THE CANADIAN REACTION ON INTERNATIONAL ACCOUNTS TO THE INFLOW OF FOREIGN CAPITAL IN THE PERIOD 1956-1962

By

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PREFACE

During the post-World War II period, the Canadian economy operated under the stimulus and pressure of heavy inflows of foreign capital. In September, 1950, the Canadian Government freed the exchange rate of the Canadian dollar leaving the long-run determination of the exchange rate to market forces. In May, 1962, Canada abandoned the free rate and re-established a fixed exchange rate. The pertinent questions thus arise of why, after eleven years, Canada abandoned a flexible rate and re-established a fixed exchange rate, what were the effects of the heavy inflows of foreign capital during this period, and what was the role of monetary and fiscal policy?

To make this study, it was necessary to collect data on the Canadian international accounts and domestic economy in the period, 1956-1962. The author wishes to express his gratitude to the Oklahoma State University Library and staff for their valuable assistance in obtaining this data.

This thesis was written under the supervision of Dr. Rudolph Trenton, and the author is indebted to Dr. Trenton for his guidance and assistance in writing this thesis.

TABLE OF CONTENTS

Chapter		Page
I.	INTRODUCTION	1
	Hypothesis of the Thesis	1
	Reason for Writing the Thesis	2
	Importance of this Thesis and Review of the Literature	2
	Definition of Terms	6
	Scope of the Thesis	8
II.	HISTORICAL PERSPECTIVE OF THE CANADIAN ECONOMY	10
	Introduction	10
	International Aspects of the Canadian Economy 1900-1946	11
	The Canadian Economy 1946-1955	13
	Foreign Investment in Canada	21
III.	INFLOWS OF FOREIGN CAPITAL 1956-1960	27
	Direct Investment Inflows Into Canada 1956-1960	27
	Portfolio and Other Short-Term Capital Movements 1956-1960	31
	The Main Effects of the Inflows of Foreign Capital on the Canadian Economy 1956-1960	40
IV.	EXCHANGE CRISIS AND GOVERNMENT REACTION	54
	Development of the Crisis	54
	Exchange Emergency Measures of the Canadian Government	59
	Results of the Emergency Measures Taken by the Canadian Government	62
V.	SUMMARY AND CONCLUSIONS	68
BIBLIOGRAPHY		73

LIST OF TABLES

Table		Page
I.	Private Capital Expenditure as a Percent of Gross National Expenditure	30
II.	Gross New Bond Issues Payable in Foreign Currencies of Canadian Provinces, Municipalities, and Corporations	33
III.	Canadian and United States Interest Rates and Canadian-United States Interest Rate Differential on a Quarterly Basis	37
IV.	Canada's Balance on Transactions With the United States and All Countries	43
V.	Nonresident Ownership as a Percent of Canadian Industry, 1957	44
VI.	Comparison of the Canadian Index of Industrial Production for Selected Industries	45
VII.	Canadian Current Account	49
VIII.	Monthly Averages of Canadian Merchandise Imports, Selected Commodities	51
IX.	Characteristics of the Canadian Labor Force	52
X.	Canadian Current Account for the Years 1961 and 1962	65
XI.	Comparison of Significant Categories of Capital Movements on Canadian International Accounts for the Years 1961 and 1962	66

CHAPTER I

INTRODUCTION

Hypothesis of the Thesis

The Canadian economy during the post-World War II period, 1946-1962, operated under the pressure and stimulus of heavy inflows of foreign capital. Prior to 1956, the inflows of foreign investment capital increased the productive capacity of the Canadian economy, and the Canadian economy was able to absorb these inflows with a minimum amount of disturbance to stable domestic and international economic conditions. The main hypothesis of this thesis is that in the period 1956-1962, these increasing inflows of foreign capital, exacerbated by the lack of coordination and cooperation that developed in Canadian monetary and fiscal policies, became a primary disturbing influence in the Canadian international accounts and domestic economy. A secondary hypothesis, supplemental to the main hypothesis, is that the increasing inflows of foreign capital and the unrealistic separation of monetary and fiscal responsibility led to increased distortion in the Canadian international accounts, and were instrumental in forcing the decision of the Canadian Government to abandon the Canadian market-determined exchange rate which was established in September, 1950, and in May, 1962, adopt a pegged exchange rate.

Reason for Writing the Thesis

The reason for the writing of this thesis was the author's initial interest in the operation of the Canadian exchange rate. Investigation of the Canadian international accounts revealed that in the post-World War II period the Canadian economy operated under the influence and stimulus of increasingly heavy inflows of foreign capital. The author was able to find only a small number of articles in learned journals concerned with this international capital flow between Canada and other countries. These articles dealt only with specific aspects of this capital flow, and the author was unable to find a comprehensive study dealing with the overall influence and magnitude of these international capital flows for the period 1956-1962. Therefore, this thesis was undertaken with the purpose of attempting an investigation of these large flows of capital, their effects on the Canadian balance of payments, and the reaction of the Canadian Government to these flows.

Importance of this Thesis and Review of the Literature

The controversy over the virtues and evils of fixed versus market determined exchange rates has been, and still is, one of the most widely debated subjects in the field of international economics. In a paper presented at the 1962 annual meeting of the American Economic Association, Professor Richard E. Caves of Harvard University stated:

> Economists seem to be moving toward agreement on two propositions: that the balance of payments of the United States

> is in disequilibrium; and that the international monetary arrangements of the free world show inadequate structural soundness. These twin problems have reopened for discussion the whole gamut of possible arrangements for international payments and liquidity. Economists concerned with these subjects find themselves once more at an intellectual Bretton Woods. In such a setting it is appropriate to consider the case for flexible exchange rates as a method of dealing with problems of international liquidity and payments equilibrium.[1]

The Canadian exchange rate from September 30, 1950, to June 20, 1961, was, for all practical purposes, a market determined rate of exchange. Although the very existence of the Government exchange fund implies that the exchange rate was "flexible" rather than freely fluctuating, the official Government exchange fund intervened in the market for foreign exchange only to smooth out sharp, short-run fluctuations in the market occasioned by such events as the placing of a large international loan or the delivery date of a large shipment of goods. The long-run rate of exchange of the Canadian dollar was left to the determination of the forces of supply and demand for foreign currency. Hence, the Canadian experience from 1951-1961 affords a unique example of the operation of a large, highly industrialized country under a system of flexible exchange rates. The Canadian economy is especially well suited for a study of this type in that a large sector of Canada's gross national product is dependent upon

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[1]Richard E. Caves, "Flexible Exchange Rates," Papers and Proceedings of the American Economic Association Annual Meeting, LIII (1963), p. 120.

export trade, and the Canadian economy has operated under the pressure and stimulus of exceptionally large inflows of foreign capital.

The operation of the Canadian international accounts has been an area of intensive interest to researchers in the field of international trade and finance. Much of the work has been done by Canadian scholars, but a number of notable studies have been made by United States economists. The classic study of the Canadian international accounts, and the standard work necessary for any understanding of the Canadian financial situation and its development, has been Jacob Viner's study published in 1924 by Harvard University Press entitled, Canada's Balance of International Indebtedness 1900-1913. Viner's study, undertaken to test the classical Mill-Thornton mechanism of adjustment of the international balances of indebtedness, pointed out many trends of foreign investment in Canada that the author found still pertinent to the post-World War II period in Canada.

Two other more recent studies of the Canadian economy and balance of payments that the author found useful were John A. Stovel's Canada In the World Economy, published in 1959 by Harvard University Press, and Richard Caves and Richard Holton's book The Canadian Economy: Prospect and Retrospect published in 1959 by Harvard University Press. Both of these books contained extensive information about the Canadian economy through the post-World War II period. Mr. Caves and Mr. Holton attempted to use their data to project the nature of the Canadian economy in the year 1970. Due to the limit of this thesis, these projections were of little use to the author. However, these projections,

and the method used by Caves and Holton in arriving at these projections, should prove extremely helpful to further research in this area.

The writings in the field of exchange rate theory are much too numerous to be adequately covered in this review. However, special mention must be made of Milton Friedman's essay, "The Case For Flexible Exchange Rates," published in 1953 in Essays in Positive Economics, published by the University of Chicago Press, which represents the best statement of the case for completely flexible exchange rates. The case for fixed exchange rates, as opposed to flexible rates, is ably presented by Ragnar Nurkse in his essay, Conditions of International Monetary Equilibrium, published in 1945 by Princeton University Press.[2] Rudolph Rhomberg's article, "The Canadian Foreign Exchange Market," published in the April, 1960 issue of the International Monetary Fund Staff Papers, was an extremely valuable theoretical work concerned with the effects of the flows of international capital on the Canadian exchange rate.

Canadian publications that are important in the area covered by this thesis are the twelve volume series of studies published by the University of Toronto. The most recent study in this series, Paul Wonnacott's book, The Canadian Dollar 1948-1958, published in 1960 by the University of Toronto Press, was an especially valuable study because of its analysis of the impact of long and short-term capital

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[2]For a more complete study of flexible and fixed exchange rates see, International Currency Experience; Lessons of the Interwar Period, League of Nations Economic and Financial and Transit Department, 1944.

movements on the Canadian exchange rate. Also, the Canadian Journal of Economics and Political Science was the best source of scholarly articles on specific aspects of the Canadian balance of payments and the Canadian economy.

The most valuable sources for research in the field of Canadian international trade and finance are the official government publications of the Bank of Canada and the Dominion Bureau of Statistics. The annual reports of the Bank of Canada[3] were a rich source of information concerning the operation of the Canadian economy and Canadian balance of payments. The annual and quarterly reports of the Dominion Bureau of Statistics[4] on Canada's balance of payments and international investment position are the best sources available specifically concerned with Canada's international financial position. These reports contain the most complete breakdown of the direction and magnitude of Canada's commodity trade and the movements of capital into and out of Canada.

Definition of Terms

The official statistics published by the Dominion Bureau of Statistics were used by the author in arriving at estimates of the direction and magnitude of the international flows of capital into

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[3]Annual Reports of the Bank of Canada to the Minister of Finance, Bank of Canada, Ottawa, Canada.

[4]Canada's Balance of Payments and International Investment Position, published annually by Dominion Bureau of Statistics.
Quarterly Estimates of Canada's Balance of Payments, published quarterly by the Dominion Bureau of Statistics.

and out of Canada and their effects on the Canadian international accounts. The statistics used in this thesis were based on the most recent revised estimates of the Dominion Bureau of Statistics. However, the data for 1961 and 1962 were still preliminary and subject to revision. Since Canadian statistics were used almost exclusively, all totals denominated in dollars refer to Canadian dollar totals unless specifically noted otherwise in the thesis.

For the purposes of this thesis, the author found it necessary to define long-term, short-term, and direct investment capital. The definitions chosen by the author correspond to those used by the International Monetary Fund in its balance of payments estimates. Net long-term capital movements will be defined as net direct investment inflows plus new private Canadian securities issued to foreigners minus retirement of foreign held private Canadian securities plus the net balance on official capital movements which includes treasury bills, net loans extended by the government, plus new securities issued by the government minus securities held abroad retired by the government. Direct investment by itself will be defined to mean investments in foreign controlled companies by the controlling interest only, which, in fact, is limited to long-term components of such investments. Direct investment totals do not include reinvested earnings of subsidiaries. Private short-term capital movements will be defined to include net transactions in outstanding Canadian securities plus net transactions by Canadians in outstanding foreign securities and an item "other capital movements" which includes changes in bank balances held by Canadians abroad, changes in private loans, commercial accounts

payable and receivable, changes in intercompany accounts, and after 1960, changes in foreign exchange liabilities by Canadian banks to foreign residents. Changes in official holdings of foreign exchange, although short-term in nature, will be omitted in calculating short-term capital movements. While Canada operated under a fixed exchange rate, changes in official reserves acted as a balancing item, and under the fluctuating exchange rate, they were used by the authorities only to smooth out short-run fluctuations in the exchange rate.

Scope of the Thesis

The scope of this thesis will be limited to the repercussions of inflows of foreign capital on the Canadian international accounts. The impact of these inflows of foreign investment capital on the structure and control of the Canadian economy will be considered only insofar as the author feels that they are pertinent to the purposes of this thesis. Such important problems as the effect of increased foreign ownership and control on the independence and operation of the Canadian economy; and the effect these inflows, predominantly from the United States, have had on increasing Canada's sensitivity to cyclical economic fluctuations originating in the United States will be mentioned, but not considered in detail. To the extent that it had a direct effect on the international flows of foreign capital into Canada, the role of monetary policy in Canada will be considered. A full examination of the monetary policy, as related to purely domestic Canadian economic conditions, will not be undertaken.

Chapter II will summarize the background of the essential features of the Canadian economy that are relevant for the purposes of this thesis. Canada's international transactions, prior to 1946, will be considered briefly, and findings by Jacob Viner in his study of the period 1900-1913 will be considered. The postwar period, 1946-1955, will be considered in greater detail. Special emphasis will be given to the changes in the Canadian international economic situation that led to an end to Canada's triangular balancing of trade with the United States and Great Britain. The growing dependence of the Canadian economy on the United States, both as an export market and a source of investment capital, will be traced, and the effect of this growing dependence on the Canadian balance of international payments will be discussed.

In Chapter III, the hypothesis posed by this thesis will be subjected to examination. The inflows of foreign capital will be measured, and their effects on the Canadian economy in the period, 1956-1960, will be examined. In Chapter IV, the reaction of the Canadian authorities in the period, 1961-1962, to these flows of international capital will be examined, and the results of these reactions studied. In Chapter V, the findings of this thesis will be briefly summarized and the author will present some observations on the Canadian experience in the period, 1956-1962.

CHAPTER II

HISTORICAL PERSPECTIVE OF THE CANADIAN ECONOMY

Introduction

The Canadian economy is essentially an open economy. "The nation that today is Canada has never been master of its own destiny; as a satellitic staple-producing economy, it reflected, and still reflects, in its rate of development the imperatives of the more advanced areas."[1] The Canadian economy leans heavily on the external supports of her foreign trade, as is illustrated by the fact that exports traditionally account for 20 to 30 percent of Canada's gross national product. Canada, however, is not primarily a "hewer of wood and a drawer of water," but is a highly industrialized country with a skilled labor force and a highly developed financial system. During the period, 1949-1959, the Canadian population increased by 2.8 percent a year, civilian employment increased by 19 percent, and productivity of labor appears to have increased by 25 percent.[2] In the decade ending in 1961, nearly 1,300,000 people were added to the work force which in 1961 averaged

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[1] Hugh G. Aitken, "The Changing Structure of the Canadian Economy," The American Economic Impact on Canada (Duke University Commonwealth Studies Center, Number 12 /Durham, 1959/), p. 3.

[2] Economic Development and Its Financing in Canada, Commonwealth Economic Committee (London, 1961), p. 8.

6,500,000. Twenty-five percent of this labor force was in manufacturing, 25 percent in the service industries, 16 percent in trade, and only 12 percent in agriculture.[3] Over the period, 1949-1962, Canadian gross national product rose from approximately 14 billion dollars in 1949 to 30 billion in 1956 and reached the 40 billion dollar mark by 1962.

International Aspects of the Canadian Economy 1900-1946

During the twentieth century, Canadian economic policy was influenced by two main external forces. The first of these was Great Britain, and the other was the United States. During each period of Canadian expansion, there was a heavy capital inflow from both of these countries supplementing domestic savings. In the period, 1900-1913, although there were large United States capital flows, the flow was predominantly British. As the century has progressed, the percentages changed with the United States becoming the predominant source of capital for Canadian domestic economic expansion.

Another characteristic of the Canadian international accounts, which was noted as early as the 1900-1913 period by Jacob Viner in his study, Canada's Balance of International Indebtedness 1900-1913,[4] was Canada's triangular balancing of international accounts. According to Viner's theory, Canadian capital borrowing from Great Britain

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[3] Canada 1962, Dominion Bureau of Statistics (Ottawa, 1960), p. 64.

[4] Jacob Viner, Canada's Balance of International Indebtedness 1900-1913 (Harvard Economics Studies Number 26 /Cambridge, 1924/).

entered Canada by the way of increased purchases of United States goods. "The British loans to Canada, by furthering the growth of manufacturing in Canada, operated indirectly to strengthen instead of weaken the predominance of the United States as a source of Canadian imports."[5]

Britain and the Commonwealth nations were the chief market for Canadian exports, while the United States was the chief source of Canadian imports. British investments in Canada in the period, 1900-1913, mainly took the form of purchases of government securities and industrial and financial bonds and stocks without voting rights. Viner found that American investors commonly retained direct control of their Canadian investments. The majority of the United States investments consisted of investment in branch plants of United States industries and in mining and lumbering enterprises controlled by the investors. The American investors generally made their Canadian investments in enterprises closely resembling those with which they were familiar at home, and operated them under similar financial, sales, and technological methods.[6] "The greater degree of control over their Canadian investments by United States investors tended to increase imports from the United States. Plant manager's familiarity with American styles, standards, specifications, machinery and production techniques led to purchases in the United States."[7] Despite heavy borrowing from Britain throughout the period prior to World

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[5]Ibid., p. 291.

[6]Ibid., p. 286.

[7]Ibid.

War II, Canada was able to maintain a favorable balance of commodity trade with Britain. However, in the case of the United States, the current account deficit exceeded the capital imported from the United States. Therefore, prior to 1946, Canada was able to settle her current account deficits with the United States, which arose from her high propensity to import United States goods, by converting sterling revenue gained from a current account surplus with the rest of the world into dollars.

The Canadian Economy 1946-1955

The predominant feature of the Canadian international accounts in the post-World War II period was the marked tendency for the Canadian export and import market to become increasingly centered in the United States, and for the triangular balancing which had existed in the Canadian accounts to disappear. The heart of the balance of payments problem of the Canadian economy in the postwar years was the difficulty of maintaining important overseas markets on which a number of basic Canadian industries depended heavily, but whose ability to settle in convertible currencies was severely limited. The Canadian authorities attacked this problem in two ways. First, Canada engaged in an ambitious program of lending to the United Kingdom and other overseas countries; and second, Canada became one of the leading countries in the postwar world in the attempt to restore international convertibility and free trade. In 1952, Canada became one of the first countries in the postwar period to accept the obligations of convertibility and nondiscrimination as set forth in

Article VIII of the Bretton Woods Articles of Agreement. Canada's original quota to the International Monetary Fund was 300 million dollars U. S., and in 1959, was raised to 550 million dollars U. S. This amounts to 3.7 percent of the Fund's total resources. In January, 1962, Canada was one of the ten major industrial countries who reached an agreement to lend their currencies to the International Monetary Fund when additional resources are needed by the Fund to cope with international instability.[8]

This program of foreign lending, however, led to serious bilateral disequilibrium in Canada's international accounts. "Canadian aid extended for grants or loans and similar investment purposes, as measured for balance of payment purposes, amounted to 3.2 billion dollars gross or 2.5 billion dollars net in the postwar period to the end of 1954."[9] The Canadian economy was expanding rapidly and private domestic and foreign investment in Canada was proceeding at a rapid pace. There was a heavy demand for both consumer and investment goods produced in the United States, and throughout the postwar period, Canada continued to run a current account deficit with the United States. Although she had a large favorable current account balance with the rest of the world, the part of this balance that was created

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[8] "The Role of the Bank of Canada in Foreign Exchange," Submissions by the Bank of Canada to the Royal Commission on Banking and Finance (Ottawa, 1962), p. 60.

[9] Canada's International Investment Position 1926-1954, Dominion Bureau of Statistics (International Payments Section) (Ottawa, 1956), p. 49.

by extending foreign loans and credits gave rise to no inflow of convertible foreign exchange. Adding to her balancing problems, foreign exchange gained from sterling countries at this time was inconvertible into dollars to settle Canada's deficit with the United States.

By 1947, proceeds from the loans Canada had extended to overseas countries were being used up much faster than had been expected, there was a rising demand for goods, the only source of which was in the United States, and domestic investment in plant, equipment, and housing reached record levels adding to the inflationary pressure. During 1947, imports from the United States rose from 1,400 million dollars to 2,000 million dollars. Current receipts from the United States rose only nine percent while current expenditures rose 30 percent.[10] Canada had a current account deficit of 1.1 billion dollars with the United States and had to make capital payments of 240 million dollars to the United States. Of her surplus of 1.2 billion dollars with the rest of the world, 600 million was financed by Canadian grants and loans which gave rise to no inflow of convertible exchange. Under these conditions, the deficit with the United States had to be met by the use of 740 million dollars of Canada's gold and dollar reserves.[11] As a result of this serious loss of reserves,

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[10] Foreign Exchange Control Board Annual Report 1947, Foreign Exchange Control Board (Ottawa, 1948), p. 21.

[11] International Monetary Fund Annual Report 1947, International Monetary Fund (Washington, 1948), p. 7.

Canada's official exchange reserves declined from 1,600 million dollars in mid-1946 to 500 million dollars in November, 1947.

By the end of 1947, some drastic steps were called for to halt the drain on the Canadian reserves. Since the problem was not one of an overall unfavorable current account balance, but rather an unfavorable balance with one currency area, the Government followed a policy, not of devaluation, but of direct controls. While these controls were officially declared to be nondiscriminatory in nature, they were, in effect, directly aimed at reducing imports from the United States and stimulating imports from Europe. As added insurance, the Canadian Government obtained a line of credit of 300 million dollars from the Export-Import Bank, although not more than half of it was drawn upon.[12]

The "Conservation of Currency Program" of the Canadian Government was a success, and in the next three years, changes occurred in the Canadian balance of payments that did much to eliminate the bilateral disequilibrium in Canada's international accounts. In 1948, the current account deficit with the United States decreased from 1,135 million dollars in 1947 to 401 million dollars. On capital account, there was a significant reduction in the amount of credit extended by Canada to foreign countries. In 1949, in the face of world-wide devaluations, Canada devalued her dollar to 90.9 cents U. S. This was a modest defensive devaluation in the face of the 30

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[12] J. Douglas Gibson, "Postwar Economic Development and Policy in Canada," Canadian Journal of Economics and Political Science, XX (1954), p. 447.

percent devaluation of sterling. This devaluation made Canadian exports cheaper in the United States market and more expensive in European markets. Also, the advent of the Marshall Plan led to an inflow of United States dollars into Canada as European countries made offshore purchases of Canadian goods, especially wheat.

In 1950, the rest of the world became a net supplier of funds to the Canadian economy, and in 1950, the annual surplus on current account turned into a deficit. However, in the early summer of 1950, speculators came to believe that the Canadian dollar was undervalued at 90.9 cents U. S. United States' speculative capital began moving into Canada in the early summer of 1950, and between July and September, Canadian reserves rose from 1,255 million dollars U. S. to 1,790 million dollars U. S., or an increase of 43 percent. At a time when domestic economic conditions called for a policy of monetary restraint, it became increasingly difficult for the Canadian monetary authority to offset the expansionary effects of this flood of foreign capital. The Canadian authorities placed considerable emphasis on the financing problem. In 1950, in its Annual Report, the Bank of Canada officially stated:

> Other means of providing necessary Canadian dollar financing such as the use of existing Government cash balances, issue of securities to banks or to the public, or the acquisition of foreign exchange by the Bank of Canada, all involved an increase in the aggregate liquid assets held by the general public.[13]

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[13] Bank of Canada Annual Report 1950, Bank of Canada (Ottawa, 1951), p. 8.

By the end of September, the monetary authority was no longer willing to absorb further excessive capital inflows. Therefore, on September 30, 1950, the Canadian Government took a bold step, and by order-in-council under the authority of the Foreign Exchange Act, cancelled the Canadian official exchange rate. The rate of exchange would henceforth be determined by conditions of supply and demand for foreign currencies in Canada, and the Exchange Control Board would only intervene in the market to smooth out large adverse movements of the rate. The move was made more palatable to the International Monetary Fund by the statement that the free rate was only temporary and Canada would return to a fixed rate as soon as conditions allowed. In justification of this policy, the Foreign Exchange Board stated in its Annual Report:

> In considering action appropriate to check the inflow, the Government reviewed the possibility of moving the par value of the Canadian dollar to a new and higher fixed level but concluded that under the conditions then existing it was impossible to determine in advance with any reasonable assurance what new level would be appropriate. It therefore decided that the rate of exchange should be left to be determined by market forces.[14]

Whereas the 1946 appreciation had been motivated mainly by domestic economic considerations, and the 1949 depreciation had been in the main a defensive policy, in 1950, the short-term capital movements had swamped the long-term and current account balance, changing a payments deficit of 189 million dollars into a surplus of 561 million dollars.

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[14] Foreign Exchange Control Board Annual Report 1950, pp. 14-15.

"The 1950 Canadian experience gives an example to support Iverson's statement that short-term capital movements may provide the initial disturbances originating in the other accounts."[15]

The postwar period was a period of rapid growth in the Canadian economy. The demand for goods and services pressed heavily against the available supply and reflecting this, the demand for loanable funds pressed heavily against the supply. In the postwar period to the end of 1956, Canada passed through three waves of inflationary pressure. When the Second World War ended, the Canadian public had control over very large liquid assets with which they could make their pent-up demand for consumer goods, industrial goods, and social goods effective. As a result, Canada experienced her first wave of inflationary pressure which lasted from 1946-1948. Canada experienced the second wave of inflationary pressure in the period, 1949-1951. Wholesale prices rose 40 percent in this period and consumer prices rose 20 percent. The period, 1952-1954, was characterized by growth with fairly stable prices, but in 1955, inflationary pressures again began to appear.

The first postwar inflation was centered mainly in the goods market; the second, 1949-1951, was in both the capital and goods markets; and the third period, 1955-1956, was centered in the capital

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[15] Paul Wonnacott, The Canadian Dollar 1948-1958 (University of Toronto Studies in Economics Number 13 /Toronto, 1960/), p. 57.

market.[16] Between June, 1955 and December, 1956, the tender rate on treasury bills rose 250 percent and the yield on fifteen year government bonds rose 28.5 percent.[17]

> In Canada the chief cause of inflationary pressures was a great increase in capital expenditures, a boom in investment, particularly business investment in resource development and in fixed assets, construction, and expansion of equipment. A significant part of the total, including many of the largest projects, arose from large foreign enterprises taking the lead in developing Canadian resources with a view to export of raw materials to the country of origin of the foreign enterprise.[18]

During the postwar period, no sector of the Canadian economy was forced to reduce its demands for goods and services. There were government surpluses resulting from heavy taxes that tended to reduce the buying power of consumers, but the disposition of these surpluses by the government tended to transfer funds back to the public via financial institutions. As a result, there were increases in expenditures by every sector of the economy. Consumer expenditures rose steadily, the stock of capital increased, and expenditures for social capital accounted for 39 percent of all expenditures on new construction and machinery in the period, 1946-1956.[19] However,

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[16]William C. Hood, _Financing of Economic Activity in Canada_, Royal Commission on Canada's Economic Prospects (Ottawa, 1958), p. 104.

[17]Ibid.

[18]_Bank of Canada Annual Report 1956_, Bank of Canada (Ottawa, 1957), p. 4.

[19]Hood, p. 119.

by the end of 1956, wholesale prices were 70 percent higher than in June, 1946 and consumer prices were 60 percent higher.[20]

On Canada's international accounts, Canadian exports more than doubled, increasing from 2,393 million dollars in 1946 to 4,837 million dollars in 1956. However, Canada's balance on current account went from a plus 460 million dollars in 1946 to a minus 272 million dollars in 1950, to a minus 452 million dollars in 1955 and reached a deficit of 1,179 million dollars at the end of 1956.[21] Canada's balance on current account with the United States went from a minus 607 million dollars in 1946, to a minus 400 million dollars in 1950, then increased to a deficit of 1,640 million dollars by the end of 1956.

Foreign Investment in Canada

This growing current account deficit, predominantly with the United States, was balanced by a steadily growing inflow of foreign capital into Canada. During the postwar period, heavy flows of United States capital, both of the direct and portfolio type, began to move across the border into Canada. Canada, since the beginning of the twentieth century, had been a prime center of United States foreign investments. In the boom period, 1900-1913, Jacob Viner had found large amounts of United States funds flowing into Canada along with the predominantly British inflow.

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[20] Ibid.

[21] John A. Stovel, Canada in the World Economy (Harvard Economics Studies Number 108 /Cambridge, 1959/), pp. 344-345.

> During the first part of the interwar period the United States became the principal source of external capital, and by 1926 the United States owned portion of Canada's international debt exceeded that owned in the United Kingdom, which had not increased since 1914. Growth in United States' investment in Canada was interrupted in the 1930's but began again in the 1940's. By the end of World War II, United States investments of 4,990 million dollars compared with British investments of 1,750 million dollars.[22]

"In the postwar years to 1954, one-third of United States long-term foreign investment was in Canada. United States' investments in Canada were greater than United States' investments in any other country, and were greater than in all Latin America."[23] British investments in Canada totaled 3,250 million dollars at the end of 1959. Although this total was much larger than the total at the end of 1945, it accounted for only 16 percent of the total nonresident investment in Canada compared with 36 percent at the end of 1939. Investments of countries other than the United States and the United Kingdom made up eight percent of the total in 1959. Nearly 90 percent of these investments came from countries in Western Eruope, mainly Belgium, Germany, France, and Switzerland. The remaining 76 percent, or 15,725 million dollars in 1959, were direct investment funds controlled in the United States.[24]

The value of United States direct investment in Canada rose one-third in the period, 1946-1948, while it rose 80 percent in the

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[22] Canada Year Book 1960, Dominion Bureau of Statistics (Ottawa, 1960), p. 1121.

[23] The Canadian International Investment Position, p. 13.

[24] Canada Year Book 1960, p. 1121.

period, 1949-1954. Much of this rise occurred in the petroleum and mining industries. The petroleum industry alone accounted for almost one billion dollars of the $2.9 billion rise in United States investments between 1945 and 1953. Mining, apart from petroleum, accounted for 362 million dollars of the 1945-1953 increase. The increase in manufacturing, other than petroleum, was 1,238 million dollars or more than the total United States' investment in that area in 1945.[25]

> A survey for the year 1953 showed that 771 establishments of 315 enterprises controlled in the United States accounted for 30 percent of the selling value of all Canadian factory shipments. These establishments, 2 percent of all manufacturing establishments, employed 21 percent of all employees in manufacturing industries, accounted for 25 percent of the earnings in the industry, 31 percent of the cost at plant of materials used and 29 percent of the value added by manufacturing.[26]

"In 1946, only twenty-seven percent of Canada's exports were directed to the United Kingdom compared to thirty-eight percent to the United States. By 1950, these proportions had been altered further to 15 percent and 65 percent. In 1956, these proportions were 16.8 percent and 58 percent, respectively."[27] In a longer prospective, adjusted for price inflation, Canada's imports from the United States rose in the period, 1937-1957, by 388 percent while United States

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[25] The Canadian International Investment Position, p. 25.

[26] Ibid.

[27] Stovel, p. 306.

imports from Canada rose by 348 percent.[28] In 1957, the United States was the principal customer for 10 out of 11 of Canada's export items worth more than 100 million dollars. The United States took 86 percent of Canadian newsprint, 80 percent of her woodpulp, 74 percent of her wood planks and boards, 62 percent of her nickel, and 40 percent of her aluminum and copper. Likewise, the United States was the principal supplier of 8 out of 9 of Canada's import items worth over 100 million dollars.[29]

The Canadian balance of international indebtedness rose rapidly since the end of World War II.[30] At the end of 1948, net Canadian international indebtedness amounted to 3.9 billion dollars, by the end of 1955, it had reached 7.9 billion dollars and by the end of 1960, it had reached 17 billion dollars, over a four fold increase since 1948.[31] However, the relatively slow growth in Canadian indebtedness during the period, 1948-1954, does not fully reflect the true growth of

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[28] Constant Southworth and W. W. Buchanan, Changes in Trade Restrictions Between the U. S. and Canada (Canadian-American Committee of the National Planning Association and the Private Planning Association of Canada [Washington D. C., 1959]), p. 12.

[29] Economic Development and Its Financing in Canada, p. 11.

[30] Canada's balance of international indebtedness or net indebtedness to other countries is the amount by which the claims of nonresidents against the Canadian economy exceed the claims of Canadians against other countries. Included in gross assets and liabilities used in arriving at the balance are all long-tern investments along with short-term assets and liabilities except those of a commercial nature.

[31] Bank of Canada Annual Report 1960, p. 47.

Canadian indebtedness to the United States. Although net Canadian indebtedness to all countries increased from 3.8 billion dollars to 6.8 billion dollars, net indebtedness to the United States alone rose by 2.9 billion dollars in the period, 1948 to 1954.[32]

The primary effect of this increase in Canadian dependence upon the United States has been to perpetuate Canada's traditional role as a staple-producing country. United States investments, although large, have been selective. Since the United States was already a highly industrialized country, with a productive industrial sector, the market demand that the United States exerted on Canada was primarily a demand for industrial raw materials. The influence of the United States was to encourage the development of the Canadian economy along lines complementary to the economy of the United States; and this made the rate of economic development in Canada depend largely upon exploiting this United States' demand.[33] According to Professor R. J. Wonnacott, "The paramount relationships binding Canada to the United States are the dependence of the Canadian metal mining and refining sector on United States' demand for base metals and their products, and the dependency of the Canadian forestry and paper products sectors on United States demand for paper products."[34]

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[32] The Canadian International Investment Position 1926-1954, p. 15.

[33] Aitken, p. 11.

[34] Ronald J. Wonnacott, Canadian-American Dependence (Amsterdam, 1961), p. 95.

Although the heavy inflow of United States capital into Canada made possible greater and more rapid expansion of the Canadian economy than would have been possible if Canada had relied solely on domestic savings, the inflow was viewed with mixed feelings by Canadians. To many Canadians, this trend of United States ownership and control of basic Canadian industries was undesirable both from an economic and a political viewpoint. They preferred a situation where there was more diversification in the economy and where more of the control of the future direction of Canadian growth rested in the hands of Canadians and less in the hands of foreigners.[35] Canadians feared the dominant position of the United States controlled firms in the Canadian economy and the increased cyclical sensitivity of the Canadian economy to United States' economic conditions. Canadian national pride was aroused by the seeming unconcern of the United States for economic conditions in Canada and the personnel policies of United States firms operating in Canada. Another fear in the mid-1950's was that "a sudden cessation of the capital inflow or a large-scale withdrawal of capital would have serious consequences for Canadian income and employment levels."[36] However, this view was usually discounted on the grounds that United States' investments were of a long-term type geared to Canadian development.

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[35] Aitken, p. 12.

[36] Irving M. Brecher, "The Flow of U. S. Investment Funds Into Canada Since World War II," The American Economic Impact on Canada (Duke Commonwealth Studies Center, Number 12 /Durham, 1959/), p. 115.

CHAPTER III

INFLOWS OF FOREIGN CAPITAL 1956-1960

Direct Investment Inflows Into Canada 1956-1960

During 1955, 1956, and the first half of 1957, Canada experienced a boom period of investment. The dynamic driving force of this boom was the inflow of foreign capital into the development of Canadian resources for export. The inflow of direct investment funds, predominantly from the United States, rose from 392 million dollars in 1954 to 417 million dollars in 1955, then reached record levels of 583 million dollars in 1956 and 514 million dollars in 1957. "Investment outlays on projects associated with resource development rose by two-thirds in 1956 and continued to rise well into 1957."[1]

By the end of 1957, it became clear that, relative to the world's supply and demand for natural resources, there was overcapacity in the Canadian economy. As a result, expansion of new capacity in the resource industry came to a halt, and borrowing by resource industries showed a sharp contraction. In 1957, borrowing from chartered banks and securities markets by resource industries amounted to 512 million dollars and in 1958, it amounted to only 194 million dollars. In 1959

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[1] *Bank of Canada Annual Report 1957*, p. 6.

and 1960, there were net retirements by resource industries of 42 million dollars and 60 million dollars.[2] In 1960, the Annual Report of the Bank of Canada stated:

> It is now apparent that the assumptions on which the huge Canadian investment programme rested will be realized much more slowly than was then expected. Total world demand for the raw materials produced by Canada's primary industries is growing at a moderate rate, but non-Canadian sources of supply have also been expanding. The capacity developed in Canada's major resource industries during the 1955-1957 boom is not being fully utilized.[3]

However, when the boom of 1955-1957 came to a halt in Canada, inflows of foreign capital did not moderate, but increased. In the period, 1951-1955, the inflows of foreign direct investment capital into Canada accounted for 1,890 million dollars of the total net capital inflow of 1,926 million dollars. In the period, 1956-1960, the inflows of direct investment capital were much larger amounting to 2,662 million dollars. However, this was only about 40 percent of the total net capital inflow of 6,624 million dollars. As in the earlier postwar years, the greatest part of the inflow of foreign direct investment capital, "technical know-how," and entrepreneur skill originated in the United States. The United States alone accounted for 1,933 million dollars of the total inflow of 2,662 million dollars in the period, 1959-1960.

Prior to 1956, the inflows of foreign direct investment capital supplemented Canadian savings and made possible a more rapid rate of

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[2]<u>Bank of Canada Annual Report 1960</u>, p. 79.

[3]Ibid., p. 11.

growth for Canada than would have been possible if Canada had relied solely on internal sources of financing. The item "direct investment," however, covers a variety of transactions. It includes not only investment in new plant facilities, but also, acquisition of existing Canadian assets by foreigners. In many cases, flows of direct investment funds may represent parent companies providing capital for branch plants in Canada who are acquiring or disposing of existing assets or are shifting the nature of their financial liabilities. Although this is extremely difficult to determine, it appears that after 1957, the inflows of direct investment capital were too large for the Canadian economy to absorb. Instead of leading to the development of new capital facilities in Canada, the inflows of capital added to the already excessive demand in Canada. This led to an increasing deficit on current account as the proceeds of these inflows of capital were transferred from Canada in the form of increased imports of goods and services.

One way of measuring the rate of capital formation occurring in the Canadian economy during this period is to look at capital spending as a percent of gross national expenditure. In 1957, capital spending as a percent of gross national expenditure reached a peak of 23.1 percent; in 1958, it declined to 21.4 percent; in 1959, to 20.1 percent and in 1960, accounted for only 18.6 percent of gross national expenditure. This conclusion is further substantiated by the Dominion Bureau of Statistics, which in its annual report for 1959 stated, "Despite difficulties of measurement, there is evidence that most, if not all, of the increased net movement into Canada in 1959 of foreign

direct investment capital was related to the acquisition of existing assets rather than to new capital formation."[4]

TABLE I

PRIVATE CAPITAL EXPENDITURE AS A PERCENT OF GROSS NATIONAL EXPENDITURE

Year	Private Capital Expenditure[a]	Gross National Expenditure	Percent of Gross National Expenditure
	-Millions of Canadian Dollars-		
1955	5,210	27,132	19.2
1956	6,774	30,585	22.2
1957	7,335	31,773	23.1
1958	6,975	32,606	21.4
1959	6,961	34,593	20.1
1960	6,692	35,928	18.6

[a]Private capital expenditure is composed of new residential construction, new nonresidential construction and new machinery and equipment expenditures.

Source: Canadian Statistical Review, Dominion Bureau of Statistics (Ottawa), various years.

The rising level of direct investment in Canada led to an increasing deficit on current account in the Canadian balance of payments. Income in the form of dividends, interest, and payments for business

[4]The Canadian Balance of Payments 1959 and International Investment Position, Dominion Bureau of Statistics, Publication Numbers 67-201 (Ottawa, 1960), p. 31.

services was transferred from Canada to foreign residents aggravating Canada's current account deficit. In the period, 1956-1960, Canada made net payments of 2,162 million dollars in interest and dividends to all countries, of which 2,012 million dollars went to residents of the United States. These remittances going to United States' residents were predominantly on direct investments. In 1959, 84 percent of the dividend remittances, or 347 million dollars, paid United States' residents were based on direct investment. Seventy percent of these payments were from United States' direct investment in manufacturing and mining and smelting.[5]

Portfolio and Other Short-Term Capital Movements
1956-1960

Whereas before 1956, direct investment capital was the predominant type of capital inflow, in the period, 1956-1960, the inflow of portfolio capital became Canada's largest source of foreign capital. A very high level of international portfolio security transactions between Canada and other countries was characteristic of the period, 1956-1960. In 1956, gross security transactions approached 3.0 billion dollars, in 1957, 3.2 billion dollars, in 1958, 2.5 billion dollars, and in 1959, 3.1 billion dollars.[6] This inflow of portfolio capital for the most part represented the sale of Canadian issues payable in United States' dollars. The largest part of these portfolio transactions

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[5]Ibid., p. 22.

[6]Ibid., p. 35.

were "initiated by Canadian borrowers who actively sought out foreign sources of financing."[7] The net inflow of capital resulting from the issue of new issues in foreign money markets increased three fold in the period, 1956-1960 compared to the previous five year period (Table II). The net inflow of capital resulting from the sale of new securities was 2,363 million dollars in the period, 1956-1960, compared to an inflow of 733 million dollars during 1951-1955. One thousand one hundred ten million of this increased total was accounted for by the heavy borrowing of provincial and municipal governments and Canadian corporate bodies in foreign money markets. The peak years of provincial and municipal government foreign borrowing were 1956, 1958, and 1959, when they accounted for net inflows of 275 million dollars, 259 million dollars, and 352 million dollars, respectively.[8] The sale of new Canadian securities was predominantly in the United States. In both 1958 and 1959, residents of the United States bought 90 percent of the new Canadian securities sold to nonresidents.[9]

Inflows of capital resulting from short-term capital movements--purchase and sale of outstanding securities plus "other capital movement"--were at a much higher level in the period, 1956-1960, than in the preceeding five years. The total movement of this type of capital

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[7]Ibid., p. 34.

[8]Bank of Canada Statistical Review, Bank of Canada (Ottawa, March, 1963), p. 171.

[9]The Canadian Balance of Payments 1959 and International Investment Position, p. 37.

TABLE II

GROSS NEW BOND ISSUES PAYABLE IN FOREIGN CURRENCIES
OF CANADIAN PROVINCES, MUNICIPALITIES,
AND CORPORATIONS

Quarter	Bond Issues Payable in Foreign Currency	Interest Rate Differential Between U.S. and Canada (In Base Points)
1956		
I	118	45
II	132	54
III	164	65
IV	136	66
1957		
I	225	82
II	245	85
III	131	83
IV	69	31
1958		
I	142	51
II	241	68
III	81	75
IV	53	90
1959		
I	144	89
II	72	74
III	172	74
IV	142	80
1960		
I	149	96
II	110	104
III	21	99
IV	19	113

Source: Robert F. Gemmill, "New Bond Issues in the U. S. Market," Federal Reserve Bulletin, Volume 49 (1963), p. 589.

led to a net outflow of several million dollars over the period, 1951-1955. In 1956-1960, there was a net inflow of 1,563 million dollars resulting from short-term capital movements. Six hundred and thirty-four million dollars of this inflow in the latter period being accounted for by purchases of outstanding Canadian stocks by foreign residents.

One of the primary reasons for the increased level of Canada's foreign borrowing was the "restrictive" monetary policy followed by the monetary authority and the heavy pressure on the supply of loanable funds in Canada during this period.[10] The Conservative Government of Prime Minister John Diefenbaker, which came to power in Canada in 1958, was committed to a program of deficit financing and expansion in the Canadian economy. While the Canadian municipal governments were running annual deficits of over 300 million dollars a year, the Government of Canada ran an annual deficit of 775 million dollars in 1958, 362 million dollars in 1959 and a deficit of 411 million dollars in 1960.[11] The monetary authority, represented by

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[10]Although the money supply in Canada increased more rapidly than the money supply in the U. S., the degree of liquidity in the Canadian economy was less than in the U. S. In 1960, the average American held about twice as much in currency and demand deposits as the average Canadian. The ratio of money supply to gross national product in 1960 was 28 percent in the U. S. compared to 19 percent in Canada. In both countries, this ratio declined from 1949-1960. In Canada, the ratio of money supply to gross national product declined from 24 percent to 19 percent. Although the decline of the U. S. ratio from 42 percent to 28 percent was greater, the Canadian contraction starting from a lower base probably had a more pronounced contractionary influence.

Clarence L. Barber, "Canada's Unemployment Problem," _Canadian Journal of Economics and Political Science_, XVIII (1962), p. 88.

[11]_Bank of Canada Annual Report 1961_, p. 39.

Mr. James E. Coyne, Governor of the Bank of Canada, was, however, committed to a restrictive monetary policy. Mr. Coyne's hostility to the Government's expansionary programs of deficit financing and Canada's increasing current account deficit grew through 1958, and reached a climax in his 1959 Annual Report. In his 1959 report, Mr. Coyne stated:

> It must be recognized that in a capital-hungry world we cannot in fact count on having ready access to foreign capital year after year on a large scale. The longer the process of attempted overexpansion goes on, the more maladjustments will be built into our economy, and the more difficult and painful will be the readjustments which will in time be forced upon us. We must in the end learn as a nation to live within our means and exhibit the strength and will to do so.[12]

This disagreement between the Bank of Canada and the Government on basic issues of economic policy led to an increasing deterioration of coordination and cooperation in the management of monetary and fiscal policies in Canada. Mr. Coyne refused to cooperate with the Government's policies, and the Diefenbaker Government refused to accept the responsibility for monetary policy and remove Mr. Coyne. As a result, both the Canadian long-term and short-term interest rate continued to rise, and the interest rate differential between the United States and Canada widened. The Canadian short-term rate of interest which had reached a high point of 1.69 in 1953 (as a yearly average) in the period, 1951-1955, averaged 2.90 in 1956, 3.78 in 1957, fell to 2.29 in 1958, then rose to 4.80 in 1959 and 3.32 in 1960. The Canadian long-term yearly average rate in the period, 1951-1955, reached a high point of 3.68 in 1953. The long-term rate rose to 4.10 in 1957, 4.86

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[12] Bank of Canada Annual Report 1959, pp. 8-9.

in 1959, and 5.04 in 1960. The interest rate differential between Canada and the United States on short-term borrowing rose from a yearly average of .265 percent in 1956 to a high of 1.38 percent in 1959. The long-term differential rose from .58 percent as a yearly average in 1956 to a high of 1.03 percent in 1960. In the third and fourth quarters of 1959, the short-term differential reached peaks of 1.88 percent and 2.03 percent. The long-term interest rate differential reached a peak of 1.30 percent in the first quarter of 1960 (Table III).

Another important effect of the increasing interest rate differential that existed between Toronto and New York was the added incentive that it gave for short-term stabilizing exchange speculation to take place. Many economists, such as Ragnar Nurkse, have found that in many cases under a system of freely fluctuating exchange rates, there may be nothing to limit people's elasticity of expectations in the short-run. Any change in the rate is likely to create anticipations of a further change in the same direction causing a flight of capital and further changes in the exchange rate.[13] However, in his study of the effect of short-term capital movements on the Canadian balance of payments in the period, 1952-1957, Rudolph R. Rhomberg found that short-term capital movements in the form of exchange rate speculation have been much more instrumental in keeping the fluctuations of the Canadian dollar within narrow limits than either

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[13] Ragnar Nurkse, Conditions of International Monetary Equilibrium (Princeton University Essays in International Finance, Number 4 /Princeton, 1945/), p. 2.

TABLE III

CANADIAN AND UNITED STATES INTEREST RATES AND CANADIAN-UNITED STATES INTEREST RATE DIFFERENTIAL ON A QUARTERLY BASIS

	Long-Term Interest Rates[a]				
Quarters	I	II	III	IV	Average Yearly Interest Rate Differential
1956					
United States	2.86	2.96	3.10	3.30	
Canada	3.31	3.50	3.75	3.96	
Interest Rate Differential	.45	.54	.65	.66	(.575)
1957					
United States	3.26	3.43	3.63	3.56	
Canada	4.08	4.28	4.46	3.87	
Interest Rate Differential	.82	.85	.83	.31	(.70)
1958					
United States	3.75	3.15	3.57	3.75	
Canada	3.99	4.08	4.32	4.65	
Interest Rate Differential	.24	.93	.75	.90	(.705)
1959					
United States	3.91	4.06	4.16	4.17	
Canada	4.76	4.80	4.90	4.97	
Interest Rate Differential	.85	.74	.74	.80	(.78)
1960					
United States	4.22	4.11	3.82	3.91	
Canada	5.18	5.15	4.81	5.04	
Interest Rate Differential	.96	1.04	.99	1.13	(1.03)
1961					
United States	3.83	3.80	3.97	4.00	
Canada	5.13	5.07	4.96	4.95	
Interest Rate Differential	1.30	1.27	.99	.95	(1.13)

TABLE III (Continued)

Quarters	I	II	III	IV	Average Yearly Interest Rate Differential
	Long-Term Interest Rates[a]				
1962					
United States	4.06	3.89	3.98	3.88	
Canada	4.95	4.91	5.40	5.11	
Interest Rate Differential	.89	1.02	1.42	1.23	(1.14)
	Short-Term Interest Rates[b]				
1956					
United States	2.38	2.60	2.60	3.06	
Canada	2.58	2.71	2.90	3.51	
Interest Rate Differential	.20	.11	.30	.45	(.265)
1957					
United States	3.17	3.16	3.38	3.34	
Canada	3.72	3.77	3.88	3.67	
Interest Rate Differential	.55	.61	.50	.33	(.50)
1958					
United States	1.84	1.02	1.71	2.79	
Canada	2.29	1.61	1.54	3.07	
Interest Rate Differential	.45	.59	-.17	.28	(.37)
1959					
United States	2.80	3.02	3.55	4.30	
Canada	3.73	4.90	5.58	4.98	
Interest Rate Differential	.93	1.88	2.03	.68	(1.38)
1960					
United States	3.94	3.09	2.39	2.36	
Canada	4.45	3.05	2.53	3.23	
Interest Rate Differential	.51	-.04	-.14	.87	(.39)

TABLE III (Continued)

	Short-Term Interest Rates[b]				
Quarters	I	II	III	IV	Average Yearly Interest Rate Differential
1961					
United States	2.38	2.32	2.32	2.48	
Canada	3.15	3.06	2.50	2.59	
Interest Rate Differential	.77	.74	.22	.11	(.46)
1962					
United States	2.74	2.72	2.86	2.80	
Canada	3.10	3.64	5.22	4.05	
Interest Rate Differential	.36	.92	2.36	1.25	(1.22)

[a]Average tender rate for three month Treasury bills.

[b]Average yield to maturity of central government bonds with at least 12 years life.

Source: International Financial Statistics, International Monetary Fund (Washington D. C.), various issues.

official intervention in the exchange market or the price effects of the exchange variations on imports and exports.[14] Rhomberg found that a depreciation in the exchange rate led to expectations on the part of speculators of a future increase in the rate which led to a speculative short-term inflow of capital which buoyed up the rate. Since the amount of funds which speculators were willing to commit to speculation depended upon the expected rate of profit on these speculative activities, there had to exist a large enough margin of profit to make such speculation worthwhile. Rhomberg found that exchange profits of four to eight percent per annum could be realized frequently. "Such potential profit margins appear large enough to produce the necessary incentives on which the mechanism relies."[15] The interest rate differential existing between the United States and Canada was another factor adding to the profitability of exchange speculation. Frequently, over the period, 1958-1961, a differential of .75 percent existed on 90 day investments. This added factor made the cost of holding Canadian dollars less than it would have been had the interest rates in the United States and Canada moved more closely together.

The Main Effects of the Inflows of Foreign Capital on the Canadian Economy 1956-1960

The excessively large inflows of foreign capital into the Canadian economy in the period, 1956-1960, had three main effects. First, they

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[14] Rudolph R. Rhomberg, "The Canadian Foreign Exchange Market," _International Monetary Fund Staff Papers_, VII (1960), p. 447.

[15] Ibid., p. 443.

acted to bouy up the exchange value of the Canadian dollar. Second, they led to distortion in the Canadian economy and the Canadian international accounts. And third, they acted to exacerbate Canada's increasing unemployment problem. In the years prior to 1956, the heavy inflows of foreign capital and the fluctuations in the current account balance which the Canadian economy experienced tended to act in a stabilizing manner. When the Canadian economy was experiencing a rapid period of economic activity, there were large flows of foreign capital into the economy. These inflows of capital made possible a more rapid growth and rate of capital formation than would have been possible if Canada had relied solely on domestic savings. In a time of heavy inflows of capital and heavy domestic capital formation, the increasing current account deficit operated to relieve the pressure of demand against the available supply of goods and services. The increased imports acted as a safety valve preventing uncontrolled inflation in the Canadian economy. In periods when domestic expansion slowed down, there was a decrease in inflow of foreign capital, and the trade account deficit improved, leading to improvement in the domestic economy via the foreign trade multiplier and price effects.

However, after the investment boom of 1956-1957 passed, the inflow of foreign capital did not decline and the deficit on current account averaged over a billion dollars a year for the next four years. Under a freely fluctuating exchange rate, it would be expected that, with a country running a current account deficit the size of Canada's vis-a-vis the United States, Canada's currency would depreciate vis-a-vis the United States' currency. Nevertheless, despite the

large current account deficit that Canada continued to run with the United States, the Canadian dollar remained at a premium of up to four percent to the United States' dollar. The inflow of United States' funds into Canada met and exceeded the United States' funds demanded by Canada to settle her current account deficit with the United States. United States' citizens wishing to invest in Canada had to obtain Canadian dollars from Canadian citizens, and the United States' demand for Canadian dollars was great enough, relative to the Canadian demand for United States' dollars to keep the Canadian dollar at a rate above a one-to-one parity with the United States' dollar (Table IV).

The continued premium on the Canadian dollar vis-a-vis the United States' dollar acted to exacerbate Canada's deficit on current account. With the Canadian dollar at a premium, Canadian exporters were placed at a disadvantage when competing in the world market. Canadian exports were more expensive to foreign consumers, especially in the United States where the greatest part of Canada's export market existed. Also, the exchange premium on the Canadian dollar led to indirect repercussions in other sectors of the Canadian current accounts. Travel in the United States was cheaper for Canadian residents and Canada's deficit on travel account with the United States was a large, persistent item adding to Canada's overall deficit on current account.

Canadian producers, especially in secondary industries, were caught in a two-way dilemma. Foreign controlled companies had access to funds flowing from their parent companies, and hence were not usually affected by the shortage of loanable funds and the high

TABLE IV

CANADA'S BALANCE ON TRANSACTIONS WITH THE UNITED STATES AND ALL COUNTRIES

Year	Balance on Current Account with U. S.[a]	Balance on Current Account All Countries	Balance on Capital Account with U. S.[b]	Balance on Capital Account All Countries	Total Balance with U.S.
	-Millions of Canadian Dollars-				
1946	-703	+357	+88	+366	-615
1947	-1,233	-50	-164	-49	-1,397
1948	-512	+332	+111	-451	-401
1949	-740	+38	+64	-177	-676
1950	-563	-497	+961	+334	+398
1951	-1,101	-667	+554	+417	-547
1952	-999	+14	-78	-164	-1,077
1953	-1,048	-693	+202	+443	-846
1954	-962	-576	+398	+432	-564
1955	-1,190	-853	+383	+698	-807
1956	-1,789	-1,516	+894	+1,366	-895
1957	-1,726	-1,602	+964	+1,424	-762
1958	-1,336	-1,291	+1,060	+1,131	-276
1959	-1,378	-1,642	+1,341	+1,504	-37
1960	-1,523	-1,432	+990	+1,243	-533
1961	-1,548	-1,144	+1,366	+982	-182

[a]In regional statements of the Canadian balance of payments published by the Dominion Bureau of Statistics, gold production available for export is treated as a receipt in the current account with the United States. In this table, gold production is treated as a means of settlement of international payments and is not included in the current account gold production for export.

[b]+ represents a net inflow of capital into Canada; - represents a net flow of capital out of Canada.

Source: 1. Bank of Canada Annual Report 1962, Bank of Canada (Ottawa, 1963), pp. 40-41.
2. Balance of Payments Yearbook, International Monetary Fund (Washington D. C.), various issues.

interest rate prevailing in Canada during this period. Also, the large inflows of foreign capital enabled the foreign controlled companies to bid scarce factors of production away from Canadian producers. This led to rising costs of production in the Canadian economy and severely hampered the competitive position of Canadian industries. By keeping the Canadian dollar at an exchange premium, the inflows of foreign capital operated to make imports of goods and services cheaper than they would have been had the exchange rate depreciated in line with Canada's growing deficit on current account.

The foreign capital flowing into Canada operated to channel Canadian resources into those industries to which these foreign capital flows were directed. As the following table illustrates, foreign investment, especially United States' direct investment, was predominantly in the resource producing sector of the economy, and as a result, this sector

TABLE V

NONRESIDENT OWNERSHIP AS A PERCENT OF CANADIAN INDUSTRY, 1957

Industry Class	Percentage of Total Owned by Nonresidents	Percentage of Total Owned by U. S. Residents
Manufacturing	50	39
Petroleum and Natural Gas	64	58
Mining and Smelting	56	46
Railways	30	11
Other Utilities	15	12

Source: Canadian Balance of Payments 1959 and International Investment Position, Dominion Bureau of Statistics, Publication Numbers 67-201 (Ottawa, 1960), p. 70.

grew rapidly. As the following table shows, there was a marked difference between the rate of growth of the Canadian index of industrial production in the mining industries, which are over 50 percent owned by nonresidents, and the iron and steel products and food and beverage industries which are over 85 percent Canadian owned. Another important sector of the economy that received inflows of foreign capital was the

TABLE VI

COMPARISON OF THE CANADIAN INDEX OF INDUSTRIAL PRODUCTION FOR SELECTED INDUSTRIES

Year	Petroleum and Natural Gas	Other Mining	Iron and Steel Products	Food and Beverages
		-1949 = 100-		
1954	429.8	124.8	106.2	120.6
1955	576.6	136.1	123.8	126.8
1956	756.5	144.1	145.3	133.1
1957	804.6	155.5	139.6	135.6
1958	745.5	161.8	128.3	141.9
1959	837.8	177.3	147.2	147.6
1960	878.7	174.7	137.3	150.2
1961	1,005.6	173.3	139.4	154.2

Source: Bank of Canada Statistical Summary, Bank of Canada (Ottawa, March, 1963), p. 185.

provincial and municipal government sector. A net inflow of 1,110 million dollars went into this sector in the period, 1956-1960. Therefore, primary producing sectors of the Canadian economy, in which there were heavy foreign direct investments, and the municipal and provincial

government sector of the Canadian economy were able to bid resources away from Canadian financed secondary industry.

The large inflow of foreign capital led to several marked distortions in Canada's international accounts. As was discussed earlier, these inflows of foreign capital became too large to be absorbed by the Canadian economy. As a result, a part of these capital inflows were transferred to Canada in the form of increased imports of goods and services. Use of foreign resources as a percent of gross capital formation in Canada rose from 17 percent from 1950-1955 to 27 percent in the period, 1956-1959. Use of foreign resources as a percent of net capital formation increased even more markedly, going from 19 percent in the period, 1950-1955, to 35 percent in the period, 1956-1959. Direct foreign financing of gross capital formation in Canada rose from 25 percent to 33 percent over the same periods, and direct foreign financing of net capital formation increased from 33 percent to 45 percent.[16]

Canada ran a deficit on merchandise account in only three years in the period, 1946-1955. In 1951, Canada had a deficit of 147 million on merchandise account, in 1953, a deficit of 58 million, and in 1955, a deficit of 211 million. In 1956, Canada's deficit on merchandise account rose to 728 million, in 1957, imports exceeded exports by 594 million, in 1958, a year of slack economic activity in Canada, Canada

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[16] _The Canadian Balance of Payments 1959 and International Investment Postion_, p. 9.

had a deficit of only 174 million, then in 1959, imports exceeded exports by 423 million and in 1960, the deficit declined to 148 million.

Another marked feature of the Canadian balance of payments was the abnormally large current account deficit that the inflows of foreign capital permitted Canada to finance. In the five year period, 1956-1960, Canada ran an annual deficit on current account of over a billion dollars a year. In 1956, Canada's deficit on current account jumped from 698 million dollars in 1955 to 1,366 million dollars. In 1957, it reached a record level of 1,455 million dollars, and in 1959, set another record with a deficit of 1,494 million dollars. The largest part of this deficit on current account was due to nonmerchandise items. Deficits on travel account, interest and dividends, and "other merchandise" items were the main causes of the deficit. The deficit on travel account led to a total net outflow of 390 million dollars over the period, 1956-1960, the deficit on "other merchandise" items was 1,868 million dollars,[17] and the deficit on interest and dividend payments was 2,214 million dollars.

The surplus of payments of interest and dividends to foreigners by Canadians over receipts of interest and dividends by Canadians from foreign investments was the most persistent and steadily rising deficit item in the Canadian current account. In the period, 1956-1960, Canada

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[17] Income transfers associated with direct investment companies have been an important factor operating to increase this deficit item. Payments for "business services" led to a deficit of 186 million dollars in 1958 and 196 million dollars in 1959.

Canada's Balance of Payments 1959 and International Investment Position, p. 27.

made net payments of 2,214 million dollars in the form in interests and dividends. These figures do not include unremitted profits on foreign investments in Canada. Total unremitted profits over the period, 1956-1960, were estimated to be about 1,855 million dollars. Thus, balance of payment figures revealed only a little over one-half of Canada's liabilities arising from interest and dividends paid on foreign investment in Canada (Table VII).

Canada was able to finance these large current account deficits by the transfer of foreign capital to Canada. The inflow of capital from the United States alone was large enough to cover over 50 percent of Canada's deficit with the United States in 1956 and 1957, and covered over 80 percent of Canada's United States deficit in 1958, and 98 percent of Canada's deficit with the United States in 1959. The remaining part of Canada's deficit with the United States was covered by convertible currency gained from a current account surplus with the rest of the world, and a rising capital inflow from overseas countries, especially the United Kingdom and countries in the European Common Market.[18]

On the domestic level, the Canadian economy faced the paradoxical problem of a rising rate of unemployment during a period of excessive

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[18]Investments of countries in Canada other than the United States and the United Kingdom reached a record level of 1,700 million dollars in 1959. This was four times the level recorded in 1951. Nearly 90 percent of the direct investments came from Western European countries. One-fourth was of Belgian origin with France, Switzerland and West Germany making up the next largest group.

Canada Year Book 1960, p. 1121.

TABLE VII

CANADIAN CURRENT ACCOUNT

Year	Balance on Merchandise Trade	Gold Production Available for Export	Freight and Shipping (Net)	Travel (Net)	Interest and Dividends (Net)	Other Merchandise Items (Net)	Total Non-Merchandise	Current Account Balance	Estimated Annual Unremitted Profits on Foreign Direct Investment in Canada
	-Millions of Canadian Dollars-								
1948	432	119	57	145	-255	-47	19	451	160
1949	293	139	50	92	-307	-90	-116	177	155
1950	10	163	-17	49	-384	-155	-344	-334	155
1951	-147	150	-3	-6	-335	-176	-370	-517	200
1952	489	150	8	-66	-268	-149	-328	164	290
1953	-58	144	-56	-63	-239	-171	-385	-443	340
1954	13	155	-43	-84	-276	-197	-445	-432	300
1955	-211	155	-17	-121	-323	-181	-487	-698	370
1956	-728	150	-45	-161	-381	-201	-638	-1,366	480
1957	-594	147	-70	-162	-435	-341	-861	-1,455	475
1958	-179	160	-59	-193	-444	-416	-952	-1,131	260
1959	-423	148	-105	-207	-474	-433	-1,071	-1,494	370
1960	-148	161	-111	-215	-480	-477	-1,122	-1,270	270
1961	173	162	-82	-160	-561	-514	-1,155	-982	220
1962	155	165	-90	-50	-570	-458	-1,003	-848	---

Source: 1. *Bank of Canada Annual Report 1960*, Bank of Canada (Ottawa, 1961), p. 44.
2. *Balance of Payments Yearbook*, International Monetary Fund (Washington D. C.), various issues.

aggregate demand. The inflow of foreign capital added to the aggregate demand for goods and services within Canada, causing aggregate demand to exceed the productive capacity of the domestic economy. This led to an increased transfer of goods and services to Canada from the United States in the form of an increased deficit on merchandise account with the United States (Table VIII). A large portion of Canada's increased imports was in the form of capital goods. Imports of machinery, other than farm machinery, and imports of electrical equipment were two of the most important import items in the Canadian balance of payments. Much of this machinery was researched, developed and imported from the United States. In this sense, industries did not develop in Canada to provide employment for workers displaced by automation. This trend is partially reflected in the manufacturing industries. Employment in manufacturing, which includes industries producing for export and import-competing industries, rose to 1,500 million workers in 1957 from 1,320 million workers in 1949, then fell to 1,480 million workers by the end of 1960.[19] The unemployment ratio among men, who were heavily employed in the manufacturing industry, was consistently higher in the period, 1956-1960, than unemployment among women, who were heavily employed in the service industries. In 1960, unemployment in the male labor force was 9.9 percent of the total male labor force, while unemployment among women was only 3.7 percent of the total female labor force.[20]

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[19] Bank of Canada Annual Report 1960, p. 7.

[20] Ibid., p. 34.

TABLE VIII

MONTHLY AVERAGES OF CANADIAN MERCHANDISE IMPORTS
SELECTED COMMODITIES

Year	Commodity			
	Other Machinery	Electrical Apparatus	Primary Iron and Steel[a]	Engines and Boilers
	-Millions of Canadian Dollars-			
1950	18.9	6.9	9.0	4.6
1951	27.4	10.1	16.9	7.4
1952	30.1	11.6	14.4	11.3
1953	33.5	16.5	11.9	9.7
1954	31.7	17.3	9.9	7.6
1955	37.2	18.9	12.4	9.1
1956	52.4	21.4	21.6	11.0
1957	52.6	20.8	20.6	11.5
1958	44.4	20.0	14.0	11.2
1959	48.8	22.5	13.4	11.3
1960	48.3	21.7	13.1	11.8

[a]Includes pigs, ingots, blooms, billets, castings, forgings, ferro alloys and rolling mill products.

Source: 1. Canadian Statistical Review, 1959 Supplement, Dominion Bureau of Statistics (Ottawa, 1960), p. 131.
2. Canadian Statistical Review, XXXVII (1962), p. 61.

Over the period, 1956-1960, as the size and participation rate of the Canadian labor force grew rapidly, the Canadian economy failed to provide adequate employment opportunities, and the level of unemployment rose markedly. Before 1954, unemployment averaged 2.5 percent. Since seasonal unemployment was estimated to account for about two percent of the labor force, unemployment, prior to 1954, was almost nonexistent.[21] For the years, 1954-1957, unemployment averaged 4.2 percent on a yearly basis. In 1957, unemployment passed the five

[21]Barber, p. 88.

percent mark, and for the period, 1958-1960, it averaged 6.7 percent.[22] In 1960, unemployment rose to over 7.2 percent of the labor force.

TABLE IX

CHARACTERISTICS OF THE CANADIAN LABOR FORCE

Year	Civilian Labor Force	Participation Rates		Unemployed
		Male	Female	
	Thousands	Percent		Percent
1955	5,610	82.0	23.9	4.4
1956	5,782	82.2	24.9	3.4
1957	6,003	82.3	25.8	4.6
1958	6,127	81.7	26.3	7.1
1959	6,228	81.1	26.7	6.0
1960	6,403	80.9	28.0	7.0
1961	6,518	80.0	28.8	7.2
1962	6,608	79.3	29.1	5.9

Source: Bank of Canada Statistical Summary, Bank of Canada (Ottawa, March, 1963), p. 191.

Therefore, it appears that the inflows of foreign capital did not lead to a corresponding proportional increase in Canadian production and employment. The inflows of foreign capital only led to an increased use of capital equipment in Canadian industries which tended to displace Canadian workers. Since this machinery was largely imported from foreign countries, no new Canadian industry developed to provide employment for the rising Canadian labor force. Also, Canadian owned industries found their costs of production rising as they were forced

[22] Ibid.

to bid for factors of production along with foreign financed companies. This decreased the Canadian firms competitive position and correspondingly their ability to increase employment.

CHAPTER IV

EXCHANGE CRISIS AND GOVERNMENT REACTION

Development of the Crisis

In December of 1960, the Canadian Government took the first official steps that marked the beginning of their departure from their market determined exchange rate. On December 21, 1960, Finance Minister Fleming presented a supplemental budget to the Canadian Parliament. Although the measures announced by the Government in this budget for encouraging Canadian investment in Canadian industries and discouraging foreign investment were relatively mild, they marked a definite reaction on the part of the Government against the continued high inflows of foreign capital. One of the measures announced by the Diefenbaker Government was directly aimed at reducing the foreign borrowing of Canadian provincial and municipal governments. Where before there was no withholding tax on interest paid on bonds payable in foreign currency, the regular 15 percent Canadian withholding tax would now apply.[1] Since foreign lenders could not be expected to pay this increased tax, it had to be borne by Canadian borrowers in the form of higher interest rates. Mr. Fleming repeatedly asserted that Canada was not specifically

[1] "Canada's Unseasonable Budget," Economist, 197 (1960), p. 1323.

adopting measures to halt the inflow of foreign capital.[2] However, in the opinion of the Economist, "It is difficult to escape the conclusion that Mr. Fleming's real aim is to reduce the exchange value of the Canadian dollar and thus give some assistance to Canadian industries."[3]

On June 20, 1961, Mr. Fleming presented the official Government budget for the fiscal year, 1961. Although, in his budget address of 1960, Mr. Fleming stated that he believed the use of exchange funds to drive down the value of the Canadian dollar on the international market was a speculation with no chance of success,[4] the 1961 budget relied almost solely on its success in driving down the value of the Canadian dollar.

> It is the Government's intention that our import surplus of goods and services, which has been running in recent years well over a billion dollars annually, should be reduced substantially, and that this be brought about through an appropriate adjustment of the exchange rate rather than by direct government controls or subsidies, quotas or tariffs.
>
> No one can say today what the appropriate level of our exchange rate would be when our balance of payments is in a position better suited to our present economic circumstances. But the rate will certainly be lower than it has been of late, and it may well be appropriate for it to move at a significant discount. It will be Government policy to facilitate such a movement.

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[2]There was a sharp decline in the rate of foreign borrowing in the fourth quarter of 1960 and first quarter of 1961. Net new issue of securities in foreign markets fell to minus 53 million dollars in the fourth quarter of 1960, and minus 39 million dollars in the first quarter of 1961. This is compared to net inflows of 130 million dollars in the fourth quarter of 1959, and 159 million dollars in the first quarter of 1960.

[3]Ibid.

[4]"Canada's Floating Dollar," Economist, 199 (1961), p. 1375.

> Accordingly the exchange fund will be prepared as and when necessary, to add substantial amounts to its holdings of United States dollars through purchases in the exchange market. Once an exchange rate position is achieved, the Government will use the resources of the exchange fund to ensure that the rate is kept within a range appropriate to Canada's changing economic situation.[5]

The Canadian Government decided to determine the rate of exchange of the Canadian dollar, not by market force, or by setting a fixed pegged rate, but according to the needs of the Canadian economy as determined by the Canadian Government. From July, 1961, through October, 1961, the Canadian authorities were able to hold the dollar at a discount relative to the United States dollar of .97 cents U. S. without large changes in reserves. In October, there was a heavy demand for Canadian dollars and reserves rose by 186 million dollars U. S. The exchange rate rose slightly in November and December and reserves fell by 55 million dollars U. S. At the end of 1961, the exchange rate of the Canadian dollar was .97 cents U. S. and official reserves stood at 2,056 million dollars U. S.[6] In February, 1962, the Government forced the exchange value of the Canadian dollar down to .95 cents U. S. where it remained for the first quarter of 1962.

Because investor's confidence in the Canadian economy remained high, and there were doubts that the Canadian Government could maintain

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[5]Donald M. Fleming, "Statement by the Governor for Canada," Summary Proceedings of the Seventeenth Annual Meeting of the Board of Governors, International Monetary Fund (Washington D. C., 1962), pp. 85-86.

[6]Bank of Canada Annual Report 1961, p. 31.

the lower exchange rate, prior to the first quarter of 1962, the Canadian authorities were able to force the rate of exchange of the Canadian dollar down without large commitments of reserves. However, the Canadian authorities were walking a narrow line. If speculators came to believe that the authorities were unable to maintain the lower exchange rate, the Government would be faced with the problem of financing another speculative inflow of foreign capital such as the one that developed in 1950. If, on the other hand, speculators came to believe that the Canadian dollar was due to depreciate more, Canada would suffer serious strains on her reserves and experience capital flights.

By the middle of March, 1962, the Canadian dollar had gotten the fatal connotation of a depreciating currency, and it became clear that the Government was no longer only smoothing out short-run fluctuations, but had begun a full-scale offensive to protect the rate of .95 cents U. S.[7] Heavy speculative selling and flights of capital began,[8] but the Government still refused to peg the value of the Canadian dollar. Uncertainty about the future direction of movement of the Canadian dollar added to the speculative pressures on the Canadian dollar. As the Economist pointed out, "A floating rate that fluctuates sufficiently to bring in stabilizing purchases by speculators has clear technical

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[7]In the first quarter of 1962, official Canadian holdings of gold and dollar reserves decreased by 366 million dollars.

[8]In the second quarter of 1962, there was an outflow of 245 million dollars of Canadian owned bank balances, and a net outflow of 13 million dollars in long-term forms of capital.

virtues. A floating rate that is held rigid by an exchange authority that has previously engineered a slow depreciation has none."[9]

On May 2, 1962, the Canadian Government announced a new fixed par value for the Canadian dollar of .925 cents in terms of United States currency. "On May 2, 1962, the International Monetary Fund concurred in the proposal by Canada of a new par value of .925 cents U. S. per Canadian dollar. The step thus taken represented the return to a fixed par value system by Canada,[10] and this was warmly welcomed by the Fund."[11]

A short period of relative stability followed the announcement of a fixed exchange rate by the Government. However, by June, 1962, there was again heavy speculation against the Canadian dollar. This instability in the exchange market was not eased by the seeming indecision of the Diefenbaker Government. In the general election of 1962, Mr. Hamilton, Minister of Agriculture, among others in the Diefenbaker Government, let slip that he personally thought the exchange rate should be .90 instead of .925.[12] This added to the

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[9] "Must Canada Stabilize?," Economist, 202 (1962), p. 1045.

[10] Mr. Coyne, Governor of the Bank of Canada, charged in hearings before the Canadian Senate that the Government policy, announced in the June 20 budget of forcing the value of the Canadian dollar down, had gone into effect secretly six months earlier without the Canadian authorities notifying the International Monetary Fund.
New York Times, July 12, 1961, p. 6.

[11] Thirteenth Annual Report on Exchange Restrictions, International Monetary Fund (Washington D. C., 1962), p. 3.

[12] "The Diefendollar," Economist, 203 (1962), p. 1236.

belief of many speculators that there was a distinct possibility of a further depreciation of the Canadian dollar, and this led to renewed speculative pressures against the dollar.

Emergency Exchange Measures of the Canadian Government

By June 24, the exchange reserves of the Canadian Government had fallen to 1,100 million dollars, a decline of 50 percent from the first of the year. The Government was forced to take a definite position and attempt to halt the dangerous drain on the exchange reserves. The reaction of the Diefenbaker Government was to establish a series of emergency controls, aimed primarily at reducing Canada's current account deficit, and to draw heavily on international financial assistance to support the value of the Canadian dollar.

Within a few days after Canada's need for assistance became known, Canada received substantial aid from the International Monetary Fund, the United States, the United Kingdom, and offers of aid from other central banks. The Government drew 300 million dollars from the International Monetary fund, and arranged a line of credit of 400 million dollars with the United States Export-Import Bank. The Bank of Canada entered into reciprocal currency arrangements of 250 million dollars with the Federal Reserve and 100 million dollars with the Bank of England.[13] The total aid extended to Canada in a short period of time was approximately 1,050 million dollars. In the third quarter

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[13] Fleming, p. 49.

of 1962, France made accelerated repayments of 67.6 million dollars on loans from Canada. The Netherlands made an accelerated repayment of 32.1 million dollars in the final quarter of 1962. Total loan repayments to Canada by national governments aggregated 119 million dollars in the second half of 1962, when the net effect of accelerated repayments was 91 million dollars.[14]

The most important part of the emergency program of the Canadian Government was the attempt by the Government to reduce Canada's large deficit on current account. To reduce the inflow of imports, the Government placed a graduated scale of temporary surcharges on certain classes of imports. These temporary surcharges affected about one-half of Canada's imports; imports that were exempted were mainly raw materials, vital industrial components, and certain foodstuffs, such as fresh fruits and vegetables, tea and coffee.

A second measure was aimed at reducing Canada's excessive deficit on nonmerchandise current account items. This measure was a reduction in the privilege of duty-free purchases by Canadians in the United States. This restriction, combined with the lower exchange value of the Canadian dollar, led to a sharp drop in the Canadian deficit on travel account with the United States.

A third measure adopted by the Canadian Government was a reduction of Government expenditures by 250 million dollars. This,

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[14] Quarterly Estimates of the Canadian Balance of International Payments, Fourth Quarter 1962, and Preliminary Estimates for the Year 1962, Dominion Bureau of Statistics, Publication Numbers 67-201 (Ottawa, 1963), pp. 14-16.

combined with an estimated surcharge revenue of 200 million dollars, it was hoped, would reduce the budget deficit by 450 million dollars in a full year.[15]

On the domestic level, the Bank of Canada under its new Governor, Mr. Louis Rasminsky,[16] took immediate steps to aid the Government in maintaining the value of the Canadian dollar. The Bank of Canada fixed the Bank Rate, the minimum rate at which the Bank of Canada makes advances to chartered banks, at six percent.[17]

> Further withdrawals of funds from Canada had to be discouraged and a renewed inflow of capital on a substantial scale had to be encouraged. Central bank operations were accordingly directed toward promoting and maintaining a level of interest rates in Canadian financial markets which would help in

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[15]Fleming, p. 50.

[16]The conflict over basic economic issues between Mr. Coyne and the Diefenbaker Government reached a climax in June, 1961. Mr. Coyne believed that the Government was about to embark on a program of deficit spending with which he could not agree. He asked for an opportunity to appear before the Conservative dominated House of Commons to state his views. The Diefenbaker Government then committed a serious political blunder. It refused to allow Mr. Coyne to testify, and attempted to remove him from office. The Liberal dominated Senate allowed Mr. Coyne to testify, and he was able to clear himself of all charges of the Diefenbaker Government. In a series of hearings before the Senate Committee on Banking and Commerce, Mr. Coyne delivered testimony that reflected very badly on the Government's economic policies.

Mr. Coyne remained in office until July 13, 1961, when he resigned and Mr. Louis Rasminsky was appointed the new Governor. Mr. Coyne had the satisfaction of telling the Diefenbaker Government he quit, but his actions and those of the Government did very little to reflect credit on monetary management in Canada.

[17]*Bank of Canada Annual Report 1962*, p. 3.

> establishing a net inflow of capital large enough to cover the current account deficit in the balance of international payments and rebuild the depleted foreign exchange reserves.[18]

In effecting this policy, "The Bank of Canada was unusually active in the government securities market in 1962 and at times the scale of transactions exerted a considerably stronger direct influence on the level and structure of market yields than the Bank would normally consider necessary or desirable in its day-to-day cash management."[19]

Results of the Emergency Measures Taken by the Canadian Government

In the third quarter of 1962, the long-term interest rate in Canada averaged 5.40 percent, then declined to an average of 5.11 percent in the fourth quarter. The long-term interest rate prevailing in the United States, during the third quarter of 1962, was 3.98 percent, and in the fourth quarter, declined slightly to 3.88 percent. This led to an interest rate differential between the United States and Canada of 142 base points in the third quarter of 1962, and 123 base points in the fourth quarter of 1962. The short-term interest rate in Canada rose from an average of 3.10 percent in the first quarter of 1962 to 5.22 percent in the third quarter, and 4.05 percent in the fourth quarter. This led to an interest rate differential on short-term funds between the United States and Canada of 236 base points in the third quarter of 1962, and 125 base points in the fourth quarter of

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[18] Ibid., p. 4.

[19] Ibid., p. 52.

1962. Although it is very difficult to measure exactly the effect of this unusually large interest rate differential, it undoubtedly was an important factor in encouraging the large re-inflows of capital into Canada which took place in the third and fourth quarters of 1962.

The effect of these emergency measures was to lead to an improvement in Canada's current account deficit of about 13 percent, and to a re-inflow of capital in the latter part of the third quarter and in the fourth quarter of 1962. Canada's deficit on current account decreased from minus 982 in 1961 to minus 848 at the end of 1962. Almost all of this improvement was in the current account deficit with the United States. Canada's deficit on current account with the United States fell by 270 million dollars for the year, 1962. Although there was a surplus on merchandise account of 155 million dollars, this was lower than the export balance of 173 million dollars in 1961. More than two-thirds of the improvement in the current account was on travel account. Canada's deficit on travel account with all countries decreased from a deficit of 160 million dollars in 1961 to a deficit of 50 million dollars in 1962.[20] The 130 million dollar cut in the deficit on current account with the United States was seven-eighths due to the improvement on travel account. A deficit of 24 million

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[20] Quarterly Estimates of the Canadian Balance of International Payments, Fourth Quarter 1962, and Preliminary Estimates for the Year 1962, p. 2.

dollars in 1961 with the United States was changed into a surplus of 90 million dollars in 1962 (Table X).[21]

In the third and fourth quarters of 1962, there was a sharp reversal of the outflow of capital that occurred in the second quarter. In the third quarter, there was an inflow of 257 million dollars of Canadian bank balances, compared to an outflow of 245 million dollars in the second quarter.[22] In the fourth quarter, there were very large capital inflows for direct investment purposes. These included large foreign purchases of existing enterprises, and a large volume of new issues of Canadian securities placed in foreign markets. The net long-term capital inflow in the fourth quarter amounted to 447 million dollars which represented 62 percent of the total for the year (Table XI).[23] About 90 percent of the movements of capital for direct investment, portfolio stocks and bonds, official loans, and other long-term capital movements originated in the United States.[24]

With the return of confidence in the Canadian dollar and the re-inflow of capital, the Canadian exchange reserves improved rapidly. From their low point of 1,100 million dollars on June 24, the official holdings of gold and dollar reserves rose to 1,159 million at the end of June, and omitting special international financial assistance, they

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[21] Ibid., p. 6.

[22] Ibid., p. 17.

[23] Ibid., p. 9.

[24] Ibid.

TABLE X

CANADIAN CURRENT ACCOUNT FOR THE YEARS 1961 AND 1962

	1961	1962
	-Millions of Canadian Dollars-	
Current Receipts		
Merchandise Exports (adjusted)	5,889	6,364
Gold Production Available for Export	162	165
Travel Expenditures	482	560
Interest and Dividends	209	211
Freight and Shipping	486	498
Inheritance and Immigrants Funds	103	124
All Other Current Items	403	426
Total Current Receipts	7,734	8,348
Current Payments		
Merchandise Imports (adjusted)	5,716	6,209
Travel Expenditures	642	610
Interest and Dividends	770	781
Freight and Shipping	568	588
Inheritance and Immigrants Funds	174	163
Official Contributions	56	32
All Other Current Payments	790	813
Total Current Payments	8,716	9,196
Balance on Merchandise Trade	+173	+155
Balance on Nonmerchandise Transactions	-1,099	-971
Current Account Balance	-982	-848

Source: Quarterly Estimates of the Canadian Balance of International Payments Fourth Quarter 1962, and Preliminary Estimates for the Year 1962, Dominion Bureau of Statistics (Ottawa, March, 1963), pp. 10-21.

TABLE XI

COMPARISON OF SIGNIFICANT CATEGORIES OF CAPITAL MOVEMENTS ON CANADIAN INTERNATIONAL ACCOUNTS FOR THE YEARS 1961 AND 1962

	1961				1962			
	I	II	III	IV	I	II	III	IV
Direct Investment in Canada	140	158	117	100	110	80	145	190
Canadian Securities								
Trade in Outstanding Bonds and Debentures	31	34	-11	9	-3	4	39	24
Trade in Outstanding Common and Preference Stocks	13	32	--	-5	-14	-44	-26	-32
New Issues	101	190	125	117	52	200	87	369
Retirements	-73	-92	-29	-103	-70	-68	-48	-109
Net Trade in Foreign Securities	-32	--	-16	-2	-15	-29	-36	-5
Loans by Government of Canada								
Drawings	--	--	--	--	--	--	-7	--
Repayments	3	7	--	27	3	7	68	51
Other Capital Movements	337	311	62	272	333	362	34	119
Bank Balances and Other Short-Term Funds Abroad	127	54	-140	72	49	-245	257	17
Other Long-Term Capital Transactions	--	-22	12	22	6	-127	26	-15
Changes in Official Holdings of Gold and Foreign Exchange (increase, minus)	-105	-51	62	-135	364	-114	-686	-101

Source: 1. _Quarterly Estimates of the Canadian Balance of International Payments Fourth Quarter 1962_, and _Preliminary Estimates for the Year 1962_, Dominion Bureau of Statistics (Ottawa, March, 1963), pp. 10-21.

2. _Quarterly Estimates of the Canadian Balance of International Payments Third Quarter 1962_, Dominion Bureau of Statistics (Ottawa, December, 1962), p. 9.

rose to 1,795 million dollars at the end of the third quarter and 2,239 million dollars by the end of the year.[25] Along with the improvement in reserves, there was a steady retirement of the short-term international credits that were extended to Canada. The 400 million dollar stand-by credit with the Export-Import Bank was reduced by 250 million dollars in September, 1962 and terminated on January 3, 1963.[26] The currency arrangements with the Federal Reserve and the Bank of England were reduced by 175 million dollars in October, by 75 million dollars in November, and the balance of 100 million dollars was retired in December.[27]

Again, as in 1947, the Canadian Government was able to successfully impose direct controls. The Government clearly expressed that the import surcharges were only temporary, and that they would be removed as soon as the Canadian balance of payments and reserve position permitted. The rest of the world accepted these statements of the Government at face value and did not retaliate by imposing restrictions against Canadian exports. The Canadian Government kept to its word, and removed the emergency restrictions as rapidly as possible. On April 1, 1963, the Canadian Government announced the removal of the last of the remaining import surcharges.[28]

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[25] Ibid., p. 15.

[26] Bank of Canada Annual Report 1962, p. 6.

[27] Ibid.

[28] "Success Without Retaliation," Economist, 207 (1963), p. 78.

CHAPTER V

SUMMARY AND CONCLUSIONS

This thesis showed that the Canadian economy in the post-World War II period operated under the stimulus and pressure of increasing inflows of foreign investment capital. These inflows of capital, which were predominantly of United States origin, had the effect of increasing Canada's dependence on the United States, both as an export market and a source of foreign investment capital. In the period prior to 1956, the Canadian economy was able to absorb these inflows of foreign investment capital, and they made possible a faster rate of growth in the Canadian economy than would have been possible had the economy relied solely on domestic sources of savings. Because the inflows of foreign capital increased the productive capacity at a rapid rate, the interest and divident payments associated with these capital investments did not prove to be a net burden for the Canadian economy.

Beginning in the year 1956, the inflows of foreign capital increased very rapidly, and became too large to be absorbed by the Canadian economy. In the period, 1956-1960, foreign borrowings of Canadian provincial and municipal governments increased markedly, the rate of capital formation as a percent of gross national expenditure declined,

the Canadian unemployment rate rose sharply, and Canada's balance on current account deteriorated to the danger point.

The interest rate policy pursued by the monetary authorities in the period, 1956-1960, led to an increasing interest rate differential between the United States and Canada. This increased the incentive for capital to move into Canada, and increased the incentive for short-term exchange rate speculation to take place. The increasing inflows of foreign capital ceased to act as a stabilizing force on the Canadian economy. Despite an overall current account deficit of over a billion dollars a year, the exchange rate of the Canadian dollar remained at a premium vis-a-vis the United States dollar. This increased the cost of Canadian exports to foreign consumers and decreased the cost of imported goods for Canadians.

The Canadian experience, 1956-1962, illustrates two important points. The first is the danger of an economy, even a highly developed economy such as Canada, attempting by inflows of foreign capital to finance a rate of economic growth that is too rapid to be absorbed by the domestic economy. The inflow of foreign investment capital added to the level of aggregate demand within the Canadian economy in the period, 1956-1962, and throughout this period, the level of aggregate demand was adequate or excessive. However, much of the increased demand created by the inflows of foreign capital was a demand for capital goods, specifically, industrial components, machinery and parts. The Canadian production of these goods was far from adequate to meet the increased demand, and new Canadian industry failed to develop rapidly enough to meet the increased demand. While the Canadian dollar

remained at a premium, both Canadian export and import competing industries' competitive position was lessened. Also, Canadian producers were placed at a disadvantage in financing expansion and development of new industries by the monetary policy pursued by the Bank of Canada. Foreign controlled firms had access to capital from parent companies aborad, but Canadian companies were forced to borrow mainly in Canadian money markets where the monetary authority maintained a high rate of interest.

As a result, much of the increased level of demand financed by the increasing inflows of foreign capital was directed to purchases of goods and services abroad, predominantly in the United States. Canada's current account balance deteriorated rapidly as the deficit on interest and dividend payments to foreigners rose to close to one-half billion dollars a year in 1959 and 1960, merchandise imports exceeded exports, the net payment for business services, mainly associated with direct investment in Canada, increased to over 150 million dollars a year in 1959 and 1960, and net purchases of goods and services abroad by Canadians, in the form of increased travel expenditures abroad, rose to over 200 million dollars in 1959 and 1960.

The second important point illustrated by the Canadian experience, 1956-1962, is the danger that exists in indecision and lack of coordination in fiscal and monetary policy. Monetary policy in the period, 1956-1960, ran directly counter to the Government's fiscal policies. The Bank of Canada, operating under the premise that inflation was "just around the corner," pursued a high interest rate policy designed to dampen inflationary forces within the Canadian

economy. This policy, however, had the effect of forcing an increasing number of Canadian borrowers into foreign money markets, increased the incentive for capital to move into Canada, discriminated against Canadian borrowers, and indirectly increased Canada's unemployment problem.

The monetary authority was not solely to blame, and the Diefenbaker Government must share the blame for the lack of cooperation and coordination that developed. The Government refused to accept responsibility for monetary management, and failed to make any constructive efforts towards greater cooperation with the monetary authority. Instead of pursuing a fiscal policy designed to restrain the inflow of foreign investment funds, the Government made no attempt, prior to December, 1960, to moderate the inflow of foreign capital. If some appropriate tax policy had been pursued, the inflow of foreign capital would probably have moderated and the monetary authority would have been free to pursue a policy designed to control inflation within Canada without exacerbating Canada's international financial position. As the situation developed, Canada had the worst of both possible worlds, and as a result, conditions deteriorated until they reached the crisis point in 1961.

The Canadian Government's handling of the Canadian exchange rate from the end of 1960 to June, 1962 was poorly managed. From June, 1961 to May, 1962, the Canadian Government attempted to operate a hybrid rate that was neither fixed nor market determined. Until the first quarter of 1962, the Canadian Government was able to manipulate the exchange rate of the Canadian dollar without large commitments of

reserves. However, in 1962, when speculative pressures against the dollar began to gain force, the Government refused to take a firm stand. The indecision and uncertainty engendered by the Government's actions led to heavy speculative pressures against the Canadian dollar. This led the Government to peg the rate of the Canadian dollar in May, 1962. Still the Government refused to make a positive statement concerning the exchange rate, and actually led speculators to expect a further devaluation. This led to a true exchange crisis in June, 1962, and the Government was forced to take a definite stand. The emergency measures adopted by the Government were extensive and determined, and appear to have been effective. The sad questions, however, remained of why monetary and fiscal policy coordination was allowed to deteriorate to the point that it reached in 1961, and why, even in 1961 and 1962, the Government did not take a firm stand on the exchange value of the Canadian dollar.

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