u>
Total	2225	1987

In line with the recent agreement with the United States, an estimate of C\$100 million purchases in that country has been added to the import estimate, making the total C\$2325 million.

For imports from other areas, the January-September 1950 rate is assumed to continue. However, in view of the sharp increases since June in raw materials prices, imports from other than the United States and United Kingdom are increased about 20 per cent or C\$100 million.

8. 1949 figures are raised by 10 per cent, the January-July 1950 increase over January-July 1949 for "returning Canadian autos." It is assumed that tourist travel with all other areas will rise in the same proportion as travel with the United States. Cf. the remarks under (3) regarding the influence of exchange variations on tourist spending. However, since the restrictions on Canadian tourist travel have been relaxed, this item might rise even more than estimated.

9. The slight rise in total Canadian dividends paid out during January-September 1950 compared with January-September 1949 (up one per cent), the higher Canadian dollar cost since September 1949 of foreign-held bonds whose interest is payable in U. S. dollars, and the added cost of servicing recent capital inflows, are assumed to raise payments to U. S. by C\$25 million over 1949, while leaving payments to other areas unchanged.

10. As for (5).

11. As for 1949.

APPENDIX B

THE STERILIZATION MECHANISM

Since the Canadian Foreign Exchange Control Board does not publish sufficiently detailed reports, the nature of the sterilization operation--and, indeed, its very existence--must be deduced from regularly published banking and fiscal statistics. The description discussed in this appendix is simply the inference drawn by the writer; to the best of his knowledge, no adequate published explanation is available.

The increase in the third quarter of 1950 in Canadian official holdings of gold and U. S. dollars was as follows:

<u>During Months of</u>	<u>US\$ Million</u>
July	65
August	184
September	335 <u>1/</u>

Much of this rise can be attributed to the capital inflow, particularly from the United States.

Converted to Canadian dollars, the net addition to official reserves (adjusted to include the amount set aside to meet an October maturity) was C\$642 million. That is, the government, through the Foreign Exchange Control Board, acquired that amount of gold and U. S. dollars, and, in turn, had to supply an equal amount of Canadian dollars. This was apparently done as follows:

Net increase in Dominion debt outstanding	C\$117 million <u>2/</u>
Reduction in Dominion deposits at the Bank of Canada and the chartered banks	159
Sale of foreign exchange by the Foreign Exchange Control Board to the Bank of Canada	293
Government excess of revenues	<u>71</u> <u>3/</u>
Total	C\$640

1/ Adjusted to include U.S.\$50 million set aside from reserves to redeem a Dominion issue due October 1st, but excludes an additional US\$50 million borrowed in New York for this purpose.

2/ Includes an issue of C\$200 million Deposit Certificates to the chartered banks. Adjusted to exclude US\$50 million issue. Also see comments in text.

3/ C\$83 million in excess of revenues less C\$12 million increase in loans to and investments in Crown agencies, foreign governments, etc.

It should be noted that the figure of debt increase selected for this analysis may be in error; the October 1950 Bank of Canada Statistical Summary furnishes two different compilations, one based on issues and retirements and the other giving distribution of debt by class of holder. There are certain other differences in the compositions of the two figures, which still differ by C\$31 million when adjusted so far as possible. It should also be noted that balance sheets of the Bank of Canada and the chartered banks indicate a substantially smaller reduction of Dominion deposits than the government figure used in this analysis.

An issue of Deposit Certificates to the chartered banks sterilized C\$200 million of the capital inflow (the alternative being borrowing from or sales of exchange to the Bank of Canada). The Bank of Canada financing (C\$293 million) and the reduction in government deposits at the Bank of Canada (C\$13 million according to Bank of Canada statements) would tend to expand chartered bank reserves, unless offset. Most of the increase was neutralized by the Bank of Canada: by open-market sales of Dominion securities (C\$208 million), by a rise in other deposits (C\$42 million), and by a rise in other (net) assets (C\$2 million). These three items amount to a neutralization of C\$252 million. The remaining C\$54 million did expand the credit base—there were rises in the note issue (C\$43 million, including C\$25 million held by chartered banks) and in chartered bank deposits at the Bank of Canada (C\$11 million).

During these three months estimated non-resident holdings of Canadian currency and bank deposits rose C\$126 million <sup>1/</sup>; since currency in circulation (outside the banks) rose but C\$18 million, most of this increase must have been in bank deposits. An additional C\$190 million non-resident capital went into Dominion securities, according to reports compiled by the Bank of Canada <sup>1/</sup>. (The chartered banks may have been sellers in addition to the Bank of Canada; their holdings of Dominion securities declined C\$69 million, apart from deposit certificates; while the Dominion debt outstanding, other than Deposit Certificates, decreased either C\$83 million or C\$114 million.) <sup>2/</sup> Other possible forms of investment by non-residents were purchases of outstanding securities of other Canadian governments and direct investments in affiliates or trading partners. Evidently these latter forms of investment were of substantial importance.

<sup>1/</sup> Bank of Canada Statistical Summary, October 1950, p. 159. "Non-resident", of course, includes more than just the United States; however, it is doubtful that much capital came in from other areas.

<sup>2/</sup> Excluding the US\$50 million issue in New York.