Bank of Canada · Banque du Canada Ottawa K1A 0G9

February 28th, 1975

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 1974 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 sincerely,

Governor

Bank of Canada

Report of the Governor - 1974

General Observations

Like most of its trading partners, Canada has moved into a period of cyclical weakness in economic activity. Throughout the industrial countries the trend of output has slowed or turned downward and unemployment has been rising. Although the present economic environment is conducive to a moderation of the recent rapid pace of inflation, its effects on the trend of prices are only beginning to be felt and are being impeded by continuing rapid increases in costs. Meanwhile the world economy is struggling to deal with the balance of payments deficits and other difficulties arising from the quadrupling of oil prices a year ago. The world economy is thus currently confronted with an unusually difficult combination of problems. There is, however, a reasonable prospect that the low point in world economic activity will be reached before long and that some recovery in a less inflationary environment may be evident by the end of the year.

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The Canadian economy has experienced a marked slackening of the growth of aggregate spending and of output since the first quarter of 1974. At that time Gross National Expenditure in money terms was still rising at a rate of about 20 per cent a year, but in the middle quarters of 1974 the rate of increase fell back to 15 per cent a year, and in the final quarter it fell further. Demand has weakened both in foreign markets for many of our exports and in major elements of domestic expenditure such as outlays for new housing, automobiles and consumer durables. By contrast, demand for imported goods and services has remained relatively strong.

Up to the present the rapid pace of increase in the price level in Canada has continued largely unabated, although the forces propelling it have changed substantially. Prices in Canada are no longer subject to the influence of sharply rising international commodity prices nor, apart from a few exceptions, to the upward pull of excessive foreign and domestic demand on industries already producing to the limits of their capacity. Instead, prices are now being pushed up by cost increases in markets where sales are clearly lagging well behind our growing productive capacity. The prices of internationally-traded industrial materials have been softening since mid-1974. Signs have also begun to appear that this softening of prices may be spreading into the area of agricultural commodities. On the other hand, the prices of manufactured and processed goods are in general continuing to rise strongly. Since primary commodities bulk large in Canada's exports and manufactured goods in its imports, the current trends in international prices are reversing the benefits that we have gained over the past two years from the more rapid increase in the prices of our exports than of our imports.

With the flow of spending rising much less strongly than a year ago but with little perceptible slackening as yet in the rate of increase of prices, the volume of sales and output in the Canadian economy has levelled off, and in the closing months of 1974 contracted in absolute terms. In response to this downturn in production the growth of employment has also begun to slacken off, and the number of people reported as without jobs and seeking work has turned sharply upwards. The emerging weakness of demand has affected some industries and regions more than others; in the Prairie Provinces the flow of income has remained exceptionally strong. During the year Canada's international balance of payments on current account swung heavily into deficit, and by the fourth quarter the deficit had risen to an annual rate of around $4 billion.

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In most industrial countries the slowdown in economic activity began several months earlier than in Canada and has gone considerably further. For the whole group of OECD countries output in 1974 was little if any above that in 1973, and in Canada's three most important trading partners – the United States, Japan and Britain – it fell substantially below that of the previous year. In the United States the level of output by the fourth quarter of 1974 was down by about five per cent from that of the same quarter a year earlier, while output in Canada, though not as high as in the spring and summer, was nevertheless running at about the same level as in the final quarter of 1973. By January of this year the unemployment rate in the United States had risen to 8.2 per cent of the labour force; in Canada it had risen to 6.7 per cent. In both countries consumer prices have continued to rise rapidly at closely similar rates, but in recent months wage and salary increases in Canada have been running substantially higher on average than in the United States.

The course of events in the rest of the industrial world has varied from one country to another in respect of the timing and intensity of the slowdown in output, the pace of the continuing inflation of costs and prices, and the degree of weakness in balance of payments positions. In spite of such differences there has been a broad similarity of pattern reflecting the operation of common forces.

The origin of these common forces was the recent world-wide inflationary boom, a boom generated by the highly expansionary monetary and fiscal policies followed in virtually all of the major industrial countries in an effort to restore high levels of output and employment following the economic slowdown in 1970. This was a period of acute international monetary instability, and in retrospect it appears that policies in many countries were unduly influenced by fear of the domestic consequences of relatively strong exchange rates. In time these policies resulted in a rapid increase in public and private spending which was mutually reinforced through international trade. Production surged ahead in most countries at roughly the same time, and by 1973 had reached levels which tended to outrun world supplies of primary commodities. At the same time it created all sorts of other shortages and extremely tight labour markets. In these circumstances price increases grew larger, more frequent and more general. The inflationary process was substantially reinforced by shortfalls in supplies of food grains and animal feeds, and later by a four-fold rise in the world price of oil.

The world economy has now reacted to these cumulative excesses and it is, in a sense, in a state of hangover. It is trying, painfully, to work off the economic distortions that have occurred and to find its way back to economic stability.

During 1973 the highly expansionary financial policies that had led to the overloading of their economies were trimmed back in many countries. Had they not been adjusted these policies would have intensified the spreading distortions and imbalances, and invited even more serious economic trouble than the world is now experiencing. Moreover, when late in 1973 a number of countries heavily dependent on imported oil suddenly faced the prospect of massive balance of payments deficits, they had little choice but to take prompt action to moderate the excessively rapid growth of domestic demand.

In seeking to reduce the degree of demand pressure on their economies, none of the industrial countries was aiming at the drastic measures required to bring inflation to a halt in a relatively short period of time. The aim of most countries was rather to restore an adequate margin of spare productive capacity in an attempt to achieve over time a restoration of economic growth with reasonable stability of prices. The problem was greatly exacerbated by the oil situation but, nevertheless, subsequent events provide an illustration of how difficult it can be for countries to find and follow a relatively smooth path back to economic stability once the forces of inflation have been permitted to gain so much momentum.

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From early 1973 to the late summer of 1974 the monetary policy followed in Canada was directed at offering increasingly strong resistance to the excessively rapid growth of aggregate spending that was then occurring. Although the total quantity of goods and services that the Canadian economy is physically capable of producing cannot be expected to increase by much more than about five per cent annually, the rate of increase of national expenditure in money terms reached a peak of about 20 per cent a year as recently as late 1973 and early 1974. The longer such a high rate of growth of aggregate spending continued, the longer a high rate of inflation of the general price level would have been inevitable.

Throughout this period the Bank of Canada was trying to reduce the degree to which the insistent demand for credit was being accommodated through the process of monetary expansion rather than allowed to generate its own feedback effects in the form of progressively higher interest rates. The persistent rise in interest rates was very strongly reinforced by the influence of rapidly rising interest rates in the United States and Europe. As interest rates rose, the rapid rate of growth of the public's money holdings in the form of currency and demand deposits (the forms of money which serve as the principal medium for making payments in Canada) slackened both in absolute terms and in relation to the growth of national income.

During this same period the growth of the more broadly-defined money supply continued at high rates because there was a rapid and indeed accelerating expansion of the public's deposit holdings in interest-bearing forms, especially shorter term deposits. In recent years the banks have increasingly responded to periods of strong loan demand and cash reserve stringency by seeking to attract sizeable blocks of funds into term deposits offering both a highly competitive interest return and a significant degree of liquidity. During the recent period of generally rising interest rates the banks obtained large amounts of funds on this basis, both in the wholesale money market and from individual savers, which they used to continue to expand the flow of bank credit at a relatively rapid pace. This did not mean that monetary policy was ineffective in discouraging excessive spending based on credit but it did mean that the cutting edge of monetary policy was to a greater extent than in the past the rising cost of credit rather than non-price restrictions on its availability through particular institutional channels.

As the year progressed the Bank of Canada began to be concerned about too sharp a reversal of the recent strength of domestic demand. Prospects for an early revival of the pace of world economic activity were fading. At the same time signs were beginning to appear, in one area of the Canadian economy after another, that sellers' markets were turning into buyers' markets, as had already happened some months earlier in the United States and many overseas countries. The changing economic situation and outlook were also reflected in the move to a more expansionary fiscal policy in Canada.

From late summer onwards the operations of the Bank of Canada were aimed at facilitating an early downward adjustment of short-term interest rates. At about the same time a downturn in U.S. and international interest rates got under way, providing a favourable environment for the achievement of this objective. The full response of Canadian rates was delayed for a time, first by the impact of the Canada Savings Bond campaign and then by seasonal tightness in the money market around year-end. In January a sharp further downward adjustment occurred very quickly and the Bank's operations were then directed towards moderating the extent of the decline in money market rates. A new and substantially lower interest rate structure has now become general in this country.

Current interest rate levels in Canada are far below their peaks of last summer. The decline in short-term interest rates has been particularly great. Nearly all of the more sensitive short-term rates have declined by at least three percentage points and declines of five percentage points or so have occurred in some sections of the market. The declines in longer term bond yields and mortgage rates, although smaller, have been significant. Other institutional lending rates have fallen substantially. Money is, moreover, readily available at these lower interest rates. The Canadian capital market has become very active, providing large amounts of credit to numerous borrowers, many of whom are seeking funds in size.

Although the current level of interest rates in Canada may not look low by historical standards, it is very low relative to the rate of inflation. Unless the current rate of inflation declines more quickly than seems likely, investors in short-term fixed-interest instruments at present rates of interest will receive a negative real rate of return on their investments; the interest that they receive will be less than the decline in the purchasing power of their money. By the same token the real cost of money to borrowers is well below the expressed or nominal interest rates they pay; on certain types of short-term borrowings the real cost seems likely to be negative, too, at current rates. In this fundamental sense interest rates in Canada are now unusually low.

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The substantially easier credit conditions that have emerged in Canada are providing a favourable monetary climate for the recovery of the economy from the current slowdown. Even with a favourable monetary environment, however, the restoration of desirable levels of economic activity in Canada is unlikely to be quickly or easily achieved. A good deal will depend on what happens abroad, for Canada cannot be expected to regain its economic health and vigour without an upturn in economic activity in the United States and in other important markets for Canadian exports. But much will also depend on what happens in Canada in other fields. The inflationary excesses of the past two years have severely strained the satisfactory functioning of the economy in various ways.

At present the most evident of these strains is the very rapid increase in costs that is taking place in Canada. While an element of cost-push is typical of periods of economic slowdown, the rates at which the money incomes of various groups in Canadian society are now increasing are extraordinary. There is, in fact, an open race going on among these groups for larger increases in money incomes. Since the race is occurring in a period in which no increase in average real income per capita is being achieved in the economy, none of the participants can gain except at the expense of others. The activity is self-reinforcing because even the less aggressive groups in society feel compelled to assert themselves for fear of falling far behind. This in turn tends to make the competition self-defeating in that as others run faster it becomes harder and harder for any group to gain and hold a lead. Meanwhile the exercise is both socially divisive and economically counter-productive. The attempt by industries to pass large cost increases along to consumers runs the risk, in present circumstances, of a reduced volume of sales and lower production and employment. Industries facing foreign competition in Canada or abroad are particularly vulnerable because of the danger that the rapid increase in their costs of production will put them at a competitive disadvantage vis-à-vis foreign suppliers. The escalation of costs is also severely hindering rational investment planning on which the longer term prosperity of the economy depends. Nothing would do more to improve the prospects for the Canadian economy than a rapid slackening in the tempo of this race for higher money incomes.

Earlier reference has been made to the impact of recent events on Canada's balance of international payments. We appear now to have moved, at least temporarily, into a period of very large international deficits on current account, much larger as a percentage of Gross National Expenditure than we have experienced since 1960. To some extent this can be regarded as a cyclical phenomenon, reflecting the fact that so far in this world-wide business cycle demand in Canada has weakened less than in the main countries with which we trade. A related factor, and one that has become important since mid-1974, is that the prices of our imports are running ahead of the world market prices of our exports. To some extent our weakening trade balance is also an indirect consequence of developments in the world trade in oil. Although Canada is not heavily dependent on net imports of oil, most of our trading partners are, and some of the strains that they have felt in particular markets as well as in their general economic positions have spilled over on to us. Some of the current weakness in our international trade in automobiles and parts is presumably of this character. The movement to a greatly enlarged current account deficit underlines the concern that we should feel about the present strong upward trend of costs in Canada. It also means that we must preserve in Canada a financial environment attractive enough to provide the flow to Canada of the large amounts of foreign capital that we shall need to finance our deficit.*

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There are some encouraging aspects of the world scene that should not be overlooked. For one thing, the international economic environment is increasingly favourable to some moderation of the pace of inflation. For another, policy adjustments in a number of countries give reasonable grounds for hope that a more satisfactory rate of growth in the world economy will have emerged by the end of 1975 or early 1976.

* A Press Statement on February 27, 1975, by the Minister of Finance withdrawing the last remaining guideline on borrowing abroad by Canadians is reproduced as an Appendix to the Report.

It is also encouraging that the greatly enlarged balance of payments deficits of various countries heavily dependent on imported oil have not led to the widely-feared disruption of the international trade and payments system. International and intergovernmental arrangements are in the process of being expanded both to supplement private market channels for the recycling of petrodollars and to provide fall-back assistance for countries encountering particularly severe payments difficulties. Canada has played an active role in support of these initiatives both in the Interim Committee of Ministers of the IMF and in meetings of the Group of Ten and the OECD. These arrangements will be helpful in providing countries with more time in which to make the necessary adjustments to their changed economic situation. The underlying problem, however, is still very real and will not quickly be resolved. Even if ways continue to be found to cope with the serious international financing aspects of the problem, the need to adjust consumption, production and trade patterns to the present much higher relative price of oil will, at least for a considerable period of transition, make it very difficult to achieve the kind of growth in real output and real incomes that has come to be taken for granted in the postwar period.

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As has been emphasized in the foregoing discussion, many of the current problems of the world economy are related in one way or another to the high rates of inflation that we have been experiencing for some time now. They provide striking evidence of the fact that inflation does not offer an easy route to sustained good economic performance. The origins of the current inflation lie to a considerable extent in the over-reaction of fiscal and monetary policy in many countries to the economic difficulties of the early 1970s. The problem of inflation is much more serious now than it was then, and it is therefore of the greatest importance that, in striving to restore satisfactory levels of economic activity, national authorities should not, in the end, over-react on this occasion as well. If they do, the prospects for reversing the drift towards an increasingly inflationary society throughout the world will be poor indeed.

Although Canada's present economic circumstances are unpleasant and difficult, the longer term prospects for the Canadian economy are excellent if Canadians can manage to prevent cost and price inflation from undermining the economy's ability to function efficiently at home and to compete strongly in international trade. In its conduct of monetary policy the Bank of Canada has been promoting domestic credit conditions conducive to the resumption of economic growth in Canada. At the same time the Bank is bearing very much in mind that a moderation of inflation is essential to Canada's longer term interests.

Economic Developments

Against the background of unfavourable economic conditions in the outside world, output and employment were relatively well sustained in Canada in 1974. The reduced availability of international oil supplies in the early part of the year had little direct impact on economic activity in this country. Domestic spending remained relatively strong until well into the year, with business investment in expanded production facilities in particular continuing to provide strong support to the economy. However, as the year progressed the developing cyclical downturn abroad came increasingly to bear on demand and prices for Canada's major exports. In addition, some sectors of domestic demand which had been extremely buoyant began to soften; this was especially true of spending on housing, automobiles and other durable goods. With domestic demand still relatively strong, however, imports continued to rise rapidly, and in the second half of the year Canada was faced with an adverse movement in its terms of trade and a marked deterioration in the current account of the balance of payments. Towards year-end output declined, the growth of employment tapered off, and unemployment began to rise. At the same time, domestic prices continued to rise at a rapid rate and efforts by wage and salary earners to maintain and, in some instances, to improve their relative positions resulted in strong upward pressure on the structure of domestic costs.

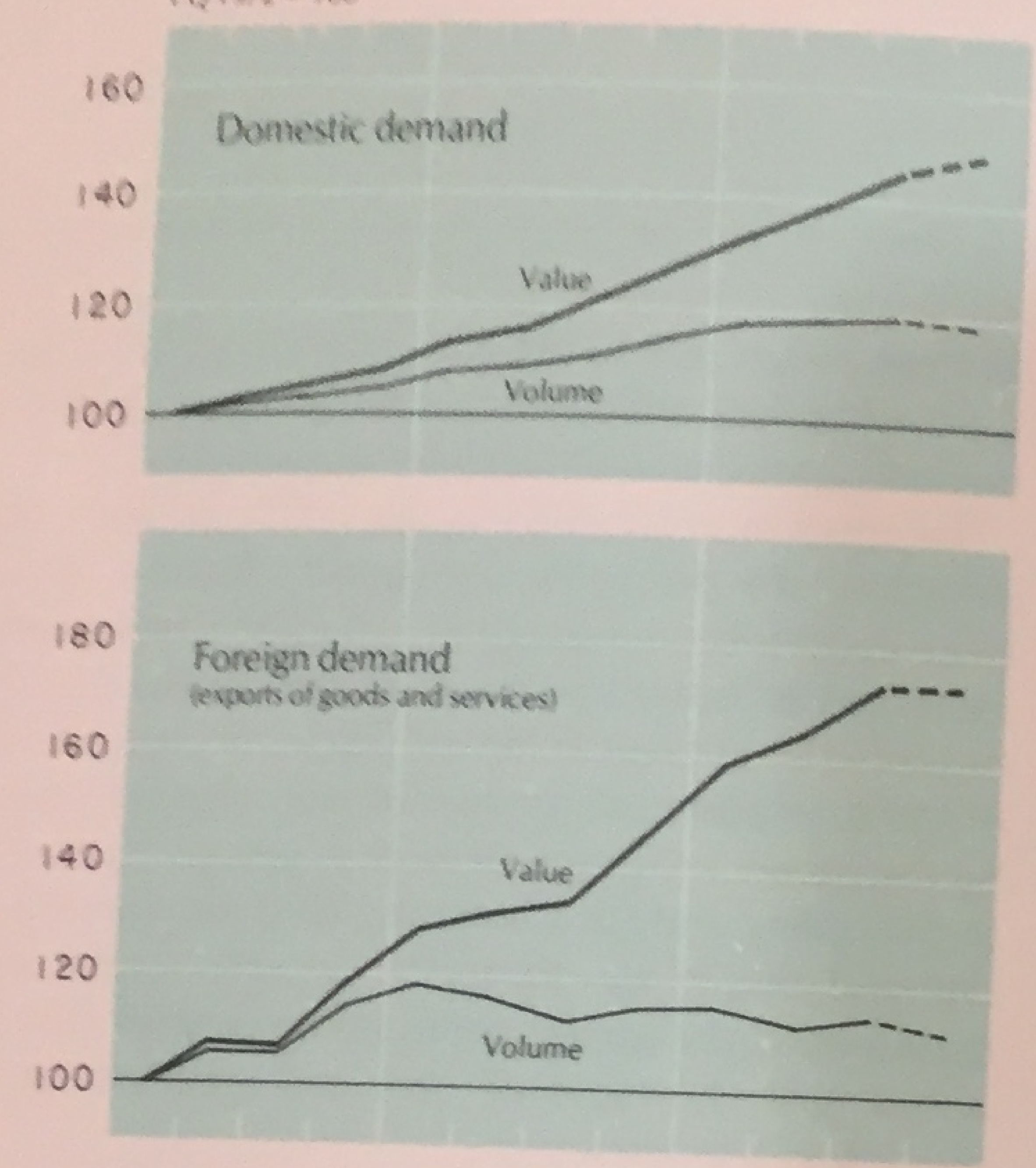
Preliminary official estimates of the National Accounts for the fourth quarter of 1974, together with any revisions to earlier quarters, are not yet available as this Report is being written. However, the information at hand suggests that total spending in money terms in Canada averaged some 17 per cent higher in 1974 than in the previous year. Most of the increase in spending reflected a rise in the over-all price level of about 13 per cent. The growth in real output of goods and services, approximately 3½ per cent on a year-to-year basis, was appreciably less than recorded in each of the three preceding years and was confined to the early part of 1974. Following sharp gains in the closing months of 1973, total real output continued to expand at a very high rate in the early months of 1974, but it then remained approximately flat at a peak level until the last quarter when it declined appreciably.

The spurt in production in late 1973 and early 1974 added to the pressures on capacity that had already been experienced during 1973, thereby limiting further increases in output in the short-run. Strains also continued to be evident in the job market throughout much of 1974. In addition, production was adversely affected by the heavy incidence of work stoppages, particularly in the spring and early summer. With the weakening of demand that began to appear in some sectors of the economy in the spring, pressures on capacity gradually eased and shortages of men and materials became much less prevalent.

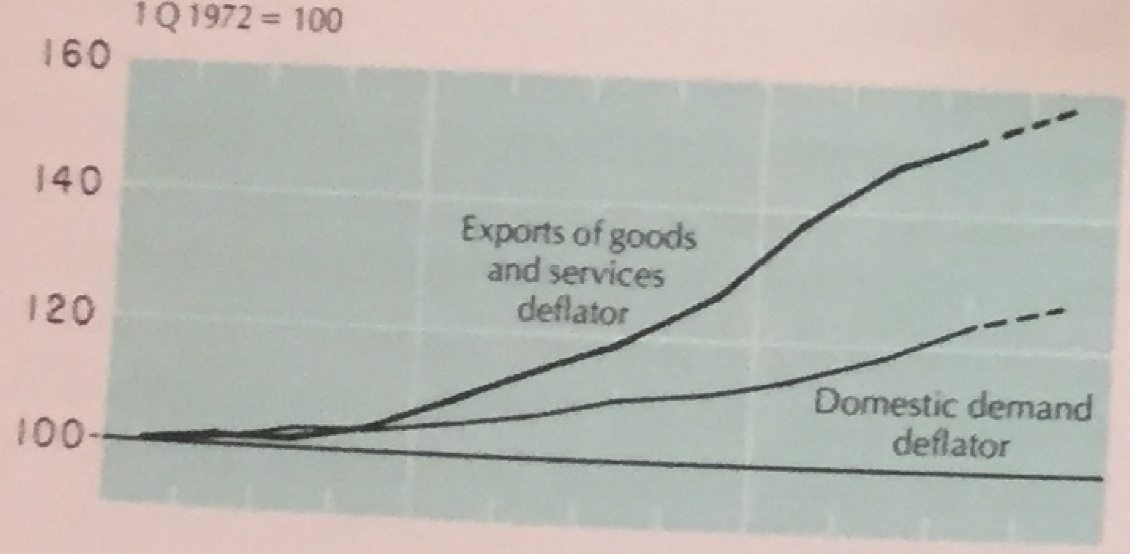
One of the remarkable features of 1974 was the unusual degree of divergence that developed between the Canadian and U.S. economies. As is illustrated in the chart on page 13, total demand in both nominal and real terms underwent a much earlier and more pronounced easing in the United States than occurred here. U.S. Gross National Product at current prices was approximately 8 per cent higher in 1974 than in the previous year, an increase that was only about half as large as that estimated for Canada. With U.S. prices rising at fairly similar rates to those here, most of the difference in the climate of demand was reflected in the performance of real output. GNP in volume terms peaked in the last quarter of 1973 in the United States and declined throughout 1974; for the year as a whole it averaged more than 2 per cent below its level for 1973 and in the last quarter of 1974 it was running 5 per cent lower than a year earlier. This compared with an estimated increase of about 3½ per cent on a year-to-year basis in Canada and apparently little net change from year-end to year-end. In both countries employment was remarkably well sustained relative to output through most of 1974, but unemployment began to rise dramatically in the United States towards year-end and in January 1975 the seasonally adjusted unemployment rate in that country was 8.2 per cent compared with 6.7 per cent in Canada.

Major Economic Indicators
Seasonally adjusted

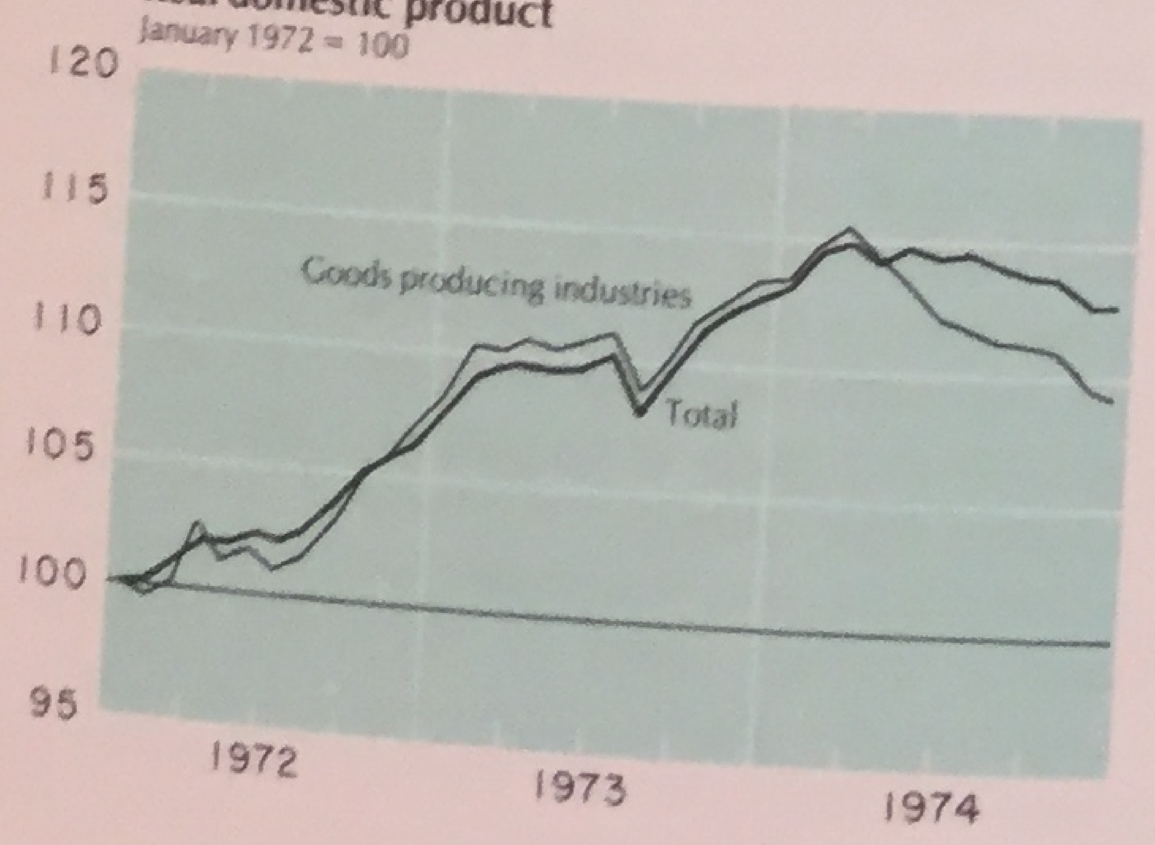
Demand
1Q 1972 = 100



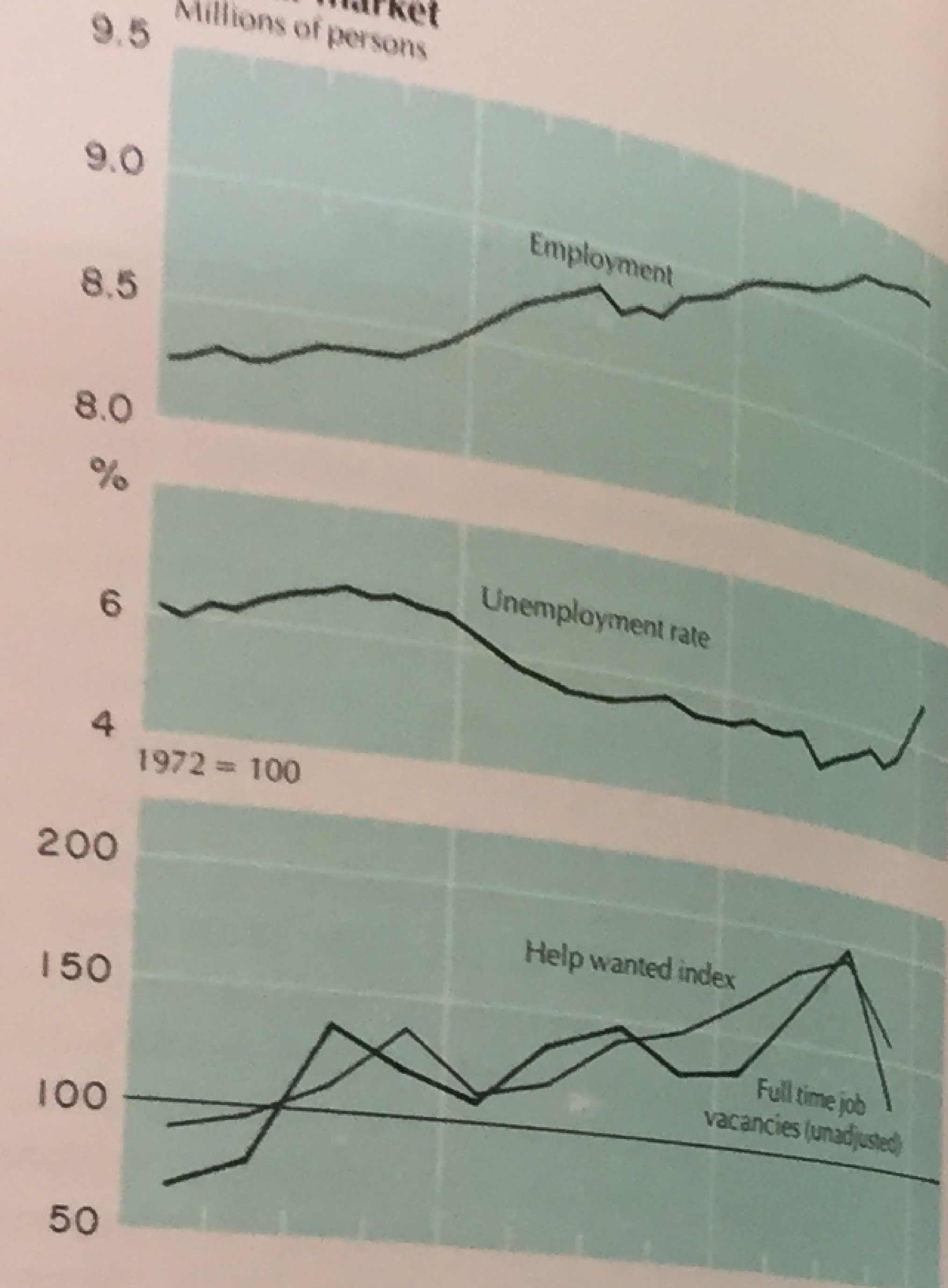
Prices
1Q 1972 = 100



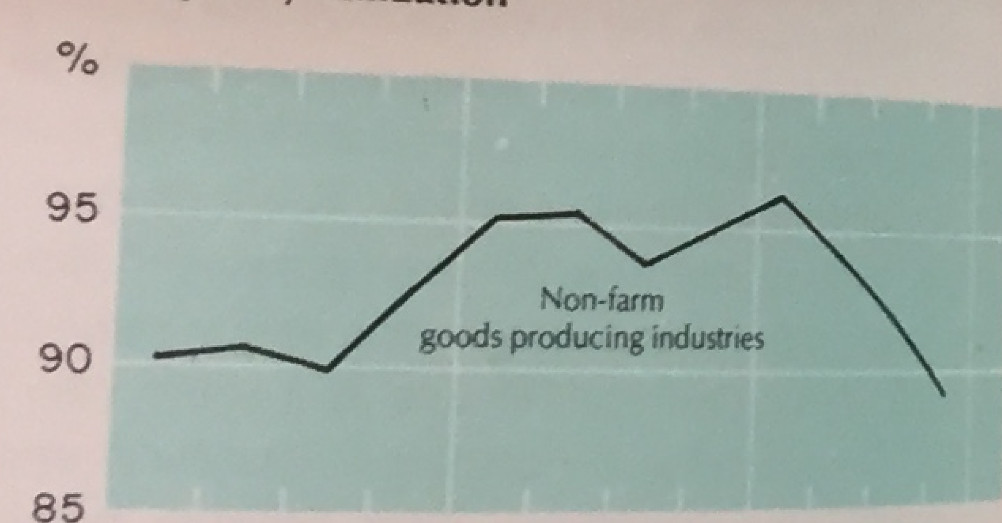
Real domestic product
January 1972 = 100



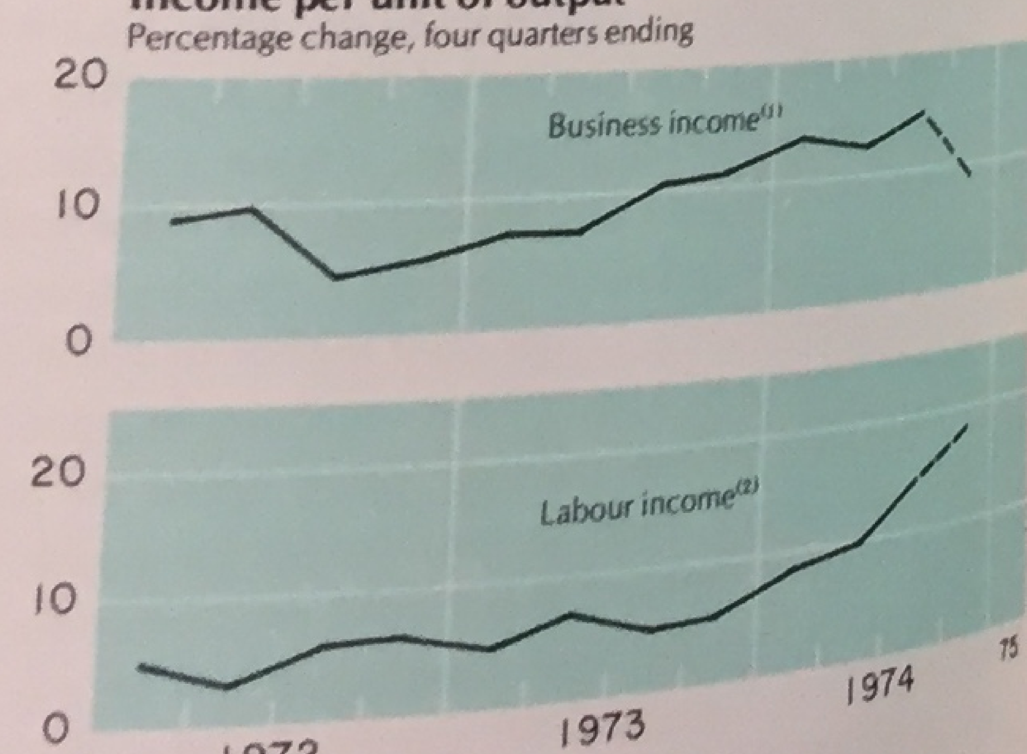
Labour market
Millions of persons



Capacity utilization



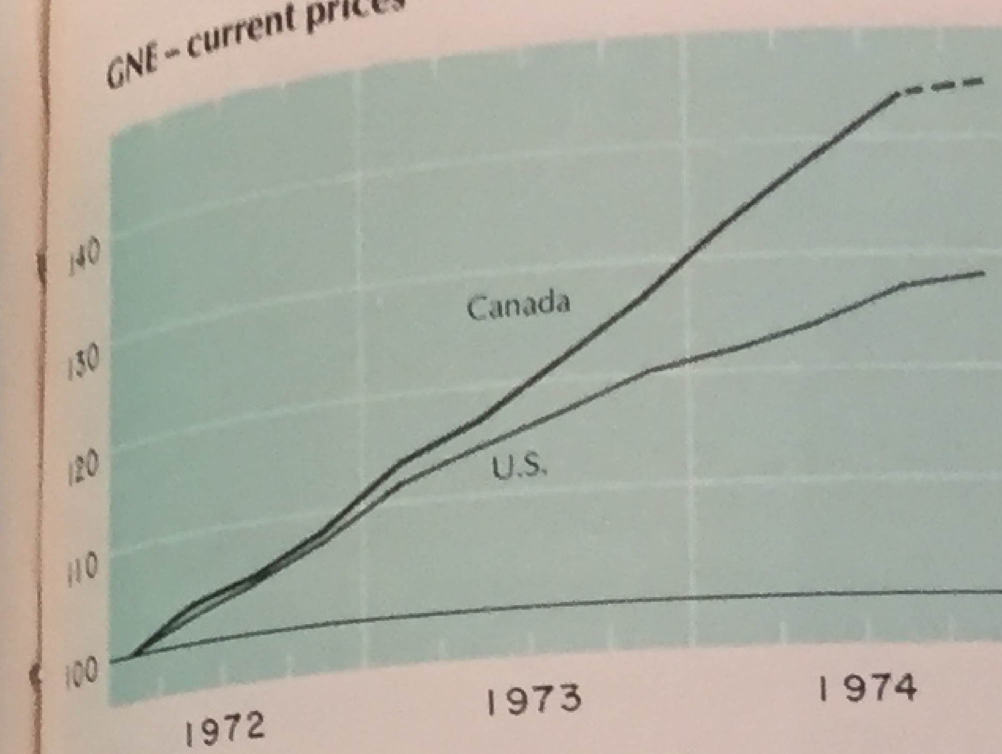
Income per unit of output
Percentage change, four quarters ending



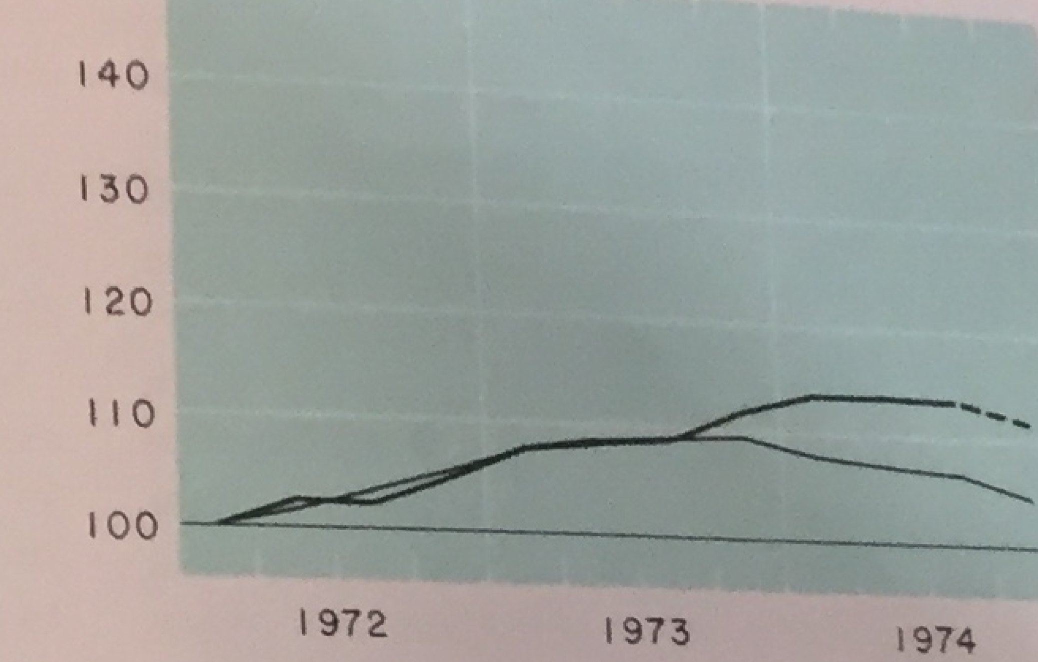
(1) Corporation profits, non-farm unincorporated business income, corporate capital consumption allowances and the inventory valuation adjustment
(2) Wages, salaries and supplementary labour income

Selected Indicators: Canada-United States
1Q 1972 = 100, seasonally adjusted

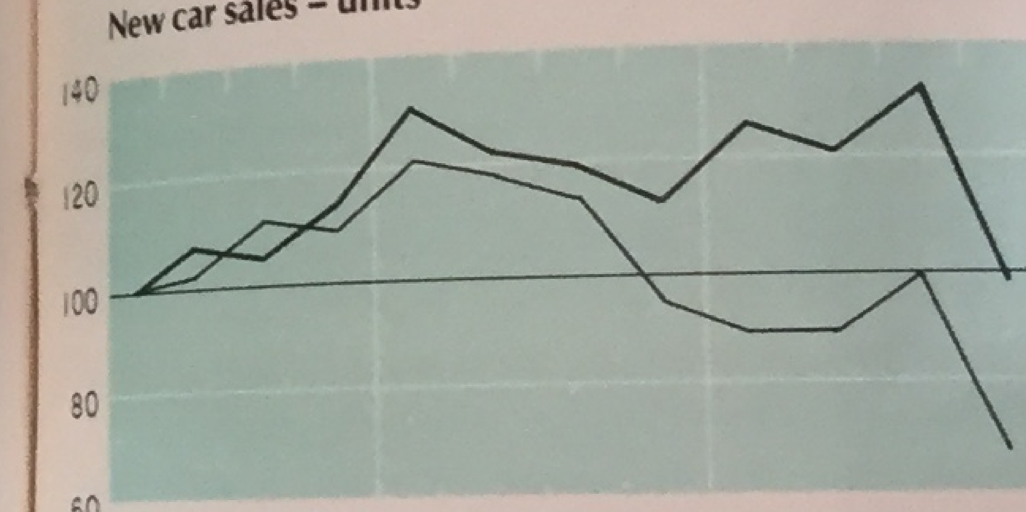
GNE – current prices



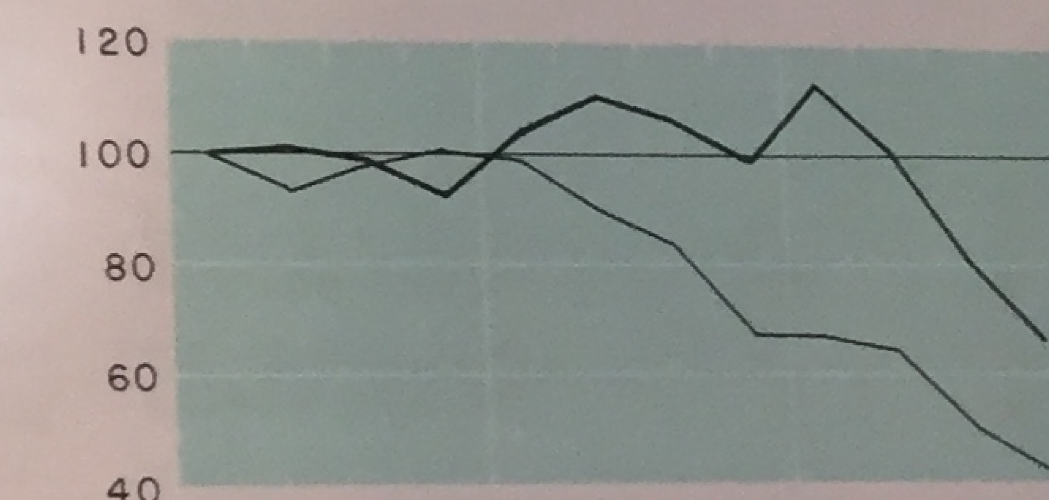
GNE – constant prices



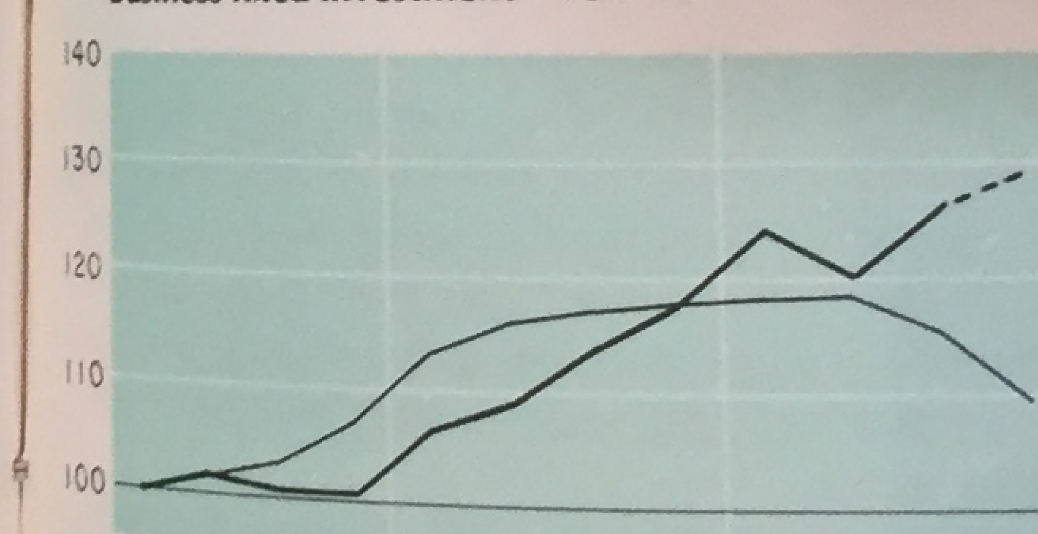
New car sales – units



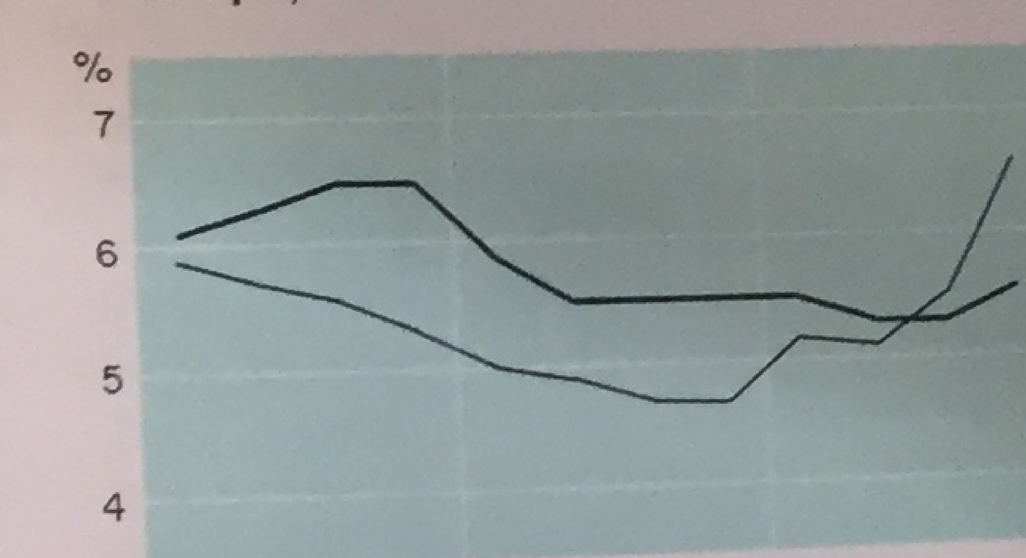
Housing starts – units



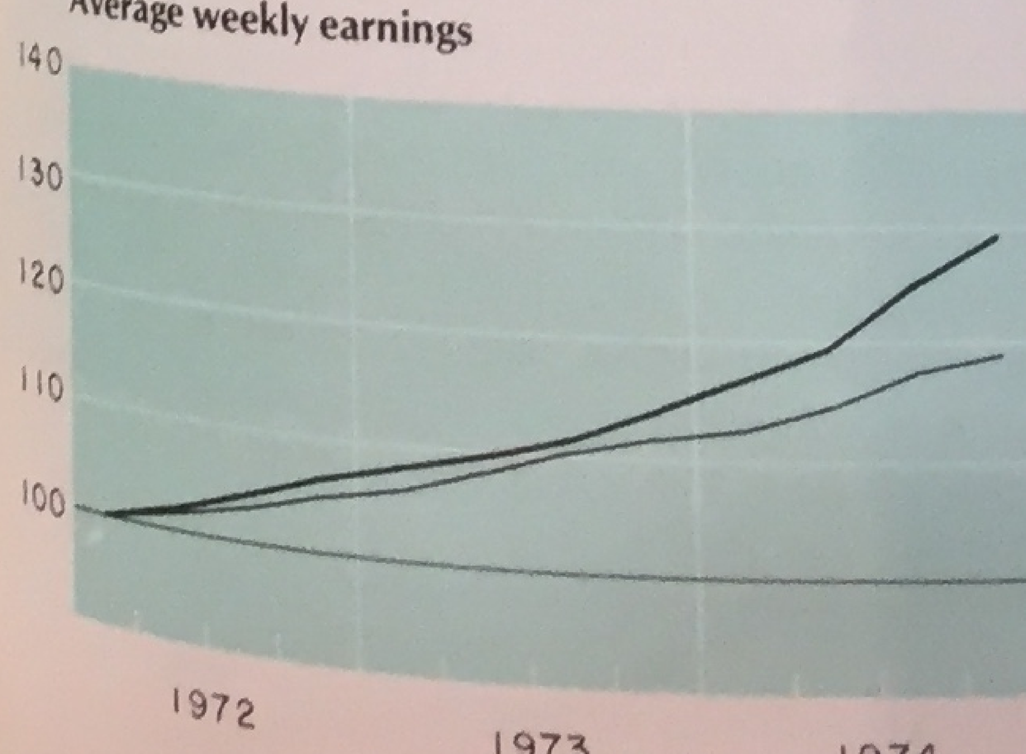
Business fixed investment – volume



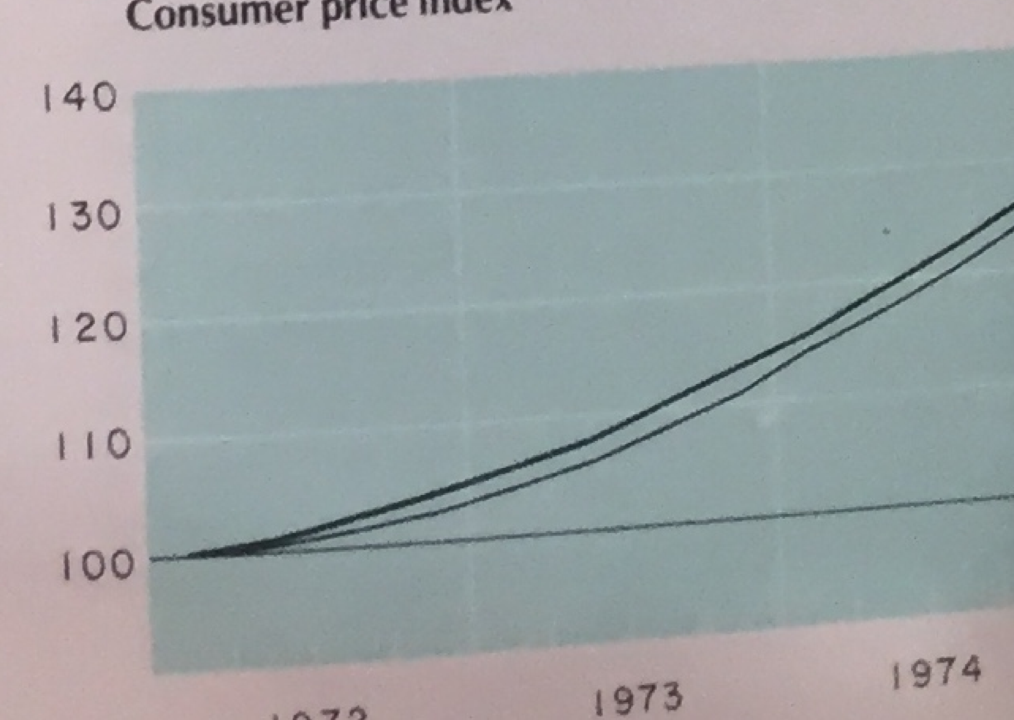
Unemployment rate



Average weekly earnings



Consumer price index



Despite the similarities in price performance in Canada and the United States in 1974, some significant signs of divergence on this front were also beginning to appear by year-end. Some underlying U.S. price and cost indicators have recently appeared to be much more favourable to a near-term moderation of inflation than is the case for Canada. Although unit labour costs have risen very rapidly in the United States, partly because of an even more adverse productivity performance than we have experienced in Canada, wage and salary levels have been rising at a much more modest rate there than here. Increases in weekly wages have not registered any very pronounced acceleration in the United States and, from at least mid-year, wage settlements in that country appeared to be running at about half the scale of increases being established in Canada.

Domestic and External Demand

According to the national accounts estimates for the first three quarters of 1974, domestic spending in nominal terms increased at the very high annual rate of close to 20 per cent, approximately the same pace as in the second half of 1973. Domestic price inflation was accelerating strongly however, and the rise in demand in volume terms slowed markedly from the extremely strong pace registered during 1973. In the final months of the year the growth in nominal spending appears to have undergone a pronounced moderation, and in real terms domestic demand evidently declined.

Most of the slowing in real domestic demand was concentrated in personal demand for durable goods and in housing, areas where particularly strong increases had been registered prior to 1974. In contrast to the experience in the United States, new car sales, which account for a major share of durable purchases, remained strong in Canada through last winter and even rose further during the summer. Since then, however, and roughly coincident with the changeover last autumn to the current model year, sales have weakened considerably, although not nearly to the extent recorded in the United States. Housing starts peaked at extraordinarily high levels in early 1974 and declined through the balance of the year. For 1974 as a whole starts totalled approximately 220 thousand, but in the final months of the year they were running at an annual rate of some 170 thousand units. The falling off of housing construction appears to have been due to a number of factors including rising costs of land and of housing construction, increased uncertainty about the adequacy of returns on new rental units, and higher interest rates on mortgages. There was also some reduction in the availability of financing, particularly for more expensive homes, although this situation had eased somewhat by year-end.

In other sectors of domestic demand indications are that the volume of purchases remained buoyant throughout 1974.

Notwithstanding the escalating costs of capital equipment and construction, business fixed investment in real terms registered its second successive year of strong gains and resulted in a further sizeable addition to the capital stock. Especially large investments were made in such industries as steel, chemicals, and pulp and paper where capacity constraints had been particularly pronounced. According to the survey information on investment intentions released in February 1975, as of the beginning of the year businesses planned to spend (in current dollars) some 18 per cent more on fixed investment this year than in 1974. Although this rise in spending would be significantly below the 24 per cent increase reported for 1974, it would nevertheless seem to promise a further sizeable gain in volume terms as well as in value.

Businesses also accumulated inventories at a rapid pace in 1974, though the forces behind inventory investment appear to have shifted considerably in the course of the year. In view of the shortages prevailing during the initial months, it is clear that the stockpiling that took place at that time was generally fully planned. Indeed, inventory investment over-all may have fallen short of intentions. With the flattening out of real final demand in the latter part of the year, however, the accumulation appears to have included a large unintended component. This was clearly the case in the automotive sector.

Outlays on goods and services by all levels of government rose strongly in 1974. Spending on goods and services by the federal Government rose at a particularly sharp pace. Transfer and subsidy payments by governments to other sectors of the economy also advanced at a much faster rate than in 1973, in part because of measures taken to mitigate the impact on consumer budgets of the rise in the cost of oil and certain other basic items, and partly on account of steps taken to offset the effect of higher living costs on the purchasing power of transfer recipients.

In 1974, the value of exports continued to rise very

Major Demand Aggregates

1972 = 100, seasonally adjusted

sharply during the first part of the year; oil prices increased sharply, but there was also a continued climb in the prices of farm products and a number of key industrial material exports. The volume of exports, which had levelled off after the first quarter of 1973, stayed flat during 1974. For the recent period this sluggishness in merchandise export volumes has reflected a combination of factors. Supply constraints continued to be operative in some areas, and the progressive weakening of economic conditions abroad resulted in a corresponding easing of real demand for Canadian exports. In the face of the severe downturn in residential construction in the United States, lumber exports registered a particularly pronounced weakening during the year in both value and volume, but declines in the volume of exports were also evident across a broad range of primary commodities. This weakening of real demand during 1974 was reflected increasingly in export prices as the year progressed.

Production and Imports

Total output in the Canadian economy, as measured by Real Domestic Product, reached a peak in March after having expanded at an annual rate exceeding 10 per cent in the previous half year. In the final months of 1973 much of the increase in production evidently constituted a rebound from earlier strike-depressed levels, but the further strong rise through the first months of 1974 pushed production in many areas still further into the zone of peak operating rates. The rate of capacity utilization in the non-farm goods producing sector in the first quarter of 1974 was virtually the same as during the peak period of tightness in late 1965 and early 1966. For manufacturing the estimated operating rates were higher than in any other quarter over the period covered by the series, which dates back to 1961.*

In the aggregate, output remained virtually at the March peak until well into the autumn of 1974. Initially, in an environment of widespread shortages compounded by the impact on production of major work stoppages, it appears that supply constraints were a determining factor in the flatness of output. However, as the year progressed signs of a softening in real demand increasingly appeared, particularly in goods producing industries, and in the final months of the year production was down from earlier peaks by an appreciable amount in all major sectors.

The weakness in production that developed during 1974, together with continued strong additions to the capital stock, resulted in a progressive easing of capacity pressures in the latter part of the year. In some areas, however, particularly the capital goods industries, operating rates were still relatively high at year-end, although shortages had largely ceased to be a problem.

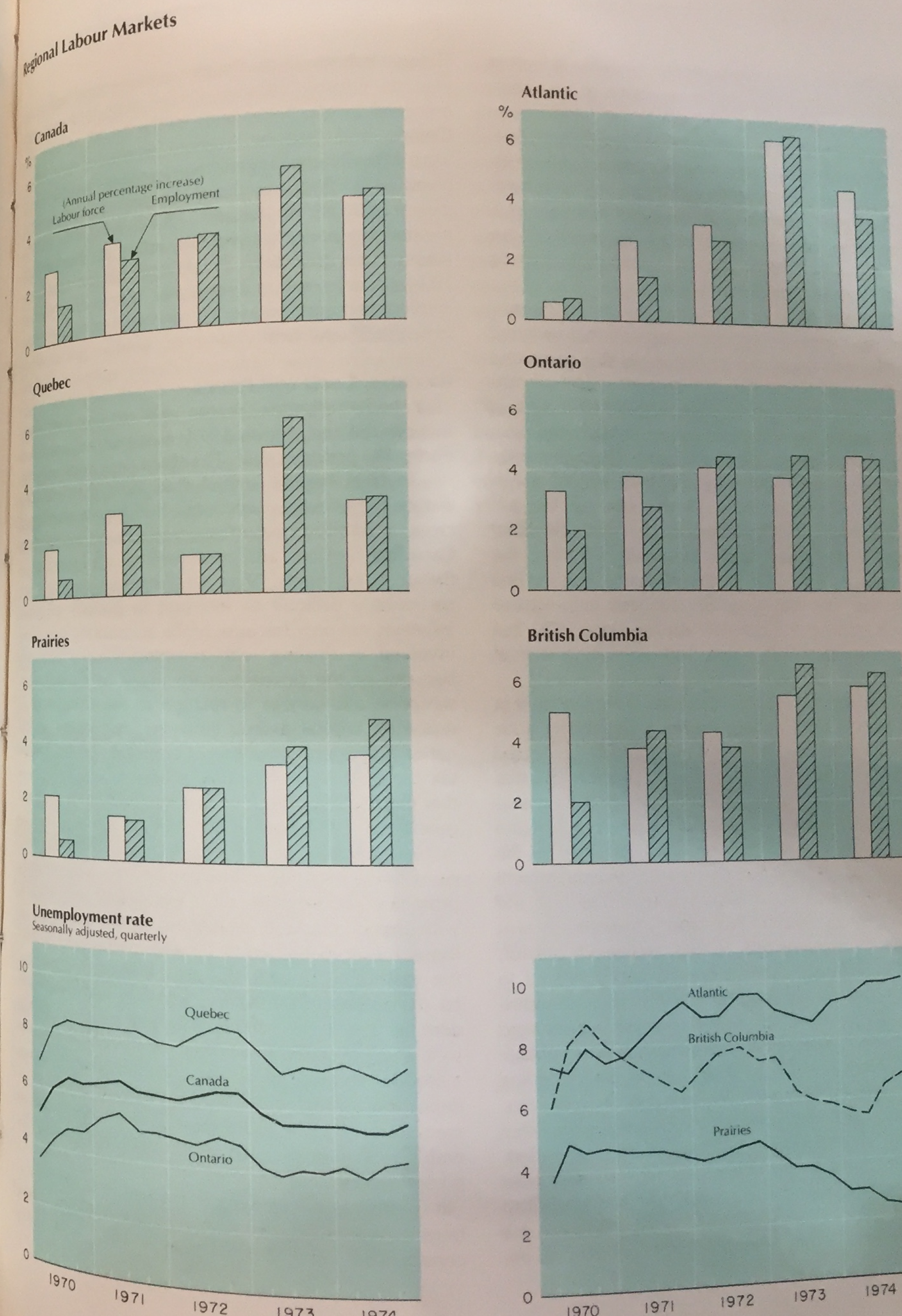
The relatively well sustained level of domestic demand in Canada, particularly in comparison with other countries, contributed to a strong rise in imports in 1974. Indeed, imports again apparently ran well ahead of domestic demand in terms of both value and volume. Imports of investment goods rose particularly sharply, but the strength was broadly based. The rise in import prices tended to slow somewhat in the second half of 1974, but this was attributable largely to the absence of any further rise in oil prices on the scale registered earlier in the year. In a number of other areas, particularly finished goods imports, price increases were very large throughout 1974. In the second half of the year import prices rose faster than export prices for the first time in two years. For the year as a whole the current account deficit increased sharply from $400 million in 1973 to close to $2 billion for 1974 and in the last quarter it was running at an estimated annual rate of about $4 billion.

Labour Markets

The net increase of 4¼ per cent in employment registered for 1974 was somewhat less than for the previous year but was still well above average. It was also appreciably larger than the year-to-year gain in total output. In contrast to the flattening out and decline in production, employment continued to expand, though at a decelerating rate. In the final quarter of the year it averaged more than two per cent higher than nine months earlier whereas real output declined over the same period. A slowing of output growth relative to employment is not an unusual cyclical development, but the recent drop in production per worker has been extraordinarily large. More in accordance with the recent path of output, employment remained flat on a seasonally adjusted basis in December and declined in January.

Labour force growth was also very high on a year-to-year basis, averaging approximately 4 per cent for 1974.

*For a description of this measure, see the *Bank of Canada Review*, September 1974.



As in the case of employment, and probably at least in part in response to the slower expansion of job opportunities, the increase in the number of labour force participants tended to slacken in the latter part of 1974. The slackening was not very pronounced, however, and the over-all seasonally adjusted unemployment rate fluctuated around 5⅓ per cent until near year-end. It then increased to 6 per cent in December and 6¾ per cent in January 1975, due in considerable part to lay-offs in the automobile industry.

Clear evidence of labour market pressures was provided by the very strong increases in help-wanted advertising and reported job vacancies that continued into the autumn of 1974, but in more recent months some easing has been evident in these indicators of labour market conditions as well as in measured rates of unemployment. In the fourth quarter both the series on job vacancies and the index of help-wanted advertising underwent declines. In the case of the job vacancy series, which extends back only to the third quarter of 1970 and is not seasonally adjusted, the year-to-year decline for the fourth quarter was the first on record. For the seasonally adjusted help-wanted index it was the first quarterly decline since 1970, but the index was still at a very high level by historical standards.

The only region to show a faster rise in employment in 1974 than in 1973 was the Prairies where the increase of 4¾ per cent was the largest on record and reflected the sustained buoyancy of economic conditions in that region through the year. British Columbia and Ontario also had strong employment gains – 6¼ per cent and 4½ per cent respectively, or nearly as large as the increases in 1973 – but the growth of employment slowed markedly in the final months of the year and into 1975. In Ontario this latter development was particularly pronounced in the automotive sector, while in British Columbia it was largely related to softening economic conditions in the resource industries. Quebec and the Atlantic region experienced employment increases that were almost 2¾ percentage points less than the very high rates of the preceding year. Labour force growth slowed markedly in Quebec and the Atlantic region while accelerating in the other regions. The unemployment experience was varied. For the Prairies the unemployment rate fell over one percentage point to 2.8 per cent and for British Columbia the rate dropped to 6 per cent from 6½ per cent in 1973. While unemployment continued to decline on balance in the Prairies in the second half of the year, in British Columbia it rose after mid-year and averaged nearly 7 per cent in the fourth quarter. In Ontario and Quebec average unemployment rates were virtually unchanged from a year earlier, but were rising in the final months of the year as employment growth slowed; in January 1975, the Ontario rate jumped to 6 per cent seasonally adjusted. Even though labour force growth for the Atlantic region slowed in 1974, it was still substantially above the rise in employment and the average unemployment rate rose to nearly 9¾ per cent.

Incomes, Costs and Prices

For both corporate profits and net accrued farm income the rise during 1974 was much slower than during the previous year. The sharp deceleration in the rise in farm income, which had more than doubled during the previous year, reflected the smaller grain crop, a levelling out of average prices received by Canadian farmers, and continued strong increases in the costs of inputs. Data on corporate earnings are particularly difficult to interpret in periods of rapid inflation, not only because of the accounting problems involved in dealing with inventory profits but also because of the possible inadequacy of capital consumption allowances in relation to the rising cost of replacing capital assets. However, according to the national accounts measure of corporate profits before tax but excluding inventory profits, it would appear that the rise over the four quarters ending in the final quarter of 1974 was about a third as large as the increase of close to 30 per cent during 1973. In 1973 gains by the resource industries had been a particularly prominent feature of the profit expansion, and in 1974, with export markets weakening, profit increases in those industries tended to slacken markedly. The easing was not confined to this area, however. In particular the automobile industry, which is heavily dependent on the U.S. market, experienced a substantial weakening in profits in the final months of the year. For a broader measure of business income, that is, before deducting capital consumption allowances, the increase during 1974 also appears to have been considerably less than the rise of 18 per cent during the preceding year.

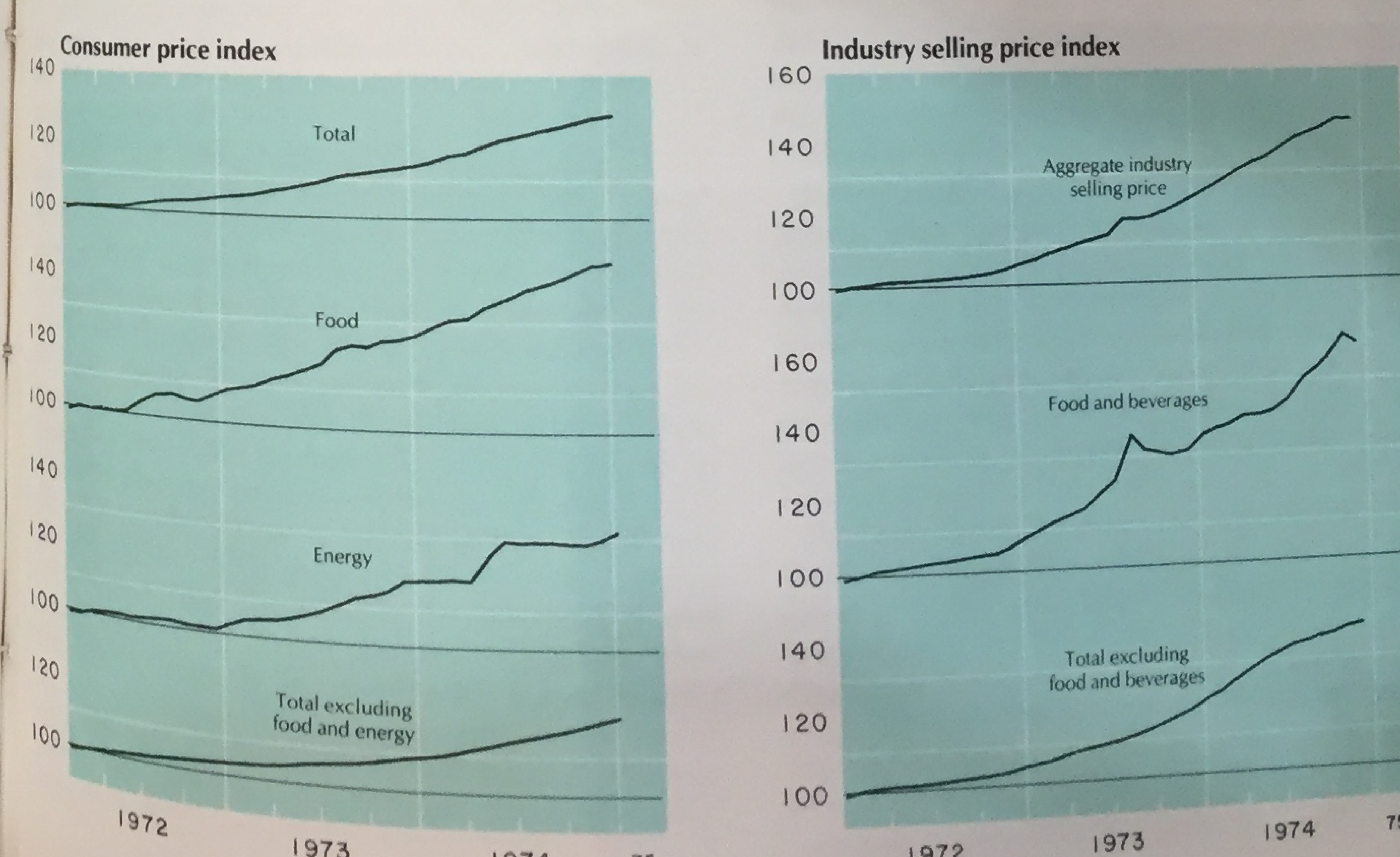
In contrast to the slowing in the rise in business and farm incomes, labour income is estimated to have risen considerably faster in 1974 than in 1973 – by more than 15 per cent over the year ended with the fourth quarter of 1974 after an increase of 12 per cent during the previous year. With the slower rise in employment in 1974, the acceleration was even more marked for average labour income per worker. The pattern of accelerating wage increases that is suggested by the available estimates of labour income is also apparent in the statistics on average weekly earnings in the commercial non-farm sector. By the final months of 1974 the year-to-year percentage increase in average weekly earnings had risen to over 13 per cent; for manufacturing, where an hourly earnings index is available, average hourly earnings were more than 17 per cent higher than a year earlier.

Newly negotiated wage settlements, which tend to foreshadow actual earnings, have escalated dramatically over the past year. In the final quarter of 1974 settlements under major collective bargaining agreements (excluding construction) provided for average annual increases in base rates of more than 17 per cent over the life of contracts, compared with an average of 10 per cent a year earlier. It should be noted that these statistics understate the size of settlements since they do not take into account clauses providing for further wage or salary adjustments contingent upon increases in the Consumer Price Index; such cost-of-living clauses became increasingly prevalent in contracts signed over the past year. Also, in many instances rates of pay were increased in 1974 through the re-opening of existing contracts or through other special adjustments.

Canadian domestic prices at both the wholesale and retail levels rose even faster in the aggregate during 1974 than in 1973. For the twelve months ended December 1974 the Industry Selling Price Index (ISPI) increased by 21 per cent compared with 16 per cent during the previous year. For the Consumer Price Index (CPI) the corresponding increases were 12½ per cent in 1974 and 9 per cent in 1973.

At the ISPI level, while the monthly increases in the

Selected Price Measures
1Q 1972 = 100, not seasonally adjusted



aggregate continued to be very large throughout the year, in the second half of 1974 some easing emerged in a number of areas, notably textiles, primary metals, and wood products. In all these sectors the slowing reflected the corresponding weakness in commodity prices that had developed some months earlier. In the case of wood products the ISPI was appreciably lower than a year earlier. This was reflected in an easing in domestic building materials price indexes, particularly for residential construction, although construction costs over-all continued to increase rapidly under the pressure of rising wage and other costs.

All major categories of the CPI recorded very large increases between the beginning and the end of 1974. For food the increase was 17 per cent for the second year running. Energy prices (fuel oil, domestic gas, electricity and gasoline) also registered a further substantial increase, 9½ per cent, although they would have gone much higher had it not been for the programme of domestic petroleum price restraints and consumer subsidies. For the remainder of the index, which makes up approximately two thirds of the total CPI basket and is more heavily influenced by the underlying trend of domestic costs than the other two components, the rise in 1974 was 10¾ per cent, which is double the rate of increase experienced in the previous twelve months.

Financial Developments

The highlights of financial developments in Canada during 1974 are discussed in the three sections of this chapter, which deal with interest rates, with the growth of the public's holdings of currency and bank deposits, and with flows of credit to borrowers.

Interest Rates

Since changes in the cost of money and in returns on financial assets are the main channel through which the impact of monetary policy is transmitted to spending and saving decisions, the Bank focuses considerable attention on the behaviour of interest rates. Short-term interest rates in the Canadian money market are of particular importance to the Bank in its day-to-day operations. These rates respond sensitively to changes in the pressure of credit demands on the available supply of funds in Canadian financial markets and to changes in international money market rates. They are also the rates most immediately susceptible to the influence of the Bank of Canada's cash reserve management.

During 1973 interest rates in Canada, as in the rest of the world, had been rising strongly. The upward movement of short-term money market rates in Canada and abroad was interrupted for a time in the early months of 1974 in the immediate aftermath of the world oil emergency but, after a limited and temporary decline, strong upward pressure on these rates re-emerged towards the end of the first quarter. These pressures continued through the spring and Canadian short-term interest rates rose to levels well above those reached in 1973. They remained at high levels until late August, although somewhat below corresponding rates in the United States and in the Euro-dollar market where the upward trend continued into the summer. The Bank of Canada adjusted the Bank Rate upwards by one percentage point in mid-April and by further steps of one half of one percentage point in mid-May and in the latter part of July, when the Rate reached 9¼ per cent.

Administered borrowing and lending rates of financial institutions also rose further after the first quarter of 1974 as these institutions continued to bid aggressively for funds in order to meet the heavy credit demands they were experiencing. The "Winnipeg Agreement" ceiling on large Canadian dollar short-term bank deposits was raised from 8½ per cent to 10½ per cent in three steps between mid-April and the end of July, and chartered bank prime lending rates were increased by the same amount over this period to a level of 11½ per cent.

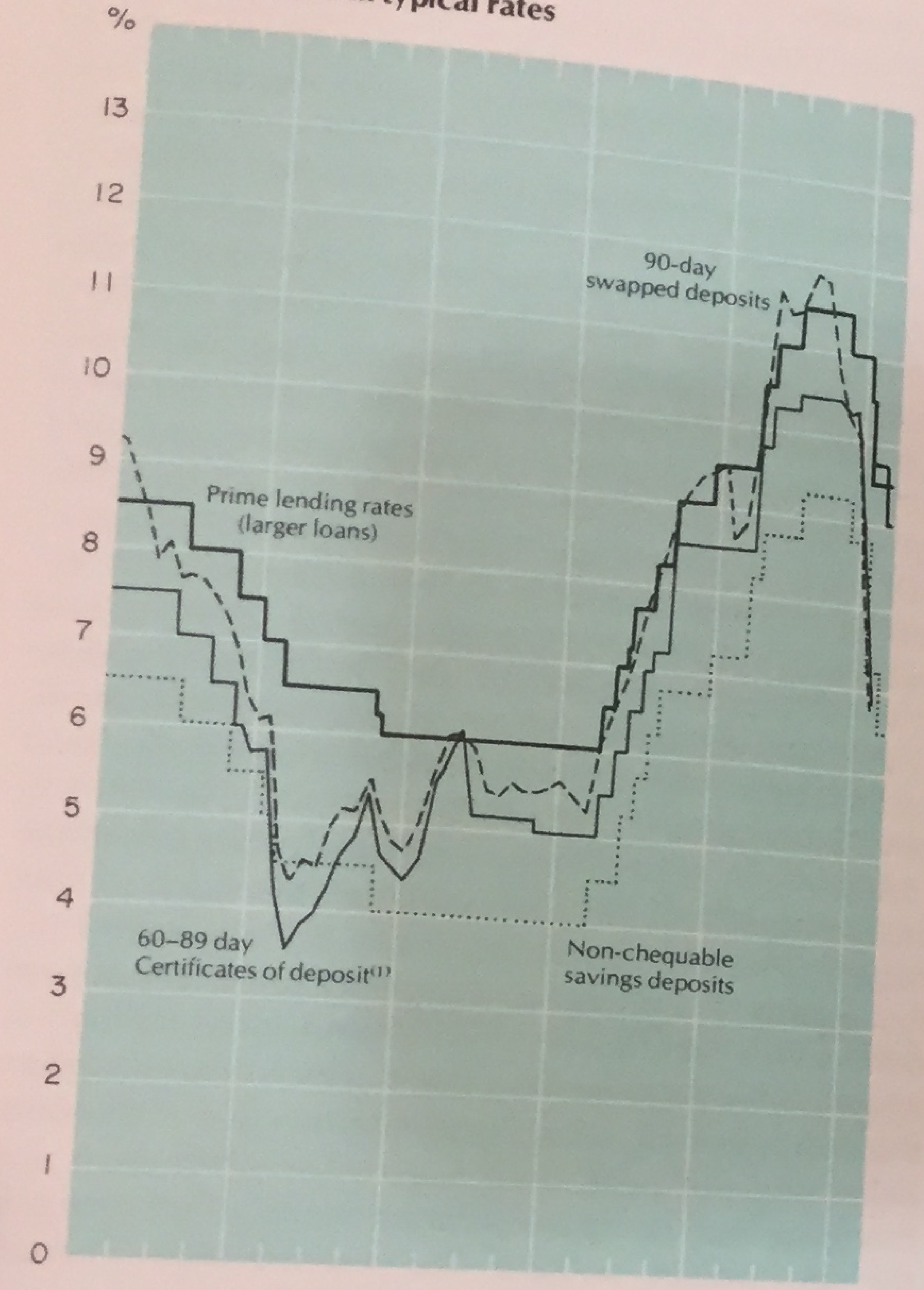
Longer term interest rates were relatively stable in the closing months of 1973 and early in 1974 but they, too, began to increase once again towards the end of the first quarter. In contrast to short-term rates, longer term bond yields continued to rise strongly until the end of August. Mortgage lending rates, which tend to reflect the behaviour of other longer term rates with some delay, did not peak until September while trust and mortgage loan companies continued to adjust upwards the rates offered on their five-year investment certificates until October.

During the course of the summer evidence began to appear that demand pressures in the Canadian economy were beginning to moderate, and late in August short-term interest rates in the United States broke sharply downward. In recognition of the changes that were occurring in the economic and financial environment, the Bank of Canada adopted a more accommodative approach in its provision of cash reserves.

Short-term market interest rates and long-term bond yields both began to fall in Canada from late August onwards. There was a brief interruption in the downward trend in the latter part of November and early December reflecting both a temporary firming of short-term rates abroad and some tightening in Canadian paper markets in the wake of the very large sales of Canada Savings Bonds. Towards year-end interest rates began to decline once again. Money market rates

Monthly

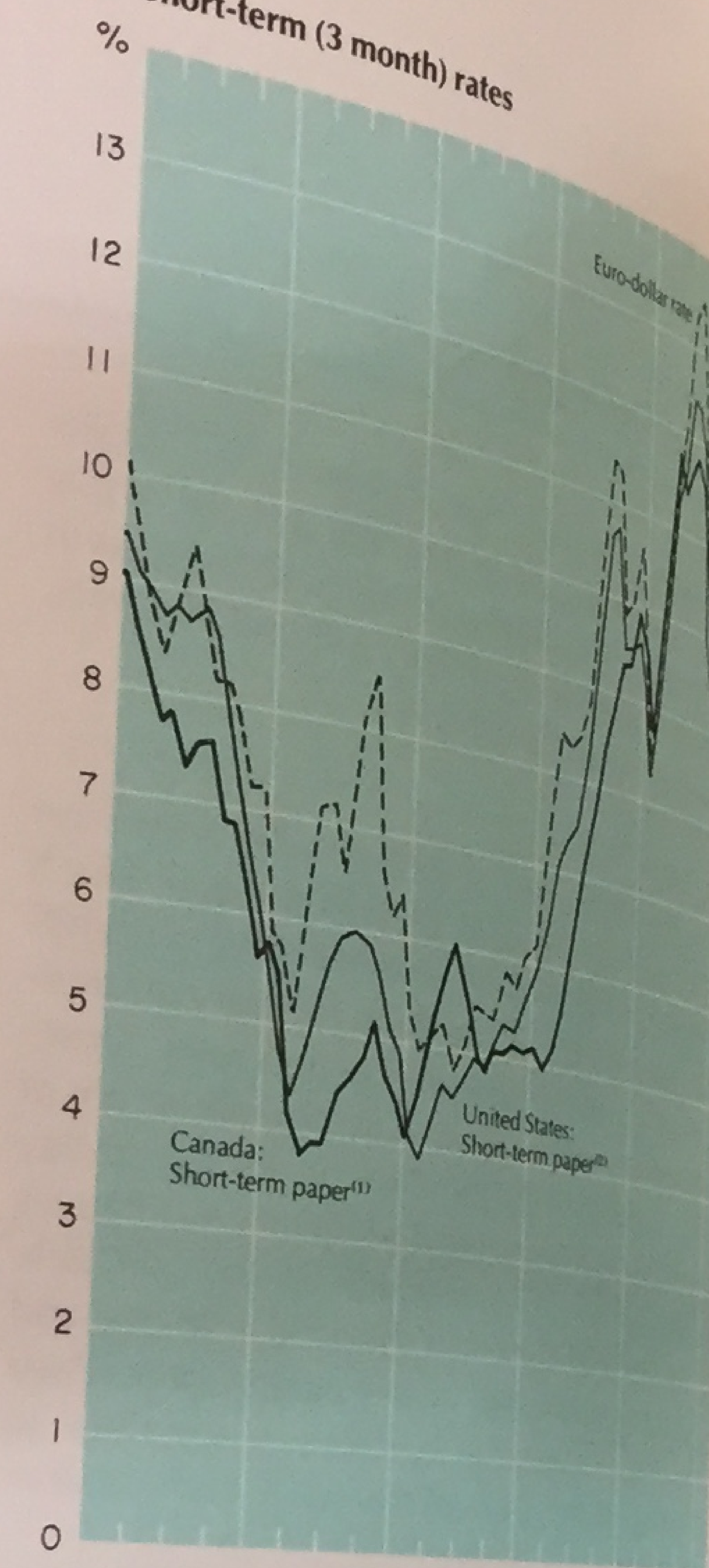
Chartered bank typical rates



(1) Until November 1970 and between June 18, 1972 and October 1974, rates prevailing under interest rate agreements.

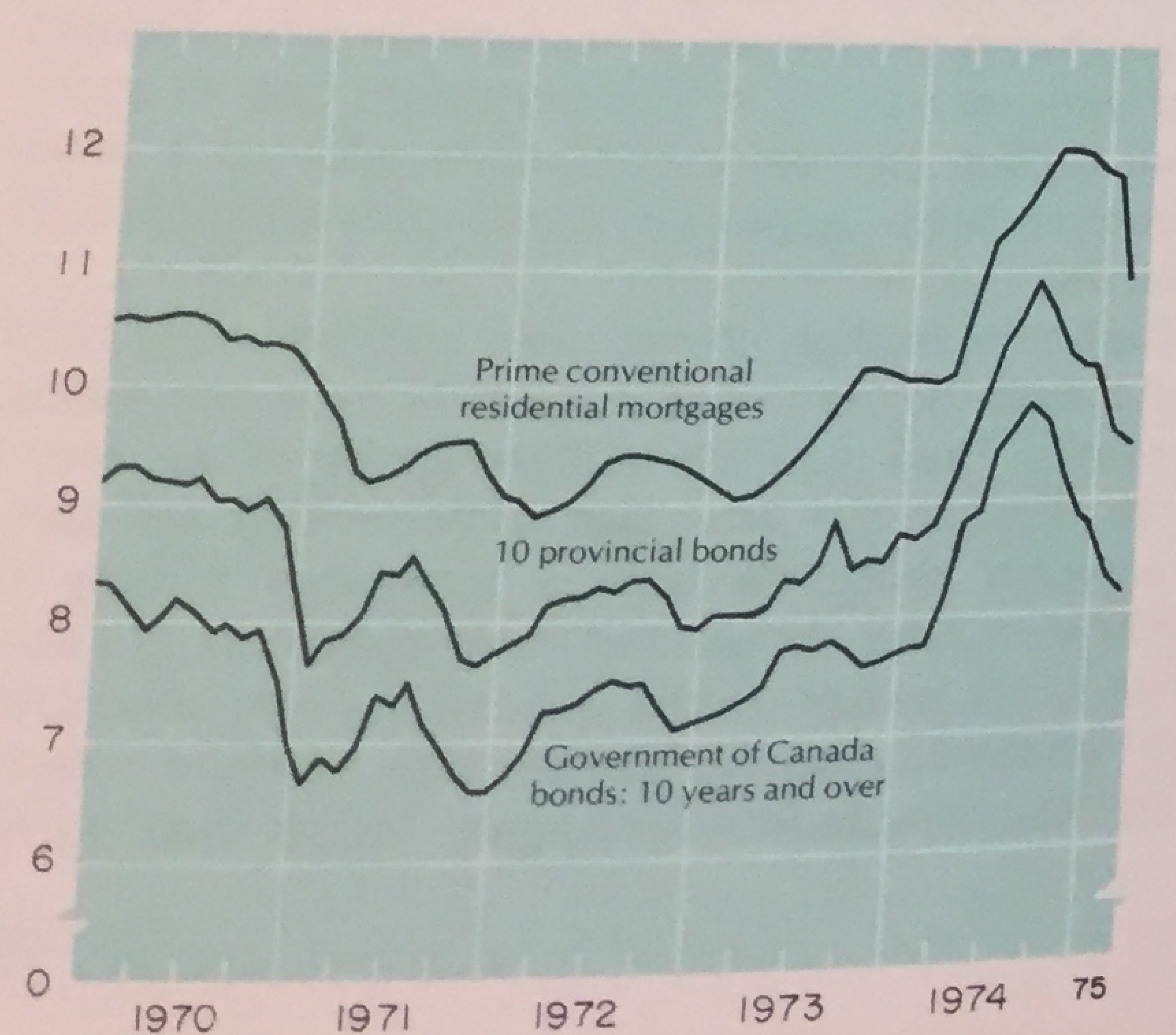
Short-term

Short-term (3 month) rates



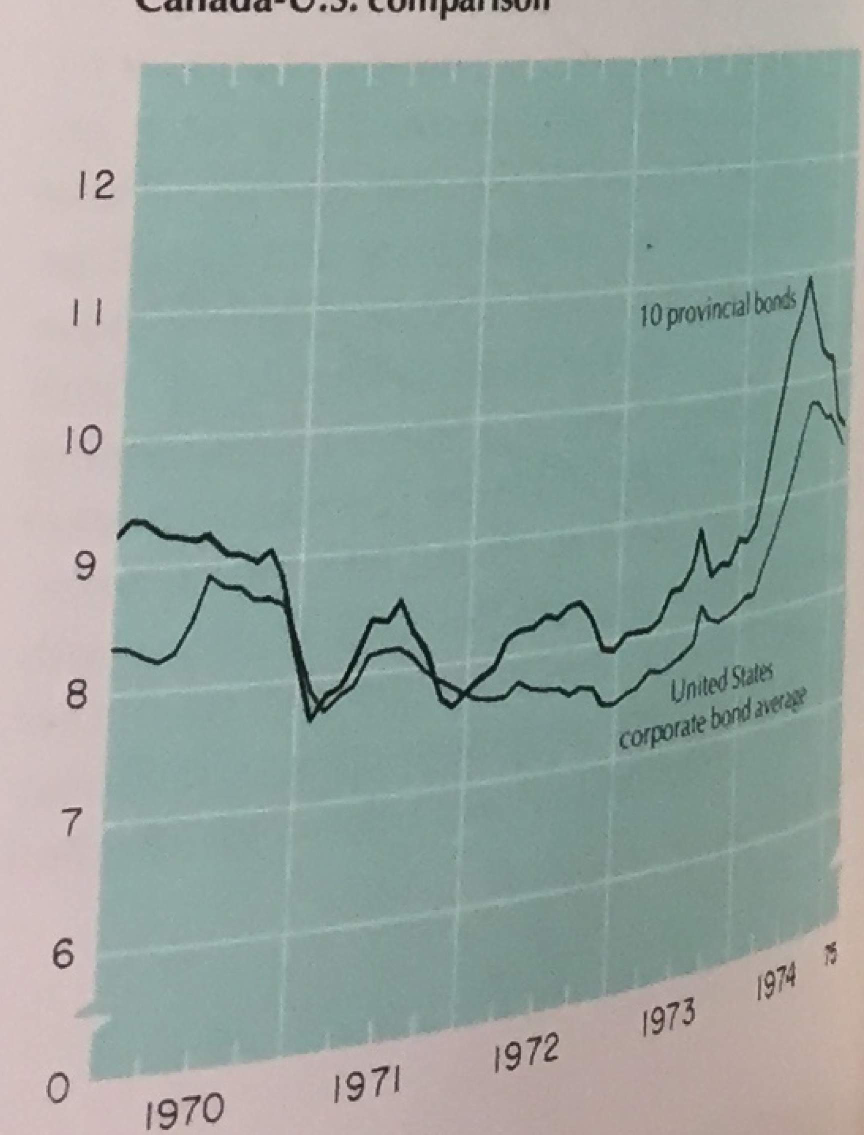
(1) Finance company paper
(2) Dealer-placed commercial paper

Canada



Long-term

Canada-U.S. comparison



fell sharply during the first few weeks of 1975, but since the latter part of January they have remained close to the levels reached at that time. The Bank Rate was reduced by one half of one percentage point in mid-November and in mid-January.

Financial institutions' borrowing and lending rates also began to be adjusted downward in the closing months of 1974. By the end of February 1975 the rates paid by the chartered banks on non-chequable savings deposits had been reduced to 6½ per cent and most banks had lowered their prime lending rates to 9 per cent. Mortgage lending rates declined more slowly; by the end of February conventional rates were typically 10¾ per cent and NHA rates were generally 10½ or 10¼ per cent.

As money market rates decreased, the structure of deposit rates under the "Winnipeg Agreement" became less of a constraint on the banks' ability to attract large blocks of short-term Canadian dollar deposits. The Agreement was terminated on January 15, 1975.

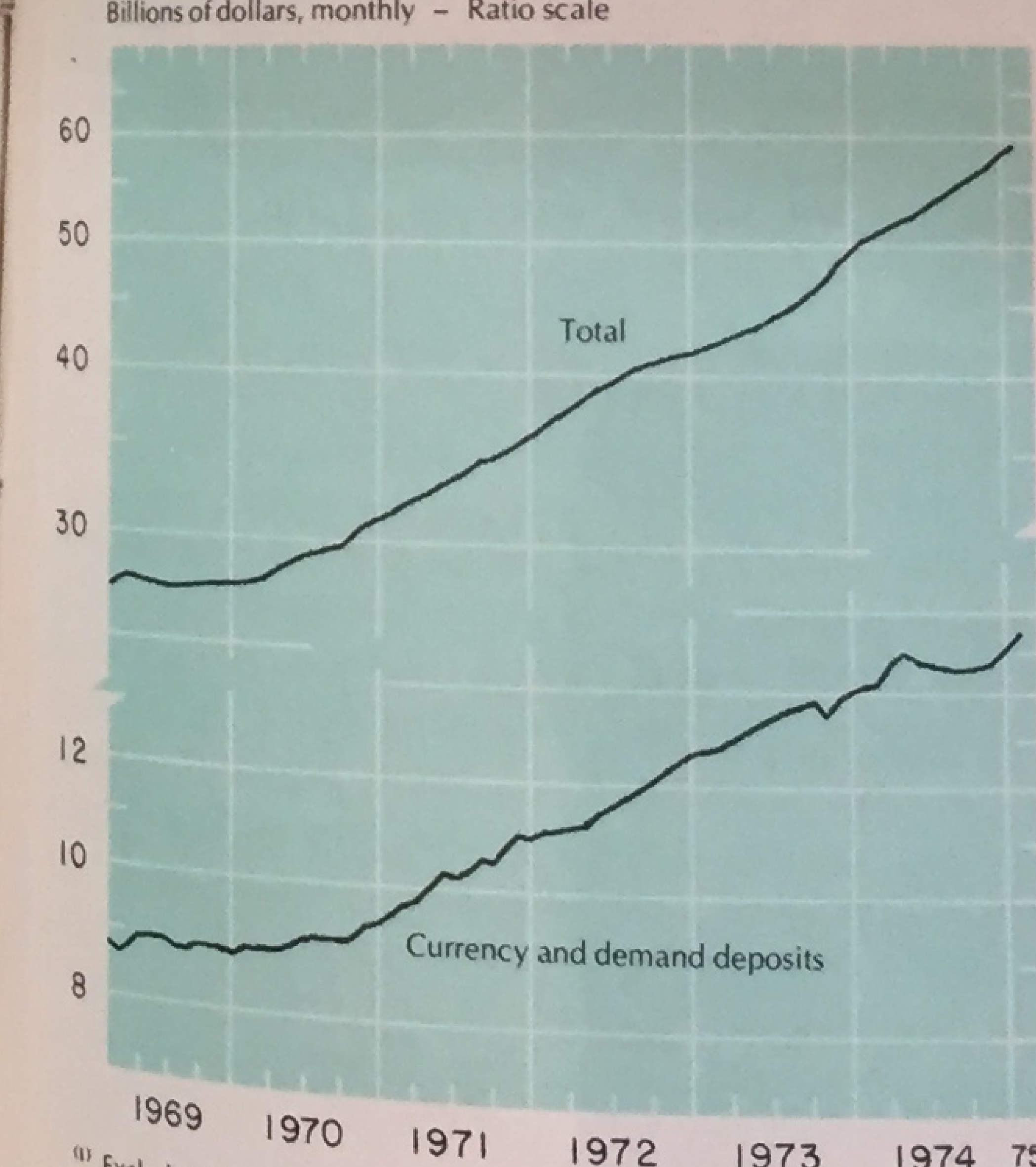
The Money Supply

There are many possible ways of defining the money supply. All of them include currency and demand deposits held by the public at chartered banks, but they differ in the extent to which they include any other categories of relatively liquid short-term claims on banks, other financial institutions, or governments from the wide array of such assets available to the public. The discussion that follows is primarily concerned with the two most frequently used definitions, namely, the narrow definition – currency and demand deposits held by the public at chartered banks – and the broader definition that includes these forms of money plus all other Canadian dollar deposits held by the public at chartered banks. The recent behaviour of these two definitions of the money supply (plotted both in absolute terms and as percentages of Gross National Expenditure) is shown in the accompanying charts.

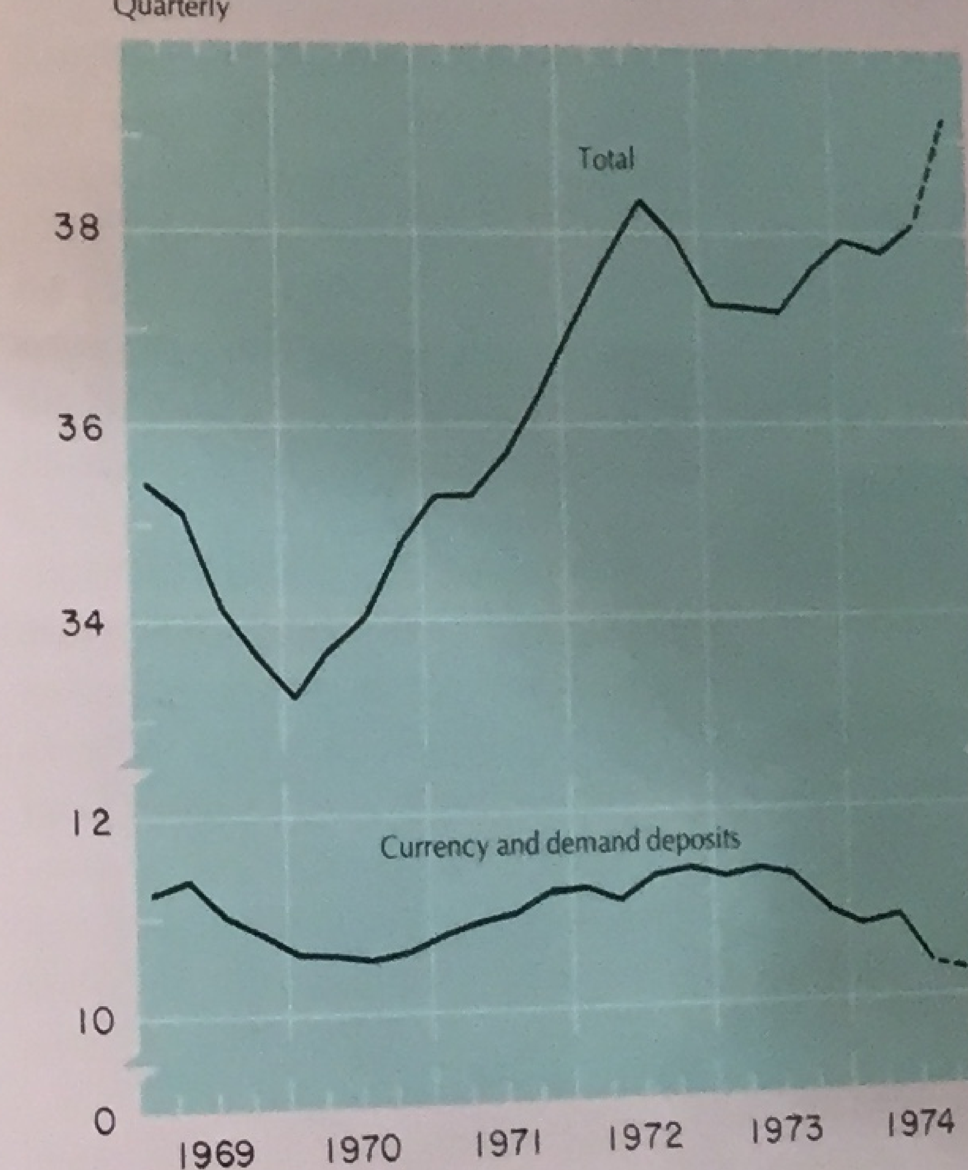
The first of the above definitions (which could be expanded to include some or all of the chequable

Currency Outside Banks and Canadian Dollar Chartered Bank Deposits Held by the Public(1)
Seasonally adjusted

Absolute amount
Billions of dollars, monthly – Ratio scale



Percentage of Gross National Expenditure
Quarterly



(1) Excludes deposits held by the Government of Canada.

savings deposits held at chartered banks and other savings institutions) concentrates on the forms of money that are most readily usable for making payments. The main reason why attention is given to this and to other closely related narrow definitions of the money supply is that, while money holdings of this type are subject to rather large, erratic movements from week-to-week and month-to-month, their growth over longer periods is related in a reasonably systematic way to two important economic variables. They respond positively to changes in the level of national expenditure and negatively (with a longer time lag) to changes in the level of interest rates. This relationship is readily apparent in the accompanying chart, which shows the line on the previous chart for currency and demand deposits as a percentage of Gross National Expenditure together with lines indicating the changing level of two representative measures of short-term interest rates.

While the relationship is not precise over short periods and is affected at times by extraneous influences, it has nevertheless shown a sufficient degree of stability over longer periods to lend considerable analytical importance to definitions of the money supply that focus primarily on transactions balances.

Recent year-on-year increases in the public's holdings of currency and demand deposits (measured from fourth quarter average levels) have declined from almost 14 per cent in 1972 to 12 per cent in 1973 to 7 per cent in 1974. From the second quarter of 1973 until very recently the percentage growth of the money supply on this definition has been persistently less than that of national expenditure in money terms.

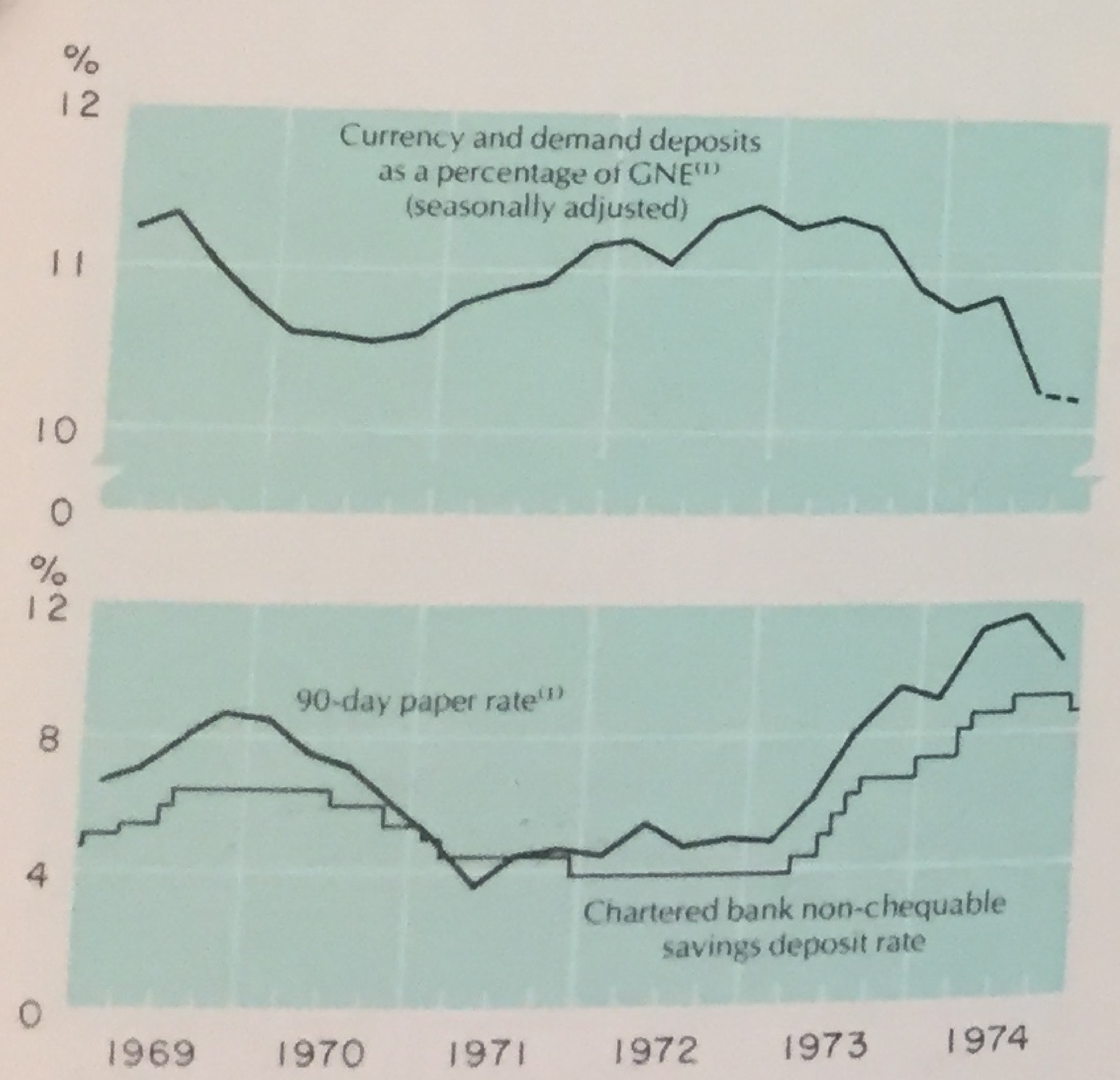
For a time during the spring of 1974 there was an interlude of relatively rapid expansion of currency and demand deposits in response to the unusually rapid growth of national expenditure and the temporary dip in short-term interest rates in the first quarter. A special influence tending to inflate the level of money holdings during this period was the temporary disruption of the flow of payments resulting from the withdrawal of mail services.

As these influences were reversed during the course of the summer, the rate of growth of currency and demand deposits declined sharply and turned negative for a time. More recently, in the wake of the sharp decline in short-term interest rates, holdings of currency and demand deposits have again been rising strongly.

In marked contrast with the slackening rate of growth of currency and demand deposits during 1973 and 1974, the interest-bearing Canadian dollar deposits of the chartered banks continued to expand rapidly throughout the period. Because of the inclusion of these interest-bearing deposits in the broad definition of the money supply referred to above, its behaviour over the past two years has been quite different from that of currency and demand deposits, as can be seen from the following table.

Although the chartered banks offer a considerable variety of interest-bearing deposit accounts (including deposits denominated in U.S. dollars), and although the volume of their interest-bearing deposit liabilities is large – much larger than their demand deposit liabilities – close substitutes for interest-bearing deposits at chartered banks are also generated on a very large scale outside the banking system. Examples include interest-bearing deposits and certificates issued by trust companies and other financial institutions, government treasury bills and Canada Savings Bonds, and short-term money market paper. There is in addition the whole range of interest-bearing financial claims of varying terms to maturity in the form of bonds and debentures. Whatever the factors that determine the total of the public's holdings of interest-bearing claims, there is clearly considerable scope for variation not only in that part of the total which represents relatively liquid short-term claims but also in the proportion of the latter which consists of deposit claims on the banking system.

Relationship of Currency and Demand Deposits to GNE and Selected Short-term Interest Rates



(1) Quarterly average

Currency and Chartered Bank Deposits Held by the Public(1)

	Annual rates of change(2): Currency and demand deposits	Currency and all Canadian dollar deposits
From same period a year earlier:		
4Q 1972	14	16
4Q 1973	12	15
4Q 1974	7	19
Latest three months(3)	8	18
From previous three months:		
1Q 1974	14	26
2Q 1974	20	15
3Q 1974	– 5	19
4Q 1974	2	17
Latest three months(3)	16	19

(1) Excludes deposits held by the Government of Canada.
(2) Based on quarterly averages of Wednesday data; seasonally adjusted.
(3) Preliminary data for the period December 1974 to February 1975.

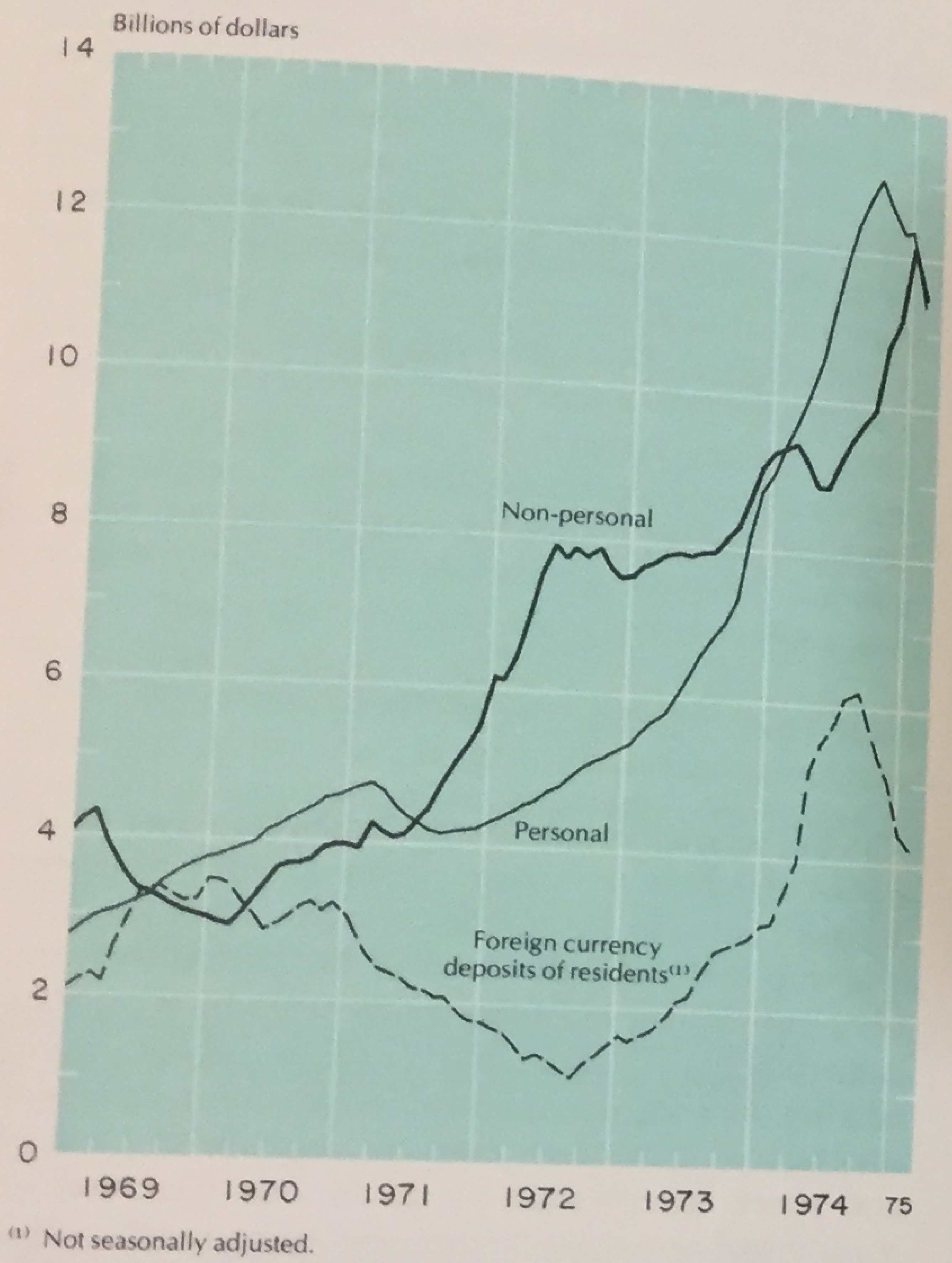
Several factors help to explain the extent to which the interest-bearing deposits of the chartered banks have grown during the past two years. One of these was that, as a result of growing uncertainty about the future value of money and of recurring expectations of further increases in interest rates, the preferences of the investing public shifted in favour of relatively short-term as opposed to longer term claims. Another factor that helped the banks in attracting funds into interest-bearing deposits during much of last year was the fact that prevailing interest rates had risen above the yields on much of the large volume of outstanding Canada Savings Bonds. Many of these Bonds were presented for redemption and the proceeds employed in interest-bearing deposits of the banks and of other financial institutions. When a new issue of Savings Bonds was offered late in 1974 at relatively attractive yields, the process of substitution swung the other way at the expense of interest-bearing institutional deposits.

On the whole, the chartered banks have had considerable freedom in recent years to offer short-term deposit claims to the public on highly attractive terms. It is true that through much of the period from mid-1972 until late in 1974 the ability of the banks to attract large blocks of funds into Canadian dollar interest-bearing deposits was constrained to some extent by the structure of maximum rates for deposits of $100,000 and more for periods of up to one year that was maintained under the "Winnipeg Agreement" ceilings. These ceiling rates were, however, adjusted upwards on several occasions. Moreover, the chartered banks were left free to compete with foreign banks in terms of the interest rates offered to Canadians on U.S. dollar deposits. To the extent that such deposits are covered forward by foreign exchange contracts, they are essentially similar to Canadian dollar deposits, and in recent years there have been large movements of Canadian-owned funds back and forth between Canadian dollar deposits at the chartered banks and U.S. dollar deposits (also principally at the chartered banks) in response to interest rate differentials. These shifts account in part for the variations in the rate of growth of the Canadian dollar interest-bearing deposits of the chartered banks over the past two years.

The unusually rapid growth in 1973 and 1974 of the main types of high-interest fixed-term deposits offered by the banks is shown in the following chart.

Chartered Bank Fixed-Term Deposits

Seasonally adjusted



(1) Not seasonally adjusted.

In the changed environment of generally declining interest rates which developed towards the end of 1974 and in early 1975, the chartered banks reduced their reliance on fixed-term deposits as sources of deposit funds.

Funds Supplied by Financial Institutions and Markets

The Canadian dollar assets of the chartered banks increased by 19 per cent in 1974, the same high rate of increase as in 1973. While the rate of growth of the banks' loan portfolios was lower than in 1973, they were able to add substantially to their holdings of liquid assets in the course of the year. Through the first half of 1974 the growth in liquid assets was roughly in line with the rising amounts needed to meet the cash and secondary reserve requirements, but in the closing months of the year and in January 1975 there was a substantial increase in the banks' "free" Canadian liquid assets*. The ratio of "free" Canadian liquid assets to total Canadian dollar assets, which had declined to about 8½ per cent by April 1974 and remained close to that level until September, rose to just over 10 per cent in January. (The increase in "free" Canadian liquid assets around year-end reflected to some extent the reductions in the secondary reserve requirement in December and January, which are discussed in the following chapter.) The banks' holdings of other short-term assets, principally bankers' acceptances and other short-term paper, also rose sharply in the latter part of 1974 and early 1975. After mid-January there was a substantial decline in the banks' "free" Canadian liquid assets and in their holdings of other short-term assets.

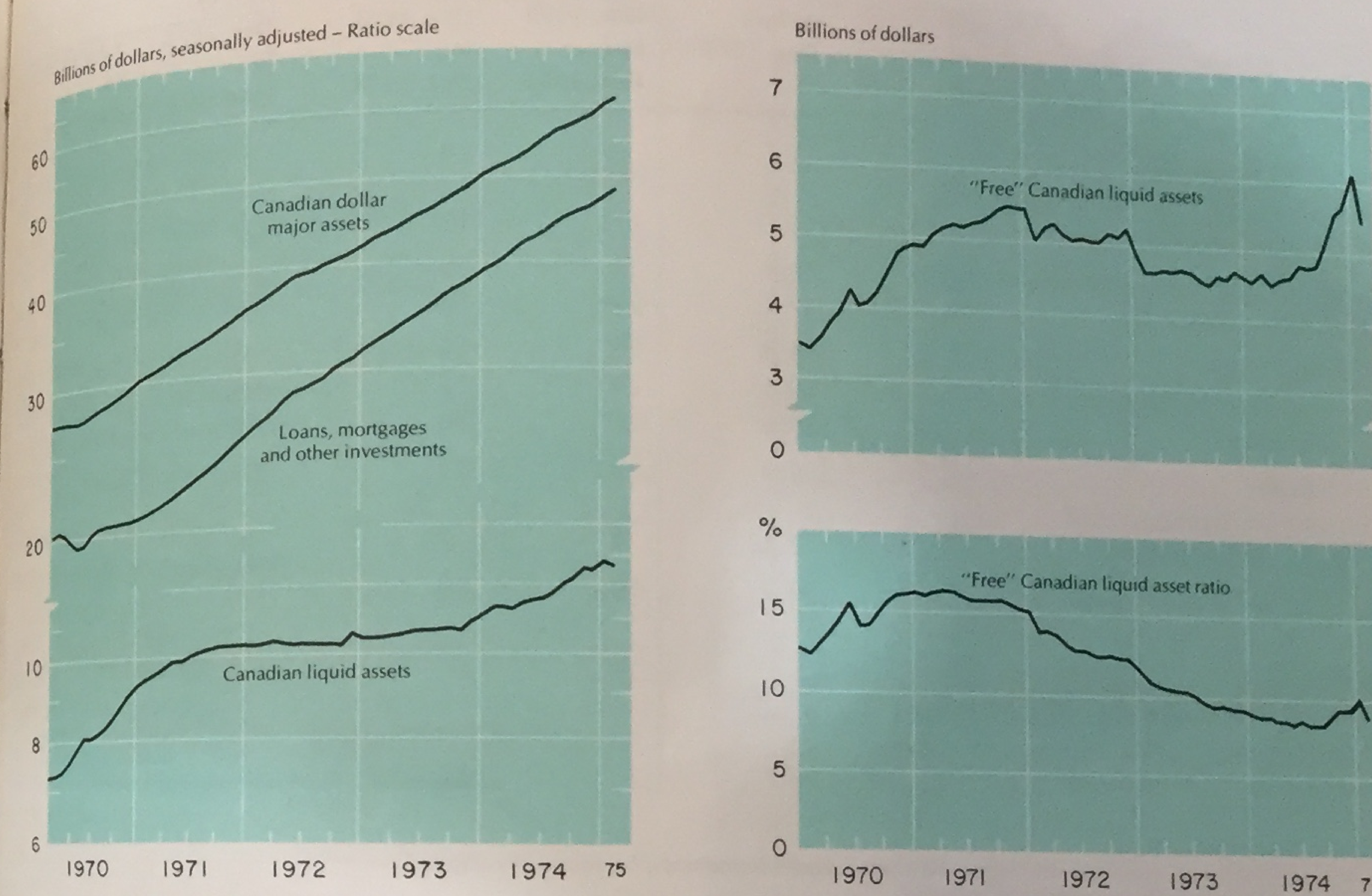
The chartered banks' Canadian dollar business loans increased less rapidly in 1974 than in 1973. During 1974 larger business borrowers raised substantial amounts of funds through the issuance of commercial paper and bankers' acceptances. In addition there were large increases in the chartered banks' foreign currency loans to Canadian business and in lending to business by Canadian financial institutions affiliated with foreign banks. These shifts in credit flows contributed to the slowdown in the growth of the chartered banks' Canadian dollar loans to business borrowers in 1974. A broader measure of credit extended to business which reflects these other sources of funds as well as chartered bank Canadian dollar loans increased more rapidly in 1974 than in 1973.

Consumer lending by the banks was very buoyant in the early months of the year but subsequently moderated in line with the weakening in the demand for consumer durables. The rate of growth of their residential mortgage portfolios slowed during the second half of 1974, following an earlier sharp decline in their mortgage loan approvals.

* "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.

Chartered Bank Assets

Average of Wednesdays



A deceleration in the growth of mortgage portfolios and consumer loans was also apparent in the case of non-bank financial institutions. The trust and mortgage loan companies, which hold roughly 80 per cent of their major assets in mortgages, experienced a substantial slowing in their rate of growth in the second half of the year from the relatively high rates in 1973 and the first half of 1974. The major assets of the credit unions and caisses populaires, which are more evenly distributed between mortgages and consumer credit, also increased less rapidly during 1974 following two years of very buoyant expansion. The sales finance and consumer loan industry grew more slowly during the second half of 1974 largely as the result of a deceleration in consumer lending.

The table on page 30 summarizes the funds raised by each of the main categories of non-financial borrower in recent years, showing the sources of these funds.

A substantial increase in the total amount of funds raised in 1974 mainly reflected increased borrowing by the federal Government (discussed in the following section of this Report) and by non-financial businesses.

In 1974 non-financial businesses obtained record amounts of funds from the chartered banks and other financial institutions as well as in short-term paper markets. In addition they raised more through bond issues in 1974 than in either of the previous two years. The strength of business borrowing throughout the year, despite the weakening of over-all economic activity, reflected continued large requirements for funds to finance fixed investment and inventories. Outlays on plant and equipment remained on a strongly rising trend throughout the year and, at the same time, rates of inventory accumulation were at high levels. In the early part of the year the increase in stocks was no doubt by and large planned but, as

Chartered Bank Selected Assets

	Billions of dollars Dec. 1974	Annual rates of change Years Dec. 1972 to Dec. 1973	Dec. 1973 to Dec. 1974	Half-years[1] Dec. 1973 to June 1974	June 1974 to Dec. 1974
Canadian liquid assets	12.7	3	14	11	18
(Canadian liquid assets, and other short-term Canadian assets[2])	(13.7)	(1)	(19)	(5)	(35)
Loans, mortgages and other investments	46.8	25	21	21	21
Canadian dollar loans	37.4	27	19	19	18
General loans	34.8	26	19	19	18
— unsecured personal	10.8	24	22	24	20
— business	20.6	27	20	22	18
Mortgages	5.9	34	33	37	30
Provincial, municipal and corporate securities[3]	2.4	4	7	7	7
Canadian dollar major assets	59.6	19	19	19	20
Memo:					
Bank business loans and foreign currency loans to residents plus commercial paper and bankers' acceptances[4]	26.7	25	33	33	33

(1) Seasonally adjusted.
(2) Canadian liquid assets plus short-term paper and chartered bank instruments; not seasonally adjusted.
(3) Excludes short-term paper; not seasonally adjusted.
(4) Includes short-term paper issued by Canadian financial institutions affiliated with foreign banks.

economic activity softened, the financing requirements appear to have reflected considerable involuntary accumulation of inventory.

Although the amount of mortgage market financing in 1974 as a whole was not substantially below the record level in 1973, there was a pronounced change in this market in the spring. The value of residential mortgage loan approvals on both new and existing housing declined substantially from very high levels after mortgage interest rates began to increase rapidly and the non-rate terms on mortgages were stiffened by the major lending institutions. Other factors such as uncertainties about prospective construction costs and rents also contributed importantly to the drop in mortgage approvals on new housing, which was especially marked for multiple units.

Net mortgage investment by the major lenders, which follows mortgage loan approvals with some lag, continued to be buoyant through the first half of 1974; during this period their mortgage portfolios increased at the same 25 per cent rate as during 1973. There was, however, a substantial deceleration in the growth of these portfolios during the second half of the year to a rate of about 15 per cent.

The slowing of the growth of consumer credit was less pronounced than in the case of mortgage credit. Sales of new automobiles, an important factor in the demand for consumer credit, remained at high levels until late in the third quarter but then weakened substantially.

Financing activity by the provinces and municipalities and their enterprises also increased appreciably during 1974. As in the case of private business, fixed

Major Assets of Financial Institutions[1]

	Billions of dollars Dec. 1974	Annual rates of change Years Dec. 1972 to Dec. 1973	Dec. 1973 to Dec. 1974	Half-years[2] Dec. 1973 to June 1974	June 1974 to Dec. 1974
Deposit-taking institutions					
Chartered banks[3]	59.6	19	19	19	20
Trust and mortgage loan companies and Quebec savings bank	18.9	23	16	23	10
Credit unions and caisses populaires	10.0	25	18	20	17
Sub-total	88.5	21	19	20	17
Contractual savings institutions					
Life insurance companies	20.0	9	9	10	8
Pension funds	17.8	14	14	14	14
Sub-total	37.8	11	11	11	10
Sales finance and consumer loan companies	7.4	20	15	21	10
Total	133.6	18	16	17	15

(1) Figures for December 1974 are estimated, except for banks.
(2) Seasonally adjusted.
(3) Canadian dollar major assets; average of Wednesdays.

investment outlays by provincial enterprises continued to rise strongly. The increase in this sector's financial requirements was met principally through higher net bond issues in foreign markets. There was a sizeable increase in borrowing in the United States where long-term interest rates were generally lower than those in Canada and, in the latter part of the year, almost $1½ billion of bonds were placed overseas.

Provincial and municipal borrowers and private business (including financial institutions) together raised just over $3 billion in the Canadian bond market in 1974, much the same amount as in 1973. Borrowing in domestic markets picked up considerably in the closing months of the year and this increased activity continued into 1975. Net new issues of bonds sold to non-residents by these borrowers reached a record level of about $2 billion in 1974 compared with $750 million in the previous year.

The increased capital inflow resulting from net new bond issues sold to non-residents was partly offset by substantially larger outflows for the financing of export credits and by smaller inflows of foreign direct investment in Canada. Short-term capital transactions, which gave rise to outflows of some $¾ billion to $1 billion in 1972 and 1973, are estimated to have resulted in inflows of a like amount in 1974. There were large and to some extent offsetting flows in the major categories of short-term capital in 1974. Although the foreign currency operations of the chartered banks gave rise to substantial outflows, transactions involving deposits at foreign banks, money market instruments and commercial leads and lags produced even larger inflows. Over-all, Canadian residents raised close to $2 billion from foreign sources in 1974 following a year in which there had been no net recourse to foreign funds.

Funds Raised by Major Non-financial Borrowers

	Billions of dollars 1972	1973	1974
Non-financial Businesses			
Increases in loans			
— chartered banks	2.3	3.8	4.3
— other institutions	0.5	1.1	1.9
Net new issues			
— Canadian dollar bonds	0.9	0.9	1.2
— foreign currency bonds	–	–	0.2
— stocks	0.4	0.4	0.4
— short-term paper	– 0.1	– 0.1	1.7
Direct investment from abroad	0.7	0.7	0.5
Total	4.8	6.8	10.1
Mortgage Borrowers(1)			
Trust and mortgage loan companies(2)	1.6	2.7	2.4
Chartered banks	1.1	1.2	1.5
Other private institutions	1.4	2.4	2.3
Total	4.1	6.3	6.1
Consumers			
Chartered banks	1.4	1.7	1.9
Other sources	0.8	1.0	1.0
Total	2.2	2.8	3.0
Total Private Borrowing	11.0	15.9	19.2
Provinces and Municipalities(3)			
Net new bond issues			
— purchased with CPP funds	1.0	1.0	1.2
— other Canadian dollar	1.5	1.4	1.3
— foreign currency	0.9	0.6	1.7
Net treasury bills and short-term paper issues	0.1	– 0.1	– 0.2
Chartered bank loans	0.1	0.4	0.3
Total	3.6	3.3	4.2
Government of Canada			
Net new issues			
— treasury bills	0.3	0.5	0.9
— Canadian dollar marketable bonds	0.1	– 0.2	0.9
— Canada Savings Bonds	1.2	– 0.4	2.4
Total	1.6	– 0.1	4.2
Total Borrowing	16.2	19.2	27.7

(1) 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.
(2) Includes mortgage loan companies associated with chartered banks.
(3) Includes government enterprises. Loans from the Government of Canada are excluded. Canadian dollar bond issues placed in overseas markets are included in foreign currency issues.

Bank of Canada Operations

This chapter provides a summary record of Bank of Canada operations during 1974 and early 1975.

Monetary Policy Operations

During 1974 until late in the summer the Bank of Canada maintained a cash management policy that was designed on balance to offer resistance to the strong credit demands and to moderate the rate of monetary growth. In light of the changing economic prospects the Bank then adjusted its policy in order to facilitate a movement to easier monetary conditions.

Bank Rate was raised from 7¼ per cent to 8¼ per cent on April 15, 1974, to 8¾ per cent on May 13 and finally to 9¼ per cent on July 24. It remained at that level until November 18, when it was reduced to 8¾ per cent. On January 13, 1975 the Bank Rate was reduced by a further one half of one percentage point to 8¼ per cent.

The record of the chartered banks' cash reserve position during 1974 is shown in Appendix Table I. The level of excess cash reserves supplied to the banking system in support of the broad policy outlined above was affected from time to time by the Bank of Canada's response to changing pressures in financial markets. A striking example occurred in the spring of 1974 when a disruption of mail services added temporarily to the strong pressures that were already evident in the Canadian financial market. The Bank of Canada moderated the impact of these pressures by supplying excess cash reserves in unusually large amounts in order to accommodate the temporary increase in the amount of cash reserves that banks wished to hold. Another example occurred this year when the Bank tightened its cash reserve management to prevent the rapid decline in money market interest rates in January from becoming excessive.

The monthly record of Bank of Canada transactions in Government of Canada securities and bankers' acceptances during 1974 is presented in Appendix Table III.

During the course of the year the par value of the Bank's holdings of Government of Canada securities and bankers' acceptances increased by $1,115 million. This increase includes net open market operations, changes associated with new issues of treasury bills and bonds, and net transactions with Government accounts and with other clients. Open market operations accounted for $535 million or almost half of the increase in the Bank's holdings of securities. In addition to assisting in the management of chartered bank cash reserves these transactions were helpful in stabilizing market conditions, particularly during periods of excessive rate pressures.

In late March and early April, when interest rates were rising rapidly, the Bank lent substantial support to markets through cash purchases of both short-term and medium-term Government of Canada bonds and through acquisitions of bonds in exchange for treasury bills. The bulk of the support was concentrated in the second half of March and in April when the Bank of Canada's portfolio of Government of Canada securities increased by about $550 million over a period of six weeks. In early June the Bank became a net seller of Government of Canada bonds at a time when demand for the new Government of Canada issues being offered in connection with the June 15 refunding operation exceeded the supply available in the market. When the market experienced a substantial rally in October and November, the Bank again became a seller of bonds for cash and on a switch basis against very short-term bonds and treasury bills. Although the Bank favoured the downward move in yields, the pace of yield adjustment became excessive at times and the Bank was acting to moderate the movement. In late November and December the Bank acquired large quantities of treasury bills and bankers' acceptances. The bill purchases were largely related to the reductions in the required minimum secondary reserve ratio. The bankers' acceptances acquired by the Bank were nearly all of a term to maturity of thirty days or less and these purchases were made primarily to assist cash management over the seasonal peak in note circulation that occurs at year-end. By the end of January these acceptances had all matured and the Bank held none in its portfolio.

The net additions to the Bank's holdings of Government of Canada bonds, treasury bills and bankers' acceptances over the year also made it possible for the Bank to reduce the level of its holdings of foreign currency assets resulting from temporary swap transactions with the Exchange Fund Account. The Canadian dollar value of these investments declined by $214 million during 1974. As has been indicated in earlier Annual Reports, the Bank uses such temporary swap transactions to assist in its management of cash reserves and to provide flexibility in the timing of its transactions in Government of Canada securities.

In May the Bank announced a change in its practice with respect to the maximum rate at which it is prepared to enter into Purchase and Resale Agreements with money market dealers. The practice had been to set the PRA rate at 1/4 of one per cent above the average 91-day treasury bill rate at the latest weekly tender, subject to a minimum of Bank Rate minus 3/4 of one per cent and a maximum at the level of Bank Rate. Under the new practice the maximum PRA rate is Bank Rate plus 1/2 of one per cent. The change was made to permit flexibility in the relationship between the average 91-day bill rate at tender and the Bank Rate. In commenting on the change at the time the Bank stated that henceforth an average yield at tender on 91-day bills that equals or exceeds the Bank Rate or even the maximum PRA rate should not necessarily be regarded as foreshadowing a change in these rates.

The Bank of Canada reduced the required secondary reserve ratio of the chartered banks from 8 per cent to 7 per cent of their Canadian dollar deposit liabilities effective December 1974, and to 6 per cent effective January 1975. These reductions were largely technical in nature. The Bank did not want to keep the secondary reserve requirement any higher than was necessary and circumstances were favourable for reducing it. The large Canada Savings Bond sale in November had increased the cash balances of the Government of Canada substantially and the programme of weekly additions to the outstanding amount of treasury bills, which make up the bulk of the banks' secondary reserves, was terminated at the end of November. The immediate increases in chartered bank "free" liquid asset holdings resulting from the reductions in the secondary requirement were substantially offset by the Bank of Canada through its cash reserve management and open market purchases of treasury bills, particularly on the occasion of the December reduction.*

Debt Management

During 1974 the outstanding amount of Government of Canada marketable securities payable in Canadian dollars plus Canada Savings Bonds increased by $4,249 million. In addition ordinary foreign exchange transactions resulted in a net inflow of Canadian dollars to the Government of $158 million. The Government's net Canadian dollar financing requirements for domestic transactions were about $1.8 billion in 1974, and the Government's Canadian dollar cash balances increased by $2,573 million over the year.

A net total of $940 million was raised through additions to the outstanding amount of treasury bills. The treasury bill programme during the year included completing the establishment of a pattern of quarterly auctions of one-year bills.

Over the year the outstanding amount of Canadian dollar direct and guaranteed marketable bonds of the Government of Canada increased by $868 million. (Details are given in Appendix Table IV). The Government borrowed in the bond market on six occasions. On five of them at the maturity of outstanding issues. On four of these occasions the Government raised funds in excess of the amount of maturing issues, while on December 1, 1974, $525 million of bonds were sold against a maturity of a like amount. On August 15, 1974 when there was no maturing bond issue, the Government raised $250 million in new funds. Part of the $550 million raised on February 1 was applied to advances to the Canadian National Railway Company in connection with the retirement of $200 million of the Company's 3 3/4% bonds maturing February 1, 1974.

The new marketable bond issues sold in 1974 were mainly of short- and medium-term maturity, although one long-term issue with a 9 1/2% coupon was sold on June 15 in the amount of $150 million. Bonds with extendible options were offered in five of the new loans. The average term to maturity of outstanding unmatured marketable direct and guaranteed bonds shortened by three months over the year to five years, four months.

The management of Canada Savings Bonds presented particular difficulties in 1974. The rapid escalation of interest rates offered on competing investments during the spring and summer sharply increased the rate of redemption of Canada Savings Bonds. In order to give holders of the bonds a more attractive return, the Government of Canada announced on May 6 that a cash bonus would be payable on outstanding Canada Savings Bonds. The bonus raised the yield from May 1, 1974 to maturity to 9% and consisted of a payment at maturity on bonds maturing on or before November 1, 1979, and two payments on bonds maturing after November 1, 1979, the first at that date and the second at maturity. The terms of the 1974/75 series of Canada Savings Bonds were announced on September 9. This series offered investors a nine-year bond with interest of 9 3/4% payable in each year, but without the option to compound interest that had been offered on recent issues. At the same time the Government announced an increase in the bonus payable on outstanding Canada Savings Bonds sufficient to produce an average yield of 10 1/2% effective from September 1 to maturity.

Because of the declining trend of interest rates during the Canada Savings Bond campaign, the Bonds proved very attractive to investors and net sales during the campaign amounted to $4,021 million. The series was withdrawn from sale on November 15. At the end of 1974 the outstanding amount of Canada Savings Bonds was $2,441 million higher than a year earlier.

Holders of the 8% marketable bonds due October 1, 1974 had the option until April 1, 1974 to exchange their bonds into an equal par value of 8% bonds maturing October 1, 1986. In total, $235 million of the bonds were exchanged, leaving $190 million of the original issue to mature in October 1974.

Government of Canada Financing, 1974

	Millions of dollars
Requirements	
Domestic transactions[1]	1,834
Ordinary exchange transactions	− 158
	1,676
Financing	
Net par value changes in Canadian dollar debt outstanding — Treasury bills	940
— Marketable bonds	868
— Canada Savings Bonds	2,441
	4,249
Increase (−) in Canadian dollar cash balances[2]	−2,573
	1,676

[1] Including an advance to the Exchange Fund Account to permit remittance of profits, but excluding advances to the Canadian National Railway Company in connection with the retirement of $200 million of the Company's bonds.
[2] Excluding the $214 million impact of a reduction in temporary swap transactions between the Bank of Canada and the Exchange Fund Account.

* The Bank of Canada announced on February 28 that the minimum secondary reserve ratio of the chartered banks was being reduced from 6 per cent to 5 1/2 per cent, effective in March 1975.

In September the Government repaid a U.S. dollar denominated loan of U.S.$45 million. The repayment was effected through a reduction in foreign exchange reserves and did not affect the Canadian dollar position of the Government.

In March 1974, the Government cancelled $6 million of 5½% August 1, 1980 bonds which it had previously acquired under provisions of the purchase fund for this issue, leaving $310 million of the issue outstanding.

Foreign Exchange Operations

The Canadian dollar traded over a wider range in terms of the U.S. dollar during 1974 and early 1975 than in either of the two preceding years. At the beginning of 1974 Canada's balance of payments was expected to be less affected by the sharp increase in world oil prices than that of most industrial countries, and very large inflows of capital and advance conversion of export receipts contributed to a steady appreciation of the Canadian dollar against most currencies. In April the dollar reached a fourteen year high of U.S.$1.0443, up from U.S.$1.0040 at the end of 1973. In the second and third quarters capital inflows subsided and the deficit on current account increased, giving rise to a steady easing in the value of the Canadian dollar. In the fourth quarter the current account deficit increased sharply, but a marked increase in capital inflows moderated the tendency for the Canadian dollar to decline. At year-end the exchange value of the Canadian dollar was U.S.$1.0095, and it declined further in the early weeks of 1975.

Canada's official international reserves rose by U.S.$468 million in the first four months of the year, but subsequently declined by U.S.$411 million, to a year-end level of U.S.$5,825 million.

The Bank of Canada's purchases and sales of U.S. dollars on behalf of the Exchange Fund Account to maintain orderly conditions in the Canadian market accounted for a major part of reserve changes during the year. Reserve holdings were reduced by U.S.$45 million as a result of the repayment of a 1949 Government of Canada U.S. dollar bond issue which matured in September. The method of valuing the Special Drawing Right, which had been in terms of gold, was altered by the IMF in July to a procedure based on a composite basket of currencies. The value of the SDR in terms of the U.S. dollar subsequently rose and as a result the value of Canada's holdings of assets denominated in SDRs increased by U.S.$32 million from July to the end of December.

The composition, though not the total, of Canada's reserves was affected during the year by loans of U.S.$168 million to the International Monetary Fund related to a special oil facility under which Canada agreed to lend a maximum of Cdn.$300 million. The loans reduced Canada's official holdings of U.S. dollars and increased our holdings of assets denominated in SDRs.

In April 1974 the Bank of Canada entered into a temporary financial arrangement with the Banca d'Italia in the amount of $250 million. The arrangement was a stand-by facility that provided for simultaneous reciprocal drawings of Canadian dollars and Italian lire for short periods of time. The facility was part of a network of financing arrangements initiated by the Italian authorities involving international financial institutions and other central banks. It was similar in character to other international swap arrangements such as the one existing between the Bank of Canada and the United States Federal Reserve System and those arranged for a temporary period by the Bank of Canada in 1968 with the Bank for International Settlements, the Deutsche Bundesbank and the Banca d'Italia. This arrangement remained in effect until January 1975; no drawings were made under it.

Exchange Rate and Official Reserves