BANK OF CANADA.

BANK OF CANADA

ANNUAL REPORT OF THE GOVERNOR TO THE MINISTER OF FINANCE

AND STATEMENT OF ACCOUNTS

FOR THE YEAR **1966**

p7

BANK OF CANADA Ottawa 4

February 28, 1967.

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 1966 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.

To mark the Centenary of Confederation, I have included in this report a special section presenting coloured photographs of some of the different types of pre-Confederation currency that the Bank has in its numismatic collection.

Yours very truly,

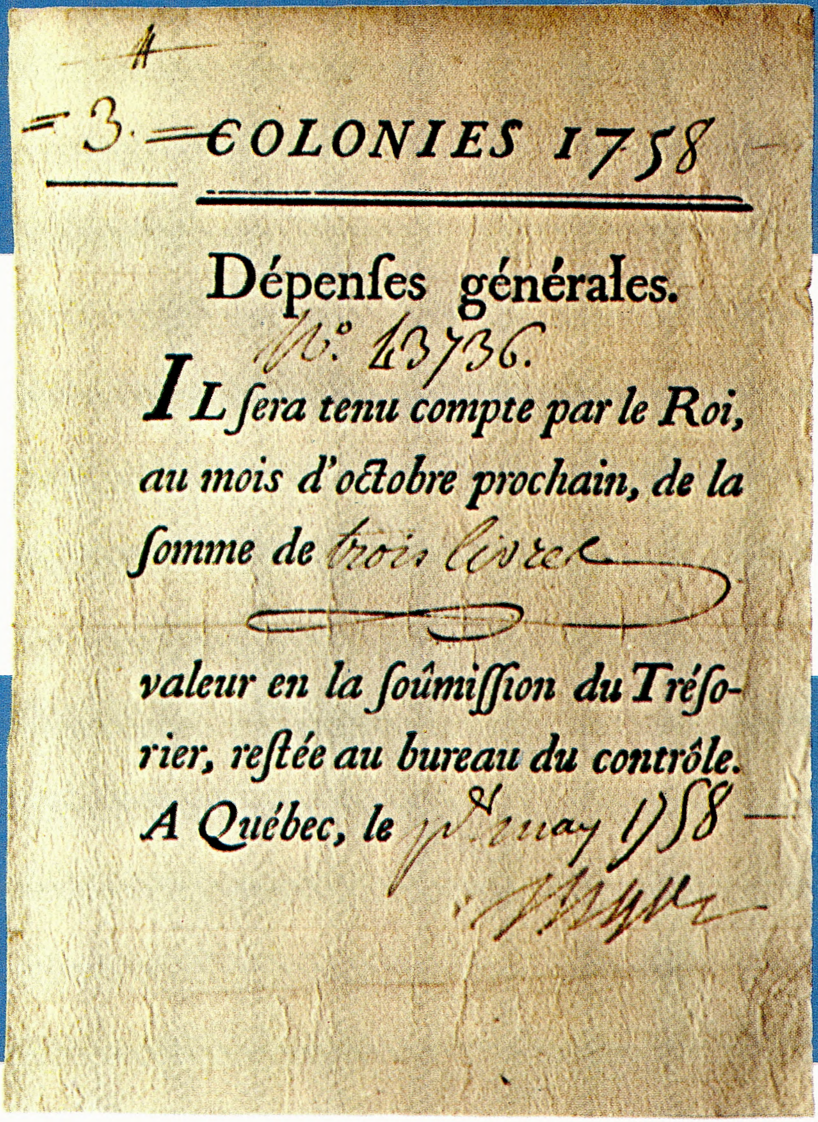
L. Rasminsky

Governor

PRE-CONFEDERATION CURRENCY IN CANADA

As we celebrate the centenary of Confederation it is interesting to recall that the beginning of Canada's currency predated Confederation by nearly two hundred years. On this and on the following pages examples of this early currency are illustrated. They have been selected from the Bank of Canada's numismatic collection.

The card money shown on this page has a dramatic history. In the early days of New France it was the practice to send out a supply of coins on the first ship in the spring to be used in paying the troops and to purchase furs and other raw products. When the supply ship returned to France in the fall it took with it most of the coins to pay taxes and purchase manufactured goods for the colony. This resulted in a scarcity of coins every winter and caused considerable inconvenience. Finally, in 1685 the Intendant, Jacques de Meulles, decided to introduce an emergency issue of paper money. As there were no printing presses and no supply of suitable paper available the notes were handwritten on the backs of playing cards. At the end of the year the notes were redeemed in full. In subsequent years further issues were made. The first five issues were made on playing cards. Their retention after the redemption date was punishable by death and no specimens of this playing card currency have survived. Later issues were made on plain white cardboard and a few of these can be found today in museum collections. The one illustrated here is on plain white cardboard and was issued in 1735.



A

= 3 = COLONIES 1758

Dépenſes générales.

No. 13736.

IL ſera tenu compte par le Roi, au mois d'octobre prochain, de la ſomme de trois livres *valeur en la ſoûmiſſion du Tréſorier, reſtée au bureau du contrôle. A Québec, le* 1er may 1758

Card money was supplemented by "ordonnances" or treasury notes issued by the Governor at Quebec. After the Treaty of Paris, in 1763 the outstanding issues of card money and ordonnances were not redeemed. This created a distrust of paper money which lasted for many years.

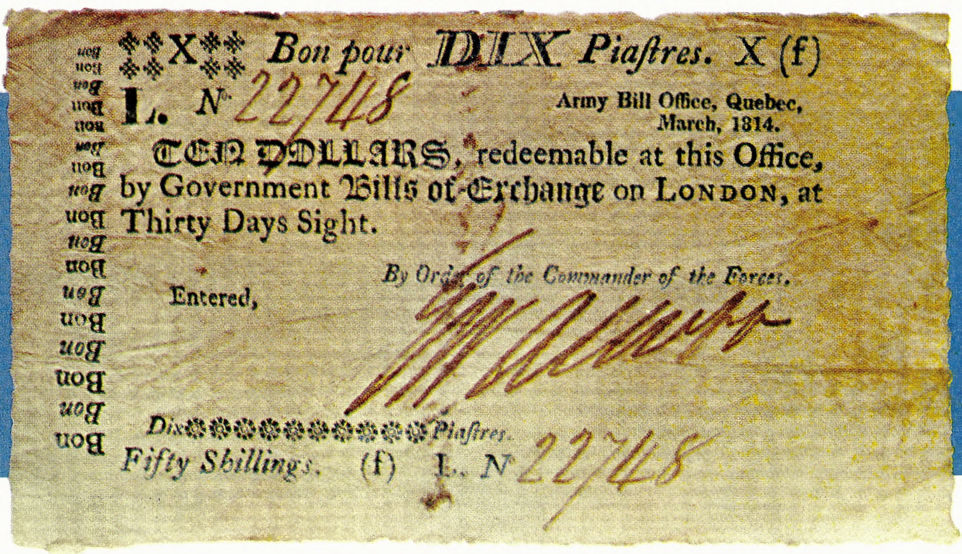
15 sols
1670

5 sols
1670

9 deniers
1721

billon marque
1744

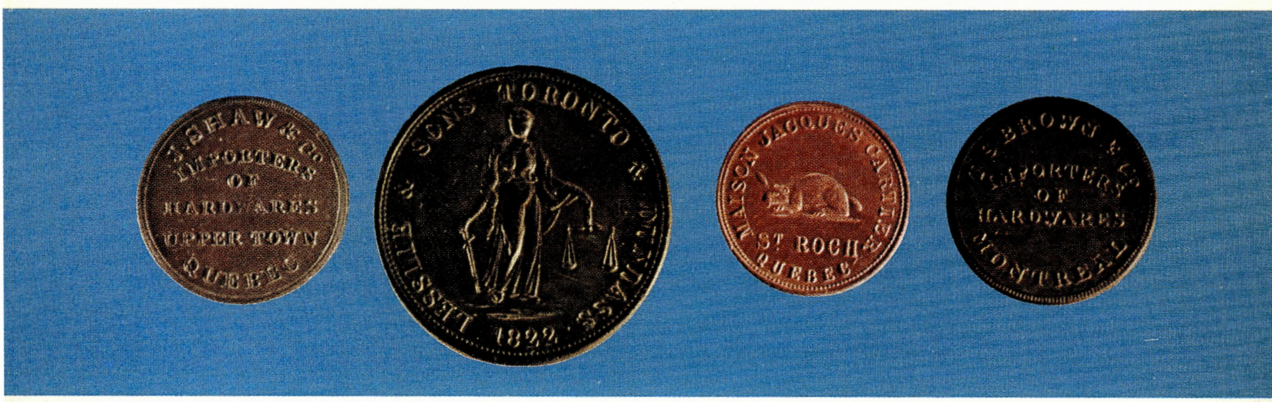
For over 60 years after the founding of Quebec the inhabitants of New France used ordinary French coins. In 1670 Louis XIV issued the first coins specifically designed for use in Canada. These were silver coins in the denominations of 5 sols and 15 sols. In 1721 copper coins were produced for colonial use and in 1738 small coins made of billon (an alloy of copper and silver) were introduced into French Canada.



The War of 1812-14 was financed by the issue of Army Bills from the headquarters of the British Army at Quebec. At the end of the war these Bills were redeemed in full. This restored trust in paper money and paved the way for the first Canadian banks which appeared on the scene a few years later.

City Bank	*Bank of Montreal*	*Quebec Bank*	*Bank of Upper Canada*
penny, 1837	*½ penny, 1844*	*penny, 1852*	*½ penny, 1857*

From 1763 to 1867 almost nothing was done to provide an official coinage for the British Colonies in North America which now make up Canada. In the first half of the 19th century coins of small denomination were in very short supply and several banks were granted authority to issue penny and halfpenny tokens. These were the Bank of Montreal, The Quebec Bank, The City Bank and La Banque du Peuple in Lower Canada and the Bank of Upper Canada in what is now Ontario.



J. Shaw & Co.	*Lesslie & Sons*	*H. Gagnon & Cie*	*T. S. Brown & Co.*
Quebec City	*2 pence, 1822*	*St. Roch, Que.*	*Montreal, Que.*

A number of merchants in Upper and Lower Canada also issued tokens to increase the supply of small change. Their tokens were frequently lighter in weight than the bank tokens. Most of the merchants' tokens were for a penny or a halfpenny but one firm, Lesslie & Sons, issued a large two penny piece, the only coin or token of this denomination ever issued in Canada.

Spanish dollar, 1747

United States
half dollar, 1825

During the century before Confederation the supply of homemade and imported coins and tokens was supplemented by foreign coins; this greatly complicated business transactions. During the early part of the nineteenth century the commonest silver coins in circulation were the Spanish dollar, which was minted in huge quantities from the rich silver mines of Mexico and South America, and the United States half dollar.

Portugal
400 reis, 1834

Great Britain
½ crown, 1820

France
2 francs, 1817

United States
1 cent, 1855

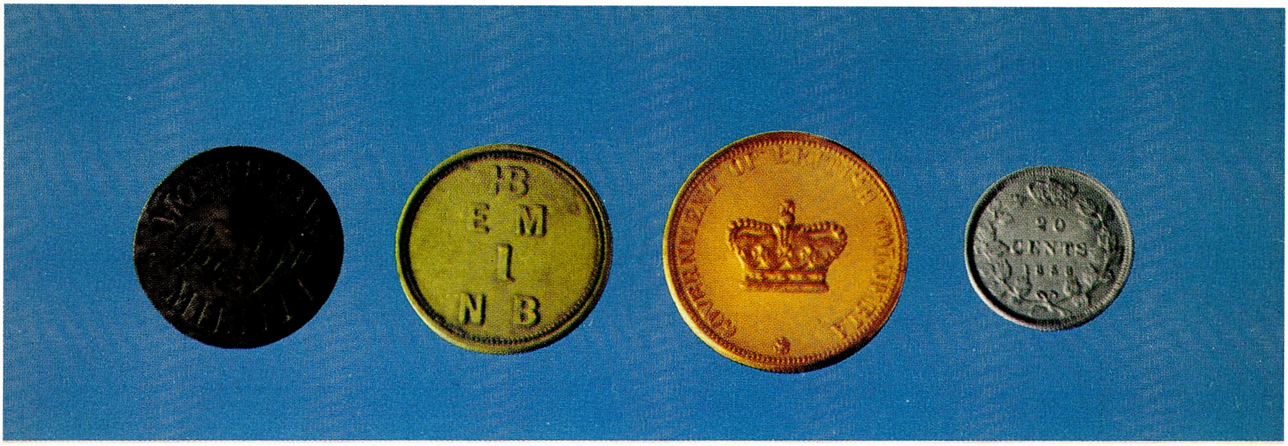
Coins from Britain, France, Portugal and almost every other European country added to the monetary confusion that plagued Canadians before Confederation. Our forefathers had to be familiar not only with pounds, shillings and pence, and dollars and cents but also with francs, écus, pistareens, ducats, guilders and many other coins with romantic-sounding names.

Nova Scotia penny, 1824 | *New Brunswick penny, 1843* | *Prince Edward Island 1 cent, 1857* | *Rutherford Bros. Harbour Grace, Nfld.*

In the Atlantic Provinces a shortage of coins also resulted in a number of issues of merchants' tokens. The governments of Nova Scotia and New Brunswick issued penny and halfpenny tokens during the 1830's, 40's and 50's. Prince Edward Island imported light weight tokens bearing such patriotic slogans as "Success to the Fisheries" and "Speed the Plough". Newfoundland, too, had its early merchants' tokens.

Prince Edward Island Holey Dollar

The Spanish dollar circulated freely in Prince Edward Island. As it was rated higher in Halifax than in Charlottetown the supply of these coins tended to flow out of the Island. To correct this situation Governor Smith in 1813 had the centre punched out of 1,000 of these coins so that they would not be accepted outside of the Island. The outside ring was to circulate at 5 shillings and the centre "plug" at 1 shilling.



Montreal Militia flattened button — *Hudson's Bay Company 1 Made Beaver* — *British Columbia \$20 gold, 1862* — *Prov. of Canada 20c, 1858*

There were times when the supply of foreign coins, bank tokens and merchants' tokens was so inadequate that almost any circular piece of metal was acceptable as a coin. One device resorted to by some ingenious people was to remove the shanks from the backs of military buttons, flatten the buttons out and put them into circulation where they were readily accepted as halfpennies.

The Hudson's Bay Company and the North-West Company issued tokens for use in their trading posts in the far north and the far west. The unit of trade was one prime beaver skin and all other furs and trade goods were valued according to this unit.

The discovery of gold in British Columbia prompted Governor Douglas to set up a mint at New Westminster and strike \$10 and \$20 gold pieces in 1862. As the plan did not have Imperial approval it came to a sudden end and very few coins were struck. The illustration above is taken from a reproduction of the specimen in the museum of the Royal Mint, London.

In 1858 the Province of Canada abandoned the sterling system and the first decimal coins in the denominations of 1c, 5c, 10c and 20c were issued. In 1870, when the first coins were issued for the Dominion of Canada, the 20c piece was replaced by a 25c coin and the 50c piece was added.

During the 19th century over one hundred note-issuing banks operated in Canada. After Confederation many banks disappeared through absorption and amalgamation and this greatly reduced the tremendous variety of notes in circulation. Since 1949 (when the note-issuing power of the banks finally expired) only the Bank of Canada, which was established in 1934 by Act of Parliament, has had the authority to issue paper money. Today, 100 years after Confederation, Canadians are able to carry on their business with only one type of coin and one type of paper money.

The Centennial Coins, 1967

Published by the Bank of Canada, Ottawa, February 1967

BANK OF CANADA

Report of the Governor — 1966

Some Highlights of the Year

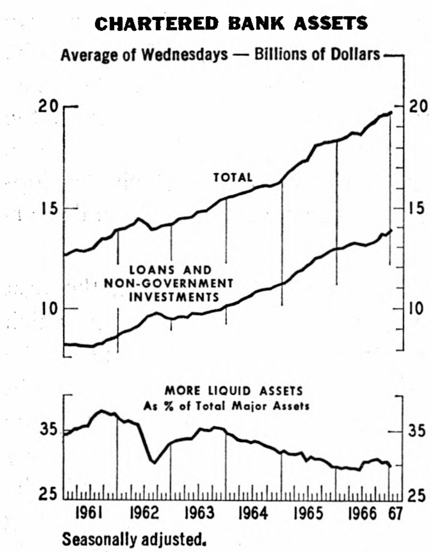
The year 1966 was another prosperous one for Canada. The external economic environment continued to be generally favourable, and real output in Canada again rose by more than 6 per cent. We were favoured by another very large wheat crop, and the increase in our non-farm output was also substantial. Employment averaged more than 4 per cent higher than in 1965 and the annual average unemployment rate, at 3.6 per cent, was the lowest since 1956. In the course of the year there was a welcome moderation of the intense pressure of demand on our resources but the economy continued to operate at a high level.

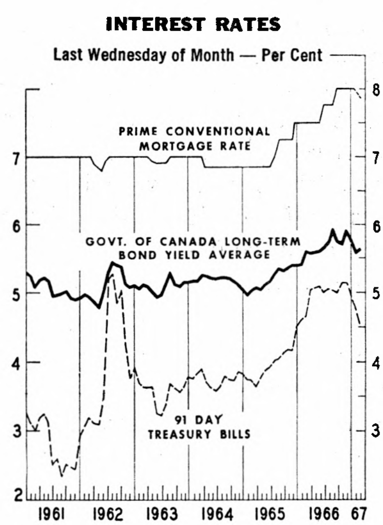
In the closing months of 1966 our total output in real terms was running some 40 per cent higher than in the closing months of 1960 before the current expansion began, and our utilization of consumer goods and services was one-third larger. Even allowing for an 11 per cent increase in our population these are very remarkable increases over so short a period. During these years we have made substantial additions to the economy's plant capacity and to its social capital in such forms as universities, schools and hospitals. Less easily measured, but no less useful, has been our progress in programmes to raise the general level of education, to increase vocational training facilities, to promote greater labour mobility, and to encourage industrial research. Such developments are favourable to the achievement of still higher levels of economic performance in the future.

These impressive advances have, however, been accompanied in the past two years by developments in the area of productivity, costs and prices which taken together give cause for concern. The intense pressure of demand in the economy which developed in the latter part of 1965 was reflected in a very tight labour situation and an acceleration of increases in wages and salaries. The average increase in wage and salary rates last year was far in excess of any reasonable estimate of the average annual increase of output per worker in the economy, and even farther above the disappointingly small gain that, according to the figures available, we appear to have made in non-farm productivity in 1966. Despite an appreciable reduction of corporate profit margins in the course of 1966, the Canadian economy experienced its sharpest increase in prices since the mid-1950's. The broadest measure of prices, the deflator of the Gross National Product, rose by over 4 per cent in 1966, while consumer prices at the end of the year were running 3½ per cent above their level at the end of 1965. Costs increased more, and productivity increased less, in Canada than in the United States in 1966. Diverging movements in costs and productivity such as we have been seeing recently cannot go on for long without seriously affecting the Canadian economy and in particular its international competitive position; a formidable obstacle would be placed in the way of maintaining the strong growth in output and employment of recent years.

I shall revert to some of the problems posed by these cost and price developments after giving a brief account of the major features of the Bank's monetary policy and Canada's external financial position during the year.

MONETARY POLICY. In the early years of this economic expansion, when there was still a great deal of unemployment and unused industrial capacity in Canada, the monetary policy followed by the Bank of Canada enabled the rising demand for credit to be accommodated without any tightening of credit conditions. It could be foreseen, however, that as the slack in the economy was progressively taken up, the time might arrive when a less expansive monetary policy would become necessary so as to exert a moderating influence on the growth of demand. The central bank began to prepare for this eventuality in 1964 by managing the cash reserves of the chartered banks in such a way as to reduce bank liquidity.





By the spring of 1965 the growth of the economy was rapidly bringing us back towards full utilization of the country's effective productive capacity, and the Bank's policy was to allow credit conditions to begin to tighten under the impact of heavy demands for credit.

In the latter part of 1965 and the early part of 1966 demand pressures on the economy became particularly intense and credit conditions progressively tightened. The Bank Rate was raised in December 1965, and again in March 1966 when I stated that "the Bank's action reflected its view that in the present state of the economy some moderation of the rate of growth of over-all demand was desirable". In the first half of 1966 the rate of growth of bank loans and money supply slowed markedly, chartered bank liquidity declined further and interest rates continued to rise.

During the summer of 1966 interest rates increased very sharply in the United States, and the Bank of Canada became concerned about the degree of strain that was developing in financial markets. Evidence was accumulating that the rate of growth of aggregate demand in Canada was moderating from the unsustainable rates of the latter part of 1965 and the early part of 1966. In addition, the restraining influence of monetary policy had been supplemented by new fiscal measures taken by the Government in its March 1966 budget. On the other hand, cost pressures were continuing to increase in Canada, and economic activity in the United States continued to be stimulated by strongly rising military expenditures. In addition, the Bank had of course to be concerned with the maintenance of credit conditions favourable to an adequate capital inflow. In all the circumstances, the Bank considered that the appropriate policy was for it to offer considerable resistance to a further tightening of credit conditions without, however, attempting to prevent all further upward movement in interest rates. This course involved some relaxation of the short rein it had kept on the banking system.

The shift in the stance of monetary policy about the middle of the year is clearly reflected in the trend of the money supply and bank assets. The total of currency and chartered bank deposits which had increased at an annual rate of 3 per cent in the first half of 1966 rose at an annual rate of 10 per cent in the second half. Chartered bank general loans followed a somewhat similar path: the annual rate of increase, which had been running at about 16 per cent in 1964 and 1965, was 5 per cent in the first half of 1966 and rose to 9 per cent in the second half. Under the policy followed by the central bank, the more rapid rise in bank loans in the second half of 1966 did not cause any decline in the banks' over-all liquidity; indeed, the ratio of cash, Government securities and other relatively liquid assets to total chartered bank assets rose perceptibly from its low point reached in the second quarter.

The Bank provided resistance to an excessive tightening of credit conditions in the second half of the year not only through its policies in regard to cash reserves and the growth of bank assets but also, from time to time, through direct support operations in the securities market. Some details of the Bank's operations, which were influenced to an appreciable extent by the unusual volatility of interest rates in the United States, appear later in this Report. Even though the central bank resisted the development of extreme credit conditions, interest rates went up to very high levels. Long-term Government bond yields rose to about 6 per cent at the peak, and rates on prime conventional residential mortgages reached 8 per cent.

Although economic activity in the final quarter of 1966 was stronger than in the preceding half-year, there seemed little prospect of an early resurgence of intense demand pressures. There was also evidence of a greater public recognition that any necessary restraints on the economy should be sought through the combined operation of fiscal and monetary policy. The operations of the Bank were conducted in such a way as to permit a considerable rise in chartered bank assets to take place, and there was a general easing of credit conditions through the latter part of 1966 and into 1967. The Bank Rate was reduced from 5¼ per cent to 5 per cent on January 30, at which time I stated that "this reduction in the Bank Rate should be taken as an indication of the Bank's view that the recent easing of credit conditions was appropriate to Canada's domestic economic circumstances and its external financial position". These developments in Canadian credit conditions were of course facilitated by the similar developments that were concurrently taking place in the United States and other leading industrial countries.

As one looks back on 1965 and 1966 it is apparent that, in the attempt to contain the excessive pressure of demand on our resources and to maintain our external financial position, credit conditions were allowed to become very tight. Having regard to the uneven incidence of such credit conditions on various regions and sectors of the economy, including their particularly severe effect on the housing industry as well as their impact on financial institutions, I feel that it would not have been desirable or practicable in the circumstances to have attempted to push the use of monetary policy any further. For the same reasons I have welcomed the opportunity to encourage some easing of credit conditions in recent months.

CANADA'S EXTERNAL FINANCIAL POSITION. By comparison with most recent years, 1966 was happily free of major difficulties in so far as Canada's external financial position was concerned. The announcement of a tightening of the United States balance of payments guidelines at the end of 1965 caused considerable concern in Canada, but in the event their application did not result in any additional exchange problems. Direct investment inflows of capital increased. Canadian borrowers continued to have unrestricted access to the new issue market in the United States exempt from the Interest Equalization Tax. On the other hand, Canadians made large purchases of outstanding United States common stocks, and substantial short-term investments of funds abroad took place through the banking system.

As part of the agreement providing for unrestricted access to the new issue market in the United States, Canada had agreed to work to a reduced target figure for its foreign exchange reserves. In the course of the year the Government repatriated about $150 million of its own U.S.-pay securities and purchased about $25 million of U.S.-pay bonds of the International Bank for Reconstruction and Development. The repatriation technique of reducing reserves added an important dimension of flexibility to monetary policy in the first half of the year. We achieved our agreed reserve target—which of course contemplates a reasonable month-to-month flexibility—well before the end of the year. Over the year, Canada's reserves (including our net creditor position with the International Monetary Fund) declined from U.S. $2,880 million to $2,500 million. The Exchange Fund sold $200 million of gold to the United States and invested the proceeds in interest-bearing securities of the United States Government.

The current account deficit in our balance of payments declined by $100 million to just under $1,000 million in 1966. There are grounds for satisfaction in achieving any reduction in our current account deficit in a period of high economic activity, but it should be noted that the improvement was more than accounted for by the increase in our wheat sales and that as a result of the Canada-United States Automotive Agreement our deficit on trade in automotive products declined in 1966. On other commodities and non-merchandise transactions there was a further appreciable increase in our deficit last year.

The Bank of Canada continued to participate in various group arrangements for short-term credit between central banks. At the end of the year we were members of three such arrangements. One of the arrangements, relating to sterling, operates through the Bank for International Settlements and provides for temporary assistance to the Bank of England against the impact on Britain's gold and dollar reserves of declines in sterling balances held by non-residents. The Bank of Canada's share is up to U.S. $60 million as may be needed. The second is a more general arrangement among a number of central banks for temporary assistance to the Bank of England under which the Bank of Canada has undertaken to make up to U.S. $50 million available as required. The third arrangement is part of a network of reciprocal short-term facilities between the Federal Reserve System and a number of central banks. This network was created in 1962, and we drew temporarily our full participation of U.S. $250 million during the exchange crisis that year. The network has since grown and in the course of its further general expansion in 1966 our reciprocal facilities with the Federal Reserve System were increased to U.S. $500 million.

I believe that the experience with these arrangements among central banks demonstrates clearly that they are making an important contribution to the strength and flexibility of the international monetary system.

THE PROBLEM OF INFLATION. As I have indicated in the opening paragraphs of this Report, the record of the Canadian economy in respect of prices and costs over the past two years of high-level activity gives cause for concern. In addition to the other reasons for being concerned about inflation, we must as a practical matter achieve at least as good a cost and price performance as the United States if we are to avoid serious difficulties. For some time now we have been falling short of this standard.

Looking back, it is clear to me that for much of the last two years we have overloaded the economy. As we were approaching the limits of our productive capacity, aggregate demand was allowed to expand too rapidly for the expansion to be accommodated without major increases in costs and prices. The pressure of demand on the economy has since moderated, but a wave of cost and price increases has been generated which is continuing to move through our economic system.

A factor which contributed to the overloading of the economy was the underestimation of the strength of the North American economic expansion. This was due in part to the fact that it was virtually impossible to foresee the degree of the intensification of the war in Viet Nam and its consequences for the United States economy. But it is also the case that economic forecasting is at all times a difficult and inexact exercise. Improved forecasting must start with better and more up-to-date statistics on the past and the development of more forward-looking information on spending intentions. There are few projects that could promise a higher rate of return than a substantial investment by government and business in the provision of better information.

A better current assessment of the strength of the economic expansion would almost certainly have led to an earlier shift of the combined weight of fiscal and monetary policy towards restraining the growth of demand. Whether this might also have resulted in a different and better mix of fiscal and monetary policy is an important related question that I do not intend to pursue here. At all events, some moderation of the rate of growth of demand in the latter part of 1965 and the first part of 1966 would have been necessary to avoid the eruption of the cost and price increases which subsequently occurred.

Canada's experience over the past six years provides another demonstration of the relationship between the degree of pressure on capacity and the price and cost performance of the economy. We went into this expansion with a great deal of unemployment, and so long as a considerable amount of slack remained in the economy our price and cost performance was relatively good; it compared favourably with that of other countries despite the depreciation of the Canadian dollar. It was not until the end of 1963 that unemployment declined to less than 5 per cent and not until late 1964 that it fell below the 4½ per cent mark. In the second half of 1965, however, the unemployment rate fell well below 4 per cent, and in the twelve months ending in June 1966 it averaged about 3½ per cent; the pressure on the labour market in this period was also reflected in the very high rate at which people were drawn into the labour force and in severe shortages of various kinds of skilled workers. (It is true that unemployment remained relatively high in certain regions of the country, but in the circumstances this could not be regarded as an effective offset to general pressure elsewhere in the economy: it was rather a measure of the size of the problem that remains to be dealt with by policies specifically directed towards particular areas or localities.) In 1965 and 1966, when the slack in the economy was taken up, there was a marked deterioration in our cost and price performance. Admittedly, some special factors contributed to this result, such as those that gave rise to the sharp increase in food prices. The problem was also exacerbated by unevenness in the pressure of demand; the pressure on the construction industry was particularly intense. But whatever weight may appropriately be attached to such special factors, it remains the case that the pressure of aggregate demand on the economy exceeded that which we were able to accommodate within a framework of reasonable cost and price stability.

The maintenance of reasonable cost and price stability in our society also depends on the vigour of competitive forces in the market. In point of fact, however, these forces may not be strong enough when the economy is operating close to the limits of its effective capacity. If we also take account of the fact that bottlenecks develop well before this point is reached and that certain groups are in a position to deploy unusually strong market power, the problem of maintaining reasonable cost and price stability is seen to be formidable.

This problem has been experienced from time to time by all countries that attempt to operate market economies at high levels—the difficulty of having more ambitious targets with respect to output than the country's practices for determining incomes are able to handle consistently with reasonable cost and price stability. It must unfortunately be acknowledged that no country has found a completely satisfactory solution to the problem. But the problem cannot be avoided.

I believe that most Canadians reject the thesis that we can or should accept inflation as a means of achieving high rates of output, and this has been made clear in various ways during the past year. For my own part I do not believe that this option is really open to us. I know that in recent years high rates of price increase have tended in general to be associated with low levels of unemployment. But I think it would be a serious mistake to infer from this that if only we were willing to accept high rates of price increase as a norm it would be easier to maintain low unemployment levels over an extended period. If this approach were adopted, the public would soon realize what was happening and would take whatever economic or political actions were available to it to protect itself against the officially-sponsored expectation of a continuous and rapid decline in the value of money. It would soon become just as difficult to prevent price rises from exceeding a high target rate as it now is to prevent them from exceeding a low target rate. The same policies of restraint would come to be required. Nothing would be gained in employment or output; the difficult efforts to adjust to inflation would thus have been to no avail and our ability to grow steadily would be continuously threatened by the impairment of our international competitive position.

It would be possible to avoid cost and price inflation by lowering our sights with respect to the levels of employment and output that should be sought. This would involve the maintenance of a margin of unused resources large enough to keep price and cost pressures from developing to the point where widespread rises occur. Unfortunately it seems likely that this would result in a greater degree of unemployment and under-utilization of capacity than most of us would find acceptable.

I hope that we can do better than this. I hope that we can find a way to operate the economy at a high level of activity without price instability by a combination of better management of demand, better policies on the supply side to increase the efficiency and productivity of the economy, and better performance of the income-determining machinery in our society. In connection with the latter, it is clear that as a minimum there must be a realistic appreciation on the part of the public of the scale of the benefits the economy can physically provide through increases in output, and of the consequences of a failure to be competitive with other economies. A good deal of the recent discussion regarding this matter has revolved around the great difficulties associated with specific guidelines for wages and prices. It has to be borne in mind, however, that with or without publicly-sponsored guidelines, patterns do emerge. It is essential that these patterns be realistic. There is very little to be said in favour of income negotiations, often difficult, prolonged and costly to all concerned, which lead to agreements that are bound to be greatly amended in their final effect by subsequent increases in prices. As a matter of simple economic arithmetic, the real income of the community is inevitably limited by the amounts we can in fact produce. You cannot get a quart of wine out of a pint jug.

The stake of the whole community in the maintenance of reasonable price stability and a competitive economy is so great that the normal reliance on market forces in the process of price and income determination needs to be reinforced by the constant pressure of informed public opinion. In this matter the attitudes and actions of governments are particularly important, not only because of the size of the government sector and closely related sectors of the economy, but also because of the disposition of others to follow patterns set, or acquiesced in, by governments. In the public sector there would appear to have been room for the smoother adjustment of incomes over time, so that equity could be maintained without occasional disruptive adjustments. In general, there is need for much more study and discussion of the relationship between productivity trends on the one hand and change in prices and incomes on the other in order to provide the public with the means of forming an objective judgment as to what price and income developments are inherently inflationary.

INTERNATIONAL MONETARY SYSTEM. During the past year officers of the Bank have continued to participate actively along with officials of the Department of Finance in discussions, in the International Monetary Fund and the Group of Ten, on means of improving the international monetary system. These discussions look towards the next step in the evolution of the international monetary system. The major forward steps during the past fifty years have been the transition from an international gold standard to a gold and exchange standard, with sterling and the U.S. dollar serving as reserve currencies; the establishment of the International Monetary Fund to promote exchange rate stability and the orderly adjustment of their positions by countries in balance of payments difficulties; and the development of central bank co-operation involving a substantial structure of short-term credit facilities. The most recent stages in this evolution have been marked by much more intensive international discussion of the payments problems confronting individual countries as well as of the functioning of the international financial machinery.

The current discussions have revealed agreement that the international monetary system needs to be improved in two respects. Better performance is needed by countries individually in achieving and maintaining a suitable balance between their international payments and receipts; and better arrangements are needed to provide for an orderly increase in international liquidity as world trade and payments grow.

These are in fact different aspects of the same problem, that of achieving an international payments system which will encourage the smooth growth of world trade and capital flows. For this to be accomplished, countries must so manage their affairs that imbalances in their international payments position can be kept within acceptable limits by means that are not disruptive of world trade or capital flows. To help them accomplish this objective, they must have available enough access to international reserves or other sources of external financing to provide time for them to achieve smooth adjustments in their external positions, but not so much as to encourage them to postpone action to deal with emerging external imbalances.

The problems involved in achieving and maintaining a suitable balance in external payments are complicated and difficult. The main reason is that governments rightly feel that they must seek external balance by means which do not prejudice the attainment of other objectives of public economic policy such as high employment, a satisfactory rate of growth, and reasonable price stability. It is much more difficult to find blends of economic policies that will achieve all of these objectives at the same time than it is to achieve any one of them by itself. In actual practice, countries are frequently tempted to give priority to their internal economic objectives and to hope that the external balance of the economy will somehow or other look after itself. If they yield to this temptation they run the risk that their external positions will become unmanageable and will eventually require remedial policies so severe as to prejudice the attainment of their internal objectives. In the meantime their erratic economic performance will have seriously complicated the economic problems of their trading partners.

Last August the Organization for Economic Co-operation and Development published a report by Working Party 3 of its Economic Policy Committee on the balance of payments adjustment process which outlines well the complexity of the problem. It stresses the inadequacy of any simple or automatic solutions, the contribution that can be made by better diagnosis of payments problems and the more flexible use of economic instruments, and above all the importance of a common will on the part of national authorities to give proper weight to, and to co-operate in achieving, equilibrium in their external accounts.

If we are to have national policies that are conducive to the smooth adjustment of countries' international payments positions we must ensure that such policies are encouraged by the international arrangements in respect of liquidity —that is, by the arrangements governing the volume of international reserves and access to short-term credit. On the whole these arrangements have evolved very well in the years since the Second World War, but some major weaknesses have become apparent in recent years. Though the growth in the role of the U.S. dollar as a reserve currency has been helpful, the increase from year to year in the amount of U.S. dollars in the hands of non-residents depends in part on the balance of payments of the United States, and there is no satisfactory way of ensuring that the United States payments balance will be responsive to the world's needs for international liquidity. Moreover, it is the consensus of opinion, including that of the United States Government, that the stock of U.S. dollars in the hands of non-residents is about as high as is warranted in present circumstances. It does not therefore seem appropriate to count on the U.S. dollar to provide any major part of the growth in official reserves which the international monetary system will need in order to accommodate the growth in world trade and payments in the years ahead.

Gold has been and still is the principal component of countries' international reserves. If there were any prospect of a substantial growth in the future in the stock of gold in the hands of national monetary authorities, international concern about any future inadequacy of international liquidity would diminish. But there appears to be no such prospect. In recent years the annual additions to national monetary gold stocks have been relatively small; indeed there appears to have been no addition at all in 1966. There are some who believe that the best means of adding to international liquidity would be to increase the effective size of the monetary gold stock by raising the price of gold but the great majority of those concerned hold the view that this would be an unsatisfactory and disruptive way of dealing with the problem.

In the circumstances described, it has been clear for some time that the countries of the world should reach a decision on how they are going to satisfy future needs for international liquidity. In view of the apparent certainty that action will sooner or later be necessary, the absence, after the prolonged discussions which have taken place, of a firm agreement on what action should ultimately be taken gives rise to uneasiness in financial markets. I therefore believe that international agreement on a plan is a matter of considerable urgency.

The international discussions that are going on have shown that there is in fact a substantial consensus on a number of important points. Given the will to act, agreement on the remaining issues should be attainable. The precise details of the plan are of less consequence; various arrangements would be workable and effective if they received the support of the world's principal trading countries.

There is a great deal of support—in which I join—for the creation of a new international reserve unit, to be backed by the currencies of all members of the International Monetary Fund who wish to participate, and to be distributed among participating members in accordance with some objective criterion of their international economic role, such as the relative size of their quotas in the Fund. A unit of this kind, with its value fixed in terms of gold, could be created and distributed by the Fund, or preferably by an affiliate of the Fund, in such amounts as by international consensus seemed appropriate over the years ahead to supplement gold and the reserve currencies as a component in countries' international reserves.

It is of course essential to ensure that any new reserve unit which is created should be widely and readily acceptable. There are various specific arrangements that could achieve this. Ultimately, however, the acceptability of a new reserve asset will depend upon the wisdom of the decisions on the amounts of it which are created. The nature of the decision-making process is therefore of great importance. The decision-making machinery must offer protection against two extremes—against irresponsible and opportunistic liquidity creation in an attempt to escape from better but less popular action in other areas, and against overly-cautious management. Given a good voting system to back it up, there is reason for confidence that decision-making would not in fact be done by voting but rather by a process in which consultation in various forums resulted in a widespread international consensus. This is how decisions are now normally reached in the Fund.

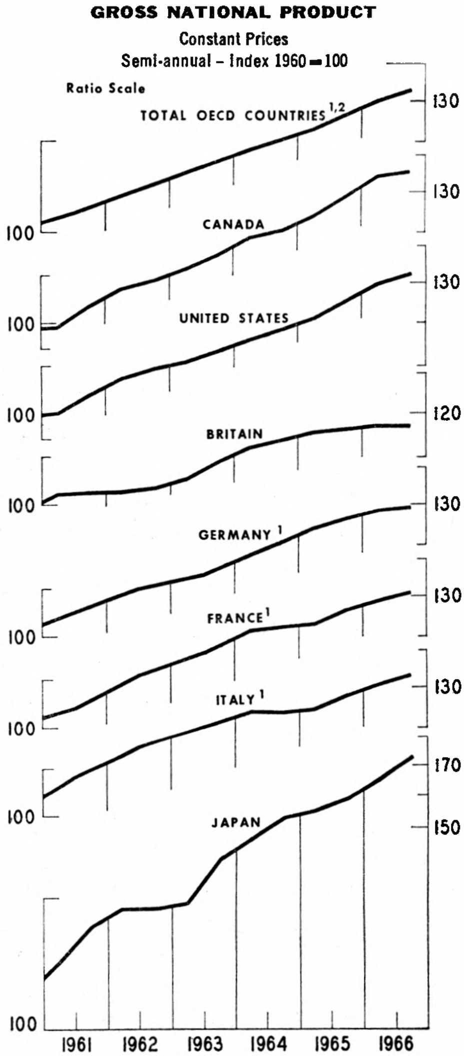
I share the widely-held view that it is desirable to separate the decision to establish machinery for the creation of international liquidity from the decision to put the machinery to use in creating additional liquidity after it has been established. I believe, however, that there is now a real need for the responsible authorities to demonstrate that they will in fact be able to create international liquidity when it becomes necessary. It will take time to work out the details of the required international agreement and to get the necessary legislative authorizations. If we do not put the machinery in place until it is obvious to all concerned that there is an immediate need for additional liquidity we shall have waited too long.

The External Economic Environment

Canada's external economic environment continued to be favourable in 1966. Output in most industrial countries rose strongly, as did total world trade. At the same time, however, signs of strain became more pronounced in a number of countries. In North America the disappearance of the earlier margins of unused resources was reflected in rising costs and prices, and similar pressures continued to be experienced in a number of Western European countries. The task of containing these inflationary tendencies fell largely on monetary policy and interest rates rose to their highest level in several decades. In the course of the year, however, some signs of reduced demand pressure emerged and towards year-end interest rates were easing. In the course of 1966 the international payments system was again subjected to a number of strains but some countries made significant progress in reducing the imbalances in their payments positions.

OUTPUT, EMPLOYMENT AND PRICES. For the OECD countries as a group, which account for the great bulk of our external trade, total output again rose in 1966 by an amount roughly in line with the 4½ to 5 per cent average annual increase experienced since the early 1960's. In the early months of 1966 there was a rapid expansion of over-all demand, but some easing occurred during the balance of the year. Public expenditures continued to expand steadily through the year, so changes in the rate of growth of output were attributable mainly to demand in the private domestic or foreign sectors.

Of particular importance to Canada was the continuation of economic expansion in the United States. The value of Gross National Product in that country rose by 8½ per cent in 1966 compared with a little less than 8 per cent in 1965. However, prices rose more in 1966, and in real terms the growth is estimated at 5½ per cent compared with about 6 per cent in 1965. During the years 1961 to 1965 the expansion of the United States economy had been greater than the growth in its long-term potential, and effective slack appears to have been largely eliminated by the end of 1965. The trend of output continued upward throughout 1966 but the pace of expansion slowed considerably in the



Seasonally adjusted.
1966 preliminary estimates.
1. Annual plots prior to 1964.
2. Includes countries shown plus Austria, Belgium, Denmark, Greece, Iceland, Ireland, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and Turkey.

second quarter. Notwithstanding some easing in the demand for automobiles and a sharp decline in outlays on housing construction, over-all demand strengthened again in the second half of the year, largely reflecting rising military expenditures and sharply higher inventory accumulation. Excluding military expenditures, however, the growth in final demand was relatively slow. In the final quarter of the year, plant and equipment investment had slowed down and automobile sales were below their year-earlier rate. On the other hand, housing starts, though still low, were rising and military expenditures were continuing to increase strongly. The official United States forecast is for a continuation of the expansion through 1967; over the year as a whole GNP in real terms would expand nearly in line with the 4 per cent growth in potential.

In France, Italy and Japan the upward movement which was resumed in 1965 became more firmly established in 1966 and strong growth continued throughout the year. The stimulus came largely from export demand but during the course of the year the upward movement became more broadly based as consumer demand recovered; by year-end there was evidence of renewed strength in private investment as well.

The pace of growth in real output in most other European countries, where the margin of slack had been reduced to low proportions by the beginning of the year, was somewhat slower in 1966 than in the previous year. Economic growth in Britain and Germany slowed markedly in the course of the year. This was associated with a weakening in consumer demand, particularly for durables, and an easing in total investment. In Britain the development of the economy was, of course, influenced by the measures taken to deal with the balance of payments problem. Lower rates of growth in a number of other European countries in the latter part of the year were related to a considerable extent to the easing in demand in the important British and German markets. Throughout Europe the construction sector was relatively weak in 1966.

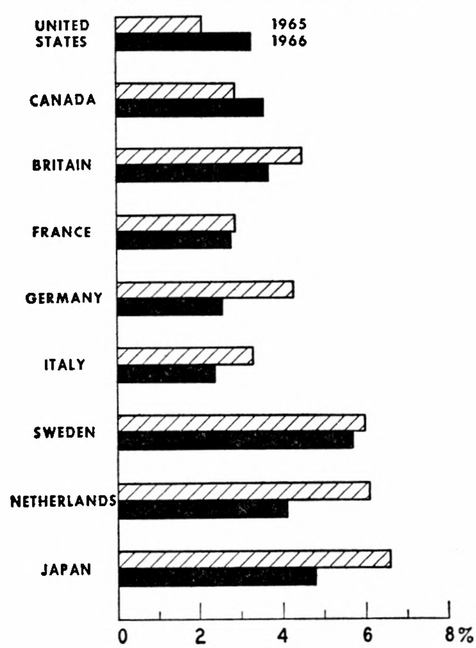
By the end of the year there was a fairly general easing in labour markets in overseas industrial countries. The rise in unemployment was particularly sharp in Britain in thc second half of the year and the recoveries in France, Italy and Japan had not yet reduced the level of unemployment significantly.

In the United States total employment continued to advance strongly in 1966. After the first quarter the gains just about matched the growth in the labour force, and the unemployment rate, which had fallen steadily from 5½ per cent early in 1964 to a little less than 4 per cent in the first months of 1966, remained relatively stable through the balance of the year. The 5½ per cent increase in real output in 1966, taken in conjunction with a 3.0 per cent rise in total employment, suggests that output per worker increased somewhat less than in 1965.

Cost and price pressures intensified in North America in 1966 and continued to be a major area of concern in most other industrial countries. Despite the slower rate of growth after the first quarter the United States economy continued to operate close to capacity levels; demand pressure remained strong throughout the year. Labour income expanded more rapidly. There was some deterioration in the relatively good unit labour cost record of recent years. The GNP price index of all goods and services rose by 3.0 per cent compared with 1.8 per cent in 1965. The Consumer Price Index rose by 3.3 per cent in the year ended December 1966 compared with an increase of 2.0 per cent over the previous twelve-month period. Only a limited number of labour contracts were negotiated in 1966, but they provided for wage increases substantially higher than those obtained

CONSUMER PRICE INDICES

Percentage Increase : 12 Months Ending December



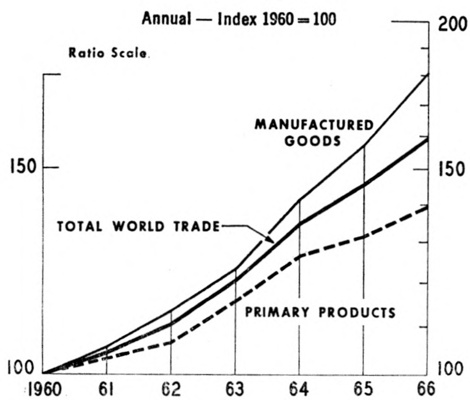
in earlier years and appreciably above the rates indicated by the wage "guideposts" that were in effect during the year. The size of the wage and fringe benefit gains tended to increase as the year progressed. The Council of Economic Advisers states in its Annual Report that ". . . the experience of 1966 clearly suggests that expanding demand cannot lower the unemployment rate much below the present level without bringing an unacceptable rate of price increase. Under present conditions, an over-all unemployment rate close to 4 per cent appears to be associated with an approximate balance between supply and demand in most labor markets. A higher level of demand for goods and services would create inflationary pressures in both product and labor markets."

In the past two years there has been some easing in the upward trend of prices in France and Italy, and since mid-1966 the rise in consumer prices in Germany appears to have tapered off. The upward trend in costs and prices in Britain was halted after the introduction in July of a six-month freeze on prices and incomes, which is to be followed by a period of "severe restraint" regulated by stringent guidelines. While most other European countries continued to experience relatively rapid price increases, the rate of increase in many cases was lower than in 1965.

TRADE AND PAYMENTS. The expansion of world trade in 1966 seems to have been about in line with the relatively high average rate of almost 10 per cent experienced in the previous three years. Part of the rapid increase in international trade in recent years reflects the expansion of trade within trading blocs where barriers to bloc trade have been progressively reduced. Trade within the European Economic Community and within the European Free Trade Association has consistently grown more rapidly than world trade since 1959. The same observation applies to the growth of trade within the Latin American Free Trade Association and within the Central American Common Market since 1961, though in these areas intra-area trade accounts for a relatively small part of total trade. However, the growth of world trade, even excluding intra-area trade, has been relatively rapid in the past few years. An important element sustaining the growth in trade in 1966 was the continued rapid rise of imports into the United States. Import demand also accelerated in France, Italy, Japan and in the less developed countries. Trade in manufactures

WORLD TRADE[1]

Annual — Index 1960 = 100



1966 preliminary.
1. Total exports f.o.b.

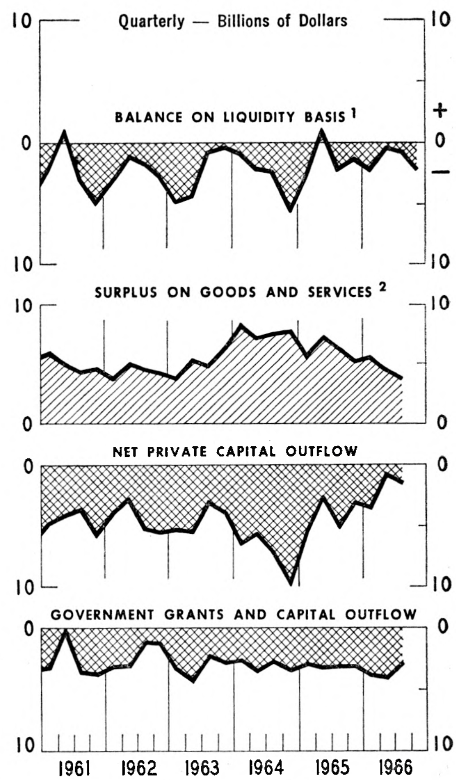
continued to grow more rapidly than trade in primary products; in part this reflected the easing in primary commodity prices in 1966.

Among the primary producing countries, those whose principal exports are petroleum, minerals or metals did relatively well in 1966; the demand for these products remained buoyant even though prices were somewhat lower in the second half of the year. On the other hand, the countries dependent on the export of tropical agricultural products fared less well; prices of these products declined throughout the year. World demand for wheat and flour was strong, reflecting poor crops in many areas and the further depletion of stocks in some of the major producing countries. The situation was particularly serious in India which suffered drought conditions for the second successive year; crops in China were also poor. The Soviet Union had record grain crops in 1966 following two years of relatively poor crops, but imports remained large.

The diverse changes in economic activity and in the underlying demand pressures on available resources which have been described were reflected in the developments of the international current account positions of the industrialized countries.

In the United States, there was a further reduction in the surplus on goods and services transactions in 1966. United States imports rose almost twice as rapidly as exports and the trade surplus declined to $3.7 billion, from $4.8 billion in 1965 and $6.7 billion in 1964 although there was some increase in the trade surplus in the final quarter of the year. The favourable balance on services account (excluding military expenditures) apparently rose slightly as investment income receipts continued to grow; however, when account is taken of military expenditures abroad, which increased sharply, the combined surplus on goods and services dropped by about $1.5 billion from the $6.0 billion figure reached in 1965.

UNITED STATES BALANCE OF PAYMENTS



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

A number of countries which had experienced deficits on current account in 1965 tended to improve their positions in 1966. The German current account deficit contracted rapidly and had been replaced by a surplus by year-end. Britain was also moving into current account surplus towards year-end though results for the year as a whole were adversely affected by the seamen's strike in the early summer.

On the other hand, as the pace of domestic activity in France and Italy accelerated, their large current account surpluses tended to contract, especially during the second half of the year. Japan maintained its surplus position in 1966, largely reflecting the export-oriented character of the economic expansion, but towards year-end there were indications that the broadening basis of its recovery was leading to some reduction in the surplus.

The reduction in the external surplus on goods and services in the United States in 1966 was largely matched by a reduced net capital outflow, and the balance of payments deficit on a liquidity basis* increased only slightly to $1.4 billion, from $1.3 billion in 1965. The outflow of United States private capital was restrained by the voluntary guidelines, and United States business corporations financed a considerable part of their foreign investment by the sale of bonds, denominated in U.S. dollars, in European capital markets. It appears nevertheless that the reduction in the net outflow of capital from the United States in 1966 reflected mainly large purchases by foreign official institutions of non-guaranteed securities of United States Government agencies and long-term certificates of deposit issued by United States commercial banks, which are not included in the calculation of the liquidity deficit. An important effect of domestic credit stringency in 1966 was that United States banks borrowed substantial amounts of short-term funds from private non-residents through the Euro-dollar market; this unusual borrowing no doubt reduced the flow of dollars into foreign official reserves.

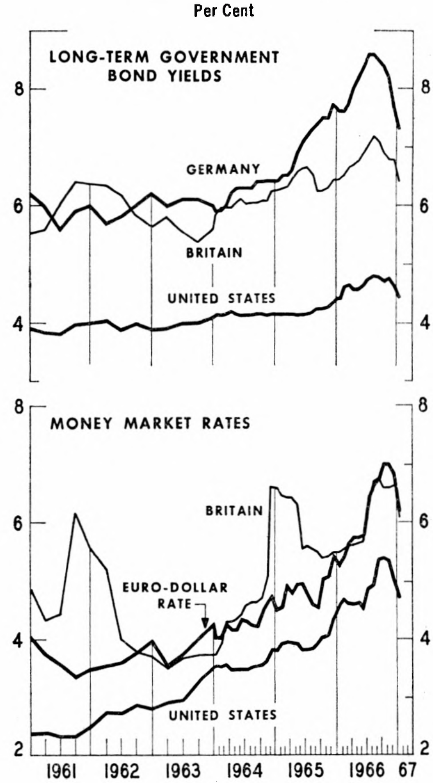
The world payments situation was characterized by an unusually large volume of international short-term capital flows in 1966. In the summer months substantial outflows from Britain were countered by the expansion of various central bank credit facilities. Short-term funds were attracted to some countries that were accumulating reserves, including Germany. To a large extent, however, short-term flows played an offsetting role, as in the case of the United States noted above, and in the cases of Italy and Japan, where short-term outflows helped to offset current account surpluses. Large amounts of these short-term funds were in U.S. dollars and moved through the international network of private

* As measured by changes in United States official reserve assets and in liquid liabilities to all foreigners.

financial institutions that make up the Euro-dollar market. The increase in short-term capital flows was associated in part with a very sharp rise in short-term interest rates which in 1966 reached peak levels not experienced since the 1920's.

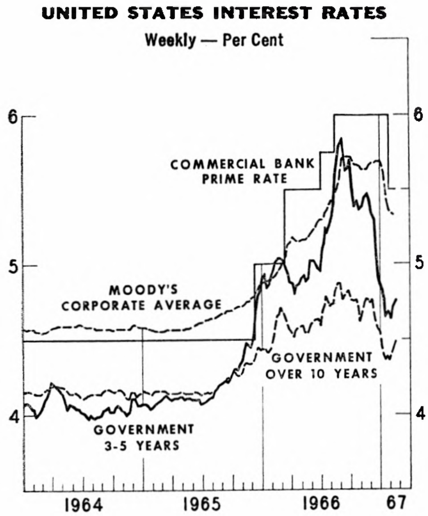
The flow of development capital to the less developed countries has continued to be adversely affected by the international payments problems of some major contributing countries. Despite the growth in production and income in the industrialized countries the total flow of official aid has remained virtually constant over the past five years. Moreover, financial developments in the industrialized countries have made it more difficult for both international organizations and private investors to mobilize new development capital. Rising debt repayments have resulted in an actual decline in the net capital flow to the developing countries in recent years.

SELECTED INTEREST RATES



Quarterly prior to 1964, monthly thereafter.

FINANCIAL POLICIES. In the United States, monetary and fiscal steps directed to meeting the dangers of overly-rapid expansion were taken at the end of 1965 and early in 1966. With the large growth in defence expenditures, fiscal policy did not provide the degree of restraint that had been intended. Credit demand continued to grow and the task of offering additional restraint fell largely on monetary policy. In August, as the chart on the next page shows, interest rates reached very high levels and conditions in credit markets became very strained. Efforts were made to moderate the growth in bank loans to business and in order to help achieve a better mix of financial policies fiscal measures were taken in September to limit the growth of business investment and to cut back non-defence expenditures. Later in 1966, as it became clear that demand and supply in the United States economy were moving towards better balance, monetary policy became less restrictive. This was first reflected in lower market yields on United States Treasury securities, but early in 1967 the easing in interest



rates became more general. In his budget message in January 1967, the President asked Congress to enact a temporary 6 per cent surcharge on personal and corporate tax liabilities to be effective at mid-year to cover a large part of the projected increase in Government expenditures. The President also asked for an extension of the Interest Equalization Tax for two years to mid-1969 and an immediate doubling of the effective rate to 2 per cent, with authority to adjust the tax so that its effective impact can be varied from zero to 2 per cent. The Administration has extended through 1967 the voluntary balance of payments programme introduced early in 1965, with a lower target for direct investment abroad.

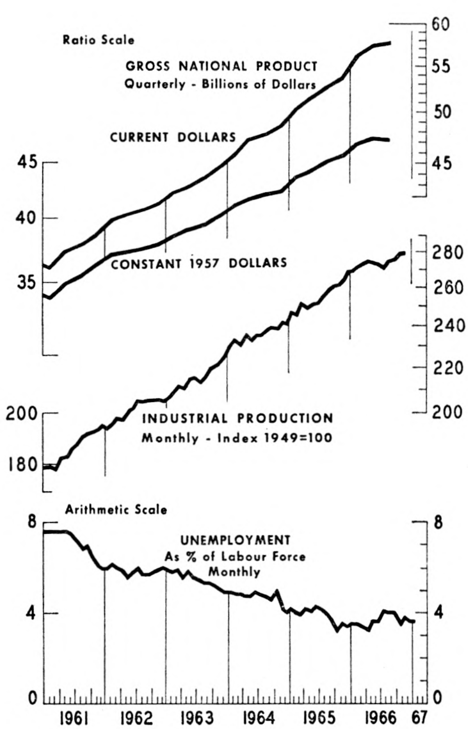
Since 1964 economic policy in Britain has been greatly influenced by the need to restore internal and external balance and to strengthen confidence in sterling. The additional measures of fiscal restraint introduced in the May 1966 budget were substantially reinforced by steps taken in July, including a freeze on prices and wages. Fiscal action was accompanied by an increasingly restrictive monetary policy and the Bank Rate was raised from 6 to 7 per cent in July. Through the summer months the position of sterling in the exchange market remained uncertain, and it was supported by a substantial increase in central bank credit facilities. Sterling subsequently strengthened, and since September reserves have recovered and there have been repayments of official short-term liabilities. In November the remaining emergency import surcharges were removed. The Bank Rate was lowered by ½ per cent to 6½ per cent in January 1967.

In France, Italy and Japan economic policy in 1966 continued to be directed towards sustaining economic expansion. In almost all other European countries the level of demand was high in the first part of the year and measures were taken to restrain price and cost pressures. The mix of public policy in these latter countries continued to place heavy reliance on monetary restraint. Several central banks raised their rediscount rates and as noted earlier the structure of international interest rates rose sharply. However, a moderation of the pressure of demand in the second half of the year, which was particularly marked in Germany, permitted some easing in restrictive policies. Early in 1967 the rediscount rate was reduced twice in Germany and it was also lowered in Sweden and Belgium.

Economic Developments in Canada

Against the background of continued expansion in the United States and the strong growth of world trade described in the preceding section, the Canadian economy made further substantial gains in 1966, though there was considerable evidence of stress and strain. A record wheat crop coincided with strong export demand, and production in the non-farm economy registered further advances, particularly in the early part of the year. Economic activity grew more slowly after the first quarter than it had through the winter and there was some easing of the pressure on resources. The trend of output was relatively flat during the summer, partly as a result of strikes, but the pace of activity picked up in the closing months of the year. At year-end the economy continued to operate at high levels of employment. However, there were uncertainties about the economic situation, related partly to the course of developments in the United States and partly to the ultimate repercussions of imbalances generated by the strong domestic pressures in 1965 and early 1966. Among the signs of imbalance were numerous industrial disputes, wage settlements substantially in excess of productivity growth and pervasive increases in prices.

OUTPUT AND UNEMPLOYMENT



Seasonally adjusted (GNP at annual rates).

Gross National Product in money terms is estimated to have been more than 10½ per cent higher in 1966 than in 1965. To an important extent this large increase reflected the very sharp rise, amounting to 4½ per cent, in the first quarter of the year. The increase in 1966 exceeded that of the previous year by about 1 per cent; it was the largest rise since 1956. However, two fifths of the increase was accounted for by higher prices rather than higher real output of goods and services. The GNP price deflator rosc by more than 4 per cent in 1966 compared with an increase of about 3 per cent in 1965. After allowing for this large price factor, the gain in total output in 1966 was slightly more than 6 per cent, or marginally less than in the previous year. As a result of the record wheat crop, agriculture contributed more than proportionately to the increase in output in 1966 and non-farm real output rose by nearly 6 per cent compared with over 6½ per cent in the previous year. On the other hand, non-farm employment rose more in 1966 than in 1965—5.4 per cent compared with 4.8 per cent. These figures indicate that the gain in productivity in 1966, as measured broadly by non-farm output per worker, was disappointingly small.

The principal source of the increase in non-farm employment in 1966 was the growth in the labour force, which was the highest since 1957. The movement out of farm employment was also larger than it had been at any time since the mid-1950's. The seasonally adjusted unemployment rate which had declined to just under 3½ per cent by the last quarter of 1965 fluctuated in the 3½ to 4 per cent range in the course of 1966 and ended the year just over 3½ per cent.

During 1966 there were marked shifts in both income and expenditure patterns, which in many cases had already begun to be significant in 1965.

On the income side, a notable feature of the year was the comparative behaviour of labour income and corporate profits. Labour income grew strongly as a result of higher employment and increased average earnings. Even though many of the large wage settlements which occurred in the course of the year were not yet fully reflected in earnings, labour income for 1966 rose by about 12½ per cent—the largest increase in a decade. On the other hand corporate profits, which had risen more strongly than labour income in the earlier part of the expansion—reflecting in part their greater cyclical variability—levelled out in the latter part of 1965 and fell in the second half of 1966. For the year as a whole corporate profits showed little change from the previous year and they declined relative to total income and to real output. The most striking increase in income during 1966 accrued to the farm sector; the net value of farm production (as measured in GNP), reflecting principally the size of the wheat crop and the higher level of livestock prices, rose by almost 40 per cent in 1966 to much the largest figure on record.

The demands placed on the economy by various sectors changed significantly during thc year. In Canada, as in the United States, automobile and housing markets exerted a dampening influence. On the other hand, the traditionally more stable elements of personal spending continued to provide strong support to the economy. The extended boom in business investment which began in

1963 continued into 1966. All levels of government made large increases in their expenditures on goods and services. There was a slight improvement in the current account deficit, which contrasted with a significant deterioration in 1965. In response to the strong general demand situation in the United States and the favourable factors affecting wheat exports, total exports registered a much larger increase in 1966 than in 1965 while the rise in imports, though large, was of about the same magnitude as in 1965.

DOMESTIC DEMAND. After four years of rapidly rising sales, the North American market for new automobiles weakened significantly in 1966. This development may have been related in part to the controversy over safety features, but it seems reasonable to suppose that it also reflected the large additions to the automobile population which had taken place in recent years; the changes which occurred in credit conditions probably also had an influence. The pattern of sales in Canada throughout the year was uneven. A particularly sharp dip in the spring was followed by a period of very high sales in the summer as automobile dealers made a major effort to clear their stocks of 1966 models. This unevenness was magnified to some extent by a spurt in buying prior to, and a reaction following, the increase in the Ontario sales tax on April 1, 1966. For the year as a whole sales of new automobiles declined by about 2 per cent compared with an increase of about 15 per cent in 1965. In the closing months of 1966 sales in both Canada and the United States were running 6 to 8 per cent below their levels of a year earlier.

As 1966 progressed, there was evidence of a tapering off in the rate of increase in personal spending on household and other durable goods as well as on automobiles. However, personal expenditures on non-durables and on services increased even more strongly in 1966 than in the previous year—to some extent reflecting higher prices, particularly for food. In total, personal expenditure is estimated to have been about 8½ per cent higher in 1966 than in 1965. At the beginning of 1966 payroll deductions were increased as a result of the inception of the Canada and Quebec Pension Plans, and effective June 1 federal tax rates on personal incomes, except in the lower brackets, were increased by about 10 per cent, which approximately reversed the tax reduction which occurred at mid-1965. Nevertheless, personal disposable income increased at almost the same rate as in 1965. The increase in personal disposable income was greater than in personal spending, so there was a further increase in the proportion of disposable income saved in 1966. The high level of personal saving probably reflected in part the sharp increase in farm income. The relationship between spending and income may also have been affected by credit conditions: during the course of the year there was a tendency for the amount of consumer and mortgage credit outstanding to rise less rapidly.

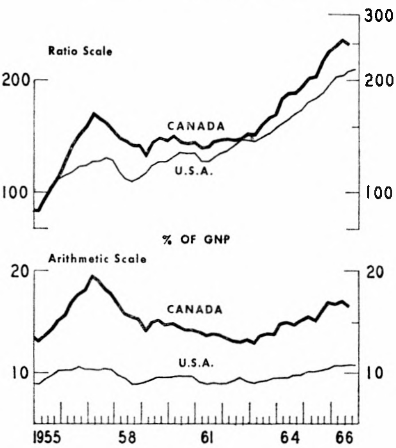
Housing starts turned down in the latter part of 1965 and continued to decline sharply through most of 1966, being adversely affected by the shortage of mortgage funds. The level of house-building activity remained high in the first half of 1966 as work continued on the large volume of earlier starts, but in the second half of the year expenditure on new residential construction declined quite sharply. As was the case with the earlier upswing in starts, most of the decline was in apartments and row houses whose financing is mainly dependent on private financial sources. Starts of single family dwellings were supported by an increase in direct government loans and were maintained close to the relatively stable level that has prevailed in recent years. Multiple starts were almost one-third lower in 1966 than in the previous year while single starts were down by about 6 per cent. As the chart on page 27 shows, the recent decline in housing starts has not been as sharp as on similar occasions in the past nor as sharp as that which occurred in 1966 in the United States; it may also be noted that the upswing in starts which preceded the contraction was much stronger in Canada than in the United States. On the other hand, Canada has a higher natural rate of household formation than the United States and has recently had very high rates of immigration as well. Vacancy rates in Canada have fallen to extremely low levels and there has been a sharp rise in house prices and rents, particularly in rapidly growing metropolitan centres. Late in 1966 and early in 1967, the Government announced a number of measures designed to stimulate house-building activity. A programme of direct government loans to builders similar to that used to promote winter-building was announced for the spring months of 1967. To encourage the flow of private funds into the mortgage market, the maximum interest rate on National Housing Act insured mortgage loans, which had been raised to 6¾ per cent in January 1966, was fixed at 7¼ per cent in November and arrangements were made for future automatic adjustments in this rate at quarterly intervals.

Business fixed investment in 1966 registered an increase in the 17 to 20 per cent range for the third successive year. The 1966 increase, though again large, was substantially smaller than the 23 per cent rise indicated by the mid-year review of investment intentions; the results of this survey had suggested that investment was continuing to increase apace, despite the various changes in public policy aimed at restraining it to more sustainable rates. Several such measures were introduced in the March 1966 budget, notably a reduction in depreciation allowances on a wide variety of new plant and equipment acquired between the date of the budget and October 1967, the introduction of a 5 per cent refundable tax on corporate cash flow (broadly, after-tax profits plus depreciation) in excess of $30,000, and the announcement of the removal of the 11 per cent federal sales tax on machinery and equipment in two stages beginning April 1, 1967. In the latter part of the year signs began to appear that the investment boom was

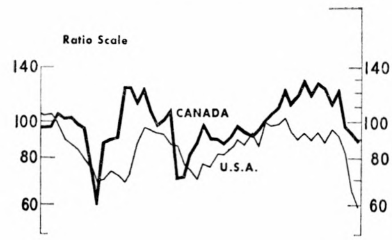
SELECTED COMPARISONS
CANADA - U.S.A.

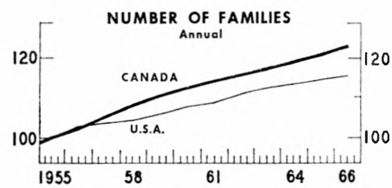
Quarterly — Index 1955 = 100 (Unless Otherwise Noted)

BUSINESS FIXED INVESTMENT



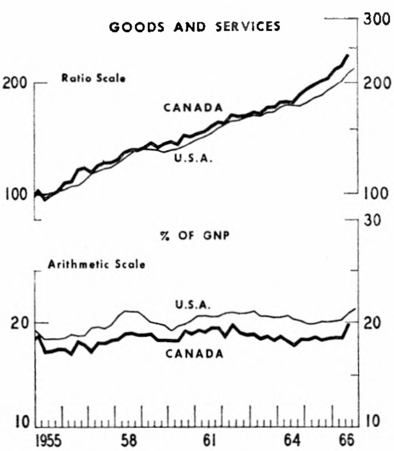
HOUSING STARTS





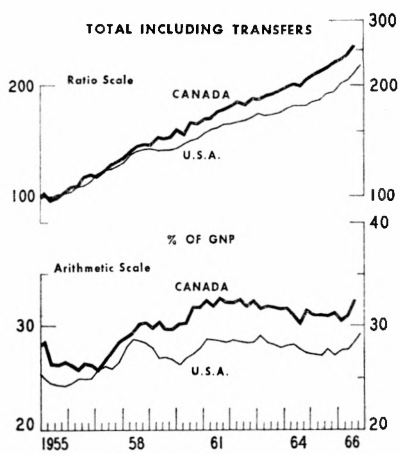
GOVERNMENT EXPENDITURE : ALL LEVELS

GOODS AND SERVICES



Seasonally adjusted at annual rates.

TOTAL INCLUDING TRANSFERS



moderating. Preliminary estimates of the third quarter national accounts showed a reduction in non-residential construction, and an official survey of large firms made in the autumn indicated that they were not expecting their total investment outlays on plant and equipment to be much higher in 1967 than in 1966.

Expenditures of federal, provincial and municipal governments continued to rise rapidly in 1966. As the chart on page 27 shows, expenditures by governments have been rising faster in Canada than in the United States despite the very large increases in United States outlays associated with the war in Viet Nam. In Canada, government expenditures on goods and services rose by 15 per cent in 1966 compared with 11 per cent in 1965. In contrast to 1965 federal government expenditures rose faster than provincial-municipal expenditures in 1966. (It should be noted, however, that provincial-municipal outlays on goods and services are now almost twice as large as those of the federal government.) Increased wage and salary costs were a major factor for all levels of government in 1966. Federal expenditures on goods and services rose by 18 per cent in 1966 compared with 7 per cent in 1965. Defence expenditures, which had declined slightly in 1965, rose by about 9 per cent in 1966; the major acceleration was in other types of expenditure which rose by about 27 per cent in 1966 compared with a rise of 16 per cent in 1965. At the provincial-municipal level, expenditures on goods and services rose by about 14 per cent in 1966, about the same rate as the previous year. Capital outlays for roads, schools and other public works registered a further large increase in 1966.

In addition to increasing their direct purchases of goods and services, governments continued to expand their transfer payments to other sectors of the economy at a rapid rate during 1966. Old age security payments rose appreciably as a result of the first of the scheduled annual reductions in the eligible age, and there were further large increases in grants to universities, vocational schools and hospitals, both for capital expansion and to meet current operating expenses. Other transfer payments, which include interest on the public debt and various subsidies, also rose substantially. In total, transfer payments increased by about 11 per cent in 1966 compared with 7½ per cent in 1965.

The total increase in federal, provincial and municipal government expenditure was about 14 per cent in 1966 compared with 9½ per cent in 1965. Total revenues (excluding the Canada and Quebec Pension Plans and the refundable corporate profits tax mentioned previously) rose by about 10 per cent compared with 11½ per cent in the previous year. The principal factor leading to the slower growth of revenues in 1966 was the failure of corporate profits to increase. At the federal level, total expenditures rose by about 14 per cent in 1966 and revenues by about 8 per cent. Revenues were strengthened during the year by the reversal of the 1965 reduction in personal income taxes and by some of the other provisions of the March 1966 budget mentioned earlier, notably the reduction in depreciation allowances. While federal revenues in total were not greatly different from the forecasts made in the March budget, the growth in expenditures and new commitments for spending was considerably greater. Shortly after mid-year the Government indicated that revenue measures would have to be considered to meet the burden of a new programme of supplementary old age security payments. In December, when this programme received legislative approval, a supplementary budget was introduced in which specific measures were proposed for financing the programme; effective January 1, 1967, the maximum amount of tax payable by individuals under the Old Age Security Act was doubled and the manufacturers' sales tax was raised from 11 per cent to 12 per cent, except on machinery and building materials. In September the Government announced a one-year postponement until July 1, 1968 of the commencement of the proposed universal medical services programme.

On a national accounts basis, the federal government's expenditures in the calendar year 1966 rose $425 million more than its revenues (not including the net receipts in respect of the Canada Pension Plan or the refundable tax on corporations). In 1965, by contrast, its revenues had risen $275 million more than its expenditures. There was also an increase in 1966 of over $400 million in the federal government's net disbursements under the various lending programmes shown in the table on page 52.

Although some provinces increased sales and other taxes during the year, the combined national accounts deficit of provincial and municipal governments increased sharply and was about $150 million higher in 1966 than in 1965. A sizeable surplus was accumulated by the Canada and Quebec Pension Plans which collected over $700 million in the first year of contributions and made no pension payments; under the arrangements pertaining to the Plans, the net funds accumulated are used to finance the spending and lending activities of the provinces or their agencies.

FOREIGN TRADE. The increase in the level of activity in the domestic economy in 1966 was not accompanied by a deterioration in the merchandise trade balance. Demand in foreign markets was buoyant and Canadian exports rose by 17 per cent, compared with 6 per cent in 1965. Merchandise imports rose by 15 per cent in 1966, about the same rate as in the previous year. The trade surplus, which had reached a post-war peak of $700 million in 1964 and then declined sharply to about $120 million in 1965, rose to $380 million in 1966. Higher export prices contributed to the increase in the value of exports in 1966; after rising by a little more than one per cent in 1964 and 1965 export prices went up by about 4 per cent in 1966. Import prices, on the other hand, which had shown little or no increase in the two previous years, rose by 1½ to 2 per cent.

Two special factors affecting trade in 1966 should be borne in mind in comparing the 1966 increase in merchandise exports and imports with earlier years. First, following the signing of the Canada-United States Automotive Agreement in January 1965 there was a large increase in two-way trade in new parts and completed automobiles and trucks. This is shown in the figures in the table below; the table also shows a reduction in 1966 in the very large deficit in trade in automotive products following a considerable widening in the deficit in 1964 and 1965. It may be noted that in 1966 this net balance of imports of automotive products still supplied more than one quarter of the Canadian market for new automobiles and trucks.

The second special feature relates to exports of wheat and flour. Shipments to the Soviet Union under large bulk contracts and sales to other markets fell off in 1965 and again rose sharply in 1966. Part of the 1966 increase in wheat exports was in shipments to India under the bilateral food aid programme. Through much of the period after mid-1965 the volume of wheat shipments was pressing on the limits of the available transportation and handling facilities.

MERCHANDISE TRADE(1)

(millions of dollars)

	1963	1964	1965	1966(2)
Automotive products				
Exports	100	190	366	969
Imports	698	849	1,168	1,647
Balance	−598	−659	−802	−678
Wheat and flour				
Exports	881	1,093	921	1,155
All other commodities				
Exports	6,101	6,955	7,458	8,146
Imports	5,881	6,688	7,459	8,243
Balance	220	267	− 1	− 97
Total				
Exports	7,082	8,238	8,745	10,270
Imports	6,579	7,537	8,627	9,890
Balance	503	701	118	380

(1) Adjusted to balance of payments basis.
(2) Data for automotive products and for all other commodities are preliminary estimates.

The balance of trade in commodities other than wheat and flour and automotive products has worsened in the past two years, moving from a surplus of \$267 million in 1964 to approximate balance in 1965 and a deficit of \$97 million in 1966.

Exports of commodities other than wheat and flour and automotive products rose by about 9 per cent in 1966 compared with an increase of 7 per cent in 1965. Much of the increase in 1966 was in exports to the United States which rose by about 13 per cent. Canadian exporters benefited from strong United States demand for most non-ferrous metals, newsprint and other forest products, and a wide range of manufactured products, especially machinery and electrical apparatus. Canada's total exports to the United States increased more rapidly than total United States imports but all of the gain in Canada's share of United States imports was concentrated in automotive products; Canada's share of other United States imports declined.

The economic conditions in the major overseas markets described earlier in this Report influenced the pattern of Canadian exports. Shipments of commodities other than wheat to Continental Europe and Japan reflected the rising demands in these markets; Canada's share of total imports into these areas expanded. Shipments to Britain, on the other hand, declined even though Britain's total imports rose slightly, so that Canada's share of that market fell. There was little or no increase in Canada's exports of commodities other than wheat to all other market areas in 1966 though total imports into these regions expanded.

CANADIAN EXPORTS EXCLUDING WHEAT AND FLOUR(1)

	Value (millions of dollars)	
	1965	1966 (11 months)
To: United States		
automotive products	194	719
other commodities	4,195	4,758
Sub-total	4,389	5,477
Britain	924	892
Continental Europe	656	715
Japan	199	271
Australia, New Zealand, South Africa	234	204
All other countries(2)	504	517
Total	6,906	8,076

(1) Trade of Canada basis, excludes re-exports.
(2) Mainly less developed countries; also includes Eastern Europe.

Canadian merchandise imports other than automotive products rose by nearly 11 per cent in 1966, almost the same rate of increase as in 1965. This reflected continued strong demand for a wide range of imported machinery and other investment goods and consumer goods. Imports of other transportation equipment continued to rise but imports of construction materials, notably structural steel, declined. Imports of automotive products rose by about 40 per cent.

Almost all of the increase in total imports which occurred during the course of 1966 was concentrated in the second half of the year. This reflected the strongly rising trend in imports of automotive products and increased deliveries towards the end of the year of investment goods ordered from the United States.

CANADIAN IMPORTS CLASSIFIED BY END-USE(1)

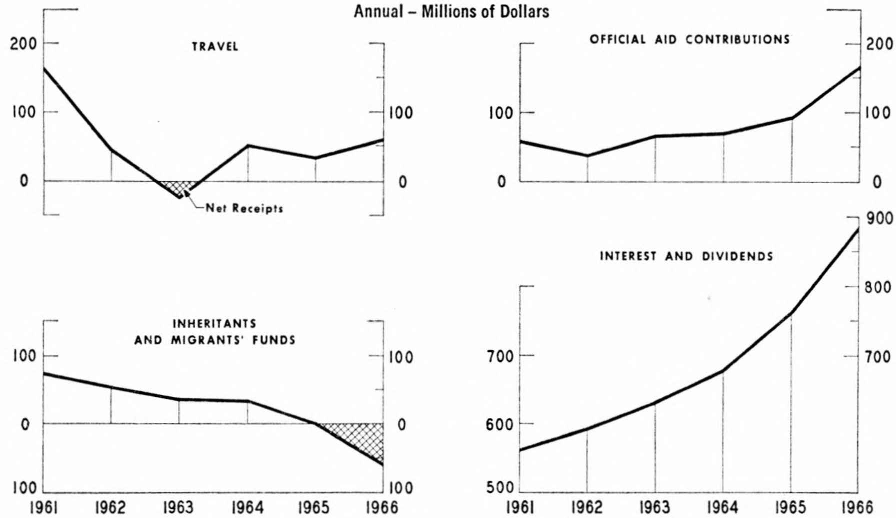
	Value (millions of dollars)		Percentage change from previous year	
	1965	1966 (11 months)	1965	1966(2)
Fuels and lubricants	570	577	15	1
Industrial materials	2,102	2,280	11	8
Producers' equipment	1,980	2,336	14	18
Construction materials	287	276	14	− 4
Transportation equipment(3)	260	303	44	17
Food	621	648	− 4	4
Other consumer goods	743	837	12	13
Special items	248	301	25	21
Sub-total	6,809	7,558	12	11
Automotive products	1,035	1,447	38	40
Total	7,844	9,006	15	15

(1) Trade of Canada basis.
(2) Change from first 11 months of 1965 to first 11 months of 1966.
(3) Excluding automotive products.

Canada's international deficit on non-merchandise transactions increased from $1,201 million in 1965 to $1,363 million in 1966. Larger deficits on interest and dividend account and in the form of official foreign aid contributions were offset only in part by an improvement in the balance of inheritances and

NON-MERCHANDISE TRANSACTIONS
SELECTED ACCOUNTS - NET PAYMENTS

Annual – Millions of Dollars



migrants' funds and an increase in receipts from foreign governments in connection with their outlays for the construction of pavilions at Expo '67. Most of the increase in foreign aid contributions took the form of wheat shipments to India which are included in merchandise exports.

Our total current account transactions with the rest of the world resulted in a deficit of $983 million in 1966 compared with a deficit of $1,083 million in 1965 and $424 million in 1964. The current account deficit with the United States rose slightly in 1966 to a new peak of $2,100 million*. As a result of larger wheat exports the surplus with other countries rose again to a higher level than in any previous year in more than a decade except 1964.

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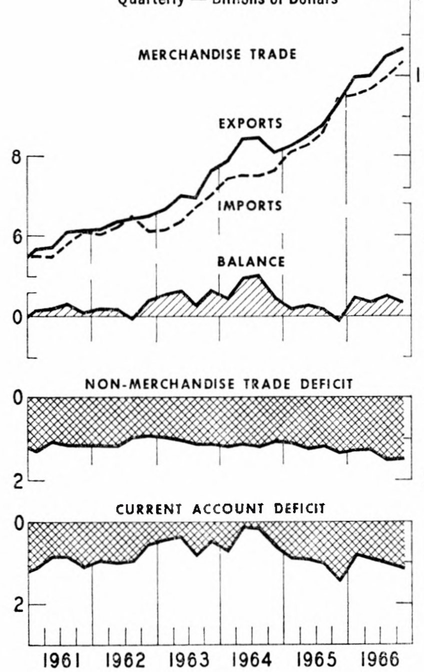
* Excluding gold production available for export.

CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

Quarterly — Billions of Dollars



Balance of payments basis; seasonally adjusted at annual rates.

PRODUCTION. The developments which have been described in domestic and foreign demands on the economy naturally had their counterpart in patterns of output in 1966. Production was also significantly affected by industrial disputes, particularly during the third quarter of the year when the number of man-days lost through strikes was as great as in the whole of 1965. Partly for this reason, industrial production dipped during the summer; in subsequent months it showed fairly sizeable gains but the underlying trend after the first quarter of the year reflected more moderate rates of growth than had prevailed during the first five years of the expansion. Automobile and steel production levelled out in 1966 and declined towards year-end. The decline in housing activity in North America led to a reduction of output in the lumber, forestry and construction industries in the latter part of the year. Non-residential construction activity also eased somewhat in the second half of the year. There was, however, continued rapid growth in the output of services, including trade, transportation, finance and public services.

EMPLOYMENT. An outstanding feature of the year was the extraordinary increase of nearly 4 per cent in the labour force on an annual average basis. This was about one per cent more than the increase in 1965 and was larger than in any other year on record except 1957 when the increase was also about 4 per cent. In 1966 as in 1957 immigration was a major factor. Total immigration rose from under 150,000 in 1965 to almost 200,000 in 1966. However, this factor was less important than in 1957 when there were over 280,000 immigrants, an unusually high proportion of whom were destined for the labour force. Another major factor contributing to the growth of the labour force in 1966 was the further strong rise in the proportion of the female population, particularly married women, holding jobs. The female labour force increased by 7½ per cent in 1966 compared with about 5½ per cent in 1965. In 1966 roughly one third of the number of women of labour force age (14 and over) were in the labour force compared with approximately one quarter a decade earlier. The female participation rate in Canada in 1966 was still considerably below that in the United States, but over the past decade the gap has narrowed from about 11 per cent to about 6 per cent. This appears to reflect changing attitudes in Canada as well as the magnetic pull of job opportunities. The Canadian male labour force rose by about 2½ per ccnt in 1966 compared with just over 2 per cent in the previous year; most of this change appears to have been associated with the increase in immigration.

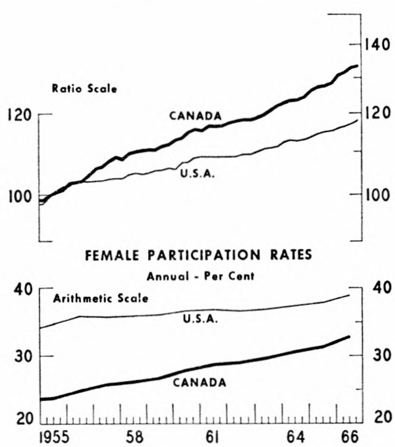
As mentioned previously, non-farm employment registered an even larger increase in 1966 than in the previous year—5.4 per cent on an annual average basis compared with 4.8 per cent in 1965. Following a decline of 5½ per cent

SELECTED COMPARISONS
CANADA - U.S.A.

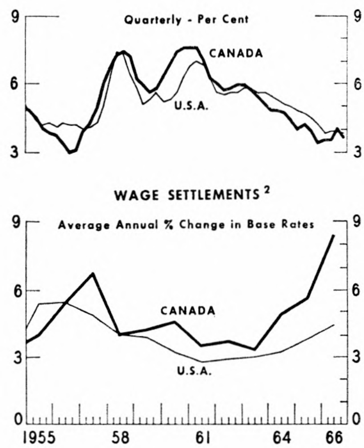
Quarterly — Index 1955 = 100 (Unless Otherwise Noted)

LABOUR MARKETS

TOTAL LABOUR FORCE[1]

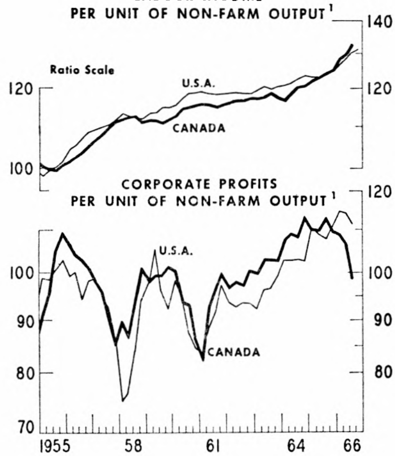


UNEMPLOYMENT RATE[1]

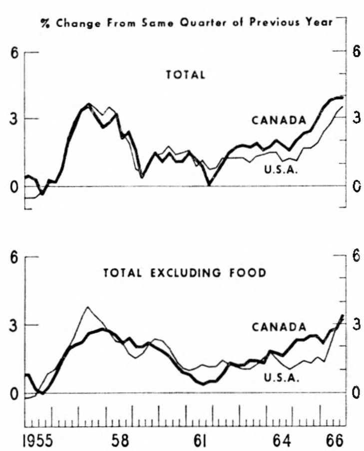


COSTS, PROFITS AND PRICES

LABOUR INCOME
PER UNIT OF NON-FARM OUTPUT[1]



CONSUMER PRICE INDEX



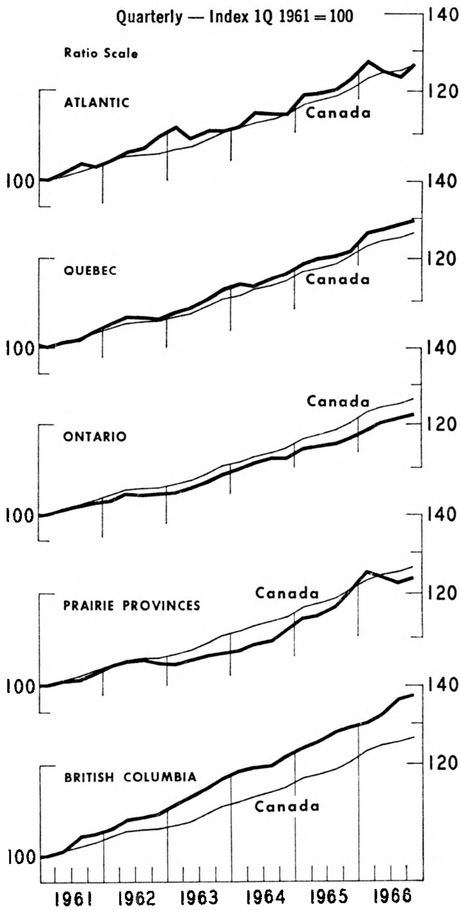
1. Seasonally adjusted.
2. Increases provided by larger collective agreements signed during year with principal exception of those in construction; based on figures of Department of Labour (Canada) and Department of Labor (U.S.A.).

in 1965, farm employment fell by a further 8½ per cent in 1966. In the last two years there has been a marked acceleration in the long-term downward drift of farm employment. In part at least the faster decline in farm employment in the past two years is another indication of the pressure of demand elsewhere in the labour market. Over the past decade, while agricultural production has continued to rise, farm employment has declined by roughly one third. Agriculture now accounts for 7½ per cent of total employment.

Total employment in the economy as a whole averaged just over 4 per cent higher in 1966 than in 1965. Male employment grew by about 3 per cent and female employment by almost 7½ per cent in 1966. There was little change in unemployment; the average annual unemployment rate declined slightly further from 3.9 per cent in 1965 to 3.6 per cent in 1966, but the unemployment rate was about the same at the end of 1966 as at the end of 1965.

NON-FARM EMPLOYMENT BY REGIONS

Quarterly — Index 1Q 1961 = 100



Seasonally adjusted.

Despite some unevenness, all the main regions of the country registered further strong increases in non-farm employment in 1966, with Quebec and the Prairies showing gains well above the national average. All regions except British Columbia also shared in the drop in farm employment. The growth of the labour force was highest in British Columbia, and was also above the national average in Quebec and Ontario; it was lowest in the Prairies and the Atlantic Provinces. Unemployment rates declined further in all regions except British Columbia though the decline in Ontario was marginal. In British Columbia the unemployment rate rose from an average of 4.2 per cent in 1965 to 4.5 per cent in 1966; in part this appears to reflect the impact on British Columbia's forest industries of the decline in housing activity in North America, but it may be noted that the British Columbia labour force rose by the extraordinarily large figure of over 6½ per cent in 1966.

REGIONAL LABOUR MARKETS - 1966

	Labour force	Employment			Unemployment rates	
		Farm	Non-farm	Total	Annual	4th quarter(1)
	(annual percentage change from 1965)				(per cent of labour force)	
Atlantic............	2.5	− 5.9	3.9	3.5	6.4	6.2
Quebec............	4.6	− 8.6	6.3	5.4	4.7	4.5
Ontario............	4.0	− 7.3	4.7	4.0	2.5	2.5
Prairies............	1.6	−11.4	6.2	2.2	2.1	2.2
B.C...............	6.6	+13.6	5.7	6.1	4.5	4.9
Canada............	3.9	− 8.4	5.4	4.2	3.6	3.6

(1) Seasonally adjusted.

COSTS AND PRICES. Upward pressures on costs and prices, which had already emerged by the end of 1965, became clearly visible during 1966. Tight labour market conditions coincided with an unusually large number of wage contract negotiations. Stimulated by the size of some earlier wage and salary settlements in construction and elsewhere, by rising prices—particularly for food—and in some cases by profit levels, large wage demands were pressed vigorously and successfully in most sectors of the economy. In the majority of cases, settlements included large increases for current and subsequent years. As the chart on page 35 shows, the average annual increase in wage rates provided for by settlements in 1966 exceeded the increase for prior years in Canada and was very substantially above the scale of 1966 settlements in the United States. It appears that wages and salaries in important areas not covered by formal collective bargaining arrangements were also subject to strong upward pressures. Although many of the adjustments which occurred were not yet wholly reflected in earnings for the calendar year, labour income per worker (including self-employed workers) in the non-farm economy was almost 7 per cent greater in 1966 than in 1965; this compared with an increase of about 6 per cent in1965.

The average increase in wages and salaries in 1966 considerably exceeded the long-run average rate of growth in productivity and surpassed by an even wider margin the productivity improvement actually achieved during the year. As the table on the next page shows, the increase in output per worker in the non-farm economy in 1966 appears, on the basis of presently available data, to have been about half the relatively modest gain of 1965. In manufacturing, where productivity measures are generally considered to be somewhat more precise, a marked slowdown in the rate of productivity improvement was also evident. Consequently, the increases in wage and salary costs per unit of output in most sectors of activity in 1966 were much greater than the 1965 increases to which attention was drawn in last year's Report.

EARNINGS AND OUTPUT

(percentage change from previous year)

	Canada				United States
	1963	1964	1965	1966(3)	1966(3)
Wages and salaries per worker					
Non-farm(1)	3.5	4.1	6.0	6.9	6.4
Manufacturing(2)	2.4	3.8	5.2	5.9	4.0
Output per worker					
Non-farm(1)	2.4	2.8	2.2	1.1	2.5
Manufacturing(2)	3.3	4.1	3.6	2.2	3.4
Wages and salaries per unit of output					
Non-farm(1)	1.1	1.2	3.7	5.8	3.8
Manufacturing(2)	−0.9	−0.4	1.6	3.6	0.6
Corporate profits per unit of output					
Non-farm	4.2	7.4	0.9	−5.9	3.8
Manufacturing	5.2	−0.5	−1.8	−8.9	−0.2

(1) Wages and salaries include military pay and supplementary labour income; employment based on labour force survey (including self-employed) and armed forces enrolment.

(2) Wages and salaries do not include supplementary labour income; employment based on all-establishment survey which differs somewhat from measure used by DBS in official productivity estimates, so far available only annually to 1965.

(3) Change from first 9 months of 1965 to first 9 months of 1966.

The 1966 increases in wage and salary costs per unit of output in Canada were also considerably greater than in the United States. For the non-farm economy as a whole, this appears to have reflected mainly the poor productivity performance in Canada. However, in manufacturing—the sector most directly relevant to Canada's international competitive position—the sharper rise in unit labour costs in Canada resulted from both a smaller gain in productivity and a larger increase in average wages and salaries than in the United States.

There was a strong tendency for profits as well as prices to feel the impact of rising costs in Canada in 1966. In 1965 the ratio of total corporate profits to output had levelled out. This ratio declined markedly in 1966, particularly in the third quarter when strikes had an appreciable impact on profits. As may be seen in the chart on page 35 and in the table above, this reduction in profit margins in Canada in 1966 was in contrast to the situation in the United States, though there too some decline in profit margins in manufacturing developed in the course of the year.

Prices in Canada rose more rapidly in 1966 than in 1965. Food prices, which had gone up sharply in 1965, continued to increase through most of 1966. Although the food component of the Consumer Price Index eased slightly towards the end of the year, the average level of food prices in the last quarter of

1966 was still almost 10 per cent higher than two years earlier. In the course of 1966 there was some tendency for meat prices, which had been the principal initial source of the upswing, to moderate but prices of a broad selection of other food items rose more rapidly. As the table below shows, the rate of increase of non-food prices was substantial in 1966. The prices of goods other than food rose more than twice as much in 1966 as they did in 1965; some part of this acceleration was related to sales tax increases. Durable goods prices, which had been stable or declining for several years, increased by about one per cent in 1966. As the chart on page 35 and the table below show, the rate of increase in Canadian prices continued to exceed that of prices in the United States, though apparently by a narrower margin towards year-end.

PRICES

(percentage change from previous fourth quarter)

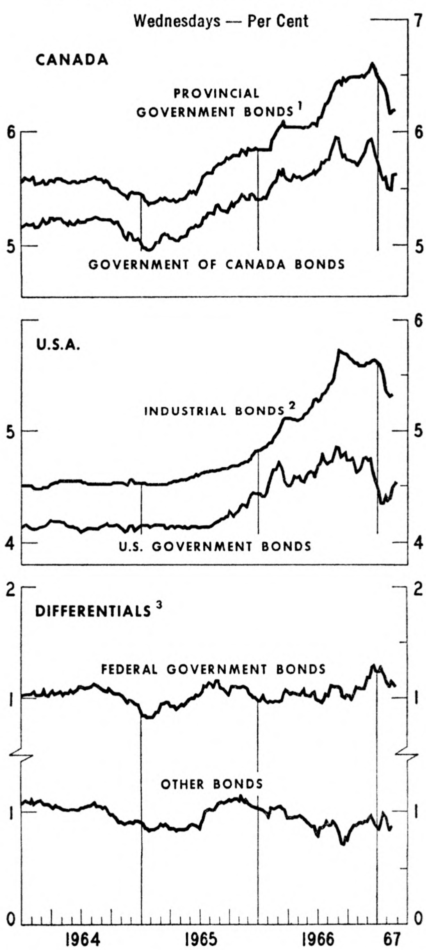
	Canada				United States
	4Q '63	4Q '64	4Q '65	4Q '66	4Q '66
Prices of all goods and services (GNP deflator)	1.7	2.8	3.1	4.7(1)	3.6
Consumer prices:					
Total CPI	1.6	1.6	2.9	3.9	3.5
Food	2.6	0.9	4.3	5.2	4.6
Total except food	1.3	1.9	2.5	3.4	3.2
Goods except food	0.8	0.8	1.2	2.8	2.1
Durables	–	−1.0	–	1.2	1.1
Non-durables	1.2	1.6	1.6	3.4	2.8
Services	1.4	3.0	4.2	3.7	4.8

(1) Change from 3Q '65 to 3Q '66.

Financial Developments in Canada

The tightening of conditions in Canadian financial markets which began in 1965 continued through most of 1966. Credit conditions also continued to tighten in the United States and Europe. Despite the slackening in the rate of economic growth which occurred in Canada in the course of 1966, the demand for credit remained very strong. Short-term interest rates rose considerably. Yields on long-term Government of Canada bonds reached a peak of about 6 per cent. Yields on other long-term securities rose somewhat more than on Government of Canada bonds. Access to mortgage credit became more difficult and by the fourth quarter of the year rates on prime conventional residential loans had risen to about 8 per cent. During the summer, when the upward pressures on interest rates in the United States became particularly severe, the Bank of Canada offered considerable resistance to a further tightening of credit conditions in Canada. The chartered banks' total assets, which had grown slowly in the first half of the year, were permitted to increase more rapidly in the second half; the banks were able to add significantly to their holdings of more liquid assets and indeed to increase the ratio of such assets to their total assets while accommodating an increased rate of loan expansion. By the end of the year interest rates were declining in Canada and abroad and the easing of credit conditions continued into early 1967.

LONG-TERM INTEREST RATE AVERAGES



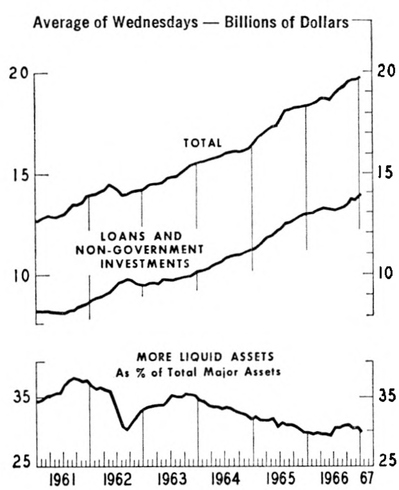
1. Average weekly yields on the 10 provincial bonds included in the monthly series published by McLeod, Young, Weir and Co. Ltd.
2. Average yield on industrial bonds published by Moody's Investor's Service Inc.
3. Rate in Canada minus rate in U.S.A.

Through the first quarter of 1966 it was evident that the pressure of demand on the economy was increasing rapidly and that our balance of payments on current account remained in substantial deficit. Interest rates were rising in the United States and Europe. On March 11 the Bank of Canada announced an increase in its Bank Rate from 4¾ per cent to 5¼ per cent, thus underlining the concern about inflationary dangers expressed in its Annual Report for 1965 which was made public on the same day. Over the first quarter of 1966 the yield on three-month treasury bills rose from 4.5 per cent to 5.1 per cent and the average yield on long-term Government of Canada bonds increased from 5.4 per cent to 5.6 per cent.

During the second quarter of the year there was little change in yields on Government of Canada securities, though some other interest rates continued to rise gradually. On occasion during this period the Bank of Canada resisted by its open-market operations a tendency for Government of Canada bond yields to decline. In addition, in connection with the May 1 Government of Canada refunding issue, the Bank repeated a technique first used at the time of the February 1 refunding and informed primary distributors of Government of Canada securities that it was prepared to purchase the new issues offered by the Government in exchange for certain longer-term bonds from its own portfolio. As a result of this offer the Bank sold $49 million of bonds maturing in 1988 and 1990, principally in exchange for the new 1980 maturity. Details of the Bank of Canada's securities transactions during 1966 are shown in Appendix Table I.

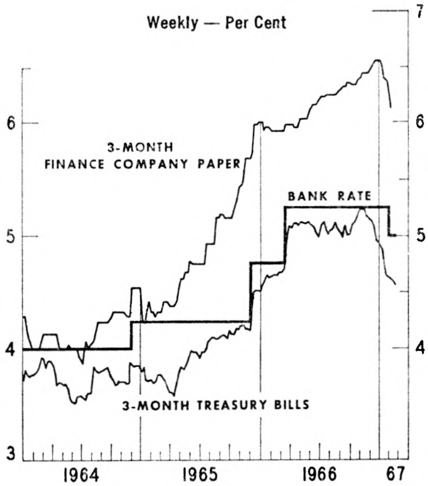
The growth of the chartered banks' Canadian assets slowed down to an annual rate of about 3 per cent in the first half of the year compared with 12 per cent in 1965. Even though total Canadian dollar bank loans rose at an annual rate of only 5 per cent during this period, compared with 20 per cent in 1965, the banks' more liquid asset ratio continued to decline. In the mortgage market, loan approvals by private institutions, which had fallen off in the second half of 1965, remained at a relatively low level and, with the demand for mortgage funds remaining strong, conventional mortgage rates rose further. The expansion of consumer credit granted by banks and other lenders slowed down significantly during the second quarter.

CHARTERED BANK ASSETS



Seasonally adjusted.

SHORT-TERM INTEREST RATES



By mid-year, as evidence accumulated that the growth of aggregate demand in the economy was moderating, the Bank of Canada began to offer resistance to a further tightening of credit conditions. It managed the cash reserves of the chartered banks in a way that permitted their total assets to expand more rapidly than earlier in the year. The banks were able to increase significantly their more liquid asset ratio at the same time as their loans began to expand more rapidly. The Bank's operations in Government of Canada securities, including its operations in treasury bills, were also directed towards restaining an increase in interest rates and the yield on 3-month treasury bills remained close to 5.1 per cent until October.

Sharp upward pressure on Government of Canada bond yields developed in August. A dramatic fall in bond prices in the United States, beginning at mid-month, complicated the task of refunding a large Government of Canada bond maturity of September 1, the terms of which were announced on August 15. The Bank took the view that it should resist an excessive increase in Canadian interest rates and in pursuance of this view it provided strong support for the bond market. In the week preceding the announcement of the new issue the Bank bought \$3 million of longer-term Government of Canada bonds in the market. On the day of the offering and the day following, it purchased \$58 million of bonds in the market. It also subscribed for substantially more of the new issues than the minimum of \$175 million which it had committed itself to buy. In total, around the middle of August the Bank purchased or subscribed for \$314 million of Government of Canada bonds; its holdings of bonds due to mature on September 1 were \$115 million. Later in the month the Bank bought an additional \$21 million of Government of Canada bonds in the market. Despite the strong action described, interest rates rose substantially and the average yield on long-term Government of Canada bonds reached a peak of 5.97 per cent late in the month.

At the end of August bond markets turned around and the yields on Government securities dropped in the United States and in Canada. To limit the extent of this reversal the Bank of Canada sold \$55 million of Government of Canada bonds to the market early in September and further cash sales were made later in the month. Most of the effect on chartered bank cash reserves of the very substantial volume of bond purchases and subscriptions referred to was offset by reductions in the Bank of Canada's portfolio of treasury bills and by sales of foreign exchange to the Exchange Fund Account.*

The volume of new Canadian issues negotiated in the United States fell to a low level in the third quarter, and in September the value of the Canadian dollar in the exchange markets began to decline. The operations of the Bank late in September and during October were designed in part to ensure that the differential of bond yields between Canada and the United States was adequate. The Bank sold Government of Canada bonds for cash to the extent of $13 million net late in September and $16 million net in October. An additional $56 million of bonds, principally long-term issues, was sold in the market in exchange for short-term maturities.

Throughout October there was little change in the yields on Government of Canada securities while comparable yields declined in the United States. There was also some widening of average yield differentials on other securities. Yields in both countries rose in November, with Canadian yields moving up somewhat more rapidly and continuing to rise in December despite some market purchases of Government of Canada securities by the Bank of Canada. By the end of the year, however, interest rates in Canada and the United States had started to decline and the easing of conditions in financial markets continued in early 1967.

On January 30, 1967 the Bank of Canada reduced its Bank Rate from 5¼ per cent to 5 per cent. The average rate on three-month treasury bills at the weekly auction, which had been 5.20 per cent in mid-November, fell to 4.68 per cent at the last tender in January and was 4.58 per cent at the last tender in February. The average yield on long-term Government of Canada bonds, which had been 5.93 per cent early in December, fell to about 5½ per cent in the first week of February, and was 5.61 per cent at the end of that month.

Developments during August and September 1966 have been described in some detail above. They provide a striking example of a problem which arose a number of times in 1966 and early 1967 as a result of the fact that interest rates in the United States fluctuated a good deal more widely than in earlier years. This can be seen in the chart on page 40. For example, the average yield on long-term United States Government bonds rose from 4.41 per cent on January

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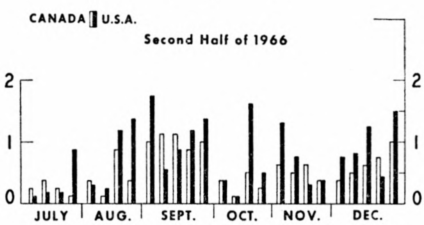
* The foreign exchange had previously been purchased on a temporary basis from the Exchange Fund Account at times when the Bank did not consider it desirable to provide for increases in the chartered banks' cash reserves by purchasing securities in the market. The Bank makes payments for such foreign exchange purchases by crediting Canadian dollars to the Receiver General's deposit account with it, and when these funds are redeposited to the credit of the Government's accounts with chartered banks, chartered bank cash reserves are increased. During 1966, the Bank of Canada made considerable use of transactions with the Exchange Fund Account to assist in the management of chartered bank cash reserves. These and other transactions in foreign currencies affect the Bank of Canada's net foreign asset position, monthly changes in which are shown in Appendix Table 11.

21, 1966 to 4.70 per cent by February 28 and then fell to 4.53 per cent by March 23. This average yield increased from 4.73 per cent on August 12 to 4.91 per cent on August 29 and by September 9 had dropped back to 4.73 per cent. There was an increase from 4.59 per cent on October 25 to 4.75 per cent on November 18, a decline from 4.76 per cent on December 8 to 4.32 per cent on January 16, 1967, and an increase to 4.53 per cent at the end of February. Expectations in the Canadian bond market were considerably affected by these swings and the Bank of Canada had of course to take account of their influence on the development of credit conditions in Canada and on our international capital flows.

WEEKLY FLUCTUATION OF BOND PRICES[1]
CANADA AND U.S.A.
Price Range in Dollars

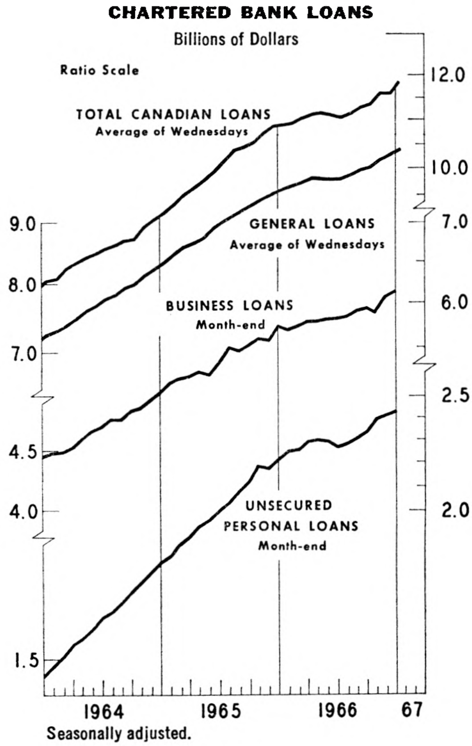


1. The bars show the weekly range between high and low closing bid quotations on the Government of Canada 5¼ per cent bonds due on May 1, 1990 and the U.S. Government 4¼ per cent bonds due on August 15, 1992.

The greater volatility of the United States securities market also involved unusually wide day-to-day changes in prices and yields. The accompanying chart shows, for the second half of 1966, the weekly variations in the price of a typical long-term federal government bond in the United States and in Canada. The volatility in the United States market was considerably greater than had earlier been the case and much greater than in the Canadian market.

CHARTERED BANKS AND OTHER FINANCIAL INSTITUTIONS. The total of the chartered banks' Canadian assets, which had increased by 12 per cent in 1965, rose at an annual rate of 3 per cent in the first half of 1966 and 10 per cent in the second half. During the second half of the year, when total Canadian dollar loans were rising at an annual rate of 9 per cent (about double the rate of increase in the first half of the year), the banks were also able to increase their more liquid asset ratio. Both business loans and personal loans increased slowly over the first half-year, the outstanding amount of unsecured personal loans actually declining during the second quarter when the banks were under severe pressure. After mid-year both business loans and personal loans began to expand more rapidly but the increases over the year as a whole were only half as large as the increases in 1965. Personal loans secured by marketable stocks and bonds declined fairly steadily throughout 1966. There were increases in other classes of loans except those to sales finance companies which had been particularly high in the second half of 1965 after the failure of Atlantic Acceptance Corporation. Loans to municipalities, which had risen sharply in 1965 in anticipation of receipts from the Municipal Development and Loan Board, continued to increase in 1966. The banks' foreign currency credits to Canadian residents increased by $91 million in 1966 compared to $275 million in 1965.

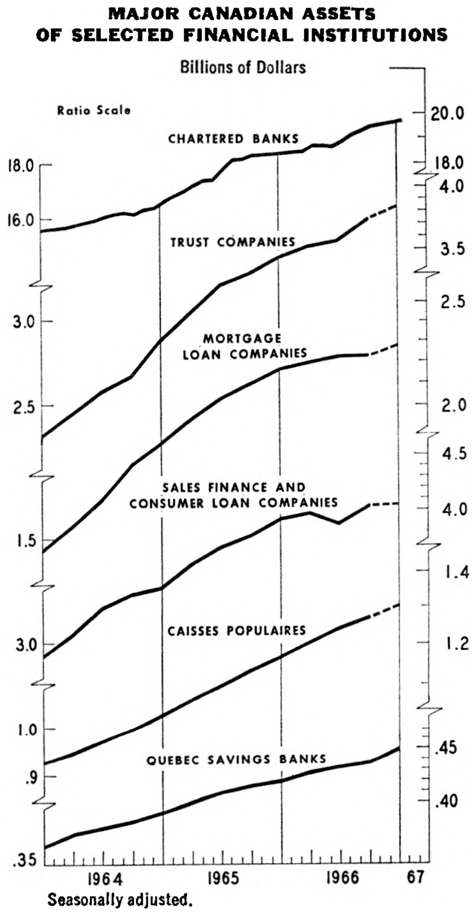
The rise in interest rates and the slower growth of the chartered banks in 1966 was accompanied by a slower growth in the assets of most other types of financial institution; the total assets of one important group, the sales finance and consumer loan companies, fell slightly during the second quarter of 1966. Final information for December 1966 is not yet available, but the indications are that the trust, sales finance and consumer loan companies expanded more rapidly after mid-year, as did the banks.



MAJOR CANADIAN ASSETS OF SELECTED FINANCIAL INSTITUTIONS(1)

	Billions of dollars Dec. 1966	Percentage increase at annual rates: Dec. 1960 to Dec. 1964	1965 First half	1965 Second half	1966 First half	1966 Second half
			seasonally adjusted			
Chartered banks	19.7	7	12	11	3	10
Other						
Quebec savings banks	.4	7	8	5	7	8
Trust companies	3.7e	22	26	12	7	15e
Mortgage loan companies	2.3e	20	20	13	6	5e
Sales finance and consumer loan companies	4.0e	11	18	12	−2	8e
Caisses Populaires Desjardins de Québec	1.3e	11	13	13	13	11e
Sub-total	11.7e	15	20	12	4	10e
Total	31.4e	9	15	12	3	10e

e: Estimate.
(1) The figures include all Canadian assets except fixed assets, investments in subsidiary or affiliated companies and sundries. Relatively small net amounts of assets in foreign currencies are also included in some cases.



The slower growth of financial institutions reflected the difficulty they encountered in raising funds at costs which would leave them an adequate profit inducement to expand their business. By the same token, their inability to expand more rapidly was an important aspect of the increasing difficulty faced by individuals and smaller business borrowers who normally obtain their loan funds through such financial intermediaries. Mortgage borrowers found conditions particularly difficult. Other borrowers such as larger businesses, governments and their enterprises were more successful in obtaining financing since they were able to raise funds directly from the public and from non-residents by sales of securities, albeit at high rates of interest. This pattern of developments is characteristic of periods in which credit conditions are tightening and short-term interest rates are high relative to long-term rates.

The table on the opposite page shows changes in recent years in the main types of liquid financial asset held by the public. From the first group of items in the table it can be seen that the public's holdings of chequable deposits and other highly liquid claims grew less rapidly in 1966 than in preceding years. There was no increase in the rate of interest offered on chartered bank personal savings deposits, on the comparable Quebec savings banks' deposits, or in the rates paid by most trust and mortgage loan companies on their savings accounts. With interest rates on most other types of liquid asset rising quite rapidly, the rate of accumulation of these liquid claims on banks and other institutions declined. Chartered bank demand deposits, however, increased at an annual rate of 13 per cent in the second half of 1966, and over the year as a whole the increase was 9 per cent compared to about 6 per cent in the two preceding years. It is possible that the relatively large increase in 1966 resulted in part from an increase in the current balances held with chartered banks as compensation for services provided to customers.

GENERAL PUBLIC HOLDINGS OF CERTAIN FINANCIAL ASSETS[1]

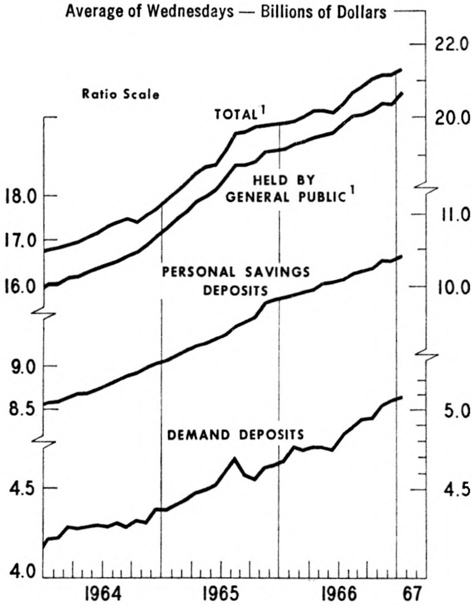
(millions of dollars)

	As at December			Percentage change		
	1964	1965	1966	1964	1965	1966
Currency	2,183	2,351	2,495	6.2	7.7	6.1
Chartered bank demand deposits	4,510	4,779	5,194	6.3	6.0	8.7
Chartered bank personal savings deposits	8,846	9,642	10,140	5.9	9.0	5.2
Quebec savings bank deposits	376	402	421	8.4	6.9	4.7
Caisses Populaires Desjardins de Québec deposits	910	1,028	1,140e	10.3	13.0	10.9e
Trust and mortgage loan company demand certificates and deposits	1,378	1,485	1,475e	27.7	7.8	−0.7e
Sub-total	18,203	19,687	20,865e	7.7	8.2	6.0e
Chartered bank						
— non-personal term and notice deposits	1,494	2,303	2,480			
— foreign currency deposits of residents						
— swapped	718	549	742			
— other	606	669	889			
Finance company short-term paper held by residents	600	550	630			
Other commercial paper held by residents	275	165	180			
Provincial and municipal short-term paper	160e	250e	316e			
Bankers' acceptances	11	150	170			
Government of Canada						
— Treasury bills	332	157	170			
— Market bonds of maturity under 3 years	1,402	1,441	1,480			
— Canada savings bonds	5,613	5,866	6,089			
Trust company investment certificates	1,535	1,973	2,375e			
Mortgage loan company debentures	981	1,085	1,200e			
Total	31,930	34,845	37,586e	8.7	9.1	7.9e

e: Estimate.
(1) This table includes relatively small amounts of some items held by non-residents.

CURRENCY AND CHARTERED BANK CANADIAN DOLLAR DEPOSITS

Average of Wednesdays — Billions of Dollars



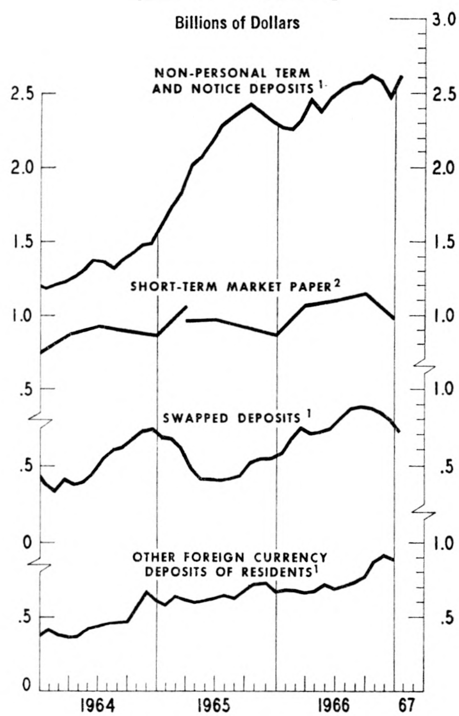
Seasonally adjusted.
1. Includes non-personal term and notice deposits shown in the following chart.

In the course of 1966 the yields available on U.S. dollar deposits placed by the chartered banks with prime banks in the United Kingdom and Europe reached a peak of about 7 per cent and money market rates in New York also rose to high levels. The attractive yields on short-term investments abroad enabled the chartered banks to offer high rates to Canadians on foreign currency deposits, and the total amount of these balances — swapped deposits and other foreign currency balances—reached a peak of $1,750 million in October. While there was some decline thereafter as short-term interest rates on U.S. dollar investments came down, these deposits rose by $413 million or 34 per cent over 1966 as a whole.

The chartered banks' Canadian dollar non-personal term and notice deposits increased by only 8 per cent in 1966 compared to an increase of about 75 per cent from the third quarter of 1964 to the third quarter of 1965 when these deposits provided higher rates of return than competing instruments. Although the banks continued to offer relatively high rates on large Canadian dollar term deposits in 1966, more attractive returns were available to the public through much of the year on some other short-term investments, including foreign currency deposits held with the banks.

SELECTED SHORT-TERM ASSETS HELD BY RESIDENTS

Billions of Dollars



1. At chartered banks.
2. Short-term paper issued by finance companies and other commercial borrowers, and bankers' acceptances.
Break in series reflects change in composition.

In December 1966 the total of currency and chartered bank Canadian dollar deposits was 6.7 per cent higher than a year earlier compared with an increase of 11.9 per cent in 1965. The amount held by the general public, i.e., exclusive of Government of Canada deposits, increased by 6.5 per cent compared with 12.0 per cent in 1965. Including foreign currency deposits of residents, the increase in general public holdings of currency and chartered bank deposits was 8.1 per cent compared with 10.6 per cent in 1965. In the case of all these series the increases were more rapid in the second half of 1966 than in the first half of the year.

Resident holdings of short-term paper issued by finance companies, other commercial borrowers and provinces and municipalities increased by about $160 million in 1966. The amount of bankers' acceptances outstanding increased by $20 million. Trust and mortgage loan companies continued to raise the interest rates on term certificates and debentures and as a result were able to attract a substantial flow of funds. There was also some increase in public holdings of short-term Government of Canada market securities and a large increase in the amount of Canada Savings Bonds outstanding as a result of the successful sale of the Centennial Series.

OTHER CAPITAL MARKET DEVELOPMENTS. The tightening of credit conditions in 1966 was particularly severe in mortgage markets. Life insurance companies, trust and mortgage loan companies and other private lending institutions had been approving new loans at an abnormally high rate in early 1965 and they sharply reduced the rate of approval of new mortgages in the second half of 1965 and during 1966. In the year and a half beginning mid-1965 the amount of mortgages approved by the private institutions was 27 per cent lower

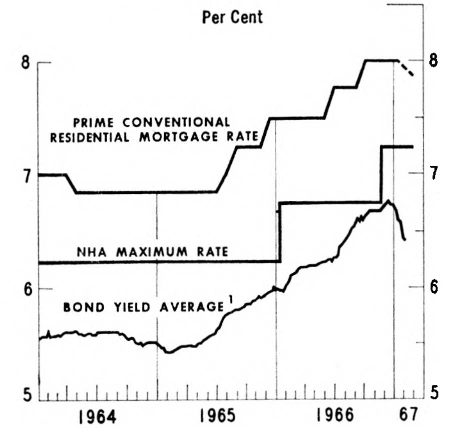
MORTGAGE LOAN APPROVALS

(millions of dollars)

	Private lending institutions					
	Conventional mortgages			Guaranteed under NHA	CMHC	Total
	Non-residential	Residential: Existing	Residential: New			
1964-First half.......	231	295	375	182	79	1,162
Second half....	276	345	437	170	297	1,525
1965-First half.......	338	436	470	186	86	1,516
Second half....	243	313	432	135	375	1,498
1966-First half.......	217	281	346	132	135	1,111
Second half....	170[e]	190[e]	225[e]	59	410	1,054[e]

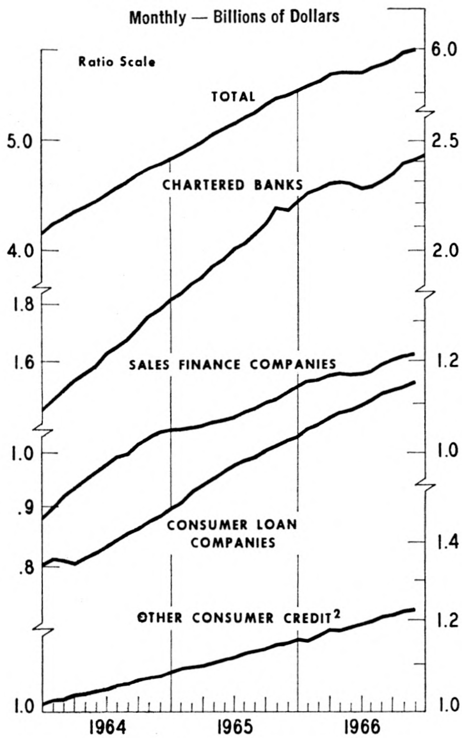
e: Estimate.

LONG-TERM INTEREST RATES



1. Average weekly yields on the 40 provincial, municipal, public utility and industrial bonds included in the monthly series published by McLeod, Young, Weir and Co. Ltd.

CONSUMER CREDIT OUTSTANDING[1]



Seasonally adjusted.
1. Balances for which monthly statistics are available.
2. Credit granted by Quebec savings banks, life insurance companies and monthly reporting retail dealers.

than in the preceding eighteen months. Private lending under the National Housing Act to finance the construction of new single-family housing fell particularly sharply, but Central Mortgage and Housing Corporation undertook an expanded direct lending programme which led to an increase in total NHA lending in 1965 and limited the decline in 1966 to 6 per cent. The brunt of tighter conditions in the mortgage market fell on the financing of new apartments and row housing, new non-residential properties and existing residential properties.

The reduction in the supply of mortgage funds led, in the face of strong demands, to increases in conventional mortgage rates. Prime rates, which had been below 7 per cent until mid-1965, rose to about 7½ per cent by the end of 1965, and to about 8 per cent by the last quarter of 1966. Early in 1967 some institutions reduced their prime lending rate to 7¾ per cent. The maximum rate on loans insured under the National Housing Act was increased from 6¼ per cent to 6¾ per cent on January 10, 1966. There was a brief recovery of private NHA lending but as the rates of interest available to the institutions on conventional mortgages and on bonds continued to rise, NHA loans again became relatively unattractive. On November 22 the maximum rate was increased to 7¼ per cent and it was announced that starting in April 1967 the maximum rate for each quarter would be set one and one-half per cent above the average yield on long-term Government of Canada bonds on the four Wednesdays preceding the first day of the quarter, rounded to the nearest quarter per cent.

In the first half of 1966, as may be seen in the chart on the previous page, chartered banks and sales finance companies cut back their consumer lending and in consequence the rate of increase in total consumer credit outstanding was sharply reduced. There was resumed growth after mid-year, particularly in lending by the chartered banks, but over the year as a whole the rate of increase in consumer credit outstanding was well below that of 1965. The statistics on consumer credit do not include borrowing for consumption purposes on the security of residential mortgages: this must also have been reduced in 1966 as a result of the tightening of the mortgage market.

Attention was drawn on page 26 to the increase in capital expenditures by business in 1966. The cash flow available from retained earnings and depreciation allowances was very little larger than in 1965 and the external financing required by business increased from about \$2 billion in 1965 to \$2¾ billion in 1966. The following table shows that while external financial requirements were increasing, the total amount raised by non-financial businesses from their major sources of funds fell substantially. While businesses were able to maintain—though at progressively higher costs—the aggregate level of their financing through bonds, stocks and commercial paper placed directly in financial markets, their borrowing from financial intermediaries such as banks, finance companies

MAJOR SOURCES OF NON-FINANCIAL CORPORATE BUSINESS FINANCING

(millions of dollars)

	1965	1966
Increases in:		
Chartered bank loans in Canadian dollars	655	393
Chartered bank loans and securities in foreign currencies	275	91
Sales finance company loans	307	−150[e]
Other term loans	50	70
Non-residential mortgages	400[e]	300[e]
Sub-total	1,687	704
Net new issues of:		
Commercial paper and bankers' acceptances	32	61
Bonds	950	773
Stocks	333	444
Net direct investment from abroad	280	670
Sub-total	1,595	1,948
Total	3,282	2,652

e: Estimate.

and mortgage lenders was much lower than in 1965. The total raised from all the sources shown in the preceding table was significantly less in 1966 than in 1965 and less than the apparent need for financing. Businesses had been steadily accumulating financial assets from 1962 to 1965 and must have run down their holdings of liquid assets appreciably during 1966 in order to finance their investment programmes. This pattern of business financing implies that smaller firms, most of which rely on borrowing from financial intermediaries, were affected more severely than many large firms by the tight conditions in financial markets during 1966.

The Government of Canada's financial accounts are shown in Appendix Table III. In 1966 the Government of Canada's net revenue and expenditure position on the national accounts basis is estimated to have weakened by about $425 million. In addition to the revenues included in that calculation, $134 million was collected from the special refundable tax on corporate cash profits introduced in March and contributions to the Canada Pension Plan amounted to $528 million. However, the proceeds of the refundable tax are set aside for

GOVERNMENT OF CANADA:
INCREASES IN MAJOR LOANS AND ADVANCES

(millions of dollars)

	1964	1965	1966
Central Mortgage and Housing Corporation(1)	203	276	456
Farm Credit Corporation	89	145	167
Municipal Development and Loan Board(1)	3	74	139
Veterans' Land Act	14	20	51
Sub-total	309	515	813
1967 World Exhibition	–	22	115
CNR (excluding advances to cover income deficits and refunding of debt)	31	25	17
Atomic Energy of Canada	– 3	14	11
National Harbours Board	2	2	17
Atlantic provinces power development	3	4	31
Loans to manufacturers re Canada-United States Automotive Agreement	–	–	11
Export Credits Insurance Corporation	33	50	38
Loans to foreign governments	– 7	10	7
Total	368	642	1,060

(1) Net of the 25 per cent share of advances to municipalities which is eligible for forgiveness of repayment and which is treated as federal expenditure in the year the advance is made.

subsequent repayment to corporations and the bulk of Canada Pension Plan contributions were re-loaned to provinces under the arrangements for the Plan. In addition to the weakening in the national accounts position, there was an increase of $418 million in the amount needed in 1966 to finance various governmental lending activities and for the other purposes indicated in the table on the preceding page.

In 1966 the net amount of Canadian dollars required for purposes unrelated to foreign exchange transactions and transactions with the International Monetary Fund was $692 million. In 1965 the comparable transactions provided net receipts of $92 million. In 1966 the group of transactions in foreign exchange and with the International Monetary Fund produced a net amount of $441 million. The amount of Government of Canada Canadian dollar securities outside Government accounts increased by $301 million and the Government's Canadian dollar cash balances increased by $50 million.

There was virtually no change in Bank of Canada holdings of Government of Canada Canadian dollar securities; those of the chartered banks increased by $167 million and those held by the general public increased by $132 million. General public holdings of Canada Savings Bonds increased by $222 million, while there was a reduction of $90 million in their holdings of Government of Canada Canadian dollar market securities. There was a reduction of $163 million in the amount of Government of Canada debt payable in U.S. dollars held outside Government accounts; $157 million of this reduction represented repatriations by the Government in connection with its management of the official foreign exchange reserves.

Expenditures by provincial and municipal governments rose more rapidly than their revenues in 1966 and in addition provincial and municipal enterprises, particularly hydro-electric commissions, carried out major capital investment programmes. As a result, this sector's financial requirements were considerably larger than in 1965. There was a decrease of $52 million in the aggregate amount borrowed from chartered banks, the Central Mortgage and Housing Corporation and the Municipal Development and Loan Board and by the sale of short-term paper, but other borrowings rose substantially. In particular, the establishment of the Canada and Quebec Pension Plans provided a very large new source of funds. $462 million was made available to the provinces other than Quebec through investment by the Canada Pension Plan Investment Fund in specially issued provincial bonds. In the case of Quebec it is believed that a substantial part of the Quebec Pension Plan receipts of about $170 million was invested in the market through the Quebec Deposit and Investment Fund in direct and guaranteed securities of the province and its municipalities.

SELECTED SOURCES OF FINANCING OF PROVINCIAL AND MUNICIPAL GOVERNMENTS AND THEIR ENTERPRISES

(millions of dollars)

	1964	1965	1966
Increases in:			
Chartered bank loans.	48	230	137
Loans by Central Mortgage and Housing Corporation and the Municipal Development and Loan Board(1)	33	101	166
Short-term paper outstanding	– 70	90	66
Receipts of Quebec Pension Plan	–	–	170e
Net new issues of bonds:			
Provincial bonds sold to Canada Pension Plan Investment Fund	–	–	462
Other provincial and municipal bonds	1,348	943	1,264
Total(2)	1,359	1,364	2,265

e: Estimate.

(1) Net of the 25 per cent share of advances which is eligible for forgiveness of repayment and which is treated as municipal revenue in the year the advance is made.

(2) To the extent that provincial government accounts and the Quebec Deposit and Investment Fund purchase provincial or municipal bonds at the time of issue or in the market, the total of the selected sources of financing includes double-counting and is thus overstated. In 1966 a substantial part of the Quebec Pension Plan receipts of about $170 million is believed to have been invested through the Quebec Deposit and Investment Fund in direct and guaranteed securities of the province and its municipalities. Purchases by the provincial accounts of other provinces are also believed to have been unusually large in the aggregate in 1966.

FINANCIAL TRANSACTIONS OF CANADIANS WITH NON-RESIDENTS. The net use of non-resident savings by Canadians declined from $1,083 million in 1965 to $983 million in 1966. Ordinary capital transactions in 1966 produced an inflow of $806 million, while special purchases of U.S.-pay bonds by the Government of Canada amounted to the equivalent of $182 million and official reserves declined by $359 million.

Details of the main transactions in the capital account are given in the table on page 56. It shows that the major types of long-term capital movements gave rise to a net capital inflow in 1966 appreciably larger than in 1965.

Deliveries of new issues of Canadian bonds sold to non-residents increased from $1,179 million in 1965 to $1,396 million in 1966. An official request made of Canadian borrowers in November 1965 to defer delivery of the proceeds of new issues already negotiated in the United States and to postpone any new United States borrowing until 1966 resulted in unusually large deliveries in the first quarter of the year. New offerings were substantial in the second quarter but declined after mid-year and did not pick up again until late in the year. Deliveries in the second half of the year were therefore relatively low.

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
1965			
1 Q	344	263	132
2 Q	282	311	103
3 Q	399	284	218
4 Q	391	291	318
1966			
1 Q	356	518	156
2 Q	386	348	194
3 Q	202	276	120
4 Q	198	203	115

Foreign direct investment in Canada rose sharply in 1966 to a near-record level of $660 million and there was a small net repatriation of funds from Canadian direct investment abroad in contrast to outflows of about $100 million in each of the past few years. United States direct investment in Canada rose in 1966 despite earlier fears that a United States balance of payments guideline limiting investment in industrial countries as a group might result in a cut-back in Canada. One of the objects of the United States balance of payments programme was to encourage United States companies to raise funds abroad for their international operations. If this had resulted in their attracting funds from Canada it would have put abnormal pressure on the Canadian capital market and could have forced Canadian borrowers to rely more heavily on the United States market. In March the Minister of Finance asked Canadian investors not to purchase "off-shore" securities of United States corporations, that is, the securities of United States corporations or their non-Canadian subsidiaries which would be subject to the United States Interest Equalization Tax if purchased by United States residents. After March there were no significant purchases of this type of securities by Canadians.

There was a sizeable reduction in capital outflows resulting from repurchases of outstanding Canadian stocks from non-residents in 1966. On the other hand there was a swing from an inflow to an outflow arising from transactions in outstanding Canadian bonds. There was also a very large increase in the outflow from Canadian purchases of foreign securities which rose from $84 million in 1965 to $332 million in 1966; most of this represented the purchase of outstanding United States equities from United States residents. Offerings of new issues of securities in Canada by foreign borrowers continued to be officially discouraged.

CANADIAN BALANCE OF INTERNATIONAL PAYMENTS

(millions of Canadian dollars)

	1965	1966	1966 1 Q	1966 2 Q	1966 3 Q	1966 4 Q
Current Account Balance	−1,083	−983	−405	−330	116	−364
Capital Account Transactions						
Direct investment						
foreign investment in Canada(1)	405	660	120	190	145	205
Canadian investment abroad(1)	− 125	10	− 15	− 40	90	− 25
Canadian stocks						
net transactions	− 242	− 83	31	− 39	− 33	− 42
Canadian bonds						
new issues	1,179	1,396	539	355	289	213
special repurchases of Govt. securities	–	−157	− 42	− 80	− 35	–
other retirements	− 374	−343	− 70	− 72	− 53	−148
net trade in outstandings	62	− 99	− 11	− 24	− 50	− 14
Foreign securities						
Government purchases of IBRD bonds	–	− 25	–	–	− 25	–
other transactions	− 84	−332	− 70	− 90	− 89	− 83
Columbia River Treaty						
net transactions	32	32	–	–	–	32
Foreign currency position of Canadian banks vis-a-vis non-residents: net increase (−)	426	−467	−124	12	−271	− 84
Canadian dollar deposits and treasury bills	45	1	− 29	− 9	27	12
Canadian commercial and other paper	10	− 2	− 12	− 5	10	5
Canadian finance company paper	− 162	− 9	23	− 5	− 55	28
Canadian finance companies' other short-term obligations	209	153	34	− 12	44	87
Other long and short-term capital	− 141	−111	−107	32	−195	159
Total capital account transactions	1,240	624	267	213	−201	345
Changes in reserves and IMF position						
Official holdings of gold and foreign exchange	− 11	−462	−166	−181	−105	− 10
Net position with IMF	168	103	28	64	20	− 9
Total	157	−359	−138	−117	− 85	− 19

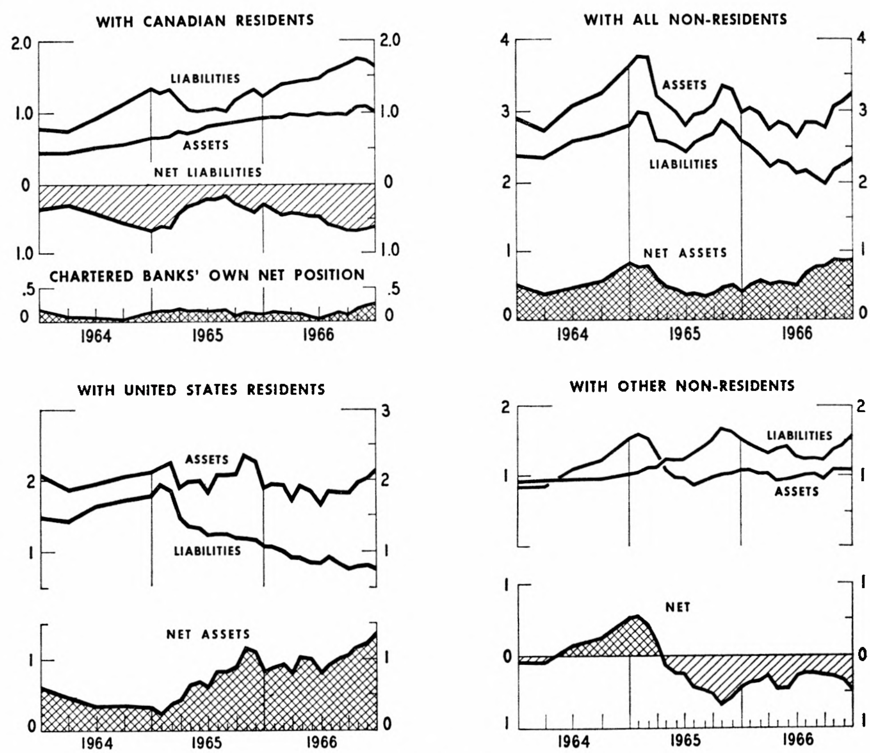
(1) Exclusive of undistributed earnings.

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.

There was a sharp swing in the main types of short-term capital flows from a substantial inflow in 1965 to a large outflow in 1966. One of the principal channels was the chartered banks which offer facilities to resident and non-resident clients to hold foreign currency deposits with them against which the banks hold claims on residents and non-residents denominated in foreign currencies. Transactions of this type with residents together with changes in the chartered banks' own foreign currency positions resulted in an outflow of $467 million in 1966 in contrast to an inflow of $426 million in 1965. In 1965 United States residents had withdrawn funds from the Canadian banks in response to the United States balance of payments guidelines, but the chartered banks had met only part of this drain by liquidating investments in the United States. There had been a net inflow of about $950 million from overseas countries with more than $500 million being channelled to the United States and the remainder to Canada. In 1966 there was a further net flow of over

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.

$500 million to the United States with most of the funds coming from a build-up in Canadian resident holdings of foreign currency deposits with Canadian banks, which rose by $400 million, and from an increase in the chartered banks' own foreign currency positions of $150 million. United States residents continued to withdraw U.S. dollar deposits from Canadian banks but at a much less rapid rate than in 1965, and after mid-year the Canadian banks increased their investments in the United States. There was a further small net withdrawal of funds from overseas countries. These developments are summarized in the table below.

CANADIAN CHARTERED BANKS
HEAD OFFICES AND BRANCHES IN CANADA

NET CHANGES IN FOREIGN CURRENCY POSITION(1)

(millions of Canadian dollars)

			1966			
	1965	1966	1 Q	2 Q	3 Q	4 Q
With non-residents						
United States residents						
Assets	−207	208	−183	− 69	165	295
Liabilities	−727	−309	−156	− 71	− 78	− 4
Net	520	517	− 27	2	243	299
Other non-residents						
Assets	−441	− 2	− 54	− 42	− 42	136
Liabilities	505	48	−205	− 28	− 70	351
Net	−946	− 50	151	− 14	28	−215
Total						
Assets	−648	206	−237	−111	123	431
Liabilities	−222	−261	−361	− 99	−148	347
Net claims on non-residents	−426	467	124	− 12	271	84
With Canadian residents						
Assets	276	84	66	5	− 11	24
Liabilities	−107	401	180	63	208	− 50
Net	383	−317	−114	− 58	−219	74
Changes in chartered banks' own net position	− 43	150	10	− 70	52	158

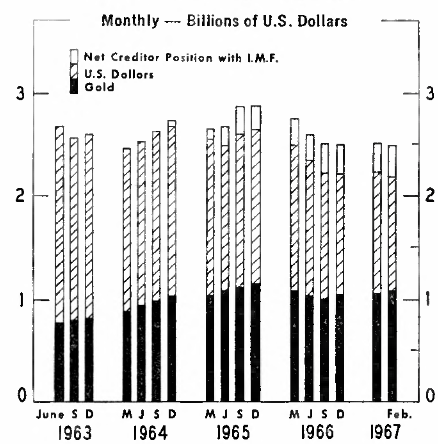
(1) Adjusted for variations in exchange rates.

Non-residents continued to reduce their holdings of Canadian finance company paper in 1966 but at a much less rapid rate than in 1965. In both years there were substantial increases in other short-term investments in finance companies, though the inflow in 1966 was somewhat smaller than in 1965.

As part of the agreement providing for the exemption of the sale of new issues of Canadian securities in the United States market from the Interest Equalization Tax and from the guideline limiting purchases by United States financial institutions of new long-term foreign securities, Canada works to a target level in its foreign exchange reserves, including for this purpose its net creditor position with the International Monetary Fund. In December 1965 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 U.S. $2,700 million figure fixed in 1963 to U.S. $2,600 million, and to aim at achieving the new level by the end of 1966. When in May 1966 Canada paid U.S. $47.5 million in gold to the IMF in connection with an increase of U.S. $190 million in Canada's quota in the Fund it was understood that the gold payment should not alter Canada's contribution to the United States payments position; in effect this amounted to a reduction of the target level for reserves to U.S. $2,550 million.

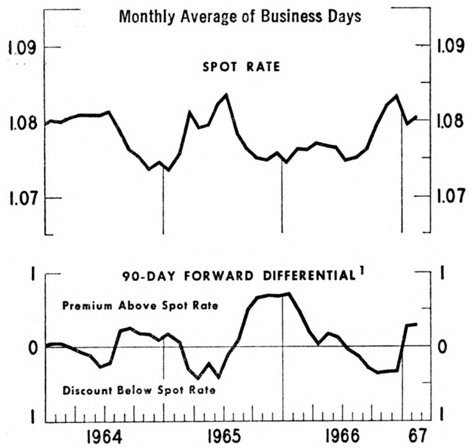
As steps toward the achievement of the end-1966 target level of Canada's reserves the Government repatriated U.S. $145 million of its own U.S.-pay securities and purchased U.S. $23 million of bonds of the International Bank for Reconstruction and Development from United States residents in the course of the first nine months of 1966. Over the year, Canada's reserves declined from U.S. $2,880 million to U.S. $2,499 million; official holdings of gold and U.S. dollars declined by U.S. $429 million while our net creditor position with the IMF increased by U.S. $48 million.

OFFICIAL HOLDINGS OF GOLD AND U.S. DOLLARS AND NET CREDITOR POSITION WITH THE IMF



The spot rate for the United States dollar in the Canadian foreign exchange market fluctuated within a narrow range between $107\frac{11}{32}$ and $107\frac{7}{8}$ during

U.S. DOLLAR IN CANADIAN FUNDS



1. Expressed as a per cent per annum.

the first nine months of 1966. It rose gradually in the final quarter and closed the year at 108⅜. The forward exchange rate for the U.S. dollar in Canada was at a premium until late June when the rate moved to a discount. From mid-September to December the 90-day forward rate for the U.S. dollar remained at a discount yielding about ¼ to ⅝ per cent when expressed at annual rates. In early 1967 the spot rate declined again and the forward rate returned to a premium.

Appendices ▶

APPENDIX TABLE I

BANK OF CANADA NET TRANSACTIONS IN GOVERNMENT OF CANADA SECURITIES IN 1966

(delivered basis – par value in millions of dollars)

	Net purchases from (+) or net sales to (−) investment dealers and banks						
		Bonds(1)					
	Treasury bills	2 and under	2 to 5	5 to 10	Over 10	Sub-total bills and bonds	Securities under PRA
Jan.	+ 4	+ 9	−12	–	–	–	–
Feb.	−33	− 2	+ 4	− 5	− 4	−40	–
Mar.	+84	+ 2	–	–	+ 2	+88	+20
Apr.	+ 3	–	–	–	−13	− 9	−20
May	− 5	+ 12	−16	–	−12	−21	+ 5
June	−20	+ 4	− 4	+ 7	+ 5	− 8	− 5
July	+ 8	+ 2	− 2	–	–	+ 8	–
Aug.	+ 4	+ 34	–	+ 9	+26	+72	–
Sept.	−13	− 4	−11	–	−26	−54	–
Oct.	+35	+ 51	−26	–	−51	+ 9	–
Nov.	–	+ 15	–	–	–	+15	–
Dec.	–	+ 14	–	–	+ 6	+20	–
Total	+68	+137	−69	+11	−66	+80	–

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

Net transactions with Government and other client accounts						Net change in holdings of Government of Canada securities		
Purchases (+) of new issues less matured holdings		Net purchases from (+) or net sales to (−)						
		Securities Investment Acct.		Other Government and client accounts				
bills	bonds	bills	bonds	bills	bonds	bills	bonds	total
−85	− 6	-	− 1	− 18	+ 2	− 99	− 10	−108
−17	+ 4	-	−60	− 15	− 2	− 65	− 65	−130
−17	-	-	+60	− 17	− 2	+ 68	+ 65	+132
+19	-	-	-	− 20	− 1	− 15	− 16	− 31
+41	− 3	-	-	− 25	-	+ 14	− 18	− 4
− 9	-	-	-	− 16	− 5	− 48	+ 6	− 42
+32	-	-	-	− 9	+ 1	+ 31	+ 1	+ 32
+20	-	-	-	− 19	-	+ 5	+ 68	+ 73
−89	+140	-	−10	− 26	-	−128	+ 88	− 39
− 8	-	-	-	− 11	− 2	+ 16	− 28	− 12
+43	-	-	-	− 37	+18	+ 6	+ 33	+ 39
+35	+ 53	-	-	− 21	+ 5	+ 14	+ 78	+ 92
−36	+187	-	−12	−233	+13	−201	+201	+ 1

APPENDIX TABLE II

BANK OF CANADA ASSETS AND LIABILITIES

(monthly changes – millions of dollars)

	Government of Canada securities at book value	Net foreign currency assets	Investment in IDB	All other assets, net	Note circulation	Canadian dollar deposit liabilities		
						Government of Canada	Other	Chartered banks
1966								
Jan......	−108	-	+ 1	−44	−132	−44	+ 6	+20
Feb......	−129	-	+ 2	− 1	− 7	−55	−11	−55
Mar......	+132	-	+ 5	−50	+ 28	+25	+ 2	+32
Apr......	− 30	-	+ 8	+54	+ 33	−14	− 1	+14
May.....	− 3	+ 49	+ 3	−19	+ 33	− 8	+ 5	− 2
June.....	− 43	+ 22	+ 3	+41	+ 35	−11	− 3	+ 1
July.....	+ 31	+135	+ 3	−35	+ 57	+71	− 3	+ 9
Aug......	+ 69	−114	+ 3	+19	− 1	−66	+20	+26
Sept.....	− 38	− 2	+ 2	+18	− 18	+48	−18	−32
Oct......	− 10	+114	+ 7	+ 3	+ 26	+29	+10	+47
Nov......	+ 41	− 24	+ 3	−39	+ 30	−28	− 9	−13
Dec......	+ 91	-	+ 2	+18	+114	−30	− 2	+29
Year...	+ 3	+178	+42	−35	+198	−82	− 5	+77

GOVERNMENT OF CANADA FINANCIAL ACCOUNTS

(millions of dollars)

	Calendar 1964	Calendar 1965	Calendar 1966
Budgetary balance	−153	+ 70	−428
Adjustments from budgetary to National Accounts basis: (plus sign indicates items added to budgetary revenue or deducted from expenditure, minus sign the reverse)			
Government employer-employee pension fund contributions (excluding CPP) and interest earnings, less pension payments	+310	+339	+355
Unemployment insurance and old age security fund receipts, less disbursements	− 37	+243	+277
All other adjustments (net)	+176	− 84	− 64
National Accounts balance	+296	+568	+140
Canada Pension Plan contributions	–	–	+528
Refundable tax on corporate cash profits	–	–	+134
Total	+296	+568	+802
Changes in Financial Assets and Liabilities Sources of funds (—), Uses of funds (+)			
1. Increase in major loans and advances(1)	+368	+642	+1,060
2. CPP Investment Fund acquisition of provincial securities	–	–	+462
3. Increase (+) or decrease (—) in Exchange Fund Account holdings of gold and foreign exchange, other than accruals of earnings	− 13	+ 19	−696(2)
Increase in Canada's subscription to the IMF	–	–	+205
Increase (—) or decrease (+) in notes payable to international organizations(3)	+266	+119	−106
Decrease (+) in Government of Canada U.S. dollar securities outside Government accounts	+ 7	+ 5	+163
Purchases of IBRD bonds	–	–	+ 25
Investment of Columbia River funds in U.S. dollar securities	+220	− 32	− 32
Sub-total of items included under heading 3	+480	+111	−441
4. Increase (—) in Government of Canada Canadian dollar securities(4) outside Government accounts	−210	−166	−301
5. Increase (+) in Canadian dollar cash balances(4)	−196	+147	+ 50(2) (5)
6. Net change in other assets and liabilities	−146	−166	− 28
Total, as above	+296	+568	+802

(1) For details see table on page 52.
(2) Exchange Fund Account holdings of foreign exchange are reduced by (and Canadian dollar cash balances are increased by) $157 million arising from the purchase of foreign exchange from the Exchange Fund Account by the Bank of Canada on a swap basis in connection with its management of chartered bank cash reserves.
(3) Non-interest bearing Canadian dollar demand notes held by the International Monetary Fund and the International Development Association.
(4) As on Bank of Canada books. Accounting differences between these and the Public Accounts are reflected in the item "net change in other assets and liabilities".
(5) Canadian dollar cash balances include $134 million of refundable tax on corporate cash profits.
Source: "Canada Gazette", "Monthly Statement of the Government's Financial Operations". Adjustments to National Accounts basis for 1966 are Bank of Canada estimates.

BANK OF CANADA STATEMENT OF INCOME AND EXPENSES

(thousands of dollars)

	1966	1965
Income		
On investments	$163,894	$154,806
All other income	596	721
Total income	$164,490	$155,527
Operating Expenses		
Salaries(1)	$ 4,889	$ 4,435
Contributions to pension and insurance funds	549	383
Other staff expenses(2)	266	218
Directors' fees	20	22
Auditors' fees and expenses	83	74
Taxes (inc. municipal and business)	1,116	1,036
RCMP guards and electric protection	153	133
Insurance	51	58
Bank notes — production and shipment	4,273	3,893
Premises and equipment (net)	483	510
Stationery and printing	213	185
Publications(3)	100	64
Postage and express	235	202
Telephones and telegrams	180	168
Travel and transfer expense	150	175
Interest paid on unclaimed balances	57	51
All other expenses	138	146
Total operating expenses	$ 13,006	$ 11,753
Depreciation on Buildings and Equipment	899	668
Net Income Paid to Receiver General of Canada	150,585	143,106
	$164,490	$155,527

(1) The number of staff averaged 963 in 1966 and 912 in 1965.
(2) Includes overtime pay, medical services and cafeteria expense.
(3) Printing of "Statistical Summary" and "Annual Report".

BANK OF CANADA • STATEMENT

ASSETS

	1966	1965
Foreign exchange		
Pounds sterling and U.S.A. dollars	$ 54,906,483	$ 28,021,133
Other currencies	243,844	242,669
	55,150,327	28,263,802
Cheques on other banks	153,208,125	158,100,628
Accrued interest on investments	43,222,855	40,135,130
Investments — at amortized values		
Treasury bills of Canada	409,110,486	608,101,218
Other securities issued or guaranteed by Canada maturing within two years	737,780,442	477,714,658
Other securities issued or guaranteed by Canada not maturing within two years	2,272,400,838	2,330,806,758
Debentures issued by Industrial Development Bank — Note	239,776,843	200,677,869
Other securities — U.S.A. Government	171,738,732	13,989,362
	3,830,807,341	3,631,289,865
Industrial Development Bank		
Total issued share capital at cost — Note	42,000,000	39,000,000
Bank premises		
Land, buildings and equipment Cost less accumulated depreciation	16,541,828	16,296,634
Net balance of Government of Canada collections and payments in process of settlement	64,663,751	41,532,683
Other assets	1,201,760	1,148,857
	$4,206,795,937	$3,955,767,599

Note: The audited financial statements of the Industrial Development Bank as at September 30, 1966 were issued to the public on December 9, 1966.

L. RASMINSKY, Governor
Ottawa, January 26, 1967

A. J. NORTON, Chief Accountant

AS AT DECEMBER 31, 1966
(with comparative figures as at December 31, 1965)

LIABILITIES

	1966	1965
Capital paid up	$ 5,000,000	$ 5,000,000
Rest fund	25,000,000	25,000,000
Notes in circulation	2,733,633,656	2,535,650,110
Deposits		
Government of Canada	34,060,265	116,230,181
Chartered banks	1,111,257,971	1,034,239,537
Other	29,727,708	34,539,477
	1,175,045,944	1,185,009,195
Liabilities payable in pounds sterling and U.S.A. dollars		
To Government of Canada	31,464,061	24,027,229
To others	5,460,415	6,739,614
	36,924,476	30,766,843
Bank of Canada cheques outstanding	229,491,229	172,387,782
Other liabilities	1,700,682	1,953,669
	$4,206,795,987	$3,955,767,599

Auditors' Report • We have examined the statement of assets and liabilities of the Bank of Canada as at December 31, 1966. 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, 1966.

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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