L.5.2 RFD 365

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

October 3, 1961

Changes in Canadian Financial Policies
1961-62 11 pages

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Over the last eighteen months, the Canadian scene has been characterized by high unemployment and growing controversy over appropriate government policies to alleviate the nation's economic ills. Yet the Canadian authorities did hot take strong measures to attack these economic difficulties until June 1961, after some signs of recovery had already appeared. Failure to initiate strong corrective measures earlier in the recessionary period appears to have been due largely to a difference of opinion between the Minister of Finance and the Governor of the Bank of Canada regarding appropriate government policies. In his budget speech on June 20, the Minister criticized the policies of the Governor of the Bank and introduced a series of measures designed to accelerate business recovery. These new measures went far beyond minor changes in the tax or spending program and included monetary and other policies opposed by the Governor. Open contraversy followed and the Governor resigned late in July.

Prior to the presentation of the budget for 1961-62, the Canadian authorities made only minor use of fiscal or monetary measures to overcome the recession which began early in 1960. In March 1960, the Finance Minister proposed a small budget surplus for the fiscal year beginning April 1, 1960, even though seasonally-adjusted unemployment then amounted to over 6-1/2 per cent of the labor force and was about one percentage point above the level of September 1959. With first quarter gross national product at an all-time high, the Minister indicated ". . . that employment will rise as the coming of spring opens up new job opportunities and as the economy continues its upward trend." Although the monetary authorities permitted a rapid decline in interest rates, conditions continued to deteriorate and by mid-year unemployment exceeded 7 per cent. Despite further growth in unemployment, the downward movement in interest rates was reversed in September and rates rose sharply through the following months. By the end of the year, unemployment reached 7.9 per cent of the labor force and industrial production was down 4 per cent from January highs.

On December 20, the Prime Minister called a special emergency secession of Parliament to deal with the recession. However, the fiscal measures intorduced by the Finance Minister at this session did little to stimulate employment and production. A revised estimate of the 1960-61 budget (ending March 31, 1961) showed a $286 million deficit instead of the $12 million surplus originally expected. Lower tax revenues due to reduced levels of economic activity was the major cause of this deficit. The Finance Minister made only minor changes in taxes to encourage domestic investment and to curtail borrowing abroad, and introduced some measures designed to help alleviate longer run structural problems. Although interest rates were permitted to decline somewhat at the turn of the year, they remained well above the 1960 lows, while employment and output continued to lag.

On June 20, 1961, after some recovery had already appeared, the Finance Minister introduced a general program designed to stimulate economic activity. Even though industrial production rose 2 per cent and unemployment declined to 7.6 per cent of the labor force in April-May, the Minister indicated that recovery would be slow without further action. The program he introduced included a large budget deficit and a number of other measures to lower Canadian interest rates as well as the exchange rate. Since the Governor of the Bank was thought to oppose these measures, the Finance Minister requested his resignation before the program was presented. In late July, after presenting his views to the Senate, the Governor resigned.

Over-all budget and cash position

The Finance Minister expects an over-all budget deficit of $1 billion for the fiscal year beginning April 1, 1961, compared with $294 million last year. The increase int he deficit is due in large part to the built-in flexibility of the tax system which leaves reserves far short of expenditures at existing reduced levels of economic activity. New cash requirements will be over three times last year's requirements, and some $500 million of bonds are due to mature later in the fiscal year.

Budget 1961-62--- In his budget speech, the Minister indicated that he considered a sizable budget deficit both appropriate and desirable to stimulate economic activity. However, the budget includes no new expenditure plans, few specific measures to alleviate unemployment, and only minor adjustments in tax rates. While the 7-1/2 per cent rise in budgetary expenditures will result in an expansionary cash impact, this increase represents only the current cost of commitments already incurred under previous expdnditure programs. Total revenues are expected to be up only about 2-1/2 per cent over last fiscal year and to be in balance with expenditures by the end of 1962. This increase in revenues assumes some rise in economic activity later in the year, spurred by the Government's expansionary measures. Reductions in certain tax rates will reduce revenues by about $100 million in the full year and about $65 million in the current fiscal year. The principal items in the new budget are summarized in Table 1.

Table 1

Canadian Budget, 1959-60 through 1961-62
(In millions of Canadian dollars)

	1959-60	1960-61	1961-62
Budgetary transactions			
Expenditures			
Defense	1,533	1,539	1,649
Civil	3,651	3,884	4,212
Payments, subsidies to provinces	519	538	554
Total	5,703	5,961	6,415
Revenue			
Income taxes	2,871	3,076	3,130
Estate taxes	88	85	90
All other taxes	1,793	1,855	1,930
Non-tax revenue	538	600	615
Total	5,290	5,616	5,765
Deficit (-)	- 413	- 345	- 650
Non-budgetary transactions			
Net loans, investments, and advances	793	639	585
Net receipts	831	690	255
Surplus (+) Deficit (-)	+ 38	+ 51	- 330
Net cash requirements	375	294	980

Changes in the structure and rates of excise taxes will reduce revenues by about $66 million in a full year and $55 million in the fiscal year 1961-62. The only major change in this respect is the elimination of the 7-1/2 per cent excise tax on new passenger cars to encourage automobile sales.

Revenues from income taxes will be reduced about $10 million in the current fiscal year and $35 million in a full year, as a result of new measures designed to encourage improvement of plant and equipment and increase research activities in Canada by both business enterprise and private foundations.

To encourage re-equipment and modernization of machinery and equipment, rates of capital depreciation allowances in the first year of the expenditure are to be increased by 50 per cent. This provision applies to new depreciable assets purchased in any tax year between now and March 30, 1963, which are in excess of similar asset purchases the previous year or the average of the last three fiscal periods. The new provision also applies to new companies and new operations.

To stimulate scientific research in Canada, two new measures are being introduced to become effective in the current tax year. One permits the full write-off in the year incurred, of expenditures on research in Canada which are of a capital nature. Another permits both individual and corporate taxpayers to deduct from their earned income, any amounts paid to foundations established for the purpose of scientific research in Canada.

Cash requirements -- New cash requirements together with refinancing of maturing bonds are expected to put a heavy burden on security markets at a time when the authorities wish to hold interest rates down, have domestic investment expand, and discourage borrowing abroad. New cash requirements are expected to be about $1 billion during the current fiscal year. The issue of $200 million of short-term bonds in late July reduced these requirements somewhat, but the need still exists to raise about $800 million between now and next March 31. Because of advance refinancing in the form of frequent issues of short-term bonds beginning last November, the authorities substantially reduced the burden of refinancing in the current year. Of the $1.6 billion of Canadian securities which were to mature in fiscal year 1961-62, over $1 billion has already been refinanced. Another $499.5 million of securities will mature late this fiscal year as follows:

$446.0	million December 1961
53.5	million February 1962
$499.5	million

To meet these needs, for new cash and for refinancing, the authorities will be expected to offer over $1.3 billion of government bonds during the next six months of the fiscal year.

Changes in debt management practices

The Minister of Finance introduced a number of changes in debt-management practices as an integral part of his program. These measures are designed to reduce some of the market uncertainties which contributed to rising rates late last year. He proposed the following three steps:

(1) Short- and medium-term Government borrowing -- To avoid congestion in the long-term market, the Government's new issues will be confined to shorter maturities, at least for the next several months. Longer-term funds will be left free to meet the needs of the non-Government sector. This policy was actually instituted late last year after the poor reception given the Canadian National Railway issue, which consisted largely of long-term securities. The Minister announced at that time that shorter maturities would be issued at more frequent intervals. With the average maturity of outstanding government securities currently at 9 years, compared with about 4-1/2 years in the United States, there is ample room for a continuation of this policy.

(2) Unemployment Insurance Fund holdings -- To eliminate market fears of large sales of securities by the Unemployment Insurance Fund in order to make unemployment payments, the Treasury will take over the entire portfolio of marketable securities and replace them with nonmarketable interest-bearing securities. With rising unemployment, total holdings of the Fund declined about $200 million from December 1959 to March 1961. The shift of the Fund's resources into nonmarketable securities is expected to remove the threat of any sudden dumping on the market of the $245 million of the medium- and long-term bonds held by the Fund.

(3) Purchase Fund -- A Purchase Fund will be established for the orderly retirement of public debt. This fund will be in addition to the existing Government Securities Investment Account which, from time to time, has purchased near-maturing government securities. According to the Minister, while the Securities Investment Account served a useful purpose, it did not provide for ". . . the regular flow of funds which is necessary for any steady retirement of debt." The new fund will have an initial capital of $100 million to be used over the next 12 months for the purchase of medium- and long-term Government of Canada securities. Details concerning the operation of the Purchase Fund are to be announced later.

Industrial Development Bank

In his budget message, the Minister also announced intentions to introduce a separate bill to expand the resources and the responsibilities of the Industrial Development Bank. The Bank's assistance is to be broadened to include all Canadian business enterprises without previous restrictions as to certain specified types of businesses. Moreover, increased use is to be made of its powers to purchase equity shares of eligible enterprises and to enter into underwriting agreements. To meet these broader requirements, the resources of the IDB will be increased from $160 million to $400 million. It is expected that this expansion of the IDB facilities will not only promote expansion of many medium sized firms, but will also decrease the foreign absorption of family enterprises which find difficulty in raising required funds to meet capital expansion needs.

Federal-Provincial tax sharing

One other change in the fiscal program, which will not go into effect until fiscal year 1962-63, concerns the method of providing revenues for the Provincial Governments. The existing system of tax sharing will be discontinued and replaced by a system which gives more responsibility to the individual provinces to raise required funds. The main proposals, which grew out of a series of conferences with the provinces in the last year, are that (1) the provinces should impose their own taxes and (2) a fairer, more realistic system of equalization should be imposed to preserve reasonable equality of services across the country.

Federal Government tax rates on income taxes and estate taxes will be reduced to permit the provinces to raise revenues from these sources. The reduction of rates on income taxes will reduce Federal revenues by about $300 million next year. In order to spare the provinces the expense of setting up separate tax collection machinery and also to avoid dual tax systems, the Federal Government is prepared to collect personal and corporate income taxes for the provinces at no charge. However, if Federal Government machinery is to be used for this purpose, the rates must be set by the provinces and calculated on the federal base. In regard to estate taxes, the Government has offered to share with the provinces 50 per cent of the tax revenues it collects from this source, or permit a maximum deduction of an equivalent amount in federal collections for provinces levying their own estate tax.

Interest rates and exchange rates

The Minister announced that measures would be taken to reduce interest rates and to lower the value of the Canadian dollar. He considered the high interest rates during the recessionary period to be a "double drag" on the economy. First, they tend to discourage domestic investment expenditures. Second, they encourage capital inflows which raises the value of the Canadian dollar and thus has an adverse effect on employment. Instead of using direct controls or export subsidies to accomplish these ends, the authorities will depend upon monetary measures and debt management operations to bring interest rates down. In addition, direct intervention will be used to lower the exchange rate immediately.

Interest rates -- During the 9 month period ending June 1961, relatively high interest rates accompanied high levels of unemployment. In mid-September, with unemployment over 7 per cent interest rates moved sharply upward. During the September-December period, short-term rates on government securities rose over two percentage points while yields on longer-term government securities rose over 50 basis points. At the end of the year, the 3-month Treasury bill rose to almost 4 per cent; at this level, it was over 1.5 per cent above yields on the U.S. 3-month Treasury bill compared with almost 1 per cent below in mid-September. Securities with maturities of 10 years and over were yielding over 5 per cent at the end of the year, and the spread over similar securities in the U.S. widened further. At the turn of the year, Canadian yields declined somewhat, but remained well above yields in the United States, and well above the lows of 1960. The following table compares yield changes in Canada and the United States for two comparable government securities:

		Treasury bill		20-year bond	
		Canada	Spread over U. S.	Canada	Spread over U. S.
1960	September 22	1.68	- 0.82	4.66	+ 0.92
	December 1	3.95	+ 1.62	5.17	+ 1.25
1961	January 5	3.34	+ 1.07	5.19	+ 1.37
	June 1	3.14	+ 0.77	5.15	+ 1.36
	June 21	2.55	+ 0.24	4.87	+ 0.93
	September 6	2.31	+ 0.01	4.90	+ 0.85

In late June, following the announced policy of reducing interest rates, yields on Canadian securities dropped sharply and moved significantly closer to United States yields. By the end of June, the 3-month bill was down 59 basis points to 2.55 per cent and the spread over the U.S. yield was reduced to about 1/4 per cent compared with about 3/4 per cent in early June. A further yield reduction in July eliminated this differential. Yields on longer maturities also declined in late June and again in August. By early September, long-term yields were below 5 per cent and there was a significant reduction in the spread over comparable U.S. securities.

Exchange rate, capital flows, and the current account -- There was a marked reduction in foreign borrowing by Canadians last year, and the premium on the Canadian dollar was almost eliminated during the second half of 1960. Between July and December, net Canadian borrowings abroad amounted to only $456 million, or just over 55 per cent of the inflow in the first half of 1960. (See Table 2). Reduced government and private borrowings during the recession contributed to this reduced capital inflow. The withdrawal in December of special tax concessions to foreign investors added further to this decline. As a result, the Canadian dollar had declined from close to 105 US cents at the beginning of 1960 to about 101 US cents at the end of the year.

Table 2.

Canada: International Capital Movements
(In millions of Canadian dollars)

	1959 Jan.-June	1959 July-Dec.	1959 Total	1960 Jan.-June	1960 July-Dec.	1960 Total
Direct (net)	244	226	470	345	260	605
Portfolio	307	310	617	297	- 79	218
Other (deposits and short-term paper)	200	163	363	72	307	379
Official and reserves	21	23	44	100	- 32	68
	772	772	1,494	814	456	1,270

The reduced value of the Canadian dollar contributed in some measure to the marked reduction in the trade deficit in 1960. Exports rose almost 5 per cent in 1960 in spite of the recession in Canada's most important market, the United States. Imports, on the other hand, declined fractionally under the influence of the recession, to the lowest ratio of imports to GNP in the postwar period. As a result, the trade deficit declined to about 35 per cent of the previous year. The deficit in service items rose through the year with the result that the current account, though improved, continued to show a deficit of about $1.3 billion. As a result, the current-account balance was only slightly below the 1959 total. (See Table 3).

Table 3.

Canada: Selected Balance of Payments Items

	1957	1958	1959	1960
Imports	5,488	5,066	5,572	5,548
Exports	4,894	4,887	5,149	5,400
Trade balance	- 594	- 179	- 423	- 148
Bal. other current transactions	- 861	- 952	-1,071	-1,122
Current Account	-1,455	-1,131	-1,484	-1,270

Exchange Fund operations

The Finance Minister announced in June 1961 that the Government's policy is to lower the value of the Canadian dollar. This is to be accomplished by appropriate general economic measures to lower interest rates and thereby reduce the demand for the Canadian dollar on capital account. However, since this reduction in capital inflows could not be accomplished immediately, the Government announced its decision to depend upon direct intervention in the market through the Exchange rate until other forces made such intervention unneces ary. To accomplish this, the Fund will be given increased resources of an undisclosed amount.

The decision to intervene directly in the exchange market represents a marked change in Canadian exchange rate policy. From 1950 through 1960, the Exchange Fund was used for the express purpose of smoothing out sharp daily changes in the exchange rate with no intention of changing the underlying rate. Total foreign exchange holdings, of which the Exchange Fund holdings are the major part, thus showed little variation over the years. Gold and U. S. dollar holdings at the end of December 1960 were $1,829 million, just $87.7 million over the end of 1950 holdings, the year that the fluctuating rate was introduced.

In the early months of 1961, however, without any announced change in policy, the authorities began to use the Exchange Fund to reduce the value of the Canadian dollar by buying U. S. dollars in the market. As a result, foreign reserves rose $63 million in January and the average noon buying rate on the Canadian dollar in the New York exchange markets declined from 101.8 (US cents) in December 1960 to 100.7 in January, 1961.

During the next four months, reserves rose another $57 million and the Canadian dollar fluctuated narrowly around 101 (US cents). Immediately after the Minister's statement of the intention to reduce the exchange rate, the noon buying rate dropped to a discount of about 3 per cent below the U.S. dollar and has fluctuated narrowly around 97 U. S. cents since that time. Reserves rose $36 million in June, and declined $25 million in July and another $16 million in August, as a result of Exchange Fund activities to stabilize the rate at this level.

Concluding remarks

The success of the new program is dependent upon the possibility of keeping interest rates low enough to hold down the exchange rate, without causing an offsetting rise in domestic prices. To solve the structural problems in the Canadian economy, the Minister has proposed monetary easing to reduce interest rates, curtail capital inflows, and lower the exchange rate. Should the monetary easing, combined with the large budget deficit, result in rising domestic prices, the advantages of the lower exchange rate would be offset and the attainment of desired levels of employment might be precluded. The continuation of appropriate monetary easing is therefore dependent upon the rate at which revenues will increase in response to rising incomes.

On the other hand, it might very well turn out that Canada's major problem was cyclical and related directly to the recession in the United States. Monetary restraint and rising interest rates would then prove no obstacle to the reduction of unemployment. The expansion of exports to the United States could take up the slack in the resource industries and eliminate what appeared to be overexpansion in this sector. In this respect, it should be noted that Canadian exports rose 5 per cent in 1960 despite a 5 per cent fall in exports to the U. S., which usually represents 60 per cent of Canada's foreign market.

In either event, future efforts to influence the exchange rate may well be limited to general monetary and fiscal measures rather than direct intervention in the exchange market. The announced decision on June 20 to intervene directly to reduce the exchange rate was considered a temporary expedient for it was hoped that lower interest rates would effectively reduce capital inflows and the demand for the Canadian dollar. It is possible that direct intervention earlier in 1961 could have been avoided by appropriate monetary measures. However, disagreement between the Governor of the Central Bank and the Minister of Finance precluded the use of such measures. The Minister, accordingly, relied upon direct intervention in the exchange market to influence the exchange rate. The new Bank Governor has indicated his intentions of maintaining close coordination with the Minister of Finance to assure the "proper mix" of fiscal, monetary, and debt management policy. In a public statement on July 31, the Governor stated that ". . . if the Government disapproves of the monetary policy being carried out by the Bank it has the right and the responsibility to direct the Bank as to the policy which the Bank is to carry out." It therefore seems likely that in the future there will be no obstacles to the use of general measures to alter the value of the Canadian dollar, and that such measures could be used effectively to bring about an exchange rate consistent with economic conditions.