Bank of Canada · Banque du Canada Ottawa K1A 0G9

February 28th, 1974

The Hon. John N. Turner, P.C.,
Minister of Finance,
Ottawa, Ontario.

Dear Mr. Turner,

In accordance with the provisions of the Bank of Canada Act I am transmitting herewith my report for the year 1973 and a statement of the Bank's accounts for this period, signed and certified in the manner prescribed in the by-laws of the Bank.

Yours very truly,

G.K. Bouey

Governor

Bank of Canada

Report of the Governor — 1973

GENERAL OBSERVATIONS

In 1973 the Canadian economy began to press against the limits of its capacity, and the main objective of the Bank of Canada became that of lessening the degree of expansionary stimulus that monetary policy had been providing.

For more than two years until early 1973 the Bank's policy had encouraged the chartered banks to lend readily and had permitted unusually high rates of growth of money holdings in Canada. As it was intended to do, this policy facilitated the large increases in spending, output and employment needed to get the Canadian economy back to satisfactory operating levels.

Strongly expansionary monetary and fiscal policies not unlike those followed in Canada were pursued during this period in virtually all of the major industrial countries, with rather similar and mutually reinforcing results. Many of the countries that followed relatively easy monetary policies did so partly in an effort to avoid or limit appreciation of their currencies as pressures against the then-existing structure of exchange rates mounted. Levels of national expenditure rose relatively slowly at first and then rapidly, and economic activity forged ahead with gathering momentum. By the early months of 1973 the rapid buildup of demand pressure was straining the limits of capacity in the United States, Europe and Japan all at the same time. In Canada, too, a powerful surge in the tempo of expansion in late 1972 and early 1973, partly communicated to us from abroad, brought the economy bumping up against the limits of its productive capacity by the spring. The rapid upsurge of industrial output throughout the western world generated intense demand pressure on the supply of primary materials, and this coincided with poor grain harvests in a number of countries and other special problems affecting world supplies of foodstuffs. In these circumstances the continuing strength of world demand set off an upward spiral of price increases for farm and industrial commodities of an intensity without modern precedent under peacetime conditions.

On the domestic economic scene production bottlenecks, backlogs of unfilled orders and delivery delays were beginning to emerge a good deal earlier than had been anticipated, and it was becoming clear that output could not go on rising at such an unusually rapid rate. The strongly expansionary monetary policy that had been followed for some time would, if continued, merely serve to intensify the mounting upward pressure on prices and costs that was already developing, without adding significantly to the growth of employment and output.

As signs of this emerging situation became clearer, the Bank of Canada took steps to moderate the pace of domestic monetary and credit expansion. Chartered bank liquidity, which had been kept under close control for some time, was put under additional pressure from the beginning of 1973 and short-term interest rates turned upward. In April the Bank Rate was raised and discussions were held with the chartered banks with the object of bringing about some moderation of their lending policies.

The Bank of Canada made it clear, both publicly and in its discussions with the banks, that the circumstances called for a slowing of the growth of bank loans rather than a drastic curtailment. The banks were encouraged in their expressed desire to try to achieve this objective in ways that would minimize the impact on small business borrowers and borrowers in the less buoyant regions of Canada. They were also asked to maintain a reasonable continuity of mortgage lending.

While it was clearly desirable to lessen the degree of monetary stimulus injected into the economy, the Bank was also anxious to avoid moving so far or so suddenly as to risk disrupting financial markets or jeopardizing continued economic growth. The effort to bring about an orderly transition to less rapid rates of monetary and credit expansion was bound to take time since it would have to contend with insistently rising demands for money and credit in financial markets. It was also bound to bring additional upward pressure on short-term interest rates in Canada, which were already being affected by sharply rising interest rates in the United States and Europe.

In the event, it is now apparent that an abrupt change in chartered bank lending policies and in the general availability of mortgage credit has been avoided. In fact chartered bank loans continued to rise strongly throughout 1973, as did total bank assets and the privately-held money supply broadly defined to include time deposits.

To some extent, however, the readings given by these particular indicators in the latter part of 1973 were affected by shifts of financial flows from non-bank channels into the banking system. Thus substantial flows of funds of a kind which in earlier years might have been invested in Canada Savings Bonds were attracted into personal fixed-term bank deposits. Moreover, during the second half of 1973 both the rapid growth of the banks' interest-bearing deposits and the rapid growth of their loans reflected, in part, a temporary decline in the outstanding amount of commercial paper. There was a particularly marked bulge in bank loan and time deposit growth in December when for a few weeks short-term paper rates rose substantially above the banks' prime lending rates. During this brief period the Bank of Canada deliberately cushioned the upsurge of pressure on interest rates because of the uncertainties about the outlook for the world economy arising from the oil problem. The pressure eased considerably after year-end. Bank loans have risen less rapidly so far in 1974, although total bank assets as well as the broader measures of money supply have continued to rise strongly.

On the other hand, the average growth rate of the money supply more narrowly defined to exclude time deposits — an indicator which is less affected by temporary shifts in financing channels and which has come to be widely regarded, particularly in the United States, as more significant than the other indicators available — has clearly slackened since the second quarter of 1973.

Supporting evidence that the monetary situation in Canada is now under firmer control is provided by the behaviour of interest rates since last spring. The interaction between strong credit demands and the changed posture of monetary policy, in an international environment of sharply rising interest rates, led to substantial increases in Canadian rates during 1973. Although the Bank of Canada did not press its policy to the point where Canadian short-term rates rose to the peak levels reached last year in the United States and in major financial markets abroad, the increases were nevertheless quite large. Thus typical rates on short-term paper were some 5 percentage points higher at year-end than at the beginning of 1973. Chartered bank prime lending rates for larger borrowers had moved up by 3½ percentage points, and there had been comparable increases in key deposit rates. The Bank of Canada had raised the Bank Rate in five steps from 4¾ per cent to its present level of 7¼ per cent.

Given the strength of the demand for credit in 1973, it is clear that to have put the growth of the banking system under even greater restraint would have caused interest rates to reach even higher levels than they did — perhaps quite a bit higher. It can be argued that this should have been allowed to happen — that while short-term interest rates reached levels that appeared high in relation to our past history, these levels were not in fact very high after allowance for what was happening to the price level, and particularly to the prices of many of the goods that were being financed. In a year in which wholesale prices were rising by 25 per cent, for example, the cost of financing inventories at prevailing interest rates could hardly be said to have involved any great disincentive to inventory accumulation even after allowance for the risks involved. By the same token, the interest return received by savers was, after allowance for the rise in prices in 1973, anything but high despite the levels reached by nominal interest rates. It should be borne in mind, of course, that the structure of borrowing and lending rates is closely tied together, and that it is next to impossible to have significantly higher rates of return for savers generally in Canada without also having higher interest costs for businesses, consumers, governments and mortgage borrowers.

In the circumstances of last year it was the view of the Bank of Canada that we were in fact pressing with sufficient vigour towards a less expansionary monetary policy. This view was based on the outlook for some slowing of the growth of the world economy in 1974, and took into account the relatively long time-lag before the change in monetary policy could have much effect in moderating spending pressures in Canada. Nevertheless, the experience of 1973 indicates clearly that if much reliance is to be placed on monetary policy for influencing the growth of aggregate demand in the economy, there may well be periods when controlling the growth of money and credit will necessarily involve substantial movements in the level of short-term interest rates.

Looking back on the experience of Canada and other countries over a longer period, it is difficult to avoid the impression that from time to time there have been more substantial and persisting departures from reasonably steady monetary growth than would appear in retrospect to have been desirable. Since the lags associated with monetary policy are rather long, the full effects of such departures do not become apparent until well after the event. This helps to explain how they come about. It is not very difficult to understand, for example, that so long as an economy is operating much below satisfactory levels there is a natural tendency to err on the high side so far as rates of monetary growth are concerned. Moreover, in a world where economic forecasting is necessarily imperfect, the temptation is strong in such circumstances to respond to troublesome short-run developments by adding somewhat further to the rate of monetary expansion. I believe that the high rates of monetary expansion around the world during the two years leading up to the surge in economic activity in the latter part of 1972 and early 1973 illustrate this basic problem.

In the light of these considerations, I have a certain amount of sympathy with the case that is often made for more stable monetary growth over time, even though I am aware that there are various difficulties involved in such an approach. The Bank of Canada certainly has no intention of basing its operations on any mechanistic formula, but in framing its judgments about the appropriate policy to be followed, it has been giving considerable weight to underlying rates of monetary growth.

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One of the disappointing aspects of the performance of the Canadian economy in 1973 was that at a recorded level of unemployment of about 5½ per cent of the labour force — a level considerably higher than had been hoped for — we apparently reached not only the effective limits of our plant and equipment capacity but also a position where labour, too, was effectively in short supply. Both the capital stock and the supply of labour will, of course, continue to grow, but if we are to avoid generating strong inflationary pressures in the domestic economy it will be important to recognize that supply limitations exist and probably cannot be overcome quickly. We begin 1974 with severe shortage problems at many points in the economy. In these circumstances the potential increase in output that can reasonably be considered to be within the economy's supply capabilities in 1974 may well be less than its longer term average growth potential. This possibility must be borne in mind if we are to follow demand policies that do not press too hard against the limits of the economy's physical capacity and that consequently avoid complicating our problems through internally-generated inflationary pressure.

Last year's price performance in Canada, as in other countries, was clearly very unsatisfactory. It is not realistic, unfortunately, to expect rapid improvement in the trend of our domestic price level, in part because the price increases already experienced have not yet fully worked their way through the cost structure. Looking somewhat further ahead, however, it should certainly be possible for the current rate of price inflation in Canada to slacken, especially since there is good reason to expect that international commodity prices, which have played such a key role in the recent upsurge, will in due course level off or decline.

The world-wide strength of demand during 1973 helped to prevent the serious crisis that developed in international currency markets in February and early March from having an adverse impact on general business confidence or on trade flows. Despite considerable short-run volatility, the changes in international exchange rate relationships that have occurred in recent years have, on the whole, worked to bring about desirable adjustments in the individual balance of payments positions of the major industrial nations. In particular there has been a strong recovery in the balance of payments of the United States, an essential element in any move to a more orderly international monetary system.

Unfortunately a new and very serious source of strain has been introduced into the world economy by the action of the Organization of Petroleum Exporting Countries in imposing two further substantial price increases for crude oil on top of the increase announced at the beginning of 1973. Combined with the cutbacks in production announced by the main Arab producing states in October and the imposition of embargoes on shipments of oil to the United States and certain other countries, these various decisions have created grave new problems.

Oil developments have imparted yet a further upward thrust to prices in all countries at a time when the boom in world commodity markets appeared to be losing some of its earlier strength. For a while it seemed likely that the production cutbacks would also aggravate existing bottlenecks so seriously as to raise the possibility of a supply-induced slowdown in world industrial activity. This risk has been eased by the subsequent relaxation of the cutbacks, although shortages of oil or fears of shortages may be accentuating the slowdown in world economic growth that was already emerging. The very steep rise in oil prices will of itself exert a considerable dampening effect on demand in the oil-consuming countries by leaving less money in people's hands to spend on other things.

If maintained, the current level of oil prices is certain to have a dramatic effect on the balance of payments positions of oil importing countries — both industrialized and less developed. The traditional collective surplus on current account of the industrial countries appears likely to be replaced by a collective deficit of unprecedented size — a swing of several tens of billions of dollars which can be sustained only by the acceptance of massive inflows of capital from the oil-exporting states. Moreover, the current account deficits of the developing countries appear likely to be increased to levels far beyond their capacity to sustain for long without huge additions to the aid which they have been receiving either directly from developed countries or indirectly through international development institutions.

Serious concern at the implications for the world economy of the large rise in oil prices was expressed by the Committee of the Board of Governors of the International Monetary Fund on the Reform of the International Monetary System and Related Issues (the Committee of Twenty) at its meeting in Rome in January of this year. The Committee urged the closest international co-operation and consultation in seeking means of coping with the problems of individual countries without aggravating those of other countries. It recognized that, in the circumstances, priority should be given to those aspects of international monetary reform which had the best prospects of early implementation, with other aspects to be agreed upon for implementation at a later date. The Committee agreed to try to complete its work at a meeting in Washington on June 12 to 13, 1974. It also agreed that when it completed its work it should be succeeded, first on an interim basis and later on a permanent basis, by a body that was similar in composition and would play a role between the full Board of Governors of the IMF and the Executive Directors in managing and adapting the monetary system, overseeing the continuing operation of the adjustment process, and dealing with sudden disturbances which might threaten the system.

On January 29, 1974 the United States authorities announced the reduction to zero of their Interest Equalization Tax and the termination of their programmes for restraining outflows of capital. Canada had had virtually full exemption from these measures under an arrangement which involved it in maintaining a structure of guidelines on outflows of capital from Canada. On January 30, 1974 the Ministers of Finance and of Industry, Trade and Commerce announced the withdrawal of these Canadian guidelines. In his press release, the Minister of Finance noted that he has not withdrawn his request to Canadian borrowers to explore fully the Canadian capital market before floating issues abroad. The texts of these press releases are appended to this Report.

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It is clear that in 1974 the Canadian economy faces major uncertainties that lie beyond our borders and beyond our power to influence significantly. The pace of activity is slackening in major countries overseas and in the United States, and it seems probable that it will remain subdued in the first half of 1974. Beyond mid-year, the range of possibilities is wide. If the adjustments required by the oil situation can be accommodated without a major disruption of international trade, the chances are good for an early resumption of strong growth in world output. The possibility that the situation may develop less favourably cannot, however, be ruled out, and this is the main uncertainty overhanging the outlook for the Canadian economy at the present time.

The direct effects of oil developments on the Canadian economy appear to be less serious than for almost any of the other developed countries since we are, on balance, largely self-sufficient in oil. The impact of oil shortages elsewhere may, however, add to the number of bottlenecks and scarcities faced by Canadian industry, especially where we are heavily dependent upon foreign sources for oil-based products such as petrochemicals and plastics. The sharp escalation of world oil prices is, of course, having a marked impact on costs and prices in Canada. It has also raised difficult problems of income transfer, although these are problems that lie within our borders; they do not involve massive net transfers abroad as is the case for many other countries.

Thus the circumstances at present are more favourable for a substantial rate of economic growth in 1974 in Canada than in the United States and many overseas countries, and a divergence in current rates of economic growth has already emerged. If things go reasonably well this divergence will narrow in the latter part of the year as the pace of economic activity in the United States and overseas countries picks up.

Looking somewhat further ahead the prospect is for a strong underlying demand situation in Canada since we have already entered a period of very heavy investment in new productive facilities to serve both internal and external needs. To the extent that this assessment of our prospects is justified, we are well placed to achieve our national objective of continuing high levels of employment. If we are also to achieve our objective of getting inflation under better control we shall have to take care to avoid aggravating the inflation we already have by permitting an excessive growth of domestic demand. Only in this way can we be in a position to benefit fully from the moderation of external price pressures that we can expect in due course.

REVIEW OF THE YEAR

Economic Developments

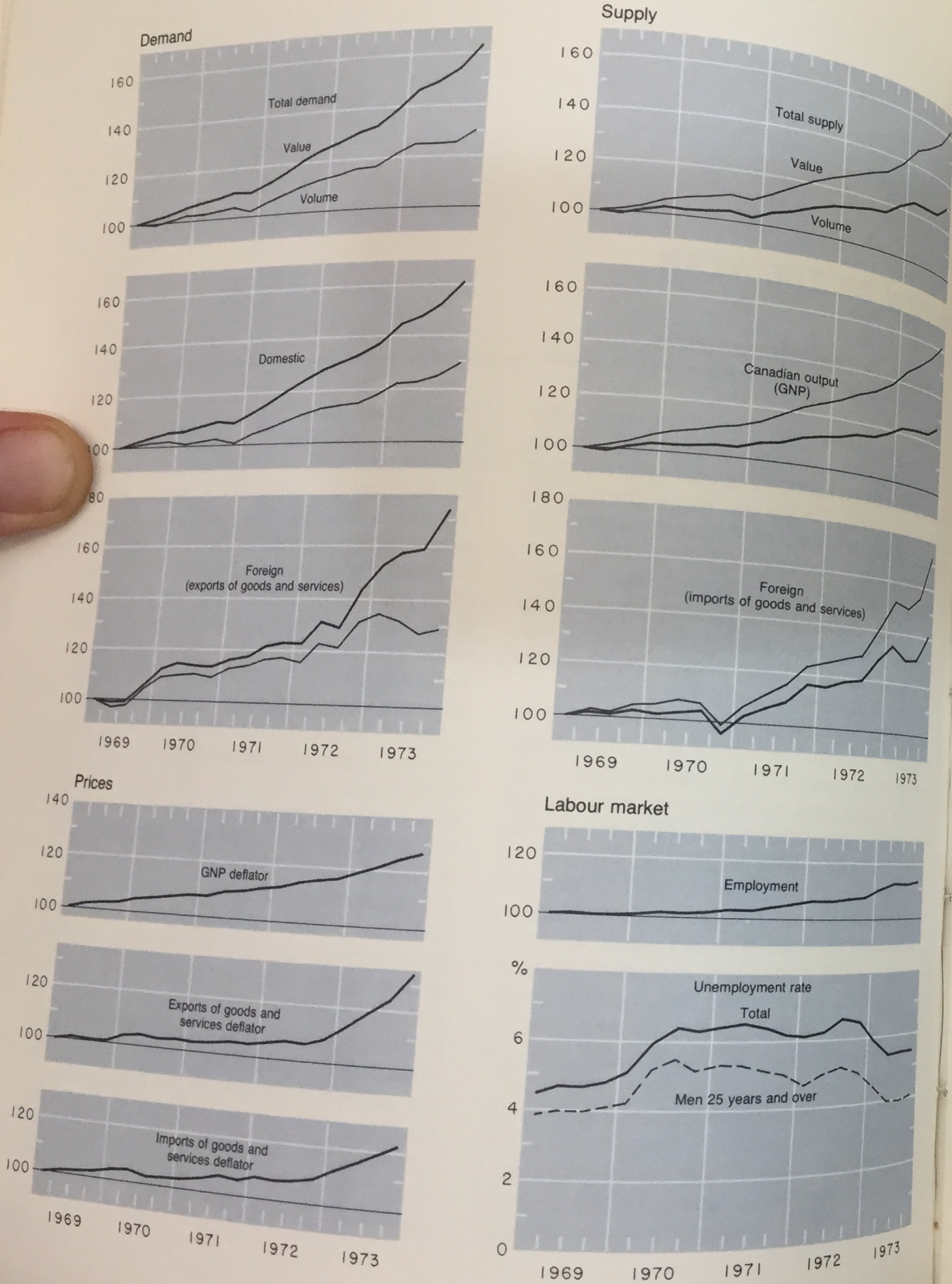
The year 1973 was one of exceptionally buoyant economic activity and strongly rising incomes, with the economy operating for the most part at full stretch. For the year as a whole the gain in output was over 7 per cent, considerably larger than for any year since the mid-1960s. The growth of employment was over 5 per cent, the strongest in about twenty-five years. Despite an unusually large number of new entrants into the labour market, the unemployment rate declined appreciably from the level of the two previous years.

A welcome feature of 1973 was the broad dispersion of the gains in income and employment among major sectors and major regions of the country. Secondary manufacturing had another good year. Tight world food supplies and sharply higher prices for a wide range of agricultural and fishery products had a major impact on incomes in these sectors; farm income, which had lagged behind other incomes in recent years, rose very sharply in 1973, particularly in western Canada. Extraordinarily strong world demand also contributed to high levels of activity and sharply increased earnings in Canada's basic resource industries.

In this environment there was an exceptionally large increase in prices in Canada in 1973. The GNP deflator averaged 7 per cent higher than a year earlier, and the Consumer Price Index rose by 9 per cent in the course of the year, with particularly steep advances in food and energy prices. The rapid rise in domestic prices was closely related to the world-wide commodity inflation. Sharp price increases for a broad range of Canadian agricultural and resource-based exports led to higher prices for such products in the Canadian market. Import prices also rose rapidly, with a particularly marked impact on food costs. In the latter part of the year the escalation of oil prices by the major producing countries led to large increases in the domestic prices of petroleum products in the eastern part of the country.

Underlying the boom in world commodity markets last year was an unusually rapid upsurge in demand and output in all the main industrial countries. During the second half of 1972 and the first half of 1973 the combined real GNP of the major countries of the OECD area increased at an almost unprecedented rate from a level of output that was already relatively high. The resulting steep climb in demand for industrial materials added to the supply problems that already existed in certain areas, notably as a consequence of the disappointing grain harvests in several major producing countries in 1972. Even though the pace of expansion in the major industrial countries tended to slacken somewhat in the latter part of the year, prices continued to advance sharply throughout 1973 for most industrial and agricultural commodities.

Main Economic Indicators
1Q 1969 = 100, seasonally adjusted



The deceleration of the growth of output in the major industrial countries in the second half of 1973 reflected in part a tightening of demand policies in a number of countries, but it is also apparent that capacity limitations and supply shortages were major restraining factors. This combination of influences was particularly evident in the United States. After expanding very rapidly over the winter months, output in the United States during the balance of 1973 rose at a much slower rate notwithstanding continued buoyancy in aggregate demand. By the final months of the year, however, signs of a moderation in demand had appeared; indeed housing starts had weakened markedly and car sales had also fallen considerably from their very high levels early in the year, in part as a result of consumer reactions to the difficult situation with respect to oil.

The combination of cutbacks in production announced by the main Arab oil-producing states in October, embargoes on shipments to certain countries, and substantial increases in the price of crude oil imposed by members of the Organization of Petroleum Exporting Countries, has created major problems and uncertainties for all oil-importing countries. For Canada, however, the immediate effects of these developments have been less serious than for most other countries. Supplies have remained generally available to Canadian industries and consumers, albeit at higher prices in eastern Canada, while the escalation of world petroleum prices will have little net impact on Canada's international trade balance on oil account.

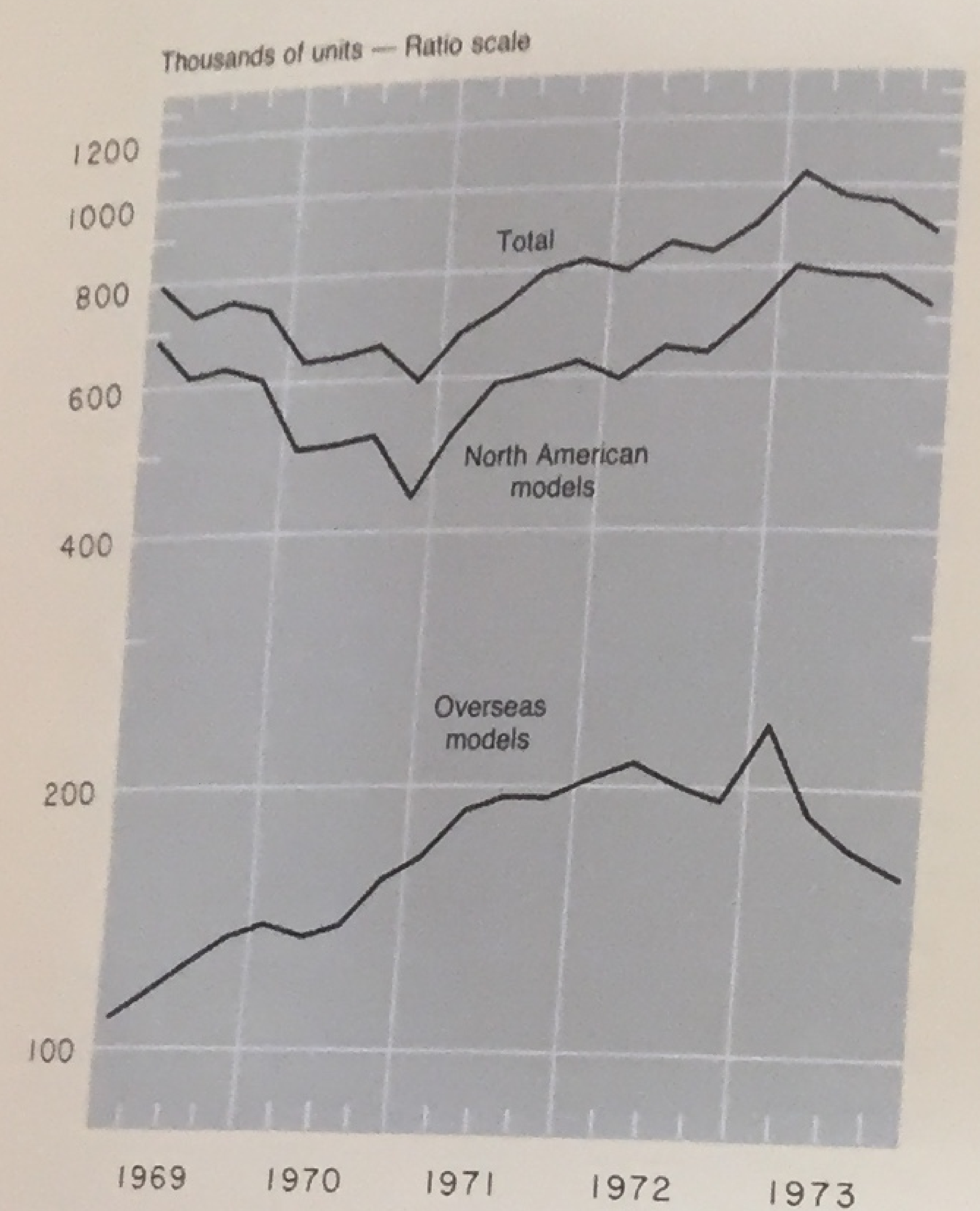
At year-end and in the early weeks of 1974 the Canadian economy was continuing to exhibit considerable buoyancy in major sectors of demand with persisting pressures on capacity. A significant part of the sizeable increase in output in the final months of 1973 reflected a rebound from the effects of work stoppages during the summer. Employment also expanded strongly in the fourth quarter and registered a further sizeable advance in January 1974. While some possible weakening of export demand could be in prospect because of the marked slowing of activity in several of Canada's major export markets, particularly the United States, exports continued to rise in January. Domestic demand continued to display evidence of considerable resilience. In contrast to the United States, both new car sales and housing starts stayed at high levels in Canada in the final months of 1973 and in the first weeks of 1974. Furthermore, current monthly indicators point to continued vigour in spending on new plant and equipment by Canadian business in the period immediately ahead. Indeed, the information available on business investment intentions indicates a continued rapid pace of capital outlays in 1974.

Demand — Domestic and Foreign

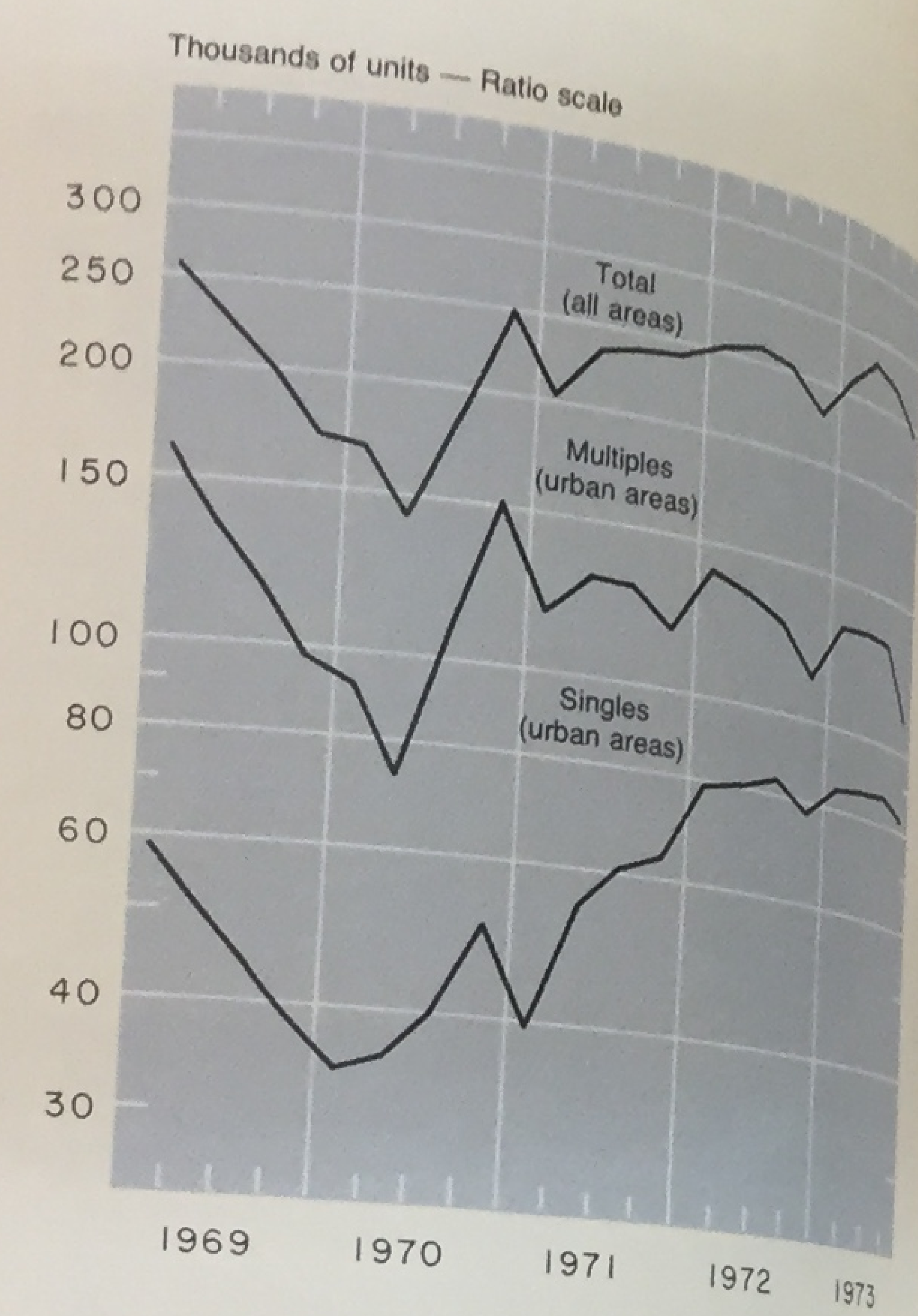
The buoyancy of total demand in the economy in 1973 reflected a combination of strength in spending from both domestic and foreign sources. The strength in domestic spending represented to an important degree a contined rapid advance in consumer outlays and residential construction. Major impetus also came from the sharp upturn in fixed capital formation by business after an extended period of relatively moderate growth.

Expenditures on consumer goods and services rose vigorously for the second consecutive year. Although part of the increase of close to 15 per cent reflected the faster rise in consumer prices, particularly for food and energy products, the percentage gain in volume was, nevertheless, higher than for total domestic demand. Purchases of both durables and semi-durables provided major support. The strong rise in expenditures on new cars that had been a feature of the closing months of 1972 continued into the early months of 1973, and outlays over the balance of the year and into the first weeks of 1974 remained close to the first quarter's record pace. Spending on other durables and semi-durables advanced strongly throughout the year, reflecting in part the demands associated with the continued strong expansion in house building. Housing starts totalled 268 thousand units for 1973 as a whole, setting a new record for the third successive year. Although housing completions also reached a

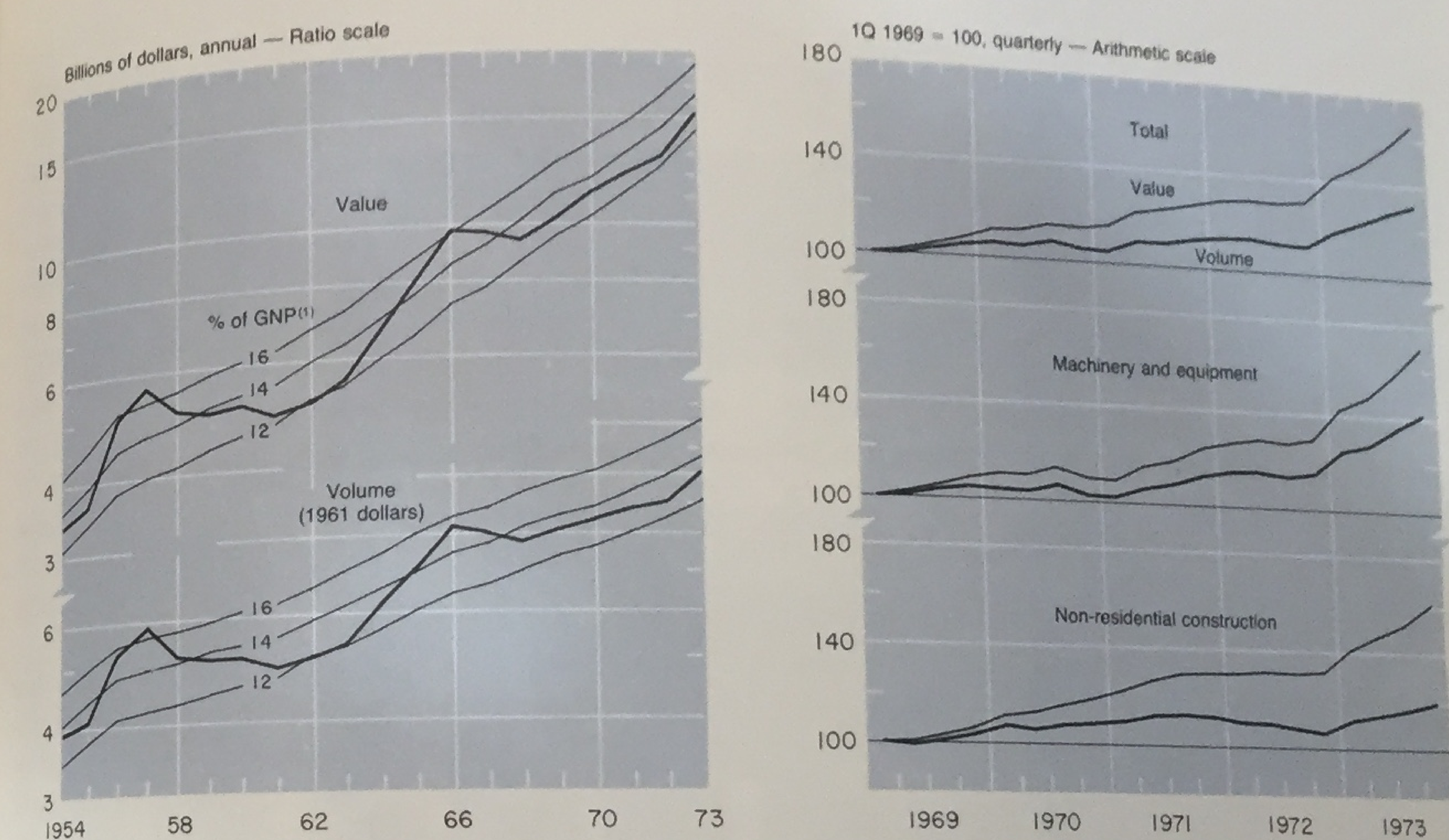
New Car Sales
Seasonally adjusted at annual rates, quarterly



Housing Starts
Seasonally adjusted at annual rates, quarterly



Business Fixed Investment



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

record total of 247 thousand units, the available information suggests that vacancy rates remained very low. This continued strength in housing demand persisted despite higher mortgage interest rates and sharp increases in the cost of construction and land.

The recovery of business fixed investment was delayed somewhat by strikes that affected construction in the latter part of 1972 and this was a factor in the very sharp rise in outlays in early 1973. Further substantial increases in spending on both plant and equipment were recorded during the remainder of the year despite growing difficulties in securing supplies, particularly in the area of non-residential construction. For the year as a whole, total business fixed investment (excluding housing) rose by 18 per cent in value and almost 12 per cent in volume. However, as a proportion of GNP, such investment has risen only moderately and is still well below the peaks reached in earlier periods of strong investment activity, as may be seen in the left panel of the chart on page 15. The high rates of profits and capacity utilization in 1973, together with recent developments in the energy field, have provided a strong inducement for further large increases in investment outlays.

The accumulation of inventories by non-farm business in 1973 was only moderately higher than in the previous year, with additions to stocks undoubtedly restricted by the over-all tightness of supply in the face of heavy final sales. In manufacturing, the ratio of stocks to shipments reached a new low while the value of unfilled orders rose steeply throughout the year. Government outlays on goods and services, that part of government spending entering directly into GNP, rose from 1972 to 1973 at a slightly faster pace than in the previous year.

A growing demand for Canadian exports, which was already evident in 1972, continued to give major impetus to the Canadian economy in 1973. Merchandise exports rose sharply in value terms as an upsurge of demand from overseas countries was added to continued strength in the U.S. market. The major part of the increase was attributable to a 16 per cent rise in export prices under the impact of the world-wide commodity boom; particularly large increases occurred in the export prices received for grains and other farm produce, lumber, woodpulp, oil, copper, and most other non-ferrous metals. In addition, the further temporary appreciation of several major overseas currencies relative to the Canadian dollar in the first half of 1973 tended to add to the upward pressures on Canadian export prices. Given that a large part of Canada's foreign trade is conducted on a contractual basis, the increase in unit values during 1973, although extraordinarily large, still did not reflect the full magnitude of the surge in spot prices for Canadian commodity exports. Accordingly, there is reason to believe that some further increase in realized export prices will occur in the first part of 1974 even if the corresponding spot prices prove to have peaked. In volume terms, exports rose by about 8 per cent or slightly less than in 1972, with all of this growth coming in the early part of the year. Supply constraints were clearly an element restricting further growth in the volume of sales. In addition, strikes in the rail and pulp and paper industries led to a sharp decline in the volume of shipments in the third quarter, followed by a rebound in the final months of the year.

Supply — Production and Imports

The value of the Gross National Product expanded by almost 15 per cent following an increase of 10¾ per cent the previous year. In volume terms the rise in output accelerated to 7 per cent from 5¾ per cent in 1972.

Following exceptionally sharp gains in production over the winter months, the expansion of the economy slackened somewhat in the second quarter, reflecting evident capacity constraints. As in 1972, major work stoppages contributed to a slowing in economic activity in the third quarter and their settlement to the rebound in the final months of the year. In the closing months of 1973 capacity limitations were apparently continuing to restrain the expansion of output in many industries. In the automotive industry, however, there were cutbacks in production that were related mainly to the slackening U.S. demand for cars.

Agricultural production rose only moderately from last year's relatively low level. A substantially larger wheat crop was harvested but there was, on balance, little change in the size of other crops. Furthermore, output of meat, dairy and poultry products appears to have been adversely affected by the sharp increase in the cost of feed.

One of the most striking features of the year was the speed with which the economy seemed to move up to the limits of its operating capacity. Indeed, the economy began to show signs of strain sooner than anticipated, particularly in the light of the relatively high rate of recorded unemployment. While some shortages had been reported in 1972, they emerged both in the case of skilled labour and materials with increased frequency from early in 1973 and became commonplace as the months passed. Delivery times for many products lengthened appreciably as unfilled orders piled up. In some cases, for example in steel, producers moved to a system of allocation among customers. These effects were intensified by the correspondingly strained capacity situation in other countries.

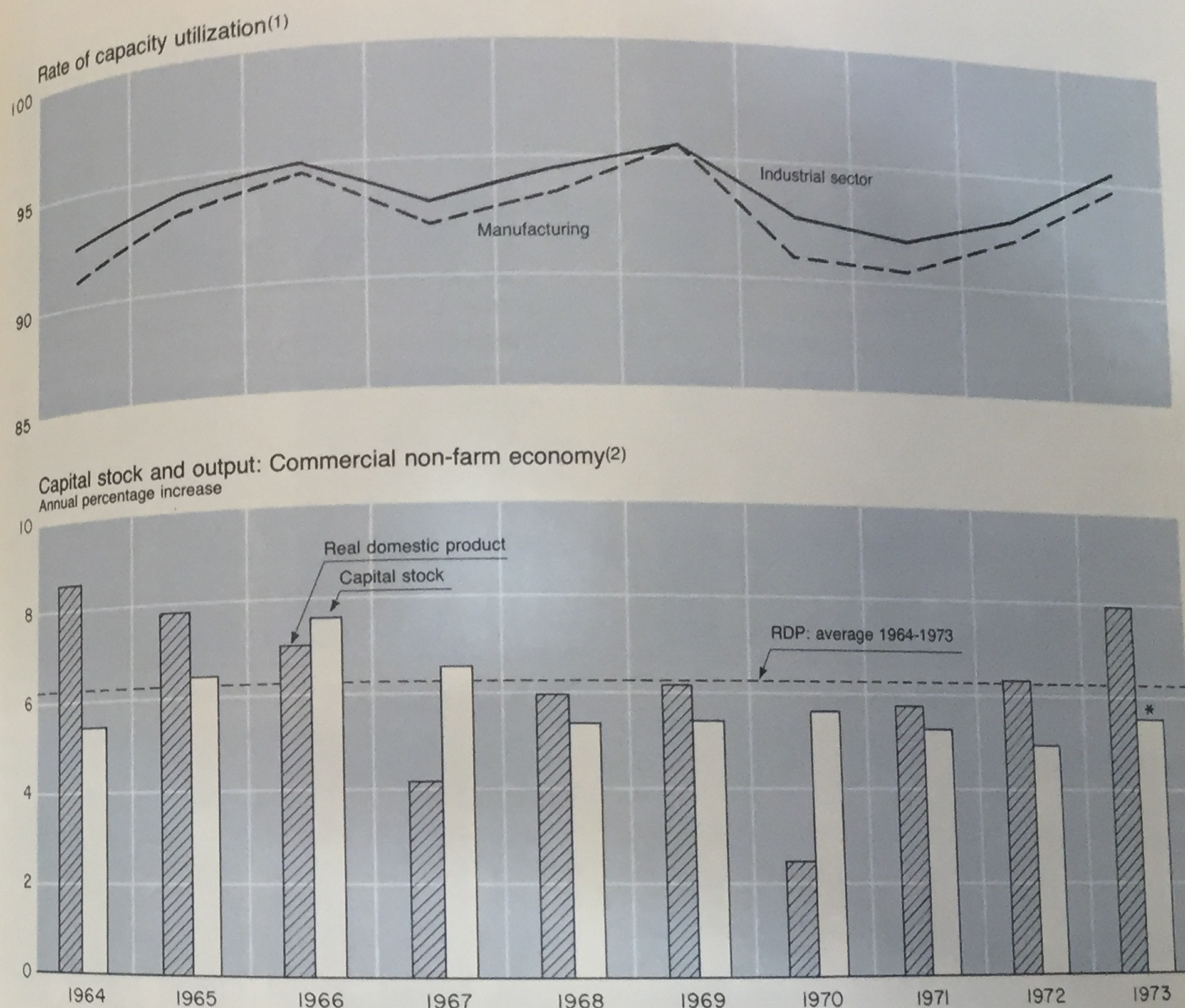
The lack of spare plant capacity represented a major constraint on the short-run response of production to demand over a broad range of industries. Very tight conditions prevailed for a number of key processed materials including steel, pulp and paper, other wood products, petrochemical feedstocks, and chemical products. For the industrial and manufacturing sectors as a whole, estimates prepared by the Department of Industry, Trade and Commerce indicate that rates of capacity utilization rose in 1973 to levels comparable with earlier peaks reached in the 1960s.

While the sharp run-up of demand was clearly the immediate cause of the tight capacity situation prevailing in Canadian industry, an important contributing factor was the relatively sluggish pace of investment for several years prior to 1973. Although estimates of the stock of plant and equipment are necessarily approximate, they do suggest that the capital stock grew quite slowly in the period after 1967. Annual changes in capital stock and output for the commercial non-farm economy are shown in the lower panel of the chart on the facing page.

The strong growth of aggregate demand in the economy, combined with sharply rising prices abroad, led to a substantial increase in the value of merchandise imports — comprising a 14 per cent increase in volume and an increase in price of almost 10 per cent. The increase in import prices was not as rapid as for exports because raw materials, whose world prices rose extraordinarily rapidly in 1973, represent a relatively smaller proportion of our import bill. Despite a higher rate of over-all growth in the Canadian economy, the rise in the volume of imports was not quite as rapid as for 1972, largely because of a decline in the volume of imports of automobiles from overseas countries, the easing of demand for imported food, and short supplies of many materials in world markets.

The more rapid growth in the volume of imports than in exports produced a substantial adverse movement in real terms in Canada's current account position. However, since export prices rose much more rapidly than import prices, leading to an improvement of some 6 per cent in Canada's terms of trade, the actual balance in value terms improved slightly compared with 1972; the current account deficit resulting from Canada's transactions in goods, services and transfers declined by about $300 million to approximately $330 million in 1973.

Capacity and Output



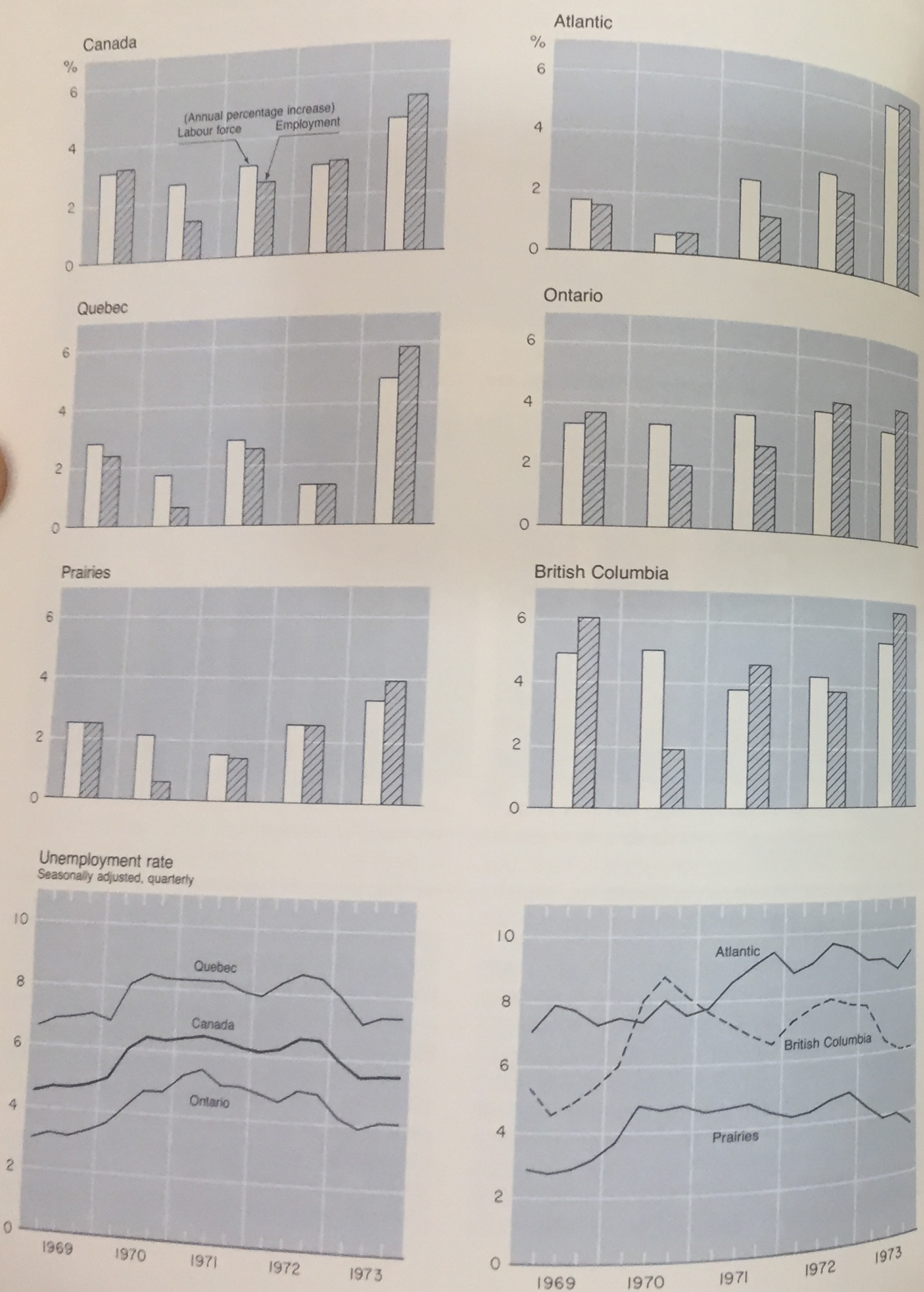
*Estimate
Source: (1) Annual average of quarterly estimates prepared by the Department of Industry, Trade and Commerce
(2) Statistics Canada

The Labour Market

The sharp expansion of output in 1973 was accompanied by extraordinary gains in employment. For the year as a whole total employment was over 5 per cent greater than in 1972. A major part of the increase came at the beginning of the year in conjunction with the very strong advance in output during that period. Also in correspondence with the movement of production, only limited increases in employment occurred during the spring and summer months, followed by renewed gains towards the end of the year. Despite the very strong expansion in output in 1973, the rise in labour productivity was below average — an indirect, but suggestive, indication of the generally tight operating conditions prevailing.

The expansion of employment opportunities gave rise to a record increase of almost 4½ per cent in the labour force. This was about 50 per cent greater than the more normal labour force growth registered in the two previous years. The sensitivity of labour force response to

Regional Labour Markets



employment growth was apparent in the behaviour of all the major labour force categories. Most strikingly, the very large expansion of more than 8 per cent in the employment of people under 25 years of age was accompanied by a 6¾ per cent increase in the labour force in that age group. The entry of young people into the labour force in such large numbers, with particularly marked increases among teenagers, was accompanied by some reduction in the proportion not in the labour force because they were attending school.

Under the impact of the rapid gains in employment in the early months of the year, the unemployment rate fell sharply, reaching 5.3 per cent on a seasonally adjusted basis in July. With the slowing of employment expansion over the summer months, unemployment moved back up somewhat from this low point, but declined again in the final months of the year. During 1973 the unemployment rate averaged 5.6 per cent of the labour force compared with 6.3 per cent in the previous year. For the core group of men 25 years of age and over, the unemployment rate fell from 4.9 per cent in 1972 to 4.2 per cent in 1973, returning to approximately the same level as in 1968-69. In 1973 this group, which constitutes about one half of the work force, accounted for only 38 per cent of total unemployment. Recorded unemployment also declined for young people and adult women but in both cases the rates remained well above the levels typical four to five years earlier.

The paradox of high rates of measured unemployment in the face of employers' apparent difficulties in hiring labour was commented upon in last year's Annual Report. The record of the labour market in 1973 has tended to confirm the view that at the present time a given level of the national unemployment rate as recorded in the Labour Force Survey does not reflect the same degree of ease in labour markets, or in the economy as a whole, as it formerly did. While the over-all unemployment rate in 1973 was still higher than that recorded during such earlier periods of high level operation as the mid-1950s and mid-1960s, there were widespread reports of shortages of skilled labour and even of unskilled labour in certain areas of the country. The statistics on job vacancies and the index of newspaper help-wanted advertising also point to a further major tightening of the labour market in 1973; in the second half of the year both measures were markedly higher than a year earlier. A further indication of the intensified pressure of demand for labour was the considerable rise in the proportion of vacancies remaining unfilled for one month or more.

In all regions except Ontario there was a marked acceleration of employment growth in 1973. The strongest gains year-over-year were in the Atlantic region and British Columbia, where the expansion was in the range of 6½ per cent, but the acceleration was greatest in Quebec — from 1¼ per cent in 1972 to 5¾ per cent in 1973. Employment growth in Ontario matched the previous year's unusually large gain of 4½ per cent, while in the Prairie region the rise was 4 per cent, about 1½ percentage points more than in 1972. The decline in unemployment was also general across Canada, although the extent of the reduction varied considerably by region. In British Columbia the rate fell by over one percentage point to 6½ per cent. In the Atlantic region the very strong growth of employment was accompanied by an unprecedented expansion in the labour force and the unemployment rate remained close to 9 per cent.

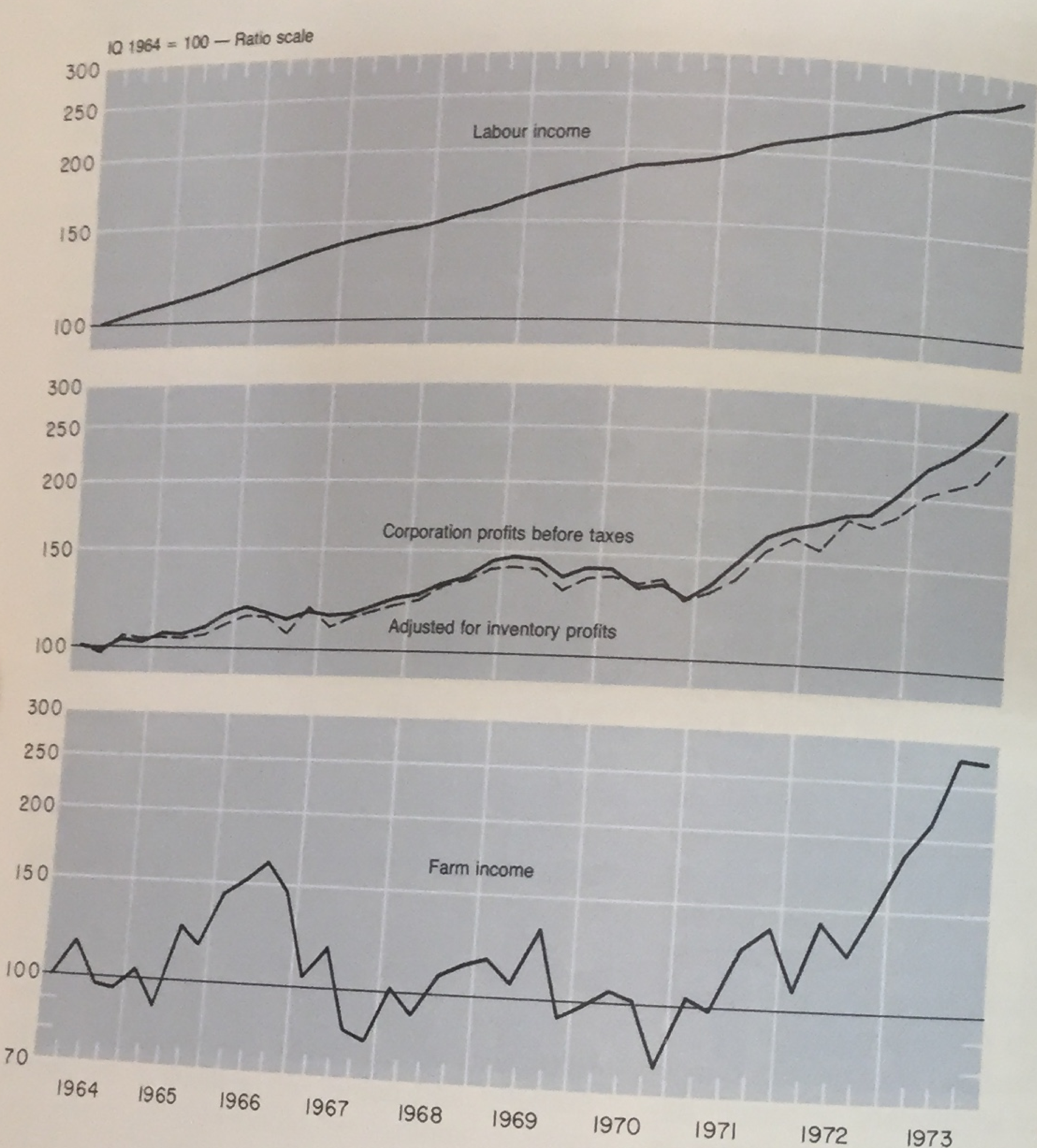
Incomes, Costs, and Prices

All major categories of income rose at a faster rate in 1973 in response to the strong increases in demand and output. As a result of the strong gains in employment, labour income rose by over 12 per cent, somewhat more rapidly than in the previous year. Other important elements contributing to the exceptional increase in personal disposable income — 14 per cent in nominal terms — were the jump in income received by farmers, cuts in personal income taxes and substantial increases in transfer payments from governments. Even after making allowance for the inflation of consumer prices, the increase in disposable income was still unusually large.

Farm income had lagged behind other incomes for a number of years, as may be seen in the chart on page 20. The remarkable rise of 83 per cent in

Selected Income Components of GNP

Seasonally adjusted, quarterly



accrued net farm income in 1973 mainly reflected sharply higher prices in domestic and export markets. The strength of export markets was also an important factor in the vigorous rise in the earnings of Canada's major resource industries, reinforcing the impetus to higher business profits coming from the cyclical expansion of domestic demand. Continuing the recovery of the two previous years from the depressed level in 1970, total corporation profits before taxes in 1973 were some 37 per cent higher than in 1972. After deducting the estimated accounting profits associated with the effect of higher prices on the value of inventories, the gain was about 27 per cent.

The faster growth of labour income does not appear to have contributed to the acceleration of costs in the economy in 1973 since, on the basis of preliminary data, the rise in unit labour costs of 4¾ per cent was about the same as in 1972. While

the available indicators do not suggest much change in 1973 in the rate of increase of average wages and salaries, a forward looking indicator of wage trends, new wage settlements under collective bargaining, clearly moved up. Excluding the construction industry, for which comparable figures are not available, the annual increases in base rates of pay over the life of contracts averaged out to over 9 per cent for the year, or 1½ percentage points more than in 1972. In the second half of 1973 the rate of increase in base rates under new settlements rose to almost 10 per cent. Furthermore, this would appear to be an underestimate of the extent of the rise, in that the base rate measure does not take into account either fringe benefits or clauses tying future wage adjustments to increases in the Consumer Price Index. Both these elements were prominent in major contracts negotiated in the latter months of the year.

Food prices had begun to show a markedly sharper rate of increase by the middle of 1972 and continued to climb steeply throughout most of 1973. Most categories contributed to the acceleration. At the end of 1973 the food component of the Consumer Price Index was 17 per cent higher than a year earlier: dairy products were up 8½ per cent, fruit and vegetables 12 per cent, bakery and cereal products 19 per cent, pork 27 per cent, and beef 28 per cent. The magnitude of food price increases tapered off towards year-end, however, particularly in the case of meat, fruits and vegetables. While the future trend of food prices remains uncertain, such indications as the substantially increased acreage planted to winter wheat in the United States point to the possibility of some improvement in supplies of feedgrains, cereals and ultimately livestock and related products.

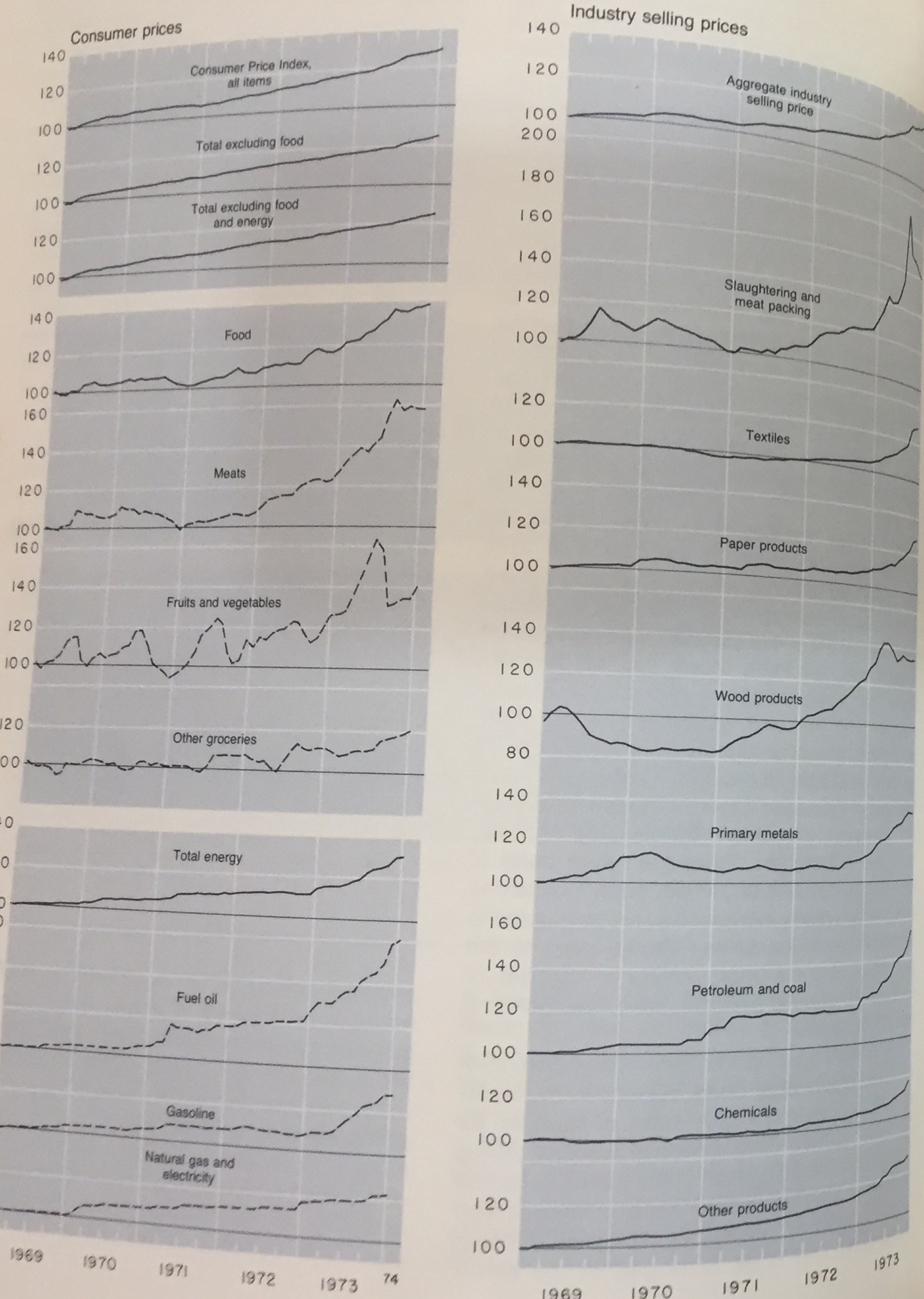
The major impact of the international commodity inflation has also been evident in the widespread and sharply higher rates of increase for the main non-food categories of industry selling prices, and the escalation in the prices of oil and oil-based products over recent months has added further to industry costs. While some of these cost and price increases at the earlier stages of processing remain to be worked through to the retail level, some relief may be forthcoming to the extent international industrial commodity prices respond to the easing of world demand pressures apparently in progress.

The large increase in the Consumer Price Index in 1973, 7½ per cent year-over-year and 9 per cent from year-end to year-end, was only partly attributable to the upsurge in food prices. The cost of energy items also rose steeply, particularly in the eastern part of the country, under the impact of large increases in the prices of gasoline and fuel oil, together with some upward adjustment in the price charged for natural gas in the final months of the year. Even apart from food and energy, there was a perceptible acceleration in prices across a broad range of goods and services purchased by consumers. From the end of 1972 to the end of 1973 the Consumer Price Index excluding food and energy items rose by 5½ per cent compared with a 4 per cent increase during 1972.

A chart showing movements in selected components of the Consumer Price Index and of the Index of Industry Selling Prices since the beginning of 1969 appears on the following page.

Selected Price Measures

1Q 1969 = 100, not seasonally adjusted



Financial Developments

The very large increase in spending that occurred in 1973 was accompanied by a substantial expansion of credit. Major non-financial borrowers other than the Government of Canada raised $4 billion more in total during 1973 than in the previous year, with the largest part of the increase accounted for by non-financial businesses and mortgage borrowers.

This very strong demand for funds, together with the less accommodating stance of monetary policy and the rapid rise in interest rates in the United States and other foreign financial markets, resulted in substantial upward pressure on domestic interest rates in Canada during 1973. Although short-term interest rates in Canada did not reach peak levels as high as in the United States and elsewhere, the increases were nonetheless substantial.

The amounts raised by non-financial borrowers in recent years are summarized in the following table.

The amount of Government of Canada securities outstanding declined slightly in 1973, despite the fact that the Government's domestic financial requirements have remained substantial. When measured over the calendar year 1973,

Borrowing by Major Non-financial Sectors(1)

	Billions of dollars		
	1971	1972	1973
Non-financial business	5.3	4.7	6.6
Mortgage borrowers(2)	2.5	4.0	6.0
Consumers	1.4	2.2	2.6
Provinces and municipalities(3)	2.9	3.5	3.1
Sub-total	12.1	14.4	18.4
Government of Canada(4)	3.0	1.6	-0.1
Total	15.1	16.0	18.3

(1) Increases in mortgages and other loans from financial institutions, plus net new issues of securities and foreign direct investment in Canada.
(2) These are principally mortgages secured by residential property. The figures exclude net mortgage lending by governments and their agencies, notably CMHC, which is reflected in the financing requirements of the respective governments.
(3) Includes government enterprises. Loans from the Government of Canada are excluded.
(4) Net changes in Canadian dollar Government of Canada securities outside Government accounts; the figures do not include temporary financing resulting from swap transactions between the Bank of Canada and the Exchange Fund Account. They are not a measure of Government of Canada cash requirements.

these requirements were just under $1 billion, an amount which, because of timing differences, is well below that expected for the fiscal year ending March 31, 1974. Ordinary foreign exchange operations were a source of Canadian dollars to the Government in 1973 and in addition the Government's cash balances were augmented as a result of temporary swap transactions entered into by the Bank of Canada with the Exchange Fund Account. Details of these transactions and of the Government's financing generally in 1973 are given in the final chapter of this Report.

Provinces and municipalities and their enterprises raised less in both domestic and foreign bond markets, although this was partly offset by increased recourse to the chartered banks. The decrease in total provincial-municipal borrowing occurred despite a widening of the deficit of this sector on a national accounts basis; it apparently was facilitated by a rundown of holdings of financial assets, which had been built up during 1972.

Despite a continued strong rise in internally-generated funds, non-financial businesses raised nearly $2 billion more from other sources in 1973 than in the previous year. This increase in funds raised reflected the strong rise in outlays on fixed investment, as well as spending on inventories and further substantial additions to holdings of financial assets. The additional borrowing was largely in the form of bank loans. Total funds raised in Canadian and foreign bond and stock markets declined slightly from the level of the previous year.

Borrowing by consumers continued to rise in 1973, although less rapidly than in the previous year. The principal source of these credit demands lay in the continued strength of outlays on automobiles and other consumer durables and semi-durables.

Mortgage borrowers obtained $6 billion of financing from private financial institutions in 1973, an increase of $2 billion from the already very large flow during 1972. The further increase in the volume of residential construction activity gave rise to a strong demand for mortgage funds. Indeed, the rate of housing starts realized over the past two years has been well above the pace required, on average, to meet the targets given in official projections of housing needs during the 1970s. The demand for mortgage funds was also influenced by the marked rise in lending on existing housing and the sharp increases in the prices of both new and existing housing.

Mortgage borrowers might have been expected to encounter considerable difficulty in obtaining funds on this scale in a year in which other credit demands were also strong. However, the principal mortgage lending institutions were able to attract sufficient funds, although at a higher cost, so that the flow of mortgage money was well maintained. This outcome contrasted sharply with the situation in the United States where the mortgage market was adversely affected by the difficulties in raising funds experienced by the institutions that specialize in mortgage lending. Mortgage holdings of Canadian institutional mortgage lenders as a group increased by 25 per cent in 1973, compared with 20 per cent in the previous year. Holdings of the trust and mortgage loan companies rose by 29 per cent, a much higher rate than in 1972 and double the rate during the previous five years. Chartered banks' mortgage portfolios rose by 34 per cent in 1973, the third consecutive year of strong growth. Official requests were made to the banks to maintain a reasonable flow of residential mortgage funds.

The substantial amount of funds raised by Canadian residents in 1973 was apparently obtained without net recourse to foreign sources. There were net inflows of capital in long-term forms of about $725 million but net outflows of short-term capital (including errors and omissions) amounted to about $850 million. The long-term capital inflow was about $1 billion lower than in 1972. This sharp reduction reflected a marked decline in net new issues of Canadian bonds sold to non-residents, a smaller inflow resulting from transactions in outstanding Canadian and foreign securities and a larger outflow in the form of Canadian direct investment abroad.

Sales of domestic securities to Canadians as well as to non-resident investors were lower in 1973 than in 1972. The increase in credit flows that occurred in 1973 was accounted for entirely by the growth in institutional lending, particularly by those institutions that rely mainly on the issue of various kinds of deposit-type claims. Additions to mortgage portfolios were a major factor in the growth of deposit-taking institutions. Their total assets increased by 19 per cent in 1973, compared with 16 per cent in 1972.

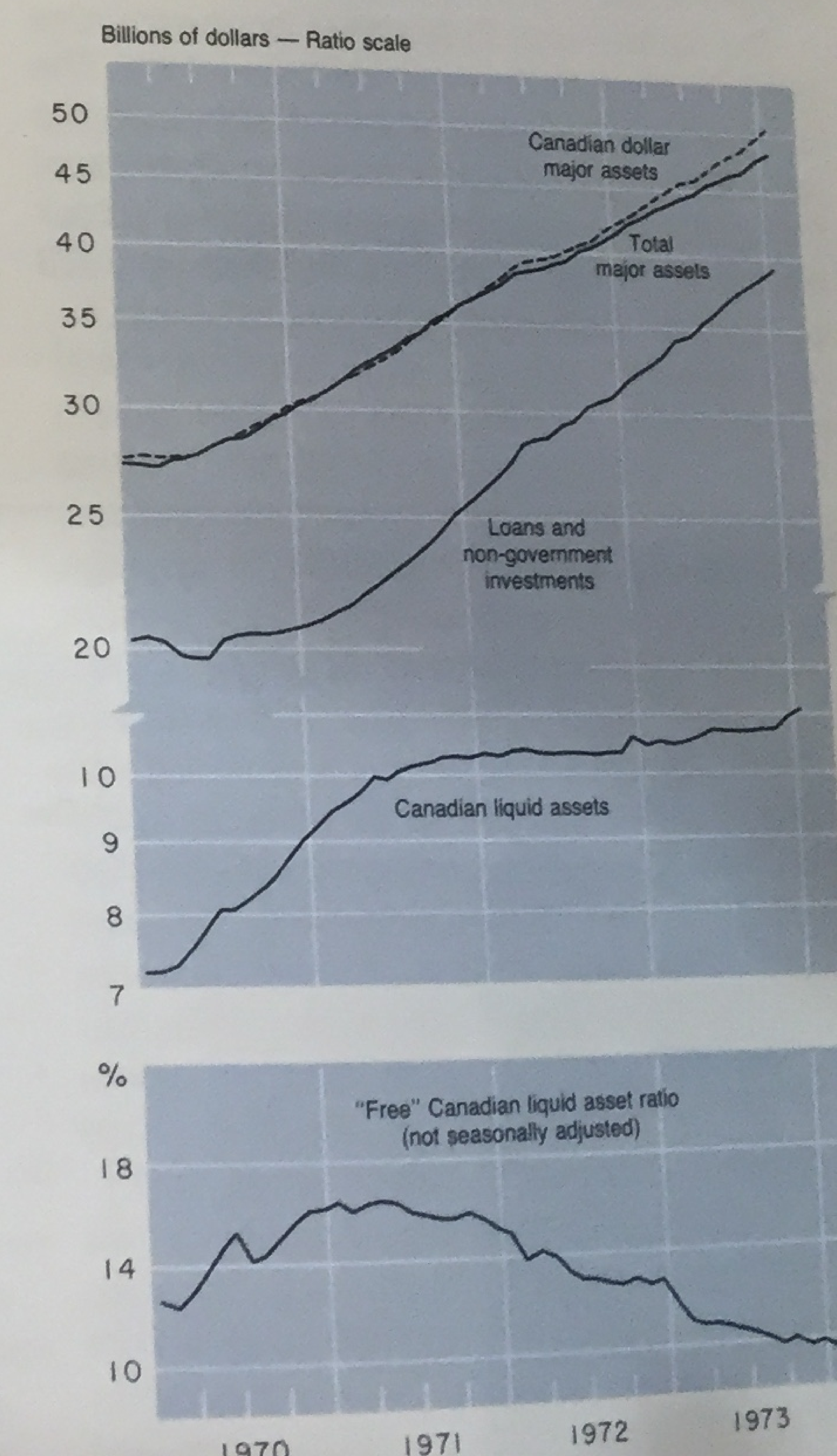
The chartered banks' total major assets rose by 17 per cent in 1973. As in 1972, there was little

Major Assets of Financial Institutions(1)

	Billions of dollars Dec. 1973	Percentage change Dec. 1971 to Dec. 1972	Percentage change Dec. 1972 to Dec. 1973
Deposit-taking institutions			
Chartered banks(2)	48.3	15	17
Quebec savings bank	0.8	10	15
Trust and mortgage loan companies	15.4	15	23
Credit unions and caisses populaires	8.4	27	25
Sub-total	72.8	16	19
Contractual savings institutions			
Life insurance companies	18.8	10	9
Pension funds	15.8	14	13
Sub-total	34.5	11	11
Sales finance and consumer loan companies	6.8	13	14
Total	114.1	14	16

(1) Figures for December 1973 are estimated, except for banks.
(2) Major Canadian dollar assets plus net foreign currency assets; average of Wednesdays.

Chartered Bank Assets
Average of Wednesdays, seasonally adjusted



change in their holdings of Canadian liquid assets so that liquidity ratios declined further. The pressure on the banks' Canadian dollar resources also gave rise to a substantial increase in their foreign currency deposit liabilities to Canadian residents. As a result the net foreign currency position of the banking system declined by over $1 billion during the year. Thus the rate of growth of total major assets, which includes the net foreign position, was less than that for Canadian dollar major assets.

In addition to the substantial increase in residential mortgages mentioned above, all major categories of bank loans rose strongly during the year. The increases in loans to municipalities and sales finance companies were particularly sharp, but the rate of growth of ordinary personal loans slowed as the year progressed.

The banks' loans to business borrowers rose more rapidly in 1973 as a whole than in 1972. The extent to which businesses borrowed from the banks reflected both the underlying strength of their credit demands and, in the case of larger borrowers, the fact that through much of 1973 bank lending rates were low relative to the cost of funds in securities markets. Authorizations to large business borrowers rose by 18 per cent in 1973, the same rate as in the previous year. The rate of growth of other authorizations slowed somewhat but was still substantial.

During 1973, as in previous years, the behaviour of bank business loans outstanding was affected by the switching of financing between the short-term paper market and the banks. Such shifts can occur on the basis of small changes in the spread between interest rates on bank loans and those prevailing in the short-term paper market. Following rapid growth from mid-1972 to mid-1973, the amount of commercial paper outstanding fell sharply in the second half of 1973. Thus, while the growth of business loans was even more rapid in the second half of 1973 than in the first half, it was associated with the sharp decline in the amount of short-term paper outstanding. The sum of these two kinds of business borrowing rose at an annual rate of 22 per cent in the second half of the year, compared with 29 per cent in the first half.

Chartered Bank Selected Assets

	Billions of dollars Dec. 1973	Annual rates of change: Years, Dec. 1970 to Dec. 1971	Dec. 1971 to Dec. 1972	Dec. 1972 to Dec. 1973	Half-years(1): Dec. 1972 to June 1973	June 1973 to Dec. 1973
Canadian liquid assets	11.1	14	4	3	1	5
General loans	29.3	20	23	26	26	27
— unsecured personal	8.9	24	24	24	30	19
— business	17.1	24	22	27	23	31
Other loans	2.3	−16	13	29	17	42
Mortgages	4.5	56	47	34	35	34
Total major assets(2)	48.3	19	15	17	16	17
Canadian dollar major assets	49.9	19	17	19	19	19

(1) Seasonally adjusted.
(2) Canadian dollar major assets plus net foreign currency assets.

Selected Measures of Short-term Credit to Business

	Billions of dollars Dec. 1973	Annual rates of change: Years, Dec. 1971 to Dec. 1972	Dec. 1972 to Dec. 1973	Half-years(1): Dec. 1971 to June 1972	June 1972 to Dec. 1972	Dec. 1972 to June 1973	June 1973 to Dec. 1973
Bank business loans	17.1	22	27	25	18	23	31
Commercial paper including bankers' acceptances	1.7	− 6	8	−31	26	84	−37
Total	18.8	18	25	17	19	29	22

(1) Seasonally adjusted.

As mentioned earlier in this Report, the banks were urged by the Bank of Canada to maintain their policies of ensuring a reasonable flow of funds to smaller businesses and to borrowers in the less buoyant regions of the country. The rate of growth of business loans under authorizations of $100,000 or less was 14 per cent in 1973 compared with 12 per cent during the previous year.

In 1973 most banks adopted a dual lending rate structure for business borrowers under which the minimum lending rate to smaller borrowers, generally those with authorizations of $200,000 or less, was lower than the prime rate to other borrowers. As lending rates were increased during the year the minimum rates applicable to smaller borrowers and the average rates charged on these accounts rose less than the comparable rates for larger borrowers.

During much of 1973, the banks competed aggressively for funds by raising the rates of interest offered on term and savings deposits. They were particularly successful in attracting personal fixed-term deposits, which in the course of the year rose by $3.4 billion — or more than 50 per cent — accounting for about one half of the total increase in the banks' Canadian dollar deposits. No doubt some of the success achieved in this area by the banks, and by other financial institutions, reflected the fact that they attracted funds of the kind that had flowed into Canada Savings Bonds in previous years.

Over 1973 as a whole, non-personal Canadian dollar term and notice deposits rose less rapidly than in 1972. Deposits of $100,000 and over for terms of less than one year continued to be subject to interest rate ceilings under the "Winnipeg agreement". Although the ceiling rate was raised substantially during the year it did constrain the banks' ability to compete for large blocks of short-term Canadian dollar funds. Occasionally the banks bid very aggressively for blocks of funds for terms just slightly longer than those governed by the "Winnipeg agreement". At the same time the banks were able to attract a substantial amount of funds — $1.4 billion — by offering Canadians more attractive yields on foreign currency deposits than they could on Canadian dollar deposits.

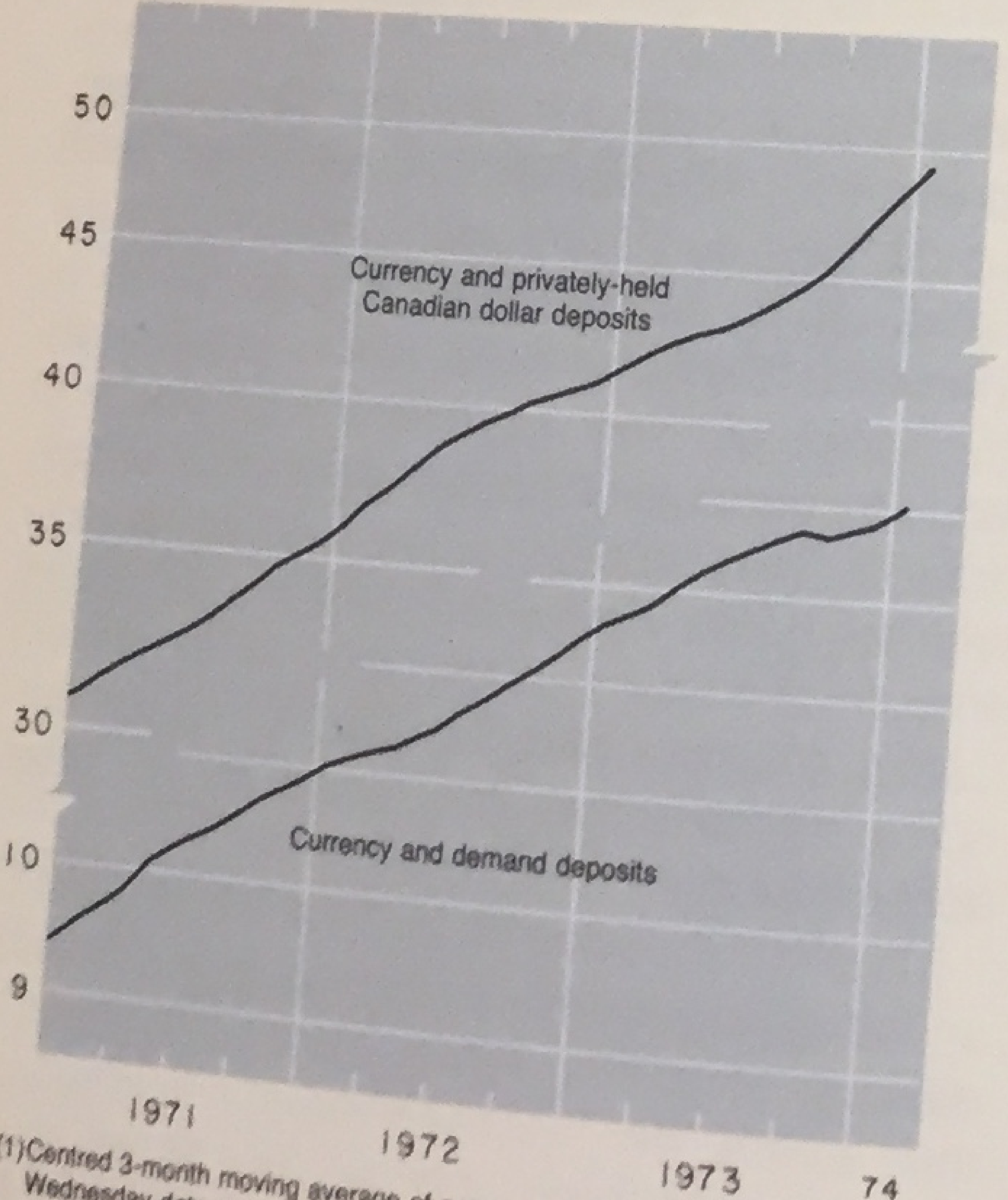
Thus in the course of 1973 the banks relied to an increasing extent on relatively high-cost term deposits of various kinds to finance the growth in their assets. This process involved a lengthening of the average term of their liabilities as well as an upward movement in interest rates paid on

Currency and Chartered Bank Canadian Dollar Deposits

	Billions of dollars Dec. 1973	Annual rates of change(1) Years 4Q 1970 to 4Q 1971	4Q 1971 to 4Q 1972	4Q 1972 to 4Q 1973	Half-years 4Q 1972 to 2Q 1973	2Q 1973 to 4Q 1973
Currency and demand deposits	14.4	17	14	12	16	8
Personal savings deposits	24.3	8	11	20	14	26
— fixed term	8.6	− 7	24	56	36	80
Non-personal term and notice deposits	9.7	39	36	11	2	22
— fixed term	8.8	35	46	13	3	24
Currency and total privately-held Canadian dollar deposits	48.4	16	16	15	12	19
Currency and total Canadian dollar deposits	50.6	18	15	16	16	16

(1) Calculated from the averages for the quarters shown; half-years are seasonally adjusted.

Currency and Chartered Bank Deposits(1)



(1)Centred 3-month moving average of seasonally adjusted average of Wednesday data

deposits. The broad measure of the money supply, which includes these term deposits, rose by 15 per cent in 1973.

As short-term interest rates rose, there was a distinct moderation in the growth of the money supply on the narrow definition that includes only currency and chartered bank demand deposits. During the period of roughly 2½ years up to the second quarter of 1973, currency and demand deposits had risen at an average annual rate of more than 15 per cent. Over the second half of 1973 the rate of increase declined to 8 per cent, bringing the year-to-year increase to 12 per cent by the fourth quarter.

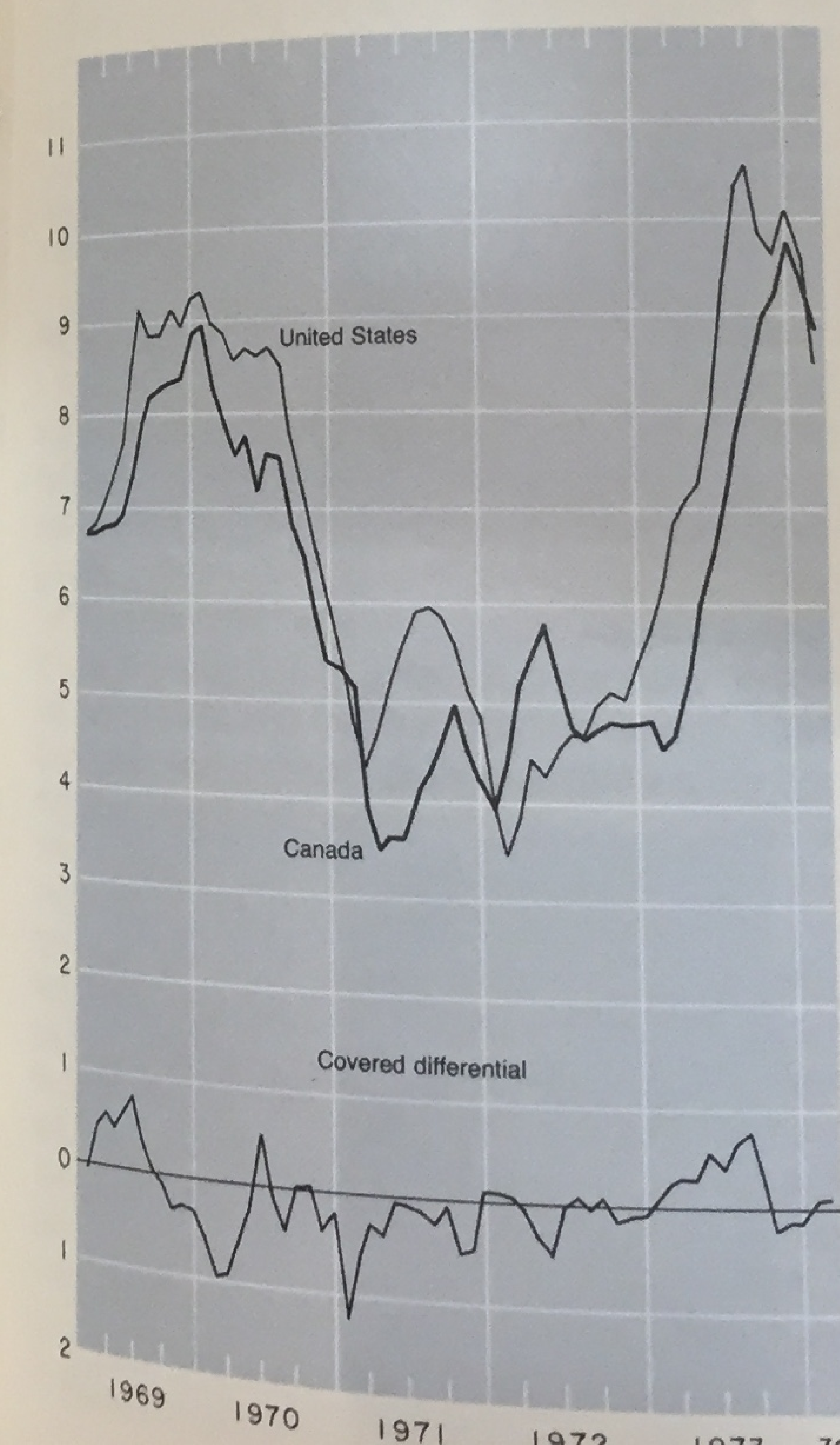
The upward movement that characterized Canadian interest rate developments in 1973 began early in the year. Yields on treasury bills began to rise in January. By March other short-term market rates had started to move up, and on April 9 the Bank Rate was raised to 5¼ per cent from 4¾ per cent where it had been since October 25, 1971. Immediately thereafter the "Winnipeg agreement" ceiling observed by the banks on their large short-term Canadian dollar

deposits was raised by ½ per cent to 6 per cent and their prime lending rates were raised by an equal amount to 6½ per cent. Other bank deposit rates were also increased.

In succeeding months market interest rates continued to rise sharply and there were a series of further increases in the institutional rates mentioned above. By September 13, four further increases in the Bank Rate had raised it to its present level of 7¼ per cent. The ceiling on large short-term deposits was also adjusted upward in several steps to a level of 8½ per cent. Through

Yields on Short-term Paper: Canada and United States

30-day



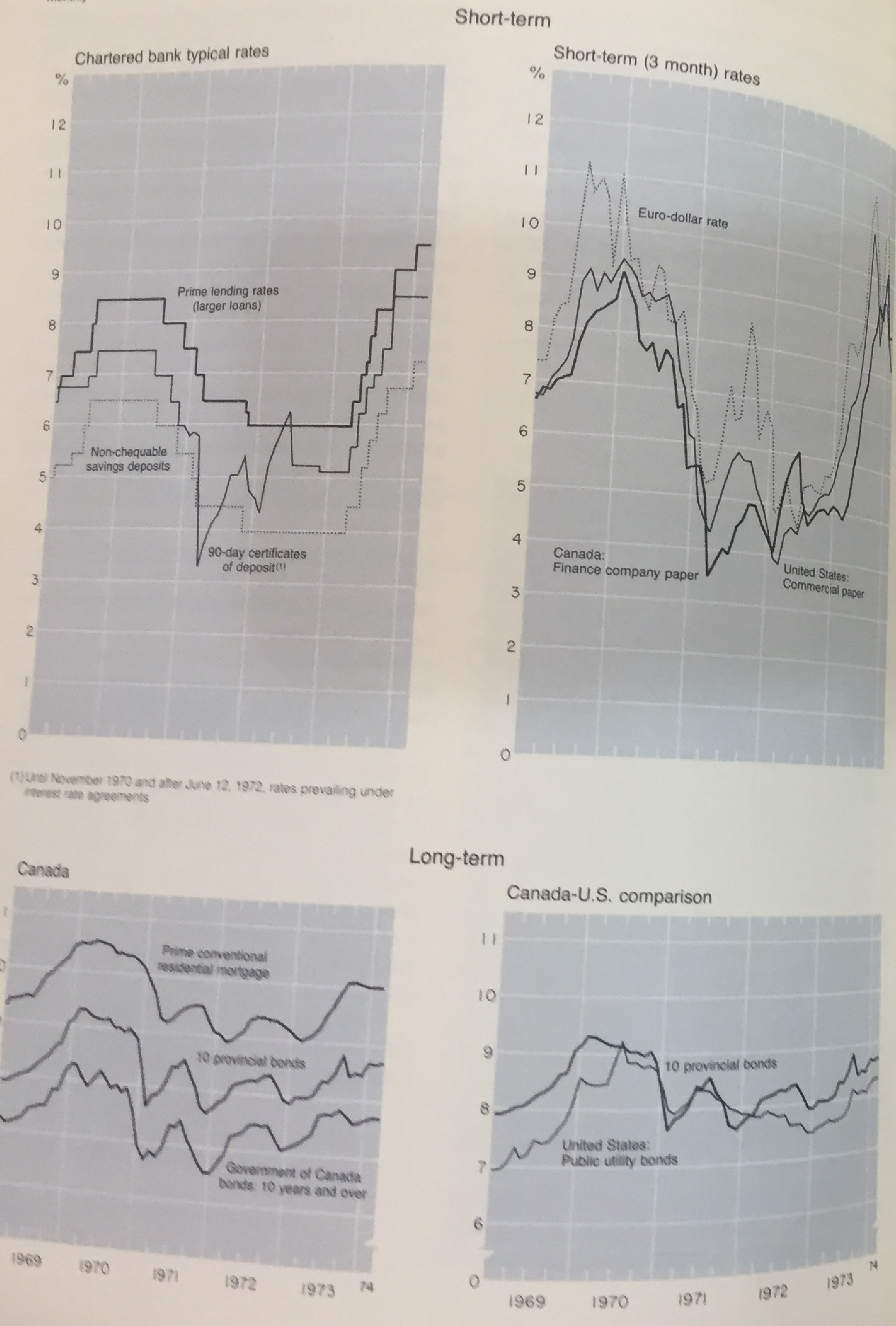
much of this period the existence of the "Winnipeg agreement" tempered the pace of the rise in short-term interest rates. The chartered banks' prime lending rates reached 9½ per cent in December.

During 1973 Canadian short-term interest rates did not rise as high as those in the United States, in the Euro-dollar market or in other foreign markets. By year-end, U.S. bank prime lending rates had reached a peak of 10 per cent, but when account is taken of the widespread U.S. practice of requiring compensating balances, the effective cost of funds to prime borrowers was probably around 11 per cent compared with the 9½ per cent prime rates in Canada. Rates on short-term commercial paper in the United States reached peak levels of about 10¾ per cent in September whereas at that time comparable rates in Canada were about 8½ per cent. Subsequently these short-term interest rates came closer together as U.S. rates moved to a lower level while Canadian paper rates rose further during the remainder of 1973. In early 1974 short-term market interest rates declined in both countries. Throughout this period the spread between spot and forward exchange rates tended to move with the changing spread between short-term interest rates in the two countries.

By the latter part of 1973 the increase in short-term rates had brought them to levels above those on long-term securities. Earlier in 1973 the cost of short-term accommodation had been substantially below that of long-term financing and this no doubt contributed to the rapid expansion of shorter-term credit. In general, long-term rates were ¾ to 1 percentage point higher by September than at the beginning of the year and, on balance, have since shown little change.

A chart showing movements in selected interest rates since the beginning of 1969 appears on the following page.

Interest Rates
Monthly



(1) Until November 1970 and after June 12, 1972, rates prevailing under interest rate agreements

Bank of Canada Operations

This chapter provides details of the operations of the Bank of Canada in 1973 related to the implementation of monetary policy, and of the Bank's operations as agent for the Government of Canada both in the management of the public debt and in connection with the activities of the Exchange Fund Account.

Monetary Policy

During 1973 the Bank of Canada so managed the cash reserves of the chartered banks that the banks' total assets were not permitted to rise in line with the rapid growth of their loans and mortgages.

The amount of "free" Canadian liquid assets(1) in the banking system fell substantially in the course of 1973 and by year-end the ratio of "free" Canadian liquid assets to total major assets had declined to 9.8 per cent, compared with 12.8 per cent at the end of 1972. The required minimum secondary reserve ratio was maintained at 8 per cent by the Bank of Canada and increasing amounts of treasury bills were therefore needed by the banking system to meet this requirement. In total, however, the banks' holdings of interest-earning Canadian liquid assets were at virtually the same level in December 1973 as they had been a year earlier.

In the face of strong credit demands the limitation on the growth of the banking system that was imposed through the pressure maintained on the banks' cash reserves led to the upward movement of interest rates that began early in 1973. The Bank of Canada raised its Bank Rate five times during the year to 7¼ per cent, where it has remained since September 13.(2)

The record of the chartered banks' cash reserve positions during 1973 is shown in Appendix Table I. Variations in excess cash reserves reflected principally the Bank of Canada's response to changes in the pressures in financial markets rather than alterations in the basic policy being followed. Thus on occasion during the year when there were particularly strong upward pressures on interest rates, cash reserves were run at somewhat higher levels than at other times, but these adjustments of the cash management stance were generally designed to moderate the upward movement of rates rather than to stop it.

The Bank of Canada was active in the securities markets throughout the year in connection with cash reserve management and at times for reasons related to market developments. During the year the Bank of Canada provided support to the market by buying bonds, principally short- and medium-term issues. As well as serving to

(1) "Free" Canadian liquid assets comprise the banks' holdings of cash, Government of Canada treasury bills and day-to-day loans in excess of minimum reserve requirements, plus Government of Canada bonds and call loans.

(2)

Effective date	Bank Rate
1971-October 25	4¾ per cent
1973-April 9	5¼ per cent
May 14	5¾ per cent
June 11	6¼ per cent
August 7	6¾ per cent
September 13	7¼ per cent

stabilize markets, these purchases assisted in the management of the public debt by reducing the amount of maturing issues that would be held outside the Bank at the time of their maturity. By the same token, these purchases increased the Bank's holdings of maturing bonds, and consequently have increased the scale of its participation in new issues.

In mid-year the Bank entered the market on a switch basis, selling near-term and medium-term bonds against purchases of bonds maturing in October and December of 1973. This was done to meet some of the demand that resulted from the reduction in the amount of Government of Canada bonds outstanding following the partial refunding of the July 1 maturity.

In September and again in November new issues offered in connection with the refunding of issues maturing on October 1 and December 1 attracted widespread investor interest and the Bank was able to supply additional bonds to the market both on a switch basis against near-term issues and for cash. In early November, and again in December when there was renewed pressure on short-term interest rates, particularly rates on short-term paper, the Bank entered into a programme of purchasing bankers' acceptances and continued to buy very short-term bonds. As well as cushioning the market against the pressures, these purchases facilitated cash reserve management during the seasonal rise in note circulation.

The monthly record of Bank of Canada transactions in Government of Canada securities during 1973 is shown in Appendix Table II.

During the year the Bank again used swap transactions with the Exchange Fund Account in the management of chartered bank cash reserves. These transactions involve the temporary acquisition by the Bank of Canada of foreign exchange assets under agreements for their resale to the Exchange Fund Account. They can be unwound, for example, in connection with open market purchases of securities or acquisition of new issues of Government of Canada bonds and treasury bills, as opportunities arise. In 1973 the Bank of Canada needed to add substantially to its assets in order to provide for the large increases in the amount of notes in circulation and in the required cash reserves of the chartered banks. The Bank increased its holdings of Government of Canada securities by $571 million during the year. In the Bank's view, purchases of Government securities on an even larger scale would have been inappropriate in the circumstances and additional assets in the amount of $370 million were acquired for the time being through swap transactions with the Exchange Fund Account.

Debt Management

The federal Government's net Canadian dollar financing requirements for domestic transactions were just under $1 billion for the calendar year 1973, an amount much lower than is expected for the fiscal year ending March 31, 1974. Ordinary foreign exchange transactions resulted in a net inflow of Canadian dollars to the Government amounting to $558 million. Furthermore, the swap transactions undertaken by the Bank of Canada with the Exchange Fund Account increased the Government's cash balances by $370 million over the year: in the absence of these transactions cash balances would have declined by $439 million. The outstanding amount of Government of Canada securities payable in Canadian dollars declined by $49 million in 1973.

A net total of $530 million was raised through sales of treasury bills by additions to the weekly auctions. Maturities of $400 million in special one-year treasury bills were rolled over during the year.

On four occasions the Government of Canada borrowed in the bond market, each time in connection with a maturing issue. The Government did not offer a public issue in connection with the July 1, 1973 maturity of $350 million. The Bank of Canada, which held $200 million of that issue, agreed to acquire $175 million of new bonds directly from the Government; the remaining $175 million of the maturing bonds were redeemed by the Government for cash. On the other hand, new funds were raised by the Government on December 1 when $600 million of bonds were

sold against only $525 million maturing. Details of these and other issues are given in Appendix Table IV.

The new issues sold in 1973 were of short- and medium-term maturity; bonds with extendible options were offered in two loans. The average term to maturity of outstanding unmatured marketable direct and guaranteed bonds shortened by two months over the year to five years, seven months.

The 1973-74 series of Canada Savings Bonds offered investors an average yield of 7.54 per cent over a twelve-year term and again included an interest compounding option. Net sales during the fourth quarter of 1973 were $243 million and at the end of the year the outstanding amount of Canada Savings Bonds was $384 million lower than a year earlier.

During the six-month period ending September 30, 1973 holders of 7¼ per cent April 1, 1974 bonds had an option to exchange them into an equal par value of 7½ per cent bonds due April 1, 1984. In total, $70 million of the bonds were exchanged, leaving $55 million of the original issue to mature in April 1974.

In June the Government repaid the loan of 250 million Deutsche marks that was negotiated in 1968. This repayment, effected through a reduction in foreign exchange reserves, did not affect the Canadian dollar position of the federal Government.

In February 1973, the Government cancelled $20 million of 5½ per cent August 1, 1980 bonds which it had previously acquired under provisions of the purchase fund for this issue, leaving $317 million of the issue outstanding.

Foreign Exchange Operations

During the various periods of rapid change in world currency relationships in 1973 the exchange rate for the Canadian dollar moved closely with that for the U.S. dollar, with both currencies falling in value in terms of most major currencies overseas in the first half of the year and rising in the second half. Weighted according to Canada's overseas trade, the Canadian dollar declined by over 12 per cent in terms of the currencies of our principal overseas trading partners from the beginning of the year to mid-year and had risen by the same amount by early January 1974.

The movement of the Canadian dollar in terms of the U.S. dollar in 1973 and the first two months of 1974 is shown in the chart on page 34.

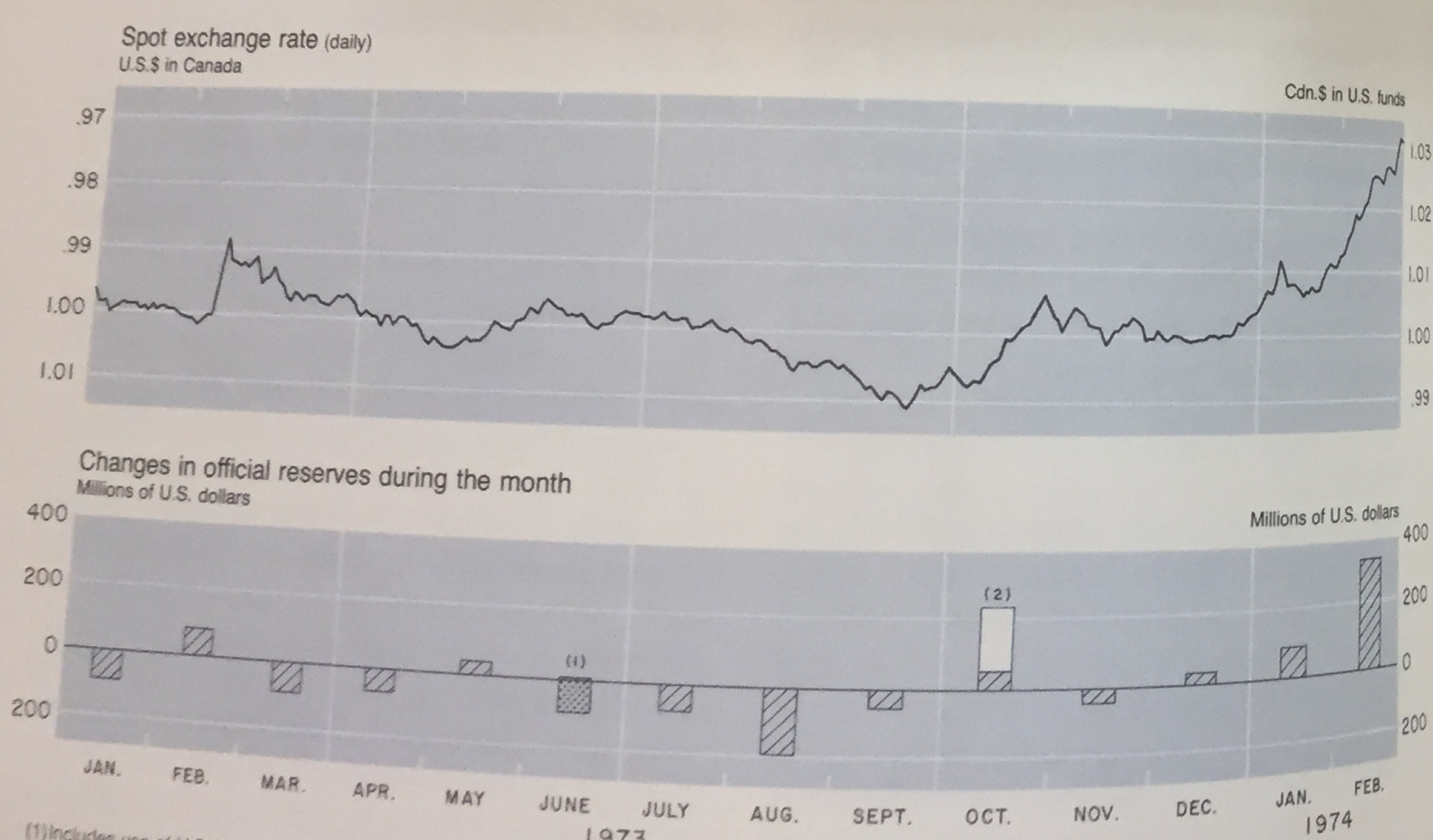
Government of Canada Financing, 1973

	Millions of dollars
Requirements	
Domestic transactions(1)	948
Ordinary exchange transactions	–558
	390
Financing	
Net par value changes in Canadian dollar debt outstanding — Treasury bills	530
— Marketable bonds	–195
— Canada Savings Bonds	–384
	– 49
Decrease in Canadian dollar cash balances(2)	439
	390

(1) Including an advance to the Exchange Fund Account to permit remittance of profits.
(2) Excluding the $370 million proceeds of an increase in temporary swap transactions between the Bank of Canada and the Exchange Fund Account.

During this period the Bank of Canada bought and sold U.S. dollars on behalf of the Exchange Fund Account to maintain orderly conditions in the market for the U.S. dollar in Canada. These operations account for the bulk of the monthly changes in the total of Canada's official international reserves shown in the chart below. Significant changes in official reserves also resulted from the drawing down in June of U.S. $94 million to repay maturing Government of Canada notes issued in 1968 and denominated in Deutsche marks, and from the revaluation in October by U.S. $185 million of Canada's holdings of gold, SDRs and other gold-based assets. In 1973 official reserves declined by U.S. $467 million excluding the October revaluation and by U.S. $282 million including it.

Exchange Rate and Official Reserves



(1) Includes use of U.S.$94 million to pay DM denominated notes at maturity
(2) Includes an increase of U.S.$185 million resulting from the revaluation of gold and gold-based assets

APPENDIX