BANK OF CANADA

ANNUAL REPORT OF
THE GOVERNOR TO THE
MINISTER OF FINANCE

AND STATEMENT OF ACCOUNTS

FOR THE YEAR 1965

Mr Clark

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March 21, 1966

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BANK OF CANADA Ottawa 4

February 28th, 1966.

The Hon. Mitchell Sharp, P.C.,
Minister of Finance,
Ottawa, Ontario.

Dear Sir,

In accordance with the provisions of the Bank of Canada Act I am transmitting herewith my report for the year 1965 and a statement of the Bank's accounts for this period which is signed and certified in the manner prescribed in the by-laws of the Bank.

Yours very truly,

L. Rasminsky

Governor

BANK OF CANADA

Report of the Governor — 1965

As the economy moved towards the completion of its fifth year of expansion, indications were becoming increasingly numerous that virtually all of the slack existing at the beginning of the expansion had been taken up. The further impressive increase of 6½ per cent in real output in 1965 had reduced the unemployment rate to 3½ per cent by the last months of the year. Shortages of skilled labour and professional workers were becoming more numerous, more industries were working at or close to capacity, costs and prices were rising at a significantly higher rate, and the current account deficit in our balance of payments was widening.

Fortunately the productive capacity of the economy is growing and can be expected to continue to grow at a substantial rate. The main sources of growth are the rapid increase in the labour force and the prospective improvement in productivity associated in part with recent high levels of investment in plant and equipment. Public policy should continue to aim at providing conditions, including an adequate level of total demand, which encourage the economy to expand in accordance with the increase in its effective capacity. But in the immediate future our capacity to grow depends essentially on the factors just mentioned, namely the prospective increases in the labour force and in productivity, and can no longer be augmented quickly by any significant reduction in the amount of slack in the economy.

The output of the economy in 1965 could have been even higher if our productivity performance had been better. The productivity gains which accompanied the reduction in the margin of unused resources over the past year or so have been disappointing. This underlines the need for emphasis on policies bearing on "the supply side" of the economy which enhance our ability to produce. It is also the case that unemployment is still high in some areas, and output would be greater if the remaining pockets of unused resources were drawn into employment. In present circumstances, however, this is a task for those policies which are aimed directly at particular areas where unused resources exist; it is not one that can be handled satisfactorily by increasing the general pressure of demand in the economy.

In the present condition of high prosperity, the formulation of public policies intended to influence the total demand for goods and services poses peculiarly challenging problems. On the one hand, it is necessary to avoid a shortfall in total demand, which would result in increased unemployment and unused capacity. On the other hand, it is necessary to be alert to the dangers of excessive demand. The early symptoms in this latter case may not arouse as much public concern. Unfortunately, if the warning signals are ignored and policy does not respond until a large number of unsustainable positions have been created, until costs and prices have risen very sharply and international competitiveness has been impaired, then the problem becomes much more difficult to deal with in a way that will not halt the expansion of the economy.

At the present time, against the background of continuing vigorous expansion in the United States, a number of domestic factors are combining to produce very strong demands on our resources. Private business is engaging in a major round of capital expenditures. The public sector of the economy is proceeding with a rapidly growing volume of capital outlays on educational facilities, hospitals, highways and other social capital while at the same time increasing its other expenditures. Consumers are well placed, as a result of rapidly growing employment and rising wages and salaries, to increase their spending substantially. In these circumstances, the aggregate of all demands on the Canadian economy may outrun the effective capacity of the economy to increase its output of goods and services. In short, we now run the risk of overloading the economy.

MONETARY POLICY AND CREDIT CONDITIONS. The monetary policy of the Bank of Canada, like that of any central bank, must take into account both domestic conditions and developments affecting the external financial position. In 1965 the main domestic consideration influencing monetary policy was the fact that the slack in the economy was being taken up and the pressure on our resources was increasing. A special domestic factor with which the central bank had to cope and which affected its operations in 1965 was the risk that the default in June of a medium-sized sales finance company might have wider repercussions on the credit system. Under the impact of a much larger increase in imports than in exports, the current account deficit in our international payments was rising, even with the benefit of another large sale of wheat to the Soviet Union. The special measures taken by the United States Government beginning in February to improve that country's balance of international payments through the issue of "guidelines" affected our position in various ways; and it was of course necessary to take into account the agreement reached with the United States in 1963 regarding our exemption from the Interest Equalization Tax and the level of our exchange reserves. The course of credit conditions in the United States also influenced us in developing our own policy.

The operations of the Bank in 1965 were condueted in the light of the various eonsiderations referred to in the preeeding paragraph. A ehronological aeeount of the way in whieh eredit conditions in Canada developed in the course of the year is given in a later section of this Report (pages 24 to 27), and the highlights are summarized here.

So long as there was a good deal of slaek in the economy the basic poliey followed by the Bank was to avoid any signifieant tightening of eredit eonditions. Apart from the exehange crisis of 1962, eredit eonditions remained relatively stable through the first four years of the economic expansion and interest rates fluetuated within a fairly narrow range. In 1965, however, as the economy moved toward full utilization of resourees, the heavy demands for funds were allowed to have an impact on eredit conditions. With bank loans continuing to rise strongly through the year—by 20 per eent—the ratio of the banks' "more liquid" assets to total assets deelined and they found it neeessary to adopt more seleetive lending polieies. Interest rates rose substantially during the year and a further upward movement occurred in the first two months of 1966.

Credit conditions in the United States also becamc less easy in 1965 and interest rates rose in the seeond half of the year and the early months of 1966. As a result, the rise in Canadian interest rates did not bring about any significant ehange in the spread between long-term interest rates in Canada and the United Statcs over the year as a whole. Taken in eonjunction with the other faetors operating, the spreads in interest rates were adequate to encourage the import of eapital on the seale needed to cover our current aeeount defieit without leading to an exeessive aeeumulation of reserves. A bulge in our reserves in the latter part of 1965 was assoeiated with exchange inflows resulting from the large sale of wheat to the Soviet Union and did not lead to any important change in monetary poliey.

In the eourse of 1965 there was a pronounced shift in the form in which the Canadian public ehose to hold its short-term financial elaims. Broadly, the publie ehose to hold a signifieantly higher proportion of its liquid assets in the form of Canadian dollar savings and term deposits with banks and a lower proportion in such forms as forcign currency deposits with banks and short-term claims on non-bank institutions. To some extent this shift in holdings occurred in response to ehanged intercst-rate relationships, though other faetors, diseussed on pages 29 to 32, were also at work. Non-resident holdings of Canadian short-term paper were reduecd and there was some shift to Canadian sourees of short-term finanee, particularly the ehartered banks.

The inerease in eurreney and ehartered bank demand deposits held by the publie in 1965 was only a little greater than in 1964—6.5 per cent eompared to 6.3 per cent. However, as indieated above, there was a substantial shift from other types of short-term asscts to Canadian dollar claims on banks in the form of savings deposits and interest-bearing term deposits of various types and the total of currency and chartered bank Canadian dollar deposits held by the public increased by 12 per cent compared with 7½ per cent in 1964. If Government deposits are included, the increase was 12 per cent in 1965 compared with 6 per cent in 1964. The increase in the money supply took place in an environment in which interest rates were rising and less easy credit conditions were developing, and a significantly smaller increase would have resulted in tighter credit conditions than the Bank considered appropriate in the circumstances of the time. The rate of increase in the money supply levelled off in the latter part of 1965, after allowing for seasonal factors.

The 1965 experience provides a clear illustration of the general approach followed by the Bank in carrying out its operations. This was explained in the Submissions of the Bank of Canada to the Royal Commission on Banking and Finance, May 31, 1962 in the following terms:

> "Although it would be possible for the Bank of Canada, with its power to control the cash reserves of the chartered banks within narrow limits, to operate on the basis of a precise view about the appropriate trend, over some period, of total chartered bank assets (or of the 'money supply', in the sense of currency outside banks plus chartered bank deposits), it does not in practice do so. The central bank is, of course, inevitably influenced in its judgments by developments in the 'money supply', but it must also take a view of the kind of credit conditions that would seem to be appropriate in the light of the current and prospective state of the economy including the external financial position and it must be prepared within limits to use its control of cash reserves as the situation develops in whatever direction is necessary to try to bring about and maintain those conditions. This may mean that on occasion the Bank of Canada allows changes in its own and in total chartered bank assets to absorb pressures developing in financial markets rather than see credit conditions tighten or ease to an undesirable extent."

Although monetary policy had to operate in 1965 in financial markets that were affected in important measure by external influences, including policy innovations in the form of United States guidelines, as well as by the disturbances arising out of the finance company default, I believe that credit conditions developed in a way that was broadly appropriate to the domestic economic situation and outlook. The fact, however, that monetary policy did have to take account of important external factors, including the reserve agreement with the United States, provides a clear reminder of one of its important characteristics, namely its influence on international capital flows, which may in certain circumstances be a limitation on its use. Another possible limitation is the uneven impact of extreme changes in credit conditions on different classes of borrowers.

The Bank has sought to follow a policy which took into account the possibility that the increase of total demand might outrun the growth in the effective capacity of the economy. Monetary policy will continue to have an important role to play in this connection but extreme reliance on it would not produce satisfactory results. It is only one of the elements in public and private policy which must be adapted appropriately to changing circumstances if we are to achieve sound and sustainable growth.

CREDIT AND LIQUIDITY STANDARDS. The failure of Atlantic Acceptance in June had a disturbing impact on financial institutions and markets which was compounded by rumours regarding a trust company which had large investments in Atlantic and which was taken over by another trust company in September. There was some risk that soundly-managed institutions which had exercised prudence in the conduct of their business might find themselves in a position of difficulty and be unable to renew maturing short-term obligations until the confidence of investors had been restored. The dangers arising out of this situation were of major concern to the central bank.

Immediately after the default, the Bank of Canada added to the cash reserves of the chartered banks in order to ease the liquidity of the banking system and financial markets generally. Within a few days I consulted with the chartered banks and indicated to them that while I did not wish to influence their judgment as to the credit standing of any customer I hoped that they would not feel unable, for reasons relating to the total amount of their resources, to accommodate credit-worthy finance companies which might find themselves in a difficult liquidity position. This unusual step was taken because in the atmosphere prevailing at thc time there was a risk that difficulties in any part of the credit system might have wider repercussions of a disturbing character. For their part, the chartered banks recognized that it was in the general interest that serious liquidity difficulties be avoided and their action in making additional credits available was helpful in the circumstances.

While the central bank is not entrusted with the function of appraising the soundness of the participants in the credit market, it is nevertheless very concerned with the maintenance of confidence in all parts of the financial system. Where such confidence is in danger of being seriously impaired the central bank may have to allow itself to be diverted from the pursuit of the current objectives of monetary policy and give priority to measures which help to maintain confidence. Thc events of last summer provided a dramatic illustration of the extent to which the whole financial system is dependent on the maintenance of high credit and liquidity standards, on the disclosure of adequate information, on the exercise of discrimination by investors and lenders, and on satisfactory arrangements for supervision and inspection of all parts of the credit system.

CANADA'S INTERNATIONAL POSITION. The current account deficit in our balance of payments increased by about $700 million to more than $1,100 million in 1965.

As a practical matter, current account deficits of this size can be financed only by obtaining large inflows of capital from the United States. This gives rise to special problems now that the United States is herself confronted with an over-all payments situation with which she is trying to deal mainly by restricting the outflow of capital. For the reasons I explained at some length in last year's Report the payments relations between the United States and Canada do not in fact impose a burden on the payments position of the United States: our net purchases of goods and services from the United States are substantially in excess of our imports of capital from that country. However, the balance of payments programmes of the United States are designed in the light of that country's position in relation to the world as a whole and Canada does not automatically obtain special treatment. This has to be negotiated with the United States authorities.

In the negotiations with the United States in July 1963 which provided that new issues of Canadian securities should be exempt from the Interest Equalization Tax, Canada stated that it would not be her desire or intention to use the proceeds of borrowing in the United States to add to her official reserves. The original "target" for official reserves was the June 30, 1963 figure of approximately $2,700 million. Later, after we had repaid our 1962 borrowings from the International Monetary Fund, it was agreed that any "net creditor position" which Canada had in the IMF should be regarded as a part of our official reserves for the purpose of the agreement.

I believe that the July 1963 agreement worked well. It provided us with the access to the U.S. capital market that we needed to cover our current account deficit. Though we naturally had to take the agreement regarding reserves into account, we were able to pursue a monetary policy which in its broad lines was appropriate to the requirements of our domestic situation as it developed.

The principal impact on Canada of the first United States guidelines issued in February 1965 was to encourage the repatriation to the United States of short-term financial assets held here by United States corporations. The effect of these short-term capital withdrawals on our international position was offset, however, in the way outlined on pages 38 and 39, by a simultaneous inflow of banking funds from overseas which was itself an indirect consequence of the guidelines.

In December 1965, the United States adopted an important new set of guidelines designed to eliminate the deficit in her over-all international payments in 1966. The principal features were (1) the establishment of a precise guideline for the purchase of long-term foreign securities by American non-bank financial institutions (insurance companies, pension funds, etc.) which limited the increase in these investments for each such institution to 5 per cent of the amount of its holdings on September 30, 1965 and (2) the establishment of a guideline on direct investment abroad—defined to include retained earnings as well as fresh capital flows—which permitted each corporation an average rate of direct investment abroad in 1965-66 up to 135 per cent of its 1962-64 average. As direct investment in 1965 was higher than this figure the guideline implied a cut-back in 1966. Canada was not exempted from the direct investment guideline.

The application to Canada of the guideline on the purchase of foreign securities by non-bank financial institutions would have had serious immediate effects on us. As a result of negotiations which took place, however, the United States, in addition to maintaining the Canadian exemption from the Interest Equalization Tax, agreed to exempt Canada from the guideline on non-bank financial institutions and to make it clear in the statement announcing this that United States investors were free to be guided by market considerations in deciding whether to buy new offerings of Canadian securities, i.e., that no moral suasion was to be applied to restrict such purchases. For its part, Canada agreed, as a contribution to the reduction in the over-all payments deficit sought by the United States Government, to reduce its "target" figure for reserves from the $2,700 million figure fixed in 1963 to $2,600 million. The Canadian Government stated that it would be prepared to repatriate its own securities held by investors in the United States if this proved necessary to maintain Canadian official reserves around the "target" level. By providing an additional direct technique for influencing our exchange reserves, this undertaking by the Government of Canada reduces the constraints on the use of monetary policy.

The limitation on our foreign exchange reserves embodied in the agreement is an undesirable feature from a Canadian point of view but from the United States point of view it is an essential one. It was the price which Canada paid to obtain access to the United States capital market for provincial and municipal governments and other Canadian borrowers which is both (1) unrestricted in amount through the securing of exemption from the guideline limiting purchases by the major United States investors of new long-term foreign securities, and (2) free of Interest Equalization Tax. Even if Canada had been willing to give up the exemption from the Interest Equalization Tax in order to avoid any commitment on our reserve levels, Canadian borrowing would still have been severely restricted by the operation of the guideline.

My comments on the direct investment guideline will be limited to its possible effects on our international capital account and on our domestic financial markets.

In view of the general character of the payments relations between Canada and the United States, it is clear that any substantial decline in direct investment inflows which results from this guideline will necessarily add to the amount of capital that Canada has to obtain from the United States market through new issues of long-term securities in order to finance our purchases of goods and services in the United States.

The application of the direct investment guideline to Canada could have important consequences on our domestic financial markets. If its effect were to increase substantially the amount of capital that subsidiaries of U.S. companies sought to raise in Canada from banks or the securities market, it could give rise to a distortion in our credit flows. With this danger in mind, I informed the chief executive officers of the larger chartered banks on December 10, immediately after the United States guidelines were published, that it was my hope and expectation that if the banks found themselves confronted with new applications for credit resulting from the United States guideline at a time when they were unable to meet in full the normal demands for business loans from their credit-worthy customers, they would continue to look after the customers who had relied on them in the past for their credit needs. The chief executive officers indicated that they agreed that this was the proper course to follow. I reiterated these views at a meeting with all the banks on January 5, 1966.

In commenting on this problem as it applies to securities markets, the Minister of Finance said in the House of Commons on February 2nd: "So far as long-term issues of American subsidiaries are concerned, I would hope and expect that there will be no abnormal recourse to the Canadian capital market, but if there were the Government would have to decide what action to take."

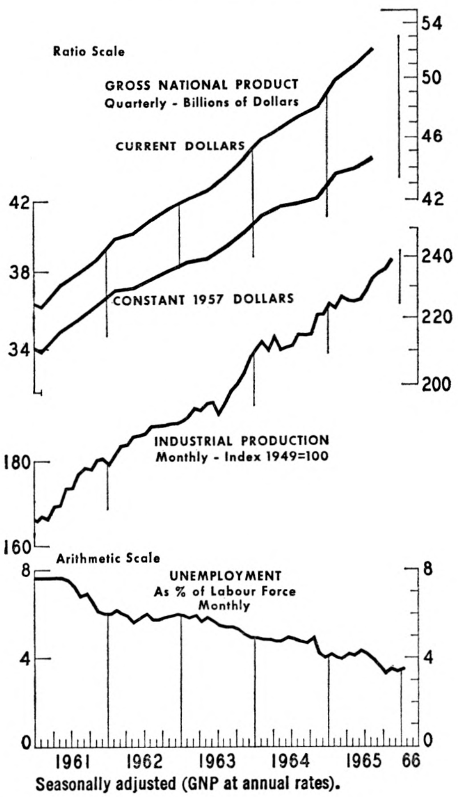
* * *

In spite of some difficult periods, we have been successful in obtaining financing of our large current account deficit under reasonably satisfactory conditions. But I believe that it would be unwise to take a detached view of the problems that arise from our dependence on continuing large imports of foreign capital. A situation in which Canada needs to import a great deal of capital from a country which is trying to restrict the export of capital is inherently unsatisfactory, and there is no easy or satisfactory way of dealing with it. It is undoubtedly the case that large net imports of capital enable us simultaneously to maintain higher levels of consumption and investment and government services than would otherwise be possible. But we would do well to bear in mind that Canada has no inherent right to import capital from abroad and that there are many conflicting claims on the resources of the capital-exporting countries. While we must continue to make the best arrangements we can for access to foreign capital to protect ourselves against the possible need for difficult and concentrated adjustments, I believe that we should be aiming at a pattern of economic growth which, while providing for full utilization of our resources, involves reduced dependence on net capital inflows. This does not mean that we should adopt inward-looking attitudes. On the contrary it means that we must attach great importance to increasing our ability to compete effectively with foreign producers both in other countries and in Canada. It means that we should be increasingly concerned with maximizing our productivity and industrial efficiency, with up-grading our labour and management skills, and with keeping our costs and prices in line. It means too that we should pay increasing attention to the over-all effect of public policies on our capacity to provide from Canadian sources the flow of savings needed to develop our economy.

Economic Developments

The Canadian economy again moved strongly ahead in 1965, its fifth year of continuous expansion. By the end of the year goods and services were being produced at a physical rate one-third greater than in the first quarter of 1961 when the expansion began. For the second successive year the growth of the economy was greater than that of the United States and most other large industrial countries. The labour force and industrial capacity continued to rise, but employment increased rapidly enough to reduce the unemployment rate to its lowest level since 1956. For the first time since the mid-1950's pressure on resources was clearly developing.

OUTPUT AND UNEMPLOYMENT



Seasonally adjusted (GNP at annual rates).

Gross National Product rose by about 9½ per cent in current dollars in 1965. This slightly exceeded the increase of the previous year, but the margin over 1964 was due to a greater increase in prices—about 3 per cent compared with 2.3 per cent. The estimated gain in real output was about 6½ per cent in both years. Farm output, which had fallen in 1964, increased in 1965. The rise in non-farm output, about 6½ per cent, was somewhat smaller than in 1964, while the rise in non-farm employment, 4.8 per cent, was somewhat greater. Consequently, non-farm output per person employed—a very broad measure of productivity—showed a gain of less than 2 per cent, which was substantially less than the gain achieved in the previous year. The sources which provided the large increase in non-farm employment were a strong rise in the labour force, a sharp decline in farm employment and a further marked reduction in unemployment. Unemployment fell from an annual average of 4.7 per cent of the labour force in 1964 to an annual average of 3.9 per cent in 1965. In the last quarter of the year the seasonally adjusted unemployment rate was down to 3.4 per cent. Further evidence of the strong demand for labour in 1965 was the frequency with which shortages of professional, technical and other skilled workers were reported.

The momentum of the economy in 1965 was reflected in a strong growth in incomes. Labour income, which had risen by more than 8½ per cent in 1964, increased by about 11 per cent in 1965. This reflected both the strong growth in employment and increased upward pressure on wage and salary scales. Corporate profits, which had risen by almost 15 per cent in 1964, showed a further increase of about 10 per cent in 1965.

The growing pressure of demand on the economy in 1965 gave rise to an adverse trend in domestic prices and in the balance on external trade. Although the principal measures of final prices were affected during the year by some special factors, it seems clear—both from the table below and the one on page 23—that prices were responding to influences of a more general nature and were beginning to rise more rapidly over a wide range of goods and services. Merchandise imports rose faster than domestic output and faster than exports, and the trend towards a declining current account deficit evident since 1959 was reversed in 1965.

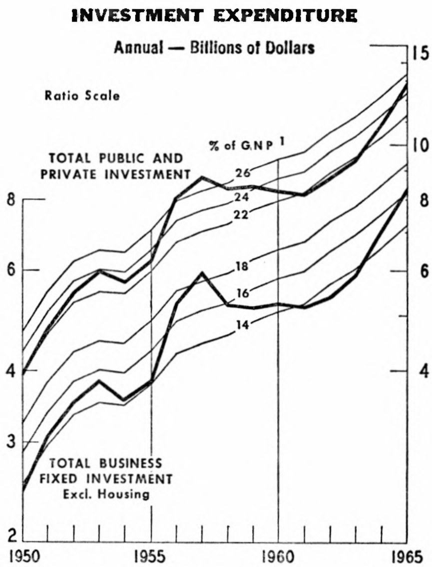
SELECTED COMPONENTS OF GROSS NATIONAL EXPENDITURE

(percentage change from previous year)

	Volume		Price		Value	
	1964	1965(1)	1964	1965(1)	1964	1965(1)
Personal expenditure	5.8	5.1	1.5	2.0	7.3	7.2
Government expenditure	4.4	6.3	2.6	3.7	7.3	10.1
Housing	12.0	3.4	5.7	5.1	18.4	8.7
Business investment	14.6	14.5	3.0	4.7	18.1	19.9
Total final domestic demand	7.0	6.6	2.1	2.9	9.2	9.7
Exports of goods and services	12.4	3.7	2.3	0.8	15.0	4.5
Imports of goods and services	11.3	10.6	1.7	0.1	13.2	10.7
GNE = GNP	6.5	6.3	2.3	2.9	8.9	9.3

(1) Change from first 9 months of 1964 to first 9 months of 1965. Some differences will be noted between these figures and those in the text which are based on estimates for the calendar year.

As the preceding table shows, all the main types of spending continued to increase in 1965. Business investment, which has been rising strongly since 1963, continued to be the most dynamic element in the expansion. For the year as a whole such investment is estimated to have gone up by a further 17 per cent in value and 12-13 per cent in volume in 1965 following even larger percentage increases in 1964. The upswing in investment since 1963 has constituted the largest wave of investment activity in Canada since the mid-fifties. The rise has been less steep than in the earlier period when much of the increase was concentrated in the one year 1956. But the marked increase in the past two years brought the ratio of business investment to GNP up to a higher level than in any post-war year except 1956 and 1957. Investment in recent years appears to have been somewhat less strongly oriented towards resource development and supporting activities than was the case in 1955-57. Investment of this type has, of course, remained very important, but there has been a perceptible shift in emphasis from primary manufacturing, electric power development, oil and gas pipelines, and rail and water transportation systems to secondary manufacturing, urban transit systems, universities, office buildings and other commercial and financial services.



1. The contour lines enable one to see the ratio of investment to GNP in each year.

In 1965 as in 1964 there was a sharp upward revision of investment plans as the year progressed. The Department of Trade and Commerce survey of investment intentions made at the beginning of 1965 indicated that business fixed capital outlays would be about 13½ per cent higher in 1965 than they had been in 1964. It is now estimated that the actual increase over 1964 was 18 per cent in business expenditures on construction and 16½ per cent in outlays on machinery and equipment.

In view of the evidence that building activity was pressing on the capacity of the construction industry in many areas and was leading to a rapid increase in costs, the Government in August announced postponement of certain of its own projects and urged selective restraint by others. (For the same reasons, the Directors of the Bank of Canada postponed construction of the Bank's new head office building in Ottawa.)

Building of high-rise apartments and various forms of row housing expanded very rapidly during 1964 and the first half of 1965 but in the second half of the year, after allowing for seasonal factors, there was a fairly sharp reduction in the number of multiple units started. In the past few years there has been little change in the annual rate of construction of single family dwellings. Residential construction taken as a whole was the only major sector of domestic expenditure to show an appreciably smaller increase in 1965 than in the previous year—about 5 per cent as against 18 per cent in 1964. Most of the increase shown for 1965 reflects higher prices rather than a rise in the physical volume of construction.

Personal consumption expenditures again increased strongly in 1965. In addition to the large rise in total wages and salaries already mentioned, personal income was further reinforced by a record level of farm cash receipts arising mainly from higher prices for livestock and the substantial receipts from the bumper grain crops harvested in Western Canada in the past three years. Even though there was an increase in the proportion of personal disposable income saved, consumer expenditures on goods and services rose by more than 7½ per cent in 1965. Spending on new cars was particularly strong. The number of new passenger cars sold, which had risen by 10 per cent in the previous year, increased by a further 15 per cent in 1965. Some of the difference between the two years reflects the impact of strikes which resulted in some spilling over of sales into 1965. There was also a continued trend towards more expensive models. The year 1965 was the fourth consecutive one of rapid expansion in the automobile market; during the period the number of passenger vehicles registered in Canada increased by about 25 per cent.

Expenditures by all levels of government on goods and services rose strongly in 1965. At the federal level, defence outlays continued to be relatively stable, but non-defence expenditures on goods and services rose by nearly 15 per cent. The total of provincial and municipal spending on goods and services, which has risen at an average annual rate of about 10 per cent in recent years, went up considerably faster in 1965. There was a particularly marked increase in capital outlays, mainly for schools and roads, but current expenses also rose substantially. In addition to the direct capital outlays of provincial and municipal governments which fall within the public sector, the outlays of their agencies and enterprises account for an important part of the rise in business fixed investment already referred to, notably in electric power development and urban transit.

Direct purchases of goods and services by all levels of government represented over 18 per cent of GNP in 1965. Provincial and municipal outlays on goods and services, at more than 12 per cent of GNP, were approximately double those of the federal government. This is a marked change from the situation a decade ago when the provincial-municipal share was about 8½ per cent of GNP and the federal share about 9½ per cent. Taking account of transfer payments to the private sector, including the rapidly rising disbursements to hospitals and universities, expenditures by all levels of government in 1965 were equivalent to more than 30 per cent of GNP. The comparable ratio a decade ago was just under 27 per cent.

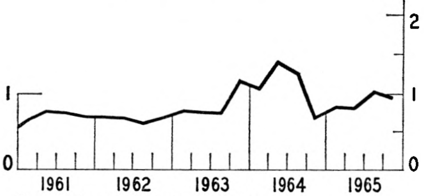
Despite the reduction in federal income tax rates which became effective at mid-year, the federal government's net fiscal position on a national accounts basis improved by about $220 million in 1965. This was about one-third of the improvement which took place in 1964. The combined deficit of provincial and municipal governments narrowed slightly in the early part of 1965, partly as a result of increased federal income tax abatements in favour of the provinces, but widened again as the year progressed.

Merchandise exports rose by only 6 per cent in 1965 after rising by 16 per cent in 1964. Wheat and flour shipments were about $175 million below their exceptionally high 1964 level, while exports other than wheat increased by 9 per cent in 1965 compared with 15 per cent in 1964.

Sales of wheat and flour under the first major contract with the Soviet Union added nearly $500 million to Canadian exports between September 1963 and July 1964. With the completion of these shipments wheat exports dropped in the latter part of 1964. They rose gradually in the first half of 1965. Through this period sales to regular markets remained very strong. Following the announcement in August 1965 of the second major contract with the Soviet Union, the physical volume of wheat shipments rose to the limit that could be handled by available transportation and marketing facilities. The total value of exports under the Soviet agreement amounted to about $200 million in the second half of 1965 with the balance, more than $200 million, scheduled for shipment in the first seven months of 1966.

EXPORTS OF WHEAT AND FLOUR

Quarterly — Billions of Dollars



Seasonally adjusted at annual rates.

The growth of Canadian exports other than wheat slowed down in 1965 though, as indicated in the chart on the following page, there was a marked improvement in the last quarter of the year. Exports to the United States in 1965 rose at about the same rate as in 1964. However, since total imports into the United States rose much more rapidly in 1965 than in 1964, Canada's share of the U.S. import market failed to increase as it had done in 1964. As noted on page 44, economic growth in some of Canada's major overseas markets slackened in 1965; apart from wheat sales, Canadian exports to overseas markets either increased more slowly than in 1964 or declined slightly. Canada's share of total imports into most of these markets either held steady or fell in 1965 in contrast to 1964 when our share had increased.

CANADIAN EXPORTS EXCLUDING WHEAT AND FLOUR[1]

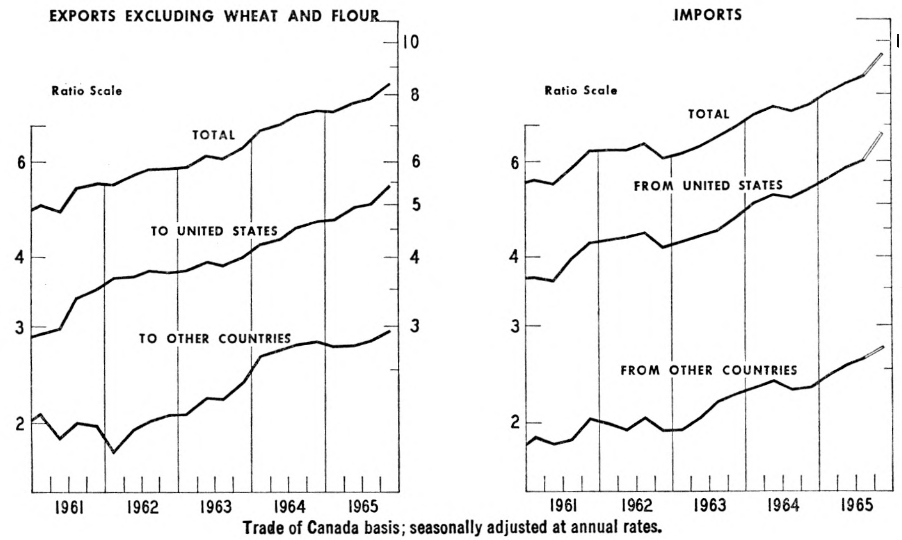
	Value (millions of dollars) 1964	1965 (11 months)	Percentage change from previous year 1964	1965[2]
To: United States	3,886	4,389	14	13
Britain	941	924	25	−2
Continental Europe	571	649	25	14
Japan	205	199	13	−3
Australia, New Zealand, South Africa	217	234	37	8
All other countries[3]	523	511	17	−2
Total	6,342	6,906	17[4]	9

(1) Trade of Canada basis, excludes re-exports.
(2) Change from first 11 months of 1964 to first 11 months of 1965.
(3) Mainly less-developed countries; also includes Eastern Europe.
(4) Adjusted for balance of payments purpose the increase was 15 per cent.

Most of Canada's major exports of primary resource products rose less rapidly than in 1964 although the increase in base metal exports was still substantial. Canadian producers of some commodities, such as steel and certain base metals, were operating at the limit of their productive capacity and experienced difficulty in meeting fully both export and domestic demand. The growth in exports of manufactured goods other than automobiles and parts slowed down considerably. Following the signing in January 1965 of the

MERCHANDISE TRADE

Quarterly — Billions of Dollars



Trade of Canada basis; seasonally adjusted at annual rates.

Canadian-United States Automotive Agreement, which provided for the removal of tariffs and encouraged an increase in two-way trade in parts and completed automobiles and trucks, exports of these products increased to nearly twice their 1964 level. Even so, the deficit on trade in automobiles and parts widened somewhat further in 1965 as imports continued to rise strongly reflecting in part the high level of Canadian demand.

Total merchandise imports again rose more rapidly than domestic output. Having gone up by nearly 15 per cent in 1964 imports increased by a further 15 per cent in 1965, with a marked upsurge in the fourth quarter. The strength in imports reflected continued strong domestic demand for industrial materials, machinery and other investment goods, automobiles and other consumer durables. Imports of aircraft also rose substantially in 1965. The value of food imports, on the other hand, fell as a result of a sharp drop in the price of sugar. The table below summarizes the changes in imports by end-use through the first nine months of 1965 but does not reflect the sharp increase which occurred in the fourth quarter, details of which are not yet available.

CANADIAN IMPORTS CLASSIFIED BY END-USE(1)

	Value (millions of dollars)				Percentage change from previous year	
	1963	1964	1964 (9 months)	1965 (9 months)	1964	1965(2)
Fuels and lubricants	529	547	394	438	3	11
Industrial materials	1,857	2,079	1,530	1,678	12	10
Producers' equipment	1,617	1,896	1,435	1,585	17	10
Construction materials	203	274	194	228	35	18
Transportation equipment	177	194	140	216	10	54
Motor vehicles and parts	698	849	635	778	22	23
Food	712	713	520	479	–	−8
Other consumer goods	625	718	526	585	15	11
Special items	138	219	149	201	59	35
Total	6,558	7,488	5,522	6,188	14	12

(1) Trade of Canada basis.
(2) Change from first 9 months of 1964 to first 9 months of 1965.

The continuing strong demand for imports coupled with the relatively small increase in total exports resulted in a reduction in the merchandise trade surplus by about $600 million between 1964 and 1965. This followed five consecutive years in which exports had risen more rapidly than imports. However, as the table on the following page shows, if exports of wheat and flour are excluded from the merchandise trade account the improving trend in the balance came to an end in 1963.

MERCHANDISE TRADE(1)

(millions of dollars)

	1963	1964	12 months ending Nov. 1965
Imports	6,579	7,540	8,510
Exports	7,082	8,240	8,650
Balance	+503	+700	+140
Wheat exports	881	1,093	920
Balance excluding wheat exports	−378	−393	−780

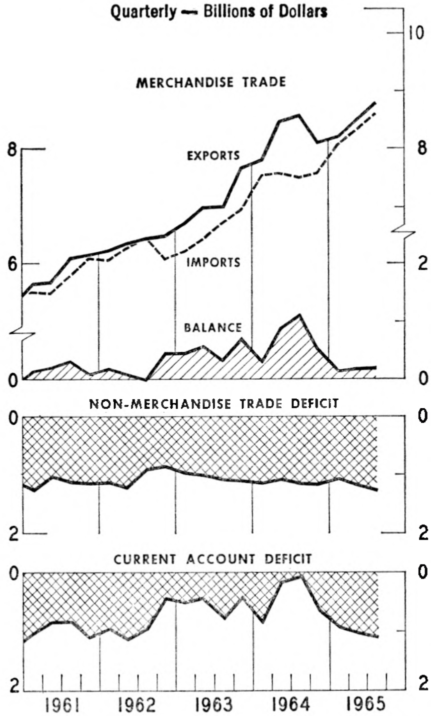
(1) Adjusted to balance of payments basis.

The deficit on non-merchandise transactions in 1965 was about $100 million larger than the $1,133 million recorded in 1964. A substantial increase in net payments of interest and dividends to non-residents, and smaller increases in official aid contributions and in expenditures on freight and shipping were offset only in part by an improvement in the balance of inheritances and migrants' funds. The deficit on travel expenditures was about the same as in 1964.

Canada's total current transactions with other countries resulted in a deficit of more than $1,100 million in 1965 compared with one of $433 million in 1964. The 1965 deficit with the world as a whole was well below the peak levels of the late 1950's but the current account deficit of over $1,900 million with the United States was considerably higher than in any previous year. The surplus with other countries was about one-third below its unusually high 1964 level, but it remained higher than in any other recent year.

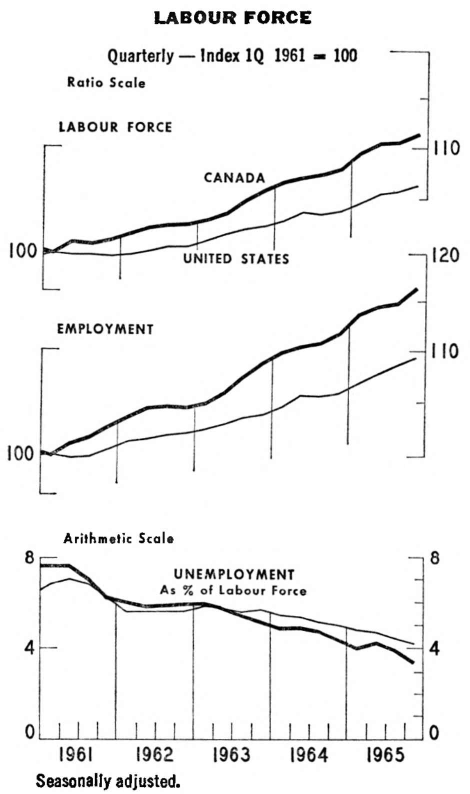
CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

Quarterly — Billions of Dollars



Balance of payments basis; seasonally adjusted at annual rates.

A feature of the Canadian economic situation which will continue to be of great importance for some time to come is the high rate of growth in the labour force. In 1965 the Canadian labour force increased by 3.0 per cent compared with an increase of 1.9 per cent in the United States. The female labour force continued to rise very strongly, though the increase of 5.3 per cent was slightly lower than in 1964. To an important extent the growing number of women in the work force reflects the trend towards higher rates of labour force participation, particularly by married women. The increase in the male labour force, which is determined more particularly by demographic factors, was 2.1 per cent. This represented a significant acceleration from the 1.7 per cent increase of the previous year and can be attributed mainly to the entry into the labour force of many of those born immediately after the war in the years of high birth rates and to a significant increase in net immigration.



Total employment in Canada rose by 3.8 per cent in 1965 compared with an increase of 2.6 per cent in the United States. Farm employment in Canada, which has been declining for many years, showed a particularly sharp drop of 5.7 per cent in 1965. Non-farm employment rose by 4.8 per cent, one of the largest annual increases on record. A significant part of the increase in employment, particularly among married women and teenagers, appears to have been associated with the increasing opportunities for, and popularity of, part-time work.

Although the movement of the seasonally adjusted unemployment rate in the course of the year was rather uneven, mainly because of the large influx of students into the labour force in June and July, the trend was clearly downward. In the fourth quarter the rate averaged 3.4 per cent. The unemployment rate in

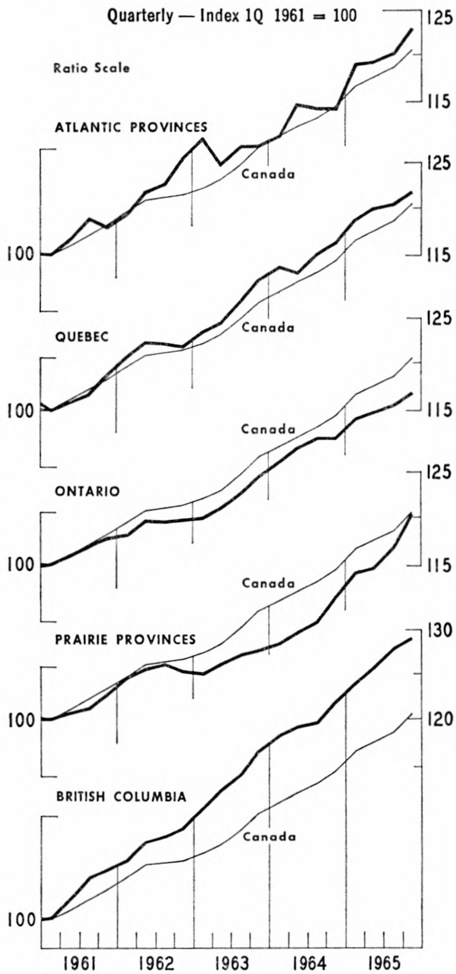
Canada, which was considerably higher than the U.S. rate at the beginning of the expansion and then fluctuated around the U.S. rate for an extended period, has been below the U.S. rate since late 1963. In the last quarter of 1965 the gap was more than ½ of 1 per cent, although the adult male unemployment rate remained slightly higher in Canada.

All the main regions of the country shared in the strong growth of non-farm employment in 1965, with increases of 3½ per cent in Ontario, close to 5 per cent in Quebec, just under 6 per cent in British Columbia and the Atlantic region, and nearly 7 per cent in the Prairies. As the insert diagram shows, the increase in non-farm employment over the period of the expansion as a whole from the first quarter of 1961 to the fourth quarter of 1965 was in excess of the national average in the Atlantic Provinces, Quebec and British Columbia.

As the following table shows, all five regions also shared in the further reduction of unemployment in 1965, although marked regional disparities remain.

NON-FARM EMPLOYMENT BY REGIONS

Quarterly — Index 1Q 1961 = 100



Seasonally adjusted.

REGIONAL UNEMPLOYMENT RATES

(per cent of labour force)

	Atlantic	Quebec	Ontario	Prairies	B.C.	Canada
			Annual averages			
1956..............	6.0	5.0	2.4	2.2	2.8	3.4
1961..............	11.2	9.2	5.5	4.6	8.5	7.1
1962..............	10.7	7.5	4.3	3.9	6.6	5.9
1963..............	9.5	7.5	3.8	3.7	6.4	5.5
1964..............	7.8	6.4	3.2	3.1	5.3	4.7
1965..............	7.4	5.4	2.5	2.5	4.2	3.9
			Seasonally adjusted			
1965-fourth quarter..	6.2	5.0	2.1	1.9	3.6	3.4
			Not seasonally adjusted			
1965-low point(1)....	3.7	3.4	1.4	1.0	2.8	2.4

(1) September or October.

In the buoyant state of the economy there were larger wage settlements and a continued increase in fringe benefits in 1965. After taking account of salaries, which also rose appreciably during the year, average earnings per employee rose more rapidly in 1965 than in 1964—particularly in construction but also in manufacturing, mining and other commercial activities. As there appears to have been a smaller increase in average output per employee in 1965 than in 1964, wages and salaries per unit of output rose much more sharply in all the main sectors of business activity than in 1964 or in the earlier years of the expansion. The total profits of incorporated and unincorporated businesses per unit of output also apparently continued to increase, though not as strongly as in 1964. The combined effect of the trend of money incomes on the main factors of production was to exert greater upward pressure on prices in 1965. The changes in the main categories of money incomes per unit of output in commercial activities other than agriculture may be seen in the following table.

INCOMES PER UNIT OF OUTPUT: COMMERCIAL NON-FARM ECONOMY(1)

(percentage change from previous year)

	1962	1963	1964	1965(2)
Wages and salaries per unit of output				
Manufacturing	−0.3	0.6	0.6	2.2
Mining	−4.2	−0.2	−5.3	6.1
Construction	6.7	3.1	1.6	9.9
Other commercial activities	0.2	1.1	2.9	4.8
Total	0.4	1.1	1.7	4.5
Business profits per unit of output	1.7	0.5	3.3	0.4
Wages and salaries plus business profits per unit of output	0.8	0.9	2.1	3.3

(1) Excludes agriculture, government and community services.
(2) Change from first 9 months of 1964 to first 9 months of 1965.

The table is based on the following D.B.S. statistics: Output — "Indexes of Real Domestic Product;" Wages and salaries — "Estimates of Labour Income" (excluding all supplementary labour income and wages and salaries in the sectors listed in footnote (1) above); Business profits — Total corporation profits before taxes plus net income of non-farm unincorporated business as given in the "National Accounts".

The response of prices to the combination of strong demand and rising costs is shown in the following table and in the table on page 13. Even after allowing for the rather special nature of certain of the price increases, for example in some food items, automobile insurance and prepaid medical care, it is evident that prices generally are reflecting the incidence of widespread upward pressures. As the following table also shows, each of the major categories of the Consumer Price Index rose significantly more in Canada than in the United States in 1965.

PRICES

(percentage change from previous fourth quarter)

	Canada				United States
	4 Q'62	4 Q'63	4 Q'64	4 Q'65	4 Q'65
Consumer prices					
Food	3.1	2.6	0.9	4.3	2.9
Goods other than food	0.5	0.8	0.8	1.2	0.7
Shelter	1.9	1.9	2.6	2.6	2.0
Services(1) — automobile insurance	1.7	−0.2	11.6	26.5	3.3
— prepaid medical care	0.2	8.7	8.0	5.6	
— other services(1)	2.3	1.4	3.2	4.8	
Total C.P.I.	1.7	1.6	1.6	2.9	1.8
Total C.P.I. excl. food	1.2	1.3	1.9	2.5	1.6
Total C.P.I. excl. food, automobile insurance, and prepaid medical care	1.2	1.1	1.7	2.0	n.a.
Prices of all goods and services (GNP deflator)	2.2	1.7	2.4	2.9(2)	1.9

(1) Excluding shelter services.
(2) Change from 3Q'64 to 3Q'65.

Monetary and Financial Developments

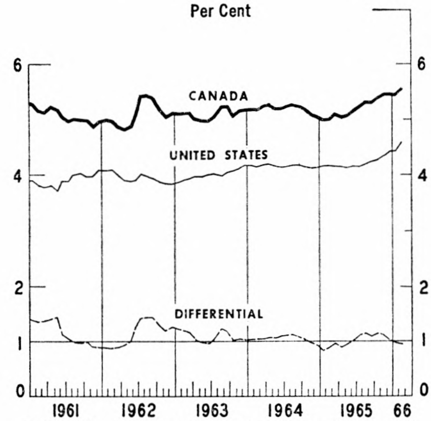
The pressures on the economy's physical resources which developed in 1965 had their counterpart in financial markets. The pressures arose mainly from a substantial increase in the capital expenditures of private businesses and of provincial and municipal business enterprises, which led to a major increase in their calls on savings. There was a further improvement in the fiscal position of the federal government. In the personal sector there was an increase in the rate of saving, although consumer and mortgage debt continued to rise rapidly. There was a sharp increase in the use of foreign savings.

As it became increasingly clear in the course of 1965 that the economic expansion was rapidly taking up the remaining margin of unused physical resources in the economy, conditions in financial markets were permitted to develop in a way which would exert more restraint on domestic spending and attract a sufficient flow of capital to balance our external position. In 1964 there had been little change in the terms on which funds were available in Canada; in 1965 the average yield on long-term Government of Canada bonds rose from 5 per cent in January to 5.4 per cent by December, yields on the bonds of other borrowers rose somewhat more, and prime rates on conventional mortgages increased by ½-¾ per cent. The yield on three-month treasury bills increased by about 75 basis points in the course of the year and other short-term paper rates rose substantially more. While chartered bank loans continued to expand rapidly, a further reduction of the banks' liquidity ratios made it necessary for them as the year progressed to become more selective in considering new credit applications. In the first half of December the chartered banks raised their prime loan rates from 5¾ per cent to 6 per cent.

The pattern of events in the course of 1965 was also influenced by developments relating to our external financial position, particularly the U.S. balance of payments guidelines, and by the repercussions of the default of Atlantic Acceptance in June.

Following the period of heavy Canadian borrowing in the United States in the autumn of 1964, there had been some temporary easing of credit conditions in Canada which continued into the early weeks of 1965. On February 10, 1965 the United States embarked on a new programme designed to improve its balance of payments. Until the details of the programme were developed and a set of guidelines issued there was a good deal of uncertainty in Canada about the nature and probable impact of the programme. The Canadian bond market weakened as a result of concern that the guidelines might interfere with access to the U.S. market by Canadian borrowers wishing to place new bond issues. The Bank of Canada resisted the downward pressure on bond prices by purchasing Government securities in the market after February 10; the rise in the average yield on long-term Government of Canada bonds during the next month was limited to about 10 basis points. By mid-March U.S. investors had started to reduce their holdings of foreign currency deposits in Canadian banks and of short-term finance company paper and it became evident that the principal impact of the U.S. guidelines would be felt in the short-term market. In the bond market, confidence had reappeared and yields were moving down again.

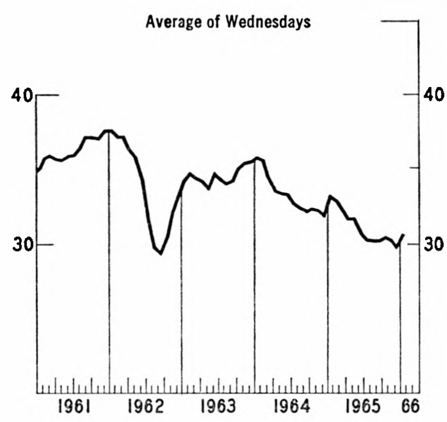
LONG-TERM GOVERNMENT BOND YIELD AVERAGES[1]



1. Monthly average of Wednesday closing yields on all direct issues due or callable in 10 years or more.

Beginning in April the cash management of the Bank of Canada was conducted in such a way that the continued strong expansion of the chartered banks' loans brought about a further reduction in the ratio of their "more liquid" assets to total assets. Credit conditions generally became less easy. The yield on three-month treasury bills, which had declined during the first quarter of the year, rose by about 40 basis points between the beginning of April and the beginning of June to a level just under 4 per cent. Other short-term paper rates moved up as much. Bond yields also rose in the second quarter: in June the average yield on long-term Government of Canada bonds was 20 basis points higher than in January and the differential over comparable U.S. yields had widened by about the same amount. In June the chartered banks' "more liquid" asset ratio was less than 31 per cent compared to 33 per cent in January 1965 and 36 per cent at the beginning of 1964.

CHARTERED BANK "MORE LIQUID" ASSETS
As % of Total Assets



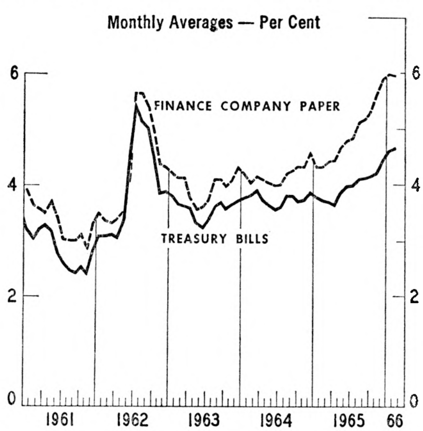
The finance company default on June 14 accelerated the development of less easy credit conditions. Though the

Bank of Canada promptly increased the banking system's cash reserves and took the other action described in the first part of the Report to guard against the possibility than other financial institutions might come under serious liquidity pressure, credit conditions tightened significantly. While the support provided by the central bank and the chartered banks helped to stabilize the situation, the central bank had to continue to take account of the problem in its operations.

During the summer, evidence of strains on the economy continued to accumulate, particularly in the large upward revision of 1965 capital spending indicated by the mid-year survey conducted by the Department of Trade and Commerce. It was also becoming clear that Canada faced a substantial increase in its current account balance of payments deficit. Long-term interest rates rose during the summer, and towards the end of July treasury bill rates also began to move up again. When the sale of wheat to the Soviet Union was announced in August and a shift in market expectations resulted in a tendency for bond prices to rise, the Bank of Canada countered this by selling securities in the market. The inclusion of $100 million of long-term bonds in the federal government refunding issue offered in mid-August operated in the same direction. By November the average yield on long-term Government of Canada bonds was 25 basis points higher than in June and the yield on three-month treasury bills had risen as much. The differential between long-term Government bond yields in Canada and the United States had widened during the summer but U.S. interest rates began to rise in August and the differential held relatively steady through the autumn.

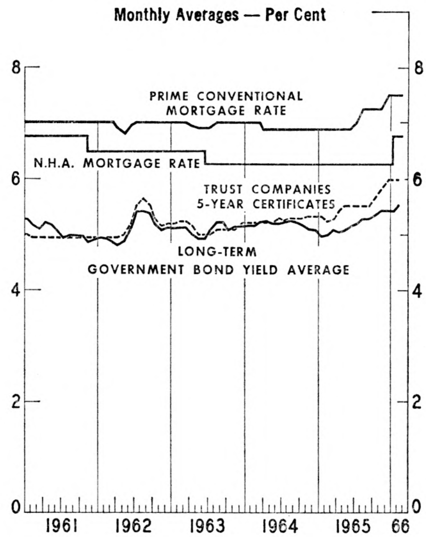
Rates of interest in some other parts of the market increased more sharply. By the end of the year the rates on finance company short-term paper were 1¼ per cent higher than in June and the chartered banks had substantially increased their rates on short-term deposit instruments. Beginning in late summer many mortgage lending institutions cut back their new lending activity from the high rate at which funds were being committed earlier in the year. The demand for mortgage funds remained strong and conventional mortgage rates rose in the second half of the year. In the fourth quarter trust and mortgage loan companies raised the rates on their certificates and debentures sharply.

CANADIAN 3 MONTH INTEREST RATES



In view of the extent to which credit conditions were tightening and the rate at which funds were being borrowed in the U.S. market the Bank of Canada offered some resistance to the rising trend of interest rates. During the autumn the Bank increased its holdings of treasury bills and maintained chartered bank cash at somewhat higher levels on occasions when the market threatened to tighten excessively. After the official request on November 9 that the delivery of issues already negotiated in the United States should be deferred and that new U.S. borrowings should be postponed until 1966, bond prices weakened and the Bank of Canada prevented a sharp upward adjustment of bond yields by providing moderate support. When the Bank Rate was raised by ½ per cent effective December 6 the following statement was issued:

CANADIAN LONG-TERM INTEREST RATES



> "The Bank of Canada announced tonight that the Bank Rate, which had been 4¼ per cent since November, 1964, has been increased to 4¾ per cent effective December 6.
>
> This action followed the announcement of the increase of ½ per cent in the rediscount rates approved by the Federal Reserve Board of the United States.
>
> The Governor, Mr. Louis Rasminsky, stated that the policy of the Bank would continue to be directed to making provision for the over-all credit needs of sound economic growth."

This indication that the increase in the Bank Rate was not intended to mark any major departure from the policy of the Bank as it had been developing helped to stabilize the bond market with little support by the central bank. Increases in market yields were concentrated in the short-term maturity range and by the end of December long-term Government yields were no higher than they had been early in November. Long-term yields were rising in the United States and the differential narrowed by about 15 basis points from mid-November to the end of the year. The arrangement announced on December 5 which ensured that Canadian borrowers would be exempt from the new guideline restricting access to the U.S. market for new long-term issues was an important factor contributing to the stability of Canadian bond prices in this period.

There were some special factors putting upward pressure on short-term interest rates during December. In particular, the supply of funds for investment in short-term paper fell off as a result of the December 15 tax date in the United States and corporate window-dressing for year-end statements. The Bank of Canada eased the banking system's cash reserve position in order to prevent these developments from tightening the short-term market unduly.

CHARTERED BANK ASSETS. The total of the Canadian dollar and net foreign assets of the chartered banks rose by 12 per cent in 1965 compared to 5¼ per cent in 1964. General loans expanded at the same 16 per cent rate as in 1964, and the expansion of the two main components of general loans, namely business loans (14 per cent) and unsecured personal loans (22 per cent), was also in line with experience in 1964. By contrast, loans to the other main groups of borrowers all increased a good deal more rapidly than in 1964. Part of the increase in loans to sales finance companies was an indirect consequence of the finance company default. Heavy municipal borrowing reflected the relatively low level of municipal security issues as well as the financing of projects for which funds will be forthcoming from the Municipal Development and Loan Board. The banks' total Canadian dollar loans rose 20 per cent compared to an increase of 14 per cent in 1964. There was also an increase in foreign currency lending to Canadian residents. During 1965 the banks' holdings of foreign currency securitics issued by Canadian borrowers plus their foreign currency loans to residents of Canada rose by $275 million compared to $195 million in 1964.

CHARTERED BANK LOANS

(millions of dollars)

	Dec. 1963	Dec. 1964	Dec. 1965	Percentage changes 1964	1965
Month-End					
Business loans	4,354	4,929	5,627	13.2	14.2
Unsecured personal loans	1,432	1,793	2,186	25.2	21.9
Other personal loans	464	531	615	14.4	15.8
Loans to farmers	635	708	804	11.5	13.6
Loans to institutions	234	262	285	12.0	8.8
Total general loans	7,119	8,222	9,517	15.5	15.8
Average of Wednesdays					
Total general loans	7,086	8,204	9,505	15.8	15.9
Loans to Provinces	44	33	56	−25.0	69.7
Municipalities	304	349	514	14.8	47.3
Grain dealers	186	143	235	−23.1	64.3
Sales finance companies	249	274	470	10.0	71.5
Total	7,869	9,002	10,780	14.4	19.8

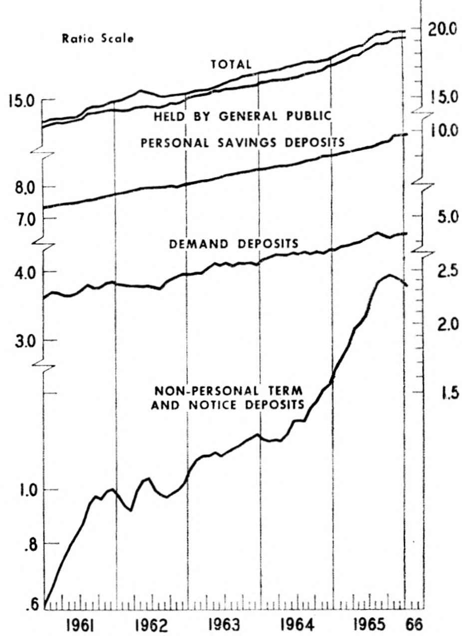
In 1965 as in 1964 the pace of expansion in the banks' loans exceeded the growth rate of their total assets. In December 1965 the banks' holdings of "more liquid" assets were about $250 million higher than a year earlier but the ratio of "more liquid" assets to total assets had declined from 32 per cent to 30 per cent.

CHARTERED BANK DEPOSITS AND OTHER LIQUID CLAIMS HELD BY THE PUBLIC. In December 1965 the total of currency and chartered bank Canadian dollar deposits was 12 per cent higher than a year earlier compared to an increase of 6 per cent in 1964. The amount held by the general public, i.e., exclusive of Government of Canada deposits, increased by 12 per cent compared to 7½ per cent in 1964. The increases in both of these series in 1965 were particularly rapid during the summer at the time of the difficulties created by the finance company default; during the last few months both series have levelled off.

The rate of growth of currency and demand deposits was about the same in the two years. The more rapid expansion of total Canadian dollar deposits in 1965 reflected the fact that the banks' personal savings deposits and more particularly their other interest-bearing term accounts expanded much more rapidly than in 1964. The table below also shows that the amount of foreign currency deposits held with the chartered banks by Canadian residents declined in 1965 after a very rapid increase in 1964. For the total of these and the Canadian dollar deposits, the rate of increase was about the same in the two years.

CURRENCY OUTSIDE BANKS AND CHARTERED BANK DEPOSITS

Average of Wednesdays — Billions of Dollars



Seasonally adjusted.

CURRENCY AND CHARTERED BANK CANADIAN DOLLAR AND FOREIGN CURRENCY DEPOSITS

(percentage change from previous December)

	1964	1965
Currency outside banks and demand deposits	6.3	6.5
Personal savings deposits	5.9	9.0
Non-personal term and notice deposits	23.0	54.1
Sub-total: currency and Canadian dollar deposits held by the public	7.3	12.0
Foreign currency deposits of residents	65.9	−8.0
Total	10.1	10.5

The impact of the finance company default on Canadian investors' preferences for various types of financial claims was also an important factor in the rapid growth of the chartered banks' Canadian dollar deposits.

The following table puts the recent trend of currency and bank deposits into a broader framework which includes other types of relatively liquid claims held by the public.

GENERAL PUBLIC HOLDINGS OF CERTAIN FINANCIAL CLAIMS(1)

(millions of dollars)

	Dec. 1963	Dec. 1964	Dec. 1965	Percentage change 1964	Percentage change 1965
Currency and chartered bank demand deposits	6,296	6,693	7,130	6.3	6.5
Chartered bank personal savings deposits	8,357	8,846	9,642	5.9	9.0
Quebec Savings Bank deposits	347	376	402	8.4	6.9
Trust and mortgage loan company demand deposits and certificates	1,079	1,370	1,475	27.0	7.7
Sub-total	16,079	17,285	18,649	7.5	7.9
Chartered Banks					
— non-personal term and notice deposits	1,215	1,494	2,303		
— foreign currency deposits of residents					
— swapped	408	718	549		
— other	390	606	669		
Finance company short-term paper held by residents	525	600	550		
Other commercial paper	241	287	167		
Provincial and municipal short-term paper(2)	230	160	250		
Bankers' acceptances	9	11	150		
Government of Canada					
— Treasury bills	430	332	157		
— Market bonds of maturity under 3 years	1,776	1,402	1,441		
— Canada Savings Bonds	5,133	5,613	5,866		
Provincial savings and parity bonds	470	575	650		
Trust company investment certificates	1,279	1,478	1,930		
Mortgage loan company debentures	845	980	1,060		
Total	29,030	31,541	34,391	8.6	9.0

(1) This table includes relatively small amounts of some items held by non-residents.
(2) Estimated outstanding amount of short-term paper issued by provinces, municipalities and their enterprises.

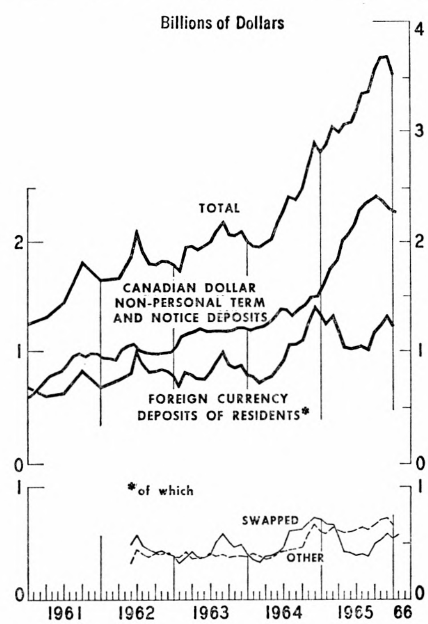
The first group of claims shown in the table, consisting mainly of accounts which may be transferred by cheque, rose at about the same rate in 1965 as in 1964. There was a significant acceleration in the increase in chartered bank personal savings deposits while the accounts of trust and loan companies grew much less rapidly than in 1964. Personal savings deposits fell less than seasonally in November when the annual campaign for the sale of Canada Savings Bonds was held, and it will be noted lower in the table that the net increase in Canada Savings Bonds outstanding was considerably less in 1965 than in 1964.

The rest of the table includes the other liabilities of the chartered banks to Canadian residents and a variety of other interest-bearing claims held by the public. Resident holdings of finance company and other commercial paper both declined during 1965, but there were substantial increases in the amount of short-term paper issued by provinces and municipalities and their business enterprises, and in the amount of bankers' acceptances outstanding. During the summer the banks reduced their acceptance fees and many commercial borrowers who found it difficult to sell their paper or to obtain bank loans chose the alternative of negotiating acceptances. An active market in acceptances has not yet developed and most of them have remained in the hands of investment dealers.

Public holdings of Government of Canada treasury bills continued to decline in 1965 but there was a modest increase in the public's holdings of short-term Government of Canada bonds and a further increase in the amount of provincial savings and parity bonds. The trust companies raised the interest rates offered on their certificates sharply in the second half of the year and succeeded in increasing the outstanding amount very substantially in 1965.

Developments in the banks' swapped deposit business and in their Canadian dollar term deposit business call for particular comment. Swapped deposits are term deposits converted into a foreign currency, usually U.S. dollars, which the bank has undertaken through a forward contract to convert back into Canadian dollars at maturity. The return to the depositor on the investment of Canadian dollars is made up of the yield on his foreign currency deposit and the profit or loss on the exchange swap. Swapped deposits compete directly with other Canadian short-term instruments. By offering attractive rates on swapped deposits the banks built up these balances by $300 million during 1964, partly at the expense of potential growth in their own Canadian dollar short-term deposits on which lower

CHARTERED BANKS: SELECTED DEPOSITS



rates were offered. Canadian residents also increased their other foreign currency deposits with the chartered banks by over $200 million in 1964.

Late in 1964 some chartered banks introduced one-year bearer discount notes and other new Canadian dollar deposit instruments with terms of one year or more. In the first half of 1965 the banks lowered the rates offered on swapped deposits below those on Canadian dollar short-term deposits, in part because the development of a substantial discount on the forward U.S. dollar reduced the return available to the banks on covered short-term foreign investments. These two developments diminished the relative attractiveness of swapped deposits, which declined by about $300 million in the first half of 1965 while the banks' Canadian dollar term deposits were rising very rapidly. Later in the year the banks began to provide flexible short-term Canadian dollar deposit instruments for customers with large blocks of funds, offering yields well in excess of the rates previously available from banks. In the same period, however, there was a sharp increase in the yields available to banks on foreign investments, reflecting in part the exchange profit which resulted from the emergence of a premium on the forward U.S. dollar. As a result the banks offered higher yields on their swapped deposits which began to rise again in September while the Canadian dollar term balances rose less rapidly and then declined during the fourth quarter.

OTHER CAPITAL MARKET DEVELOPMENTS. In addition to the rapid increases in bank loans during 1965 there were unusually large flows of credit in other parts of the financial system. The total amount of consumer credit outstanding increased by about 15 per cent, slightly less than in 1964. The chartered banks continued to increase their share of this business and other lenders also contributed to the growth.

The strong demand for credit was also reflected in the mortgage market. Approvals of residential mortgages by private institutions and Central Mortgage and Housing Corporation were 13 per cent higher in 1965 than in 1964, while approvals of mortgages on non-residential properties were 15 per cent above their 1964 level. The life insurance companies, trust and mortgage loan companies and other private institutions committed mortgage funds at a very rapid rate early in 1965: the value of their approvals in the first half of the year was 32 per cent higher than a year earlier. Later in the year some of the mortgage institutions sharply reduced the rate of their new lending from this unsustainably high rate, although disbursements under earlier commitments led to continued increases in the mortgage portfolios of the institutions. Since the demand for residential and other mortgage financing remained strong, most lenders raised the rates charged for conventional loans by ¼-½ per cent in July and August.

By the end of the year there had been further increases averaging ¼ per cent and many lenders were charging 7½ per cent on prime conventional mortgages.

The maximum interest rate permitted on mortgages guaranteed under the National Housing Act was 6¼ per cent throughout 1965. As higher yields were available on conventional loans, particularly in the second half of the year, private institutions invested less in NHA mortgages than in 1964 while their approvals of conventional mortgages rose by 14 per cent. Central Mortgage and Housing Corporation increased the amount of its direct NHA lending in the second half of the year. On January 10, 1966 the maximum rate was raised to 6¾ per cent in order to attract more private funds into NHA mortgages.

In addition to the increases in mortgage borrowing and bank loans to which reference has been made, private non-financial businesses borrowed heavily from the sales finance companies, and although the amount of short-term commercial paper outstanding at the end of 1965 was $106 million lower than a year earlier there was a more-than-offsetting increase in borrowing through bankers' acceptances. Private non-financial business firms also raised about $200 million more than in 1964 by sales of new bonds and stocks. These new issues included substantial sales to non-residents.

SELECTED ITEMS OF BUSINESS FINANCING[1]

(millions of dollars)

	1963	1964	1965
Increases in			
Bank loans[2]	309	571	655
Sales finance company loans	221	204	210
Commerical paper (excluding grain dealers)	−18	49	−106
Bankers' acceptances	2	2	139
Industrial Development Bank loans	27	31	29
Net new issues of bonds	450	547	841
Net new issues of stocks	223	345	252
Total	1,214	1,749	2,020

(1) Excludes most forms of mortgage borrowing by non-financial businesses, for which comparable information is not available.
(2) Business loans, excluding provincially guaranteed loans to public utilities.

The financial requirements of provincial and municipal governments and their enterprises taken as a whole rose sharply in 1965. The amount raised by these governments and their enterprises by the net sale of bonds was well below the level in 1964, but their bank borrowings increased substantially, particularly in the case of municipalities, and the outstanding amount of their short-term market paper also rose substantially. The total of these borrowings appears to have fallen short of the aggregate requirements of the governments and their enterprises and there was probably some reduction in their holdings of cash and liquid assets.

The federal government's balance of revenues and expenditures improved by about $220 million in 1965, on a national accounts basis, following an improvement of $620 million from 1963 to 1964. The changes in the Government's accounts since 1963 are shown in the following table.

GOVERNMENT OF CANADA FINANCIAL ACCOUNTS

(millions of dollars)

	Calendar 1963	Calendar 1964	Calendar 1965
Budgetary balance	−633	−153	+ 70
Adjustments from budgetary to National Accounts basis: (plus sign indicates items added to budgetary revenue or deducted from expenditure, minus sign the reverse)			
Government employee pension fund contributions and interest earnings, less pension payments	+292	+310	+345
Unemployment insurance and old age security fund receipts, less disbursements	−150	− 37	+240
Capital assistance to non-defence industry	+ 56	+ 76	+ 80
Increase in corporate tax liabilities, less collections	+ 28	−123	−132
Disbursements of other Government funds and agencies, less receipts under budgetary appropriations	− 25	+ 74	− 66
Reserves and write-offs	+ 85	+119	+ 44
All other adjustments (net)	+ 55	+ 62	− 31
National Accounts balance	−292	+328	+550
Financing: uses (+) and sources (−) of funds			
Funds advanced to Government lending agencies(1)	+150	+326	+544
Funds from sale of Northern Ontario Pipelines	−108	-	-
Funds repaid or lent to International Monetary Fund	+ 87	+264	+ 68
Investment of Columbia River funds in U.S. securities	-	+220	− 33
Change in accrued corporate tax liabilities less collections	+ 28	−123	−132
Funds advanced to Exchange Fund	+ 35	+ 48	+ 81(2)
Increase (−) in direct and guaranteed debt held outside Government accounts	−976	−195	−137
Change in Canadian dollar bank balances	+470	−307	+156
Change in all other assets and liabilities (net)	+ 22	+ 95	+ 3
Total	−292	+328	+550

(1) Central Mortgage and Housing, Export Credits Insurance and Farm Credit Corporations and the Municipal Development and Loan Fund Board.

(2) Includes $33 million advances in connection with redemption of Columbia River securities which was offset by a corresponding reduction in "Investment of Columbia River funds in U.S. securities".

Source: "Canada Gazette", "Monthly Statement of the Government's Financial Operations". Adjustments to National Accounts basis for 1965 are Bank of Canada estimates.

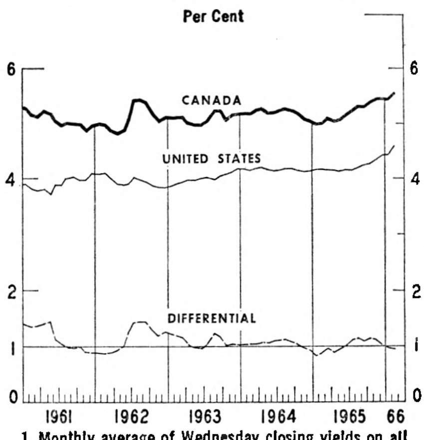
The outstanding amount of Government of Canada direct and guaranteed securities exclusive of Government account holdings increased by $161 million in 1965.* Public holdings of Canada Savings Bonds increased by $253 million while there was a decline of $92 million in the amount of market securities outstanding outside Government accounts. The fact that the Government was able to effect some net pay-off of maturing market issues at the time of refundings was an important factor in the development of the bond market during the year.

Chartered bank holdings of Government securities changed little on balance in 1965, the Bank of Canada's portfolio increased by $357 million, and there was a net decline of $468 million in the public's holdings of market debt.

FINANCIAL TRANSACTIONS OF CANADIANS WITH NON-RESIDENTS. The net use of non-resident savings by Canadians increased from $433 million in 1964 to over $1,100 million in 1965. Capital inflows into Canada rose from almost $800 million in 1964 to about $1,300 million in 1965 while official reserves of foreign exchange plus Canada's net creditor position with the International Monetary Fund, which had increased by $363 million in 1964, rose by $157 million in 1965. Details of the main items in the capital account for the first three quarters of 1965 together with estimates of some of the movements in the fourth quarter are given in the table on the following page.

Taken together the major types of long-term capital movements shown in the table gave rise to a net capital inflow of about the same size in 1964 and 1965. Foreign direct investment in Canada was substantially higher than in 1964 but capital outflows resulting from non-resident sales of outstanding Canadian stocks to Canadians and the retirement of called and matured Canadian bonds held by non-residents were also considerably larger. Deliveries of new issues of Canadian bonds sold to non-residents amounted to $1,100 million in both 1964 and 1965. Offerings of new Canadian bond issues in the United States market were exceptionally heavy in the late summer and early autumn of 1964 following the enactment of the U.S. Interest Equalization Tax and the granting of an exemp-

LONG-TERM GOVERNMENT BOND YIELD AVERAGES[1]



1. Monthly average of Wednesday closing yields on all direct issues due or callable in 10 years or more.

* This change differs from that shown in the table as a result of differences in the methods of calculation.

CANADIAN BALANCE OF INTERNATIONAL PAYMENTS

(millions of Canadian dollars)

	1964	1965	1965 1 Q	1965 2 Q	1965 3 Q	1965 4 Q
Current Account Balance	−433	n.a.	−397	−363	6	n.a.
Capital Account Transactions						
Direct investment						
foreign investment in Canada(1)	255	n.a.	70	120	100	n.a.
Canadian investment abroad(1)	−140	n.a.	− 35	–	− 40	n.a.
Canadian stocks						
net transactions	−128	−226	− 77	− 81	− 30	− 38
Canadian bonds						
new issues	1,102	1,105	264	302	297	242
retirements	−306	−366	− 63	−175	− 54	− 74
net trade in outstandings	77	64	3	17	38	6
Foreign securities						
net transactions	− 63	− 74	− 35	− 5	− 22	− 12
Columbia River treaty						
net transactions	54	32	–	–	–	32
Foreign currency position of Canadian banks						
vis-a-vis non-residents net increase (−)	−303	426	219	248	− 23	− 18
Canadian dollar deposits and treasury bills	12	45	64	− 51	− 26	58
Canadian commercial paper	− 11	11	–	7	4	–
Canadian finance company paper	196	−179	− 38	− 7	− 65	− 69
Canadian finance companies' other						
short-term obligations	52	205	25	99	89	− 8
Other long and short-term capital	− 1	n.a.	− 72	−110	− 48	n.a.
Total capital account transactions	796		325	364	220	
Changes in reserves and IMF position						
Official holdings of gold and foreign exchange	86	− 11	−118	− 92	144	55
Net position with IMF	277	168	46	93	82	− 53
Total	363	157	− 72	1	226	2

(1) Exclusive of undistributed earnings.

Note: A positive figure indicates an inflow of capital into Canada, and thus an increase in Canadian liabilities or a decrease in Canadian assets. A negative figure indicates the reverse.

tion for new Canadian security issues. The interest-rate spread between long-term Canadian and U.S. Government bonds narrowed by about 25 basis points between August 1964 and January 1965. In early December 1964 the Canadian authorities suggested to provincial governments that it would be helpful if little use were made of the U.S. market for the time being. The volume of new offerings was reduced until March when the suggestion was withdrawn following the introduction of the U.S. balance of payments measures. After the tightening of the U.S. guidelines in June, when access to other sources of capital was further restricted, the volume of new offerings of Canadian long-term bonds in the U.S. market increased. It remained heavy until mid-November when an official request was made of Canadian borrowers to defer until 1966 the delivery of the proceeds of new issues already negotiated in the United States and to postpone any new U.S. borrowing until then. The carryover of bonds offered in late 1965 for delivery in early 1966 was therefore unusually large.

NEW ISSUES OF CANADIAN BONDS SOLD TO UNITED STATES RESIDENTS

(millions of Canadian dollars)

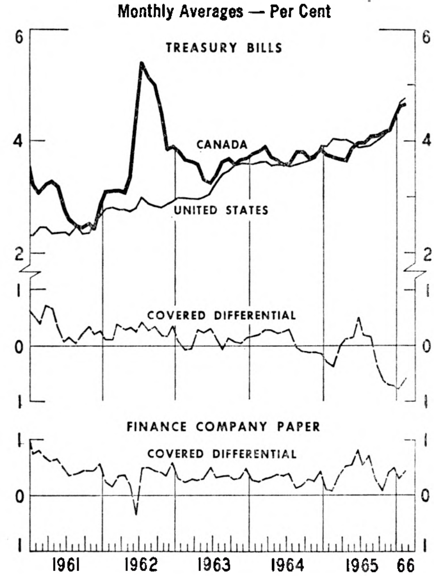
	By date of offering	By date of delivery	Undelivered at end of period
1964			
1 Q	91	125	88
2 Q	238	294	32
3 Q	309	103	238
4 Q	345	532	51
1965			
1 Q	339	255	135
2 Q	265	298	102
3 Q	378	290	190
4 Q	344	232	302

In contrast to the broadly similar pattern of long-term capital flows in 1964 and 1965, there were very substantial changes in the main types of short-term flows. Foreign investors' interest in Canadian finance company paper was reduced by both the U.S. guidelines and the June default. Although the covered yield to foreign investors was relatively high during much of 1965, there was an outflow of $179 million compared to an inflow of $196 million to Canada in 1964. Other short-term borrowings of finance companies provided an inflow of $205 million in 1965. The latter figure includes the effects of the takeover and subsequent finaneial reorganization of a Canadian finance company by a U.S. firm as well as other short-term transactions between Canadian companies and foreign banks and parent companies.

In 1965 there was a small net capital inflow from transactions in treasury bills and commercial paper and from changes in non-resident holdings of Canadian dollar deposits, compared with almost no net movement in 1964. However, there was a very substantial reversal in flows arising from the foreign currency business of the banks. During 1964 Canadians had built up their swapped deposits and other foreign currency bank balances with Canadian banks, and these funds, together with increased balances deposited by United States residents, werc channelled principally into investments in Britain and Continental Europe.

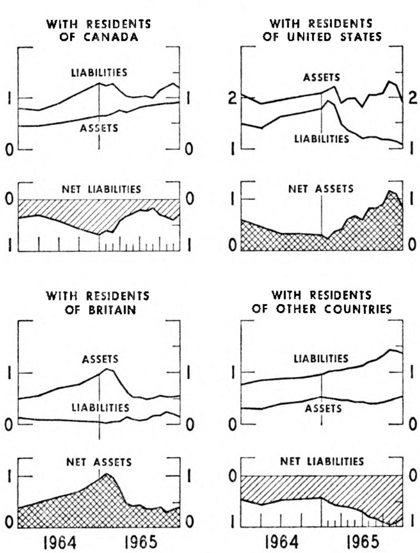
SELECTED 3 MONTH INTEREST RATES

Monthly Averages — Per Cent



CHARTERED BANKS FOREIGN CURRENCY ASSETS AND LIABILITIES[1]

Billions of Canadian Dollars



1. Assets and liabilities carried on the books of head offices and branches in Canada.

Following the introduction of the U.S. balance of payments programme in February 1965, the Minister of Finance requested each chartered bank to conduct its foreign currency operations in such a way that the net asset position of head offices and Canadian branches vis-a-vis U.S. residents would not fall below the level at the end of 1964. As U.S. residents withdrew U.S. dollar deposits from Canadian banks in response to the guidelines, the chartered banks met only part of the drain by liquidating investments in the United States; they drew funds from other countries to the extent of $955 million in 1965 by liquidating assets and increasing liabilities. On balance, the foreign currency operations of the Canadian banks resulted in a net flow of capital into the United States of $529 million and a net inflow into Canada of $426 million in 1965. As the table on page 36 shows this inflow into Canada provided an important part of the financing of the current account deficit in the first half of 1965.

CANADIAN CHARTERED BANKS
HEAD OFFICES AND BRANCHES IN CANADA

NET CHANGES IN FOREIGN CURRENCY POSITION[1]

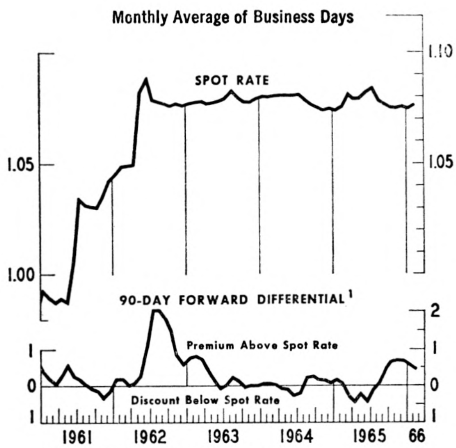
(millions of Canadian dollars)

	1964	1965	1965 1 Q	1965 2 Q	1965 3 Q	1965 4 Q
With non-residents						
U.S. residents						
Assets	40	−208	−215	−83	271	−181
Liabilities	337	−737	−337	−261	−25	−114
Net	−297	529	122	178	296	−67
Other non-residents						
Assets	691	−440	−231	−324	16	99
Liabilities	91	515	110	102	289	14
Net	600	−955	−341	−426	−273	85
Total						
Assets	731	−648	−446	−407	287	−82
Liabilities	428	−222	−227	−159	264	−100
Net claims on non-residents	303	−426	−219	−248	23	18
With Canadian residents						
Assets	198	277	100	71	60	46
Liabilities	532	−107	−167	−136	143	53
Net	−334	383	267	207	−83	−8
Changes in chartered banks' own net position	−31	−43	48	−41	−60	10

(1) Adjusted for variations in exchange rates.

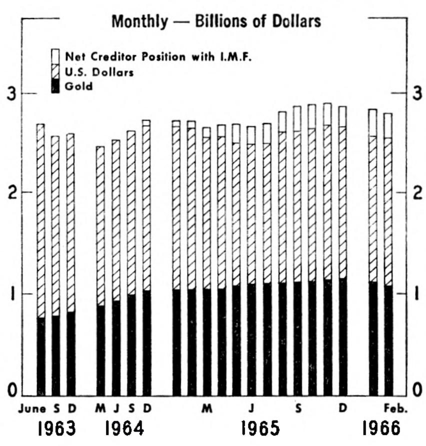
The spot rate for the United States dollar in the Canadian foreign exchange market rose from 107⅜ at the beginning of the year to 108½ in July. It declined following the announcement of the Soviet wheat sale in mid-August and closed the year at 107½. The forward exchange rate for the U.S. dollar in Canada was at a premium from August 1964 to February 1965. The rate moved to a discount in February and to a premium again in late July. From September to December the 90-day forward rate for the U.S. dollar remained at a premium yielding ½-¾ per cent when expressed at annual rates.

U.S. DOLLAR IN CANADIAN FUNDS



1. Expressed as a percent per annum.

OFFICIAL HOLDINGS OF GOLD AND U.S. DOLLARS AND NET CREDITOR POSITION WITH THE I.M.F.



Canada's official holdings of gold and U.S. dollars declined by U.S. $10 million in 1965 while our net creditor position with the IMF increased by U.S. $156 million. Of this latter amount, the equivalent of U.S. $121 million was accounted for by other countries' drawings of the Fund's holdings of Canadian dollars, and the equivalent of U.S. $35 million was accounted for by other countries' drawings of Canadian dollars which the Fund borrowed from Canada under the General Arrangements to Borrow.

BANK OF CANADA OPERATIONS. The Bank of Canada's operations in Government of Canada securities in each month of 1965 are summarized in the table on pages 42 and 43. A net amount of $229 million of Government securities was acquired by the Bank in market transactions, and other transactions led to an additional net increase of $128 million in the Bank's portfolio of Government securities.

The technique of entering into special one-month purchase and resale agreements with money market dealers was used at the end of 1963 and 1964 to offset seasonal currency movements during December and January. In 1965 the Bank of Canada's ordinary security transactions together with variations in the level of the Government's deposit at the Bank provided the necessary offset. On occasion during 1965 the Bank of Canada purchased foreign currency assets from the Exchange Fund on a temporary basis in order to assist in the management of chartered bank cash reserves. In 1965 as in 1964 the Bank of Canada's net earnings were transferred to the Receiver General at various times during the year.

The U.S. $200 million credit facility which was made available by the Bank of Canada to the Bank of England in November 1964 had been drawn on to the extent of U.S. $50 million by the end of 1964. Additional amounts of U.S. $25 million each were drawn in January and April 1965. In May the Bank of England used part of the proceeds of a United Kingdom drawing on the IMF to cxtinguish its liability to the Bank of Canada. In September 1965, the Bank of Canada along with other central banks entered into new arrangements with the Bank of England to support the improved sentiment towards sterling in the exchange markets. In the case of the Bank of Canada the facility was for an amount of U.S. $75 million; no drawings have bcen made.

In 1965 the United States drew Canadian dollars in an aggregate amount of $85 million from the IMF. The funds were used to facilitate repayments to the Fund by other countries and the Bank of Canada co-operated in the carrying out of these transactions.

Bank of Canada advances to banks were outstanding on 48 business days during 1965 compared with 15 business days in 1964. The maximum amount outstanding on any one day was $31.7 million and the daily average for the year was $1.77 million compared with $0.02 million in 1964. The Bank of Canada held securities purchased from money market dealers under ordinary resale agreements on 42 business days during the year compared with 49 days in the previous year. The maximum amount outstanding on any one day was $71 million and the daily average for the year was $2.83 million compared with $2.43 million in 1964.

The assets and liabilities of the Bank of Canada at December 31, 1965, together with comparative figures for December 31, 1964, are set forth in the balance sheet at the end of the Report.

BANK OF CANADA NET TRANSACTIONS IN GOVERNMENT SECURITIES IN 1965

(delivered basis — par values in millions of dollars)

	Net purchases from (+) or net sales to (−) investment dealers and banks						
		Bonds[1]					
	Treasury bills	2 & under	2 to 5	5 to 10	Over 10	Sub-total: bills and bonds	Securities under PRA
Jan.	+19	+ 75	− 71	−14	–	+ 9	−100[2]
Feb.	+15	+ 67	+ 3	−46	+ 8	+ 46	–
Mar.	−18	+ 51	+ 4	+ 7	+ 17	+ 61	–
Apr.	−51	+ 82	+ 31	+15	+ 10	+ 87	–
May	+69	+ 8	+ 10	+ 7	+ 12	+106	+ 3
June	−54	+ 2	+ 2	+ 5	+ 37	− 7	− 3
July	−13	− 9	+ 15	–	+ 2	− 5	–
Aug.	− 9	− 4	− 18	–	− 18	− 48	–
Sept.	−21	− 30	− 70	–	+ 1	−119	–
Oct.	+27	+ 2	–	–	–	+ 29	–
Nov.	+ 4	+ 8	–	+ 5	+ 31	+ 48	–
Dec.	+39	− 12	− 7	− 1	+ 5	+ 24	–
Total	+ 7	+239	−101	−22	+105	+229	−100

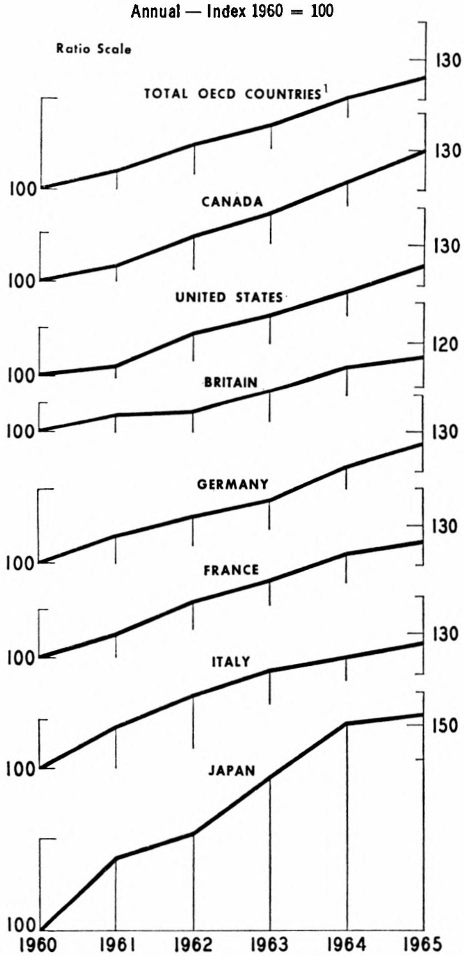
(1) Classified by years to maturity at time of transaction.

(2) Special PRA's: includes $97 million of bonds and $3 million treasury bills.

Net transactions with Government and other accounts								
Purchases (+) of new issues less matured holdings		Net sales (−) to Securities Investment Acct.		Net sales (−) to other Govt. and client accounts		Net change in holdings of Government securities		
bills	bonds	bills	bonds	bills	bonds	bills	bonds	total
− 11	–	–	+ 5	− 46	–	− 41	−102	−143
+ 26	+ 3	–	− 60	+ 6	–	+ 47	− 26	+ 21
+ 37	–	+10	− 30	− 31	−26	− 2	+ 23	+ 21
+ 16	+ 27	–	− 80	+ 12	+10	− 23	+ 96	+ 73
− 42	–	–	+105	− 23	+ 9	+ 6	+152	+158
+ 76	–	–	− 75	− 17	+ 5	+ 4	− 25	− 20
+ 12	+ 44	–	–	− 36	–	− 36	+ 52	+ 16
+ 14	–	–	–	− 16	–	− 10	− 40	− 50
+ 45	+122	–	–	− 22	+ 5	+ 3	+ 29	+ 31
+140	–	–	–	− 15	− 2	+152	–	+153
+ 17	–	–	–	− 20	− 1	–	+ 43	+ 44
+ 5	+ 43	–	–	− 14	− 4	+ 30	+ 24	+ 54
+337	+239	+10	−135	−219	− 3	+131	+226	+357

The External Economic Environment

GROSS NATIONAL PRODUCT
Constant Prices
Annual — Index 1960 = 100



1965 preliminary estimates.

1. Includes countries shown plus Austria, Belgium, Denmark, Greece, Iceland, Ireland, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and Turkey.

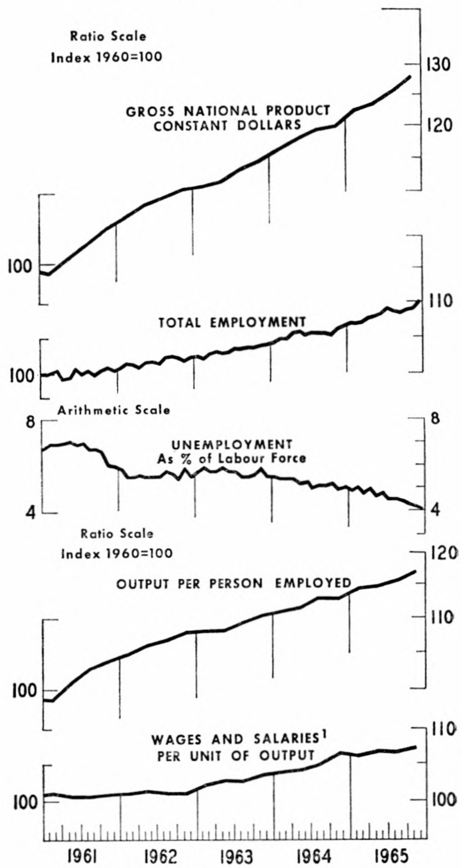
The world trading environment continued on balance to be reasonably favourable to Canada in 1965, despite the slowdown of import demand in two of our important external markets—Britain and Japan. The total output of OECD member countries (which take about 85 per cent of Canada's exports) rose by about 4½ per cent and the value of world trade by some 8-9 per cent. While these increases were somewhat below the exceptionally large gains experienced in 1964, they compare favourably with the average of recent years. In Canada's most important external market, the United States, the economic expansion was even stronger in 1965 than in 1964. Canada's wheat and flour exports received strong support from a shortfall in the Soviet Union's 1965 grain crops and continued strong world-wide demand for wheat.

At the beginning of 1965 most of the overseas industrialized countries were attempting to restrain price and cost pressures. In the course of the year this emphasis in policy was intensified in Germany and also in the Scandinavian countries and in Britain where balance of payments considerations had a major influence on policy formulation. On the other hand as the year progressed the authorities in Italy and Japan, and to some extent in France as well, felt able to shift the emphasis of policy towards encouraging some acceleration in the growth of demand. In the United States, as unemployment declined the authorities became increasingly concerned that price and cost pressures might develop which could endanger the strong expansion of the past few years. The Government laid stress on its "guideposts" for non-inflationary price and wage behaviour and intervened directly on several occasions to influence price and wage movements. Another important feature of United States policy during 1965 was the issuance of a number of balance of payments guidelines directed towards reducing net capital outflows.

In the United States economic expansion continued through its fifth year at a faster pace than had generally been expected at the beginning of 1965. Total output is now estimated to have risen by 7½ per cent in value and 5½ per cent in volume in 1965, compared with gains of 6¾ per cent and 5 per cent respectively in 1964. Business fixed investment was the most dynamic area of demand, increasing by 15 per cent. Consumer expenditures also advanced strongly, reinforced by tax reductions and increased social security benefit payments. Following two years of virtual stability Federal Government expenditures rose during 1965 as a result of higher defence commitments and expanded welfare programmes. On a national accounts basis the fiscal position weakened at a seasonally adjusted annual rate of $6½ billion from the first to the second half of the year. On the other hand residential construction failed to rise above the previous year's level and export growth was small.

The margin of unused capacity in the United States was further re-

UNITED STATES
MEASURES OF ECONOMIC ACTIVITY

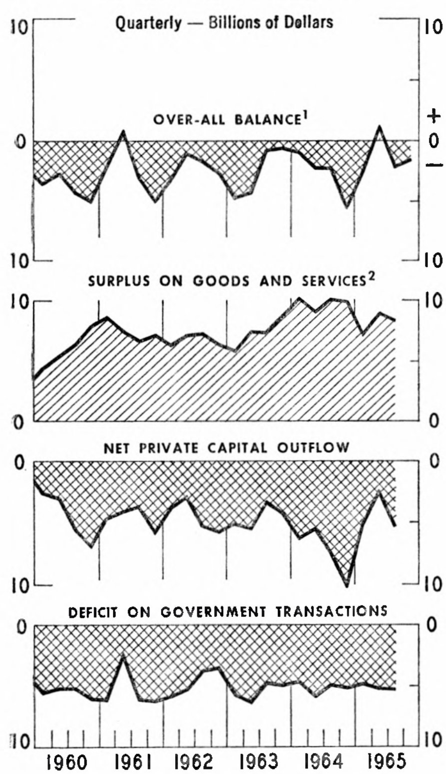


Seasonally adjusted.

1. Includes supplementary labour income and employer contributions for social insurance and to private pension, health and welfare funds.

duced in 1965. This was accompanied by a large increase in imports which went up by 14 per cent compared with 9 per cent in the previous year. As in 1964, employment increased more than the labour force and the unemployment rate fell to an average of 4.2 per cent in the fourth quarter from 5.0 per cent a year earlier. The 5½ per cent increase in output, taken in conjunction with the 2½ per cent rise in employment, implies an increase in output per worker not very different from that experienced in 1964. However, the average number of hours worked went up, and the gain in output per man-hour fell short of both the previous year's performance and the average for the whole expansion. On the other hand wage and salary increases continued to be moderate and unit labour costs in the private sector rose less than in 1964. The higher level of economic activity was accompanied by more upward movement in prices than had been the case in the first four years of the expansion. After increasing at an average annual rate of 1.3 per cent between 1960 and 1964, the GNP price index of all goods and services rose by 1.8 per cent in 1965. The over-all consumer price index in December was 2.0 per cent higher than a year earlier, almost twice the increase experienced during the previous twelve-month period.

UNITED STATES
BALANCE OF PAYMENTS



Seasonally adjusted at annual rates.
1. As measured by changes in U.S. official reserve assets and in liquid liabilities to all foreigners.
2. Excludes net military expenditures abroad.

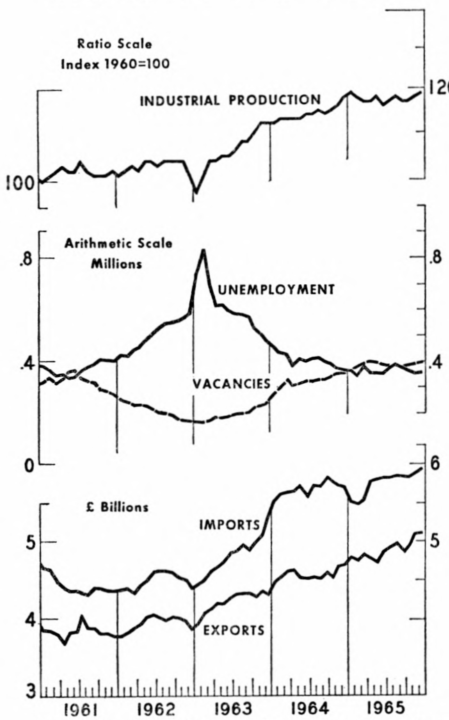
During the course of the year increased attention was given to the risk that aggregate demand might rise at a rate which would exert stronger upward pressure on costs and prices with adverse consequences for the domestic economy and the balance of payments. Credit conditions became tighter in the latter part of the year. There was a rapid growth in bank lending in the course of the year which was associated with a marked increase in public holdings of time and savings deposits at banks and by a reduction in bank holdings of United States Government securities. Commercial bank loans and investments increased by 10 per cent compared with an 8½ per cent increase in 1964. Both the banking and non-financial business sectors of the economy became less liquid and from July onward interest rates moved progressively higher. By early 1966 interest rates generally had risen to the highest levels for many years. To help moderate the growth in final demand and to meet rising Government expenditures, the President in his 1966 budget message asked Congress to approve tax changes which would accelerate tax payments by corporations and individuals, rescind the recent reduction in excise taxes on automobiles and provide for new charges on the users of transportation facilities.

As the diagram on the preceding page shows, the United States balance of payments position improved sharply immediately after the announcement of the first guidelines in February, but some of the improvement was temporary and the deficit widened again in the second half of the year. For the year as a whole the over-all deficit was about $1.3 billion,* compared with $2.8 billion in 1964. The merchandise trade balance became less favourable, moving from a surplus of $6.7 billion in 1964 to a surplus of $4.8 billion in 1965. Direct investment outflows increased in 1965, particularly in the first half of the year, but the outflow of other capital was greatly reduced. Modifications of the guidelines made early in December were aimed at eliminating the deficit in the over-all payments position in 1966.

Economic developments in Britain during 1965 continued to be dominated by the need to correct the severe balance of payments deficit which had emerged in 1964 and which led to very heavy losses of reserves. The initial steps taken to deal with the situation late in 1964 were reinforced in the April budget, and late in July further measures were taken to restrain the growth of domestic demand, restore equilibrium in the balance of payments and re-establish confidence in sterling. While investment outlays and some other elements of demand, particularly expenditures on consumer durables, were dampened, the easing of pressure on available resources appears to have been modest so far. The labour market remained very tight throughout the year and overtime work continued at a high level. There was a further upward drift in prices. Average weekly earnings in manufacturing rose by more than 8 per cent in 1965 while productivity gains appear to have been slight. The Prices and Incomes Board which was established during the year undertook a number of reviews of proposed increases in both prices and wages and towards year-end issued its first reports. In October the Government announced plans to introduce legislation to strengthen

* As measured by changes in United States official reserve assets and in liquid liabilities to *all foreigners*. (As measured by changes in United States official reserve assets and in liquid and certain non-liquid liabilities to foreign official agencies the deficit was $1.4 billion in 1965 and $1.25 billion in 1964.)

BRITAIN
MEASURES OF ECONOMIC ACTIVITY



Seasonally adjusted (Imports and Exports 3-month moving average at annual rates).

its prices and incomes policy by providing a statutory delaying and reviewing mechanism. Under this legislation price and wage increases could be postponed until a review was conducted by the Prices and Incomes Board.

Britain's payments position strengthened in the course of the year as the result of improved export performance and the reversal of short-term capital outflows consequent upon the re-establishment of confidence in sterling. Exports rose by 7 per cent in 1965 while imports, under the continued restraining influence of import surcharges, went up very little. Non-merchandise earnings were adversely affected by higher interest payments abroad and by the increase in royalty payments to oil-producing countries. Restrictions placed on long-term capital transactions contributed to some improvement on capital account.

Britain's reserves fell very sharply in late 1964 and early 1965 and were maintained only by substantial external official borrowings. Largely to repay temporary financing from a number of central banks Britain drew the equivalent of U.S. $1,000 million from the IMF in December 1964 and a further $1,400 million in May 1965. Through late spring and most of the summer the position of sterling in the exchange market remained uncertain and, as previously noted, further restraints were introduced late in July. Sterling strengthened in September as adverse speculation subsided and some short positions were covered. On September 10, 1965 the Bank of England announced that new arrangements had been made with ten central banks, including the Bank of Canada, to support the improved sentiment towards sterling in the exchange markets. Since September reserves have risen and there has been a sizeable repayment of official short-term liabilities.

The pattern of economic developments in Continental Europe was mixed in 1965. Germany, with a very strong over-all demand situation in conditions of full capacity utilization and an extremely tight labour market, experienced a somewhat slower rise in total output, further significant increases in prices and costs and a rise of 20 per cent in imports. In France, where price and to a lesser extent wage increases were moderated by the maintenance of the 1963 stabilization programme, there was a modest recovery in demand and output. While the authorities refrained from adopting a vigorous expansionary policy on the ground that this might lead to a revival of the "inflation psychology" which accompanied earlier periods of more rapid growth, they nevertheless took some selective measures to reactivate the economy and to improve the conditions for financing investment. In 1965 Italy experienced a gradual recovery in output and employment; exports continued to rise strongly, expenditures on public works increased and consumer outlays revived somewhat. Measures also were taken to encourage private investment.

Economic activity in most other Western European countries continued to expand in 1965, though less rapidly than in 1964. In nearly all these countries, economic policy was directed towards restraining domestic inflationary pressures.

In Japan industrial output increased only marginally during the year despite the relaxation of the measures taken in 1964 to deal with the sharp deterioration in the balance of payments; a strongly expansionary fiscal policy was adopted late in 1965.

Australia, New Zealand and South Africa continued to experience strong domestic expansion in 1965 and adopted measures of restraint as price and cost pressures mounted and reserves fell.

The economic performance of the primary-producing countries, whose domestic level of activity is heavily dependent on export earnings of one or a few primary commodities, varied widely in 1965. Those exporting petroleum and non-ferrous metals did relatively well as demand for their products remained buoyant and export prices of metals continued to rise; many of these countries added to their exchange reserves. Countries relying mainly on the export of tropical agricultural products, on the other hand, fared less well although their external positions appear to have improved somewhat towards year-end with the firming of prices for cocoa, coffee and to a lesser extent sugar. Among the countries most adversely affected by developments in commodity markets were India and Pakistan whose external positions remained extremely difficult throughout the year. The major countries of Latin America had on balance a reasonably satisfactory year in external trade. Aided by further measures under the Government's stabilization programme, there was a marked recovery in Brazil's international trade and reserve position during 1965.

CHANGES IN COMMODITY EXPORTS AND IMPORTS

(percentage change from previous year)

	1964		1965(1)	
	Exports	Imports	Exports	Imports
United States	14	9	4	14
Canada	16	15	6	15
Britain	4	15	7	1
France	11	15	12	3
Germany	11	12	11	20
Italy	18	−5	21	−1
Japan	23	16	28	6

(1) Preliminary estimates.

The differing degrees of demand strength in the main industrial countries were strikingly reflected in the development of current account balance of payments surpluses and deficits. In countries where the pace of expansion had slackened and the pressure of domestic demand had eased, substantial trade surpluses developed, reinforced in some cases by strengthened invisible earnings. Japan experienced a favourable swing on current account estimated at more than U.S. $1,000 million which moved her into substantial surplus, while Italy's position improved by an estimated $800 million. France also moved into surplus in 1965, the favourable swing amounting to somewhat more than $500 million, while Britain's 1964 current account deficit of $1,200 million was reduced by over $600 million. On the other hand, Germany moved into a substantial deficit position as her current account deteriorated by about $1,700 million; the United States current account surplus declined by approximately $1,500 million and Canada's current account deficit increased by about U.S. $650 million.

For most of the countries concerned the impact on reserves of these wide swings in current account transactions appears to have been largely offset by capital movements and IMF transactions. Some detail of changes during 1965 in the official reserve assets of IMF member countries (plus Switzerland) are summarized in the table on the following page.

The $1,222 million decline in the United States holdings of reserve assets financed the bulk of its deficit of just under $1,400 million on an official transactions basis. The official holdings of United States dollars of Continental European countries declined substantially in the course of 1965 but there was a small net increase in the official holdings of IMF member countries taken as a group. The increase in Britain's gold and foreign exchange reserves in 1965 was facilitated by a drawing of the equivalent of U.S. $1,400 million in May from the IMF. This brought Britain's total indebtedness to the Fund to about $2,300 million. The Continental European countries' increase in reserve assets was more than accounted for by the rise in their reserve positions in the Fund. The sharp fall in their holdings of foreign exchange (largely United States dollars) was accompanied by an almost equal increase in their holdings of gold.

CHANGES IN THE MAIN COMPONENTS OF OFFICIAL RESERVE ASSETS

(change from previous year-end in millions of U.S. dollars)

	1964	1965			
	Total	Total	Gold	Foreign exchange	IMF reserve position(1)
United States	–171	–1,222	–1,406(2)	349	–165
Canada	279	145	125	–135	155
Continental Europe(3)	3,031	929	2,310	–2,529	1,148
Belgium	252	112	107	–103	108
France	816	619	977	–623	265
Germany	232	–453	162	–778	163
Italy	418	590	297	–110	403
Netherlands	247	67	68	–94	93
Spain	367	–105	194	–333	34
Sweden	206	7	13	–61	55
Switzerland	45	125	317	–192	–
Other	448	–33	175	–235	27
Britain	–831	688	688		–(4)
Japan	–39	133	98		35
Other IMF members	126	425(5)	375(5)		48
Total of above countries	2,395	1,100(5)	–100(5)		1,221

(1) The figures in this column represent the amount which members of the Fund are entitled to draw under their "gold tranche position" and as a result of loans made to the Fund under the General Arrangements to Borrow.
(2) Excludes the effect of $259 million gold payment to the IMF in connection with the forthcoming increase in quota.
(3) Includes Switzerland which is not an IMF member.
(4) Britain has had no reserve position in the Fund since December 1964.
(5) Rounded estimates.

This table is based on data from "International Financial Statistics" published by the IMF. The figures for December 31, 1965 are in some cases still preliminary.

Between 1961 and 1964 the official reserve assets of IMF members taken as a group rose at an average annual rate of about U.S. $2,100 million. Some 60 per cent of this increase was in foreign exchange, almost entirely United States dollars; approximately 30 per cent came from net additions to monetary gold stocks and the balance was in the form of larger reserve positions in the IMF.

In 1965 Fund member countries' total reserve assets rose by an estimated U.S. $1,100 million or about one-half the average increase of recent years. As noted previously there was only a small net increase in total official holdings of United States dollars, and official holdings of sterling appear to have declined somewhat. There appears to have been very little net growth in monetary gold stocks (including those of international institutions) despite the maintenance of normal levels of world gold production and continued gold sales by the Soviet Union at about the average rate of recent years. The growth in reserve assets in 1965 was thus more than accounted for by the increase in reserve positions in the IMF.

In 1965 the IMF provided financial assistance amounting to the equivalent of U.S. $2,434 million to member countries experiencing balance of payments difficulties. This was higher than the 1964 level of $1,950 million and only slightly below the record of $2,479 million provided in 1961. The largest single request for financial assistance was made by Britain; it amounted to $1,400 million of which the equivalent of U.S. $107.5 million was provided in Canadian dollars. In connection with the British drawing, the Fund sold the equivalent of $400 million in gold (including U.S. $27.5 million to Canada) to replenish its holdings of various currencies and borrowed the equivalent of $525 million from participants in the General Arrangements to Borrow (including U.S. $35 million from Canada). This was the second occasion on which the General Arrangements to Borrow had been utilized, the first being in December 1964 at the time of the earlier British drawing. Of the total drawings made on the Fund during the past year, approximately half the amount was in Italian lire, deutsche mark or French francs; Canadian and United States dollars each accounted for 12 per cent of the currencies used; and the remaining 25 per cent was in nine other currencies, including Australian pounds and Mexican pesos which were used for the first time in 1965. In October 1965 the Executive Directors approved a four-year renewal of the General Arrangements to Borrow. Under these arrangements ten industrial members of the Fund, including Canada, have agreed to make available to the Fund supplementary financial resources up to the equivalent of U.S. $6,000 million if needed to deal with disturbances in the international financial system.

The developments in world reserves during 1965 provide a good illustration of the concern which has underlain the growing interest of recent years in possible improvements in the international monetary system. In reports made in 1964 by the International Monetary Fund and by the Ministers and Governors of the Group of Ten, both groups concluded that, while there was no immediate danger of a general shortage of international liquidity, there were reasons to believe that the supply of gold and foreign exchange reserves would be inadequate in the longer run to meet the liquidity needs of an expanding world economy. The continuance of large additions to foreign exchange assets stemming from deficits of the reserve currency countries was no longer regarded as compatible with continued strength of the reserve currencies, and the year-to-year increases in official gold holdings were too uncertain, and in any event too small, to rely on. Both reports therefore indicated that new solutions should be sought.

The Group of Ten set up a committee to examine the technical aspects of the creation of reserve assets, and the report of this group was published in August 1965. In September the Ministers and Governors of the Group of Ten reviewed the situation and decided to undertake "contingency planning" so as to ensure that the future reserve needs of the world would be adequately met. They instructed their deputies to examine and report in the spring of 1966 on "what basis of agreement can be reached on improvements needed in the international monetary system, including arrangements for the future creation of reserve assets, as and when needed, so as to permit adequate provision for the reserve needs of the world economy". They also expressed the hope that Working Party 3 of the Organization for Economic Co-operation and Development, which had earlier been invited by the Group of Ten to carry out a review of the means best suited for achieving a smooth and efficient adjustment over time of countries' payments imbalances, would be able to report in the spring of 1966. Officers of the Bank of Canada, along with those of the Department of Finance, are currently participating in the work of both of these groups.

BANK OF CANADA STATEMENT OF INCOME AND EXPENSES

(thousands of dollars)

	1965	1964
Income		
On investments	$154,806	$140,126
All other income	721	354
Total income	$155,527	$140,480
Operating Expenses		
Salaries[1]	$ 4,435	$ 4,142
Contributions to pension and insurance funds	383	365
Other staff expenses[2]	218	208
Directors' fees	22	23
Auditors' fees and expenses	74	75
Taxes (inc. municipal and business)	1,036	904
RCMP guards and electric protection	133	128
Insurance	58	100
Bank notes — production and shipment	3,893	3,895
Premises and equipment (net)	510	509
Stationery and printing	185	180
Publications[3]	64	69
Postage and express	202	151
Telephones and telegrams	168	163
Travel and transfer expense	175	154
Interest paid on unclaimed balances	51	63
All other expenses	146	173
Total operating expenses	$ 11,753	$ 11,302
Depreciation on Buildings and Equipment	668	941
Net Income Paid to Receiver General of Canada	143,106	128,237
	$155,527	$140,480

(1) The number of staff averaged 912 in 1965 and 896 in 1964.
(2) Includes overtime pay, medical services and cafeteria expense.
(3) Printing of "Statistical Summary" and "Annual Report".

ASSETS

	1965	1964
Foreign exchange		
Pounds sterling and U.S.A. dollars	$ 28,021,133	$ 97,345,863
Other currencies	242,669	237,058
	28,263,802	97,582,921
Cheques on other banks	158,100,628	190,553,152
Accrued interest on investments	40,135,130	37,135,600
Investments — at amortized values		
Treasury bills of Canada	608,101,218	478,687,089
Other securities issued or guaranteed by Canada maturing within two years	477,714,658	349,198,716
Other securities issued or guaranteed by Canada not maturing within two years	2,330,806,758	2,236,452,654
Debentures issued by Industrial Development Bank*	200,677,869	176,500,390
Other securities — U.S.A. Government	13,989,362	13,447,904
	3,631,289,865	3,254,286,753
Industrial Development Bank		
Total issued share capital at cost*	39,000,000	36,000,000
Bank premises		
Land, buildings and equipment Cost less accumulated depreciation	16,296,634	13,223,342
Net balance of Government of Canada collections and payments in process of settlement	41,532,683	10,865,572
Other assets	1,148,857	2,203,118
	$3,955,767,599	$3,641,850,458

*The audited financial statements of the Industrial Development Bank as at September 30, 1965 were issued to the public on December 1, 1965.

L. RASMINSKY, Governor
Ottawa, January 31, 1966.

A. J. NORTON, Chief Accountant

AS AT DECEMBER 31, 1965
(with comparative figures as at December 31, 1964)

LIABILITIES

	1965	1964
Capital paid up	$ 5,000,000	$ 5,000,000
Rest fund	25,000,000	25,000,000
Notes in circulation	2,535,650,110	2,380,559,300
Deposits		
Government of Canada	116,230,181	68,912,508
Chartered banks	1,034,239,537	882,106,056
Other	34,539,477	35,632,245
	1,185,009,195	986,650,809
Liabilities payable in pounds sterling and U.S.A. dollars		
To Government of Canada	24,027,229	38,446,788
To others	6,739,614	6,420,049
	30,766,843	44,866,837
Bank of Canada cheques outstanding	172,387,782	197,914,086
Other liabilities	1,953,669	1,859,426
	$3,955,767,599	$3,641,850,458

Auditors' Report • We have examined the statement of assets and liabilities of the Bank of Canada as at December 31, 1965. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances. In our opinion, the accompanying statement of assets and liabilities presents fairly the financial position of the Bank as at December 31, 1965.

T. A. M. HUTCHISON, F.C.A.
of Peat, Marwick, Mitchell & Co.

H. MARCEL CARON, C.A.
of Clarkson, Gordon & Cie.

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* On leave of absence as an Executive Director of the International Monetary Fund.

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