Monetary and Fiscal Policy in Canada*

By mid-1966 the Canadian economy had moved into its sixth year of continuous economic expansion. The vigor and duration of the Canadian expansion reflect in considerable part the pace of the broadly concurrent upswing in the United States. Nevertheless, Canada's prosperity also owes much to the flexibility with which the Canadian authorities have adapted fiscal, monetary, and other policies to changing economic conditions.

Throughout most of 1965 the Bank of Canada allowed credit conditions to tighten, and thereby helped to contain the advance in aggregate demand. However, with the labor market tightening and capacity stretched to the limit in some industries, costs and prices moved up at a significantly faster rate, and there was an abrupt deterioration in Canada's balance on current international transactions. As evidence accumulated that most or virtually all the economy's slack had been absorbed, it became increasingly clear that monetary policy alone could not bear the entire burden of providing the needed restraint. Accordingly, in the budget presented last March, the Canadian authorities reversed the 1965 cut in personal taxes. In addition, the government has adopted a number of temporary tax measures designed to dampen the investment boom now in progress. The new tax program thus represents a significant shift in the posture of fiscal policy. Together with a continuing policy of monetary restraint, this year's tax program will help mitigate inflationary excesses, and thereby contribute to further balanced growth.

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THE EXPANSION IN PROFILE

Whether measured in terms of its longevity or in terms of the magnitude of the gains in output and employment, the current expansion has been unequaled in postwar Canadian experience. Although somewhat less vigorous in its early stages than previous periods of rapid growth, the current upswing has turned out to be much more durable. Since early 1961, when the recovery got under way, real gross national product (GNP) has increased by more than one third, for an average annual increase of almost 6½ per cent. Over the five years ended in the spring of this year, total employment has increased by 23 per cent, enough not only to absorb an unusually rapid increase in the labor force but also to reduce substantially the number of unemployed.

The year-to-year increases in output, however, have varied considerably over the course of the upswing, partly reflecting similar variations in the United States. Thus, after a rapid start in 1961-62, the rate of growth slowed down considerably in 1963. Toward the end of 1963 and throughout 1964, the pace of the advance in activity picked up once again as a renewed surge of fixed business investment was reinforced by an exceptionally large increase in exports. The revival of investment was the result not only of the gradual decline in unused productive capacity but also of a number of tax incentives, including authorizations for rapid amortization of certain capital assets. The export gains reflected both the improved competitive position of Canadian industries following the exchange rate depreciation of 1961-62 and the beginning of large bulk sales of wheat to Eastern countries. Although exports rose much less rapidly in 1965, there was a further acceleration of business investment, and real GNP increased by almost 6½ per cent, or about the same rate as in 1964. The recent emergence of fixed business investment as a source of thrust for the economy contrasts with its somewhat weaker role during the initial stages of the current upswing. On the other hand, exports expanded more slowly in 1965 after several years in which exceptionally large increases had made an important contribution to the expansion of domestic production and employment.

The strong surge in aggregate demand in recent years has resulted in a significant reduction in the amount and rate of unemployment. Following relatively small gains in employment early in the recovery, total employment began to rise rapidly in 1964-65. Toward the end of 1965 and in early 1966, unemployment had been reduced to less than 3½ per cent of the labor force (seasonally adjusted), compared with nearly 5 per cent as recently as mid-1964 and almost 8 per cent early in 1961. With the decline in the overall unemployment rate in 1965, there were some signs that manpower shortages, which had previously been localized and confined largely to skilled employees, had begun to spread to a widening range of occupations and skills and a growing number of regions.

When the recovery began, there was a large margin of excess industrial capacity inherited from the investment booms of the fifties. Thus in its early and middle stages the recovery was conspicuously free of the strains, bottlenecks, and pressures that had often accompanied earlier periods of rapid growth. The productivity gains associated with fuller utilization of industrial capacity permitted a moderate rise in wage rates to be absorbed without increases in labor costs per unit of output in manufacturing or a deterioration of producers' profit margins. With cost trends thus fairly well stabilized, aggregate price measures edged up at a very moderate rate in 1961-62 and held almost steady in 1964. However, 1965 was marked by a distinct acceleration of the rate of advance of costs and prices. Employment gains were accompanied by larger wage settlements, and productivity gains slowed down appreciably, despite the substantial additions to plant facilities that had been made in preceding years. Some part of the rise in costs was absorbed through a halt in the growth of profit margins. In addition, a substantial increase in imports helped to relieve the upward pressure on prices where demand had outrun the growth of domestic supplies. Nevertheless, consumer prices advanced by almost 3 per cent, and the average of final product prices, as measured comprehensively by the implicit GNP deflator, rose at a slightly higher rate.[1]

MONETARY POLICY

Throughout most of the current long upswing, monetary policy in Canada has been designed primarily to facilitate and sustain the expansion. Credit conditions remained relatively easy through the first four years of the expansion, and interest rates generally fluctuated within a fairly narrow range as the monetary authorities enabled the commercial banks to accommodate the demand for bank credit. In the boom atmosphere that was developing in 1965, however, monetary policy gradually became less expansive, and the continued strong demand for credit—especially by businesses—was more fully reflected in upward pressure on interest rates. By the end of 1965 the posture of monetary policy had clearly shifted to one of active restraint.

Although oriented primarily toward domestic requirements, there have been periods in recent years when monetary policy was shaped largely by changes in Canada's exchange and balance-of-payments positions and by temporary strains in Canadian financial markets. Thus, in early 1962, with the emergence of heavy drains on official exchange reserves, credit conditions were allowed to tighten, and in June of that year the discount rate was raised to 6 per cent as part of a comprehensive program to restore confidence in Canada's newly established par value. The reserve loss was arrested and reversed almost immediately after the announcement of the June emergency program, and the need for monetary restraint proved short-lived. The bank rate was lowered in successive stages to 4 per cent, and the money supply rose steadily throughout the latter part of 1962 and the first half of 1963.[2] By May of that year, when the discount rate was lowered to 3½ per cent, credit conditions were approxi-

[1] The implicit deflator is a price index computed by dividing constant dollar estimates of the major components of GNP into the corresponding estimates in current prices.

[2] The money supply in Canada is defined as currency in circulation and bank deposits (including personal savings deposits) other than those of the federal government.

mately as easy as they had been a year earlier.

During the summer of 1963 Canadian financial and foreign exchange markets again became unsettled, although these disturbances were not comparable in either intensity or duration with those arising from the 1962 exchange crisis. The proposed United States interest equalization tax played an important role in the short-lived foreign exchange problem, but the announcement of an exemption for Canada did much to dispel the apprehensions that had arisen in Canadian markets.[3] Credit conditions tightened sharply but only temporarily, and after the September announcement of massive wheat exports to the Soviet Union, the Bank of Canada was able to formulate its policies on the basis of a strong balance-of-payments and exchange position. The tempo of monetary expansion was stepped up, and at the same time the banks rebuilt their liquidity to some extent. By the end of 1963, monetary conditions reflected substantially complete readjustment to the summer disturbances, with interest rates only slightly higher than they had been at the start of the year.

As the expansion gained momentum in 1964, there was a strong increase of demands for credit by the private sector. At the same time a sharp decline in the cash requirements of the federal government helped to relieve any congestion in the money and capital markets that might otherwise have developed, and interest rates held steady over the year. The rapid rise in bank loans brought about a general tightening of bank liquidity. The ratio of the banks' "more liquid" assets—mainly cash reserves, Treasury bills, and other government securities—to the total of their major assets turned down slowly from about 36 per cent at the start of the year to around 32 per cent in December, the decline occurring largely in bank holdings of Treasury bills.

During 1965, the underlying strength of the Canadian business expansion was reflected in a further substantial increase in the demand for bank credit. However, the expansion of bank lending was accompanied by increasing pressure on the reserves and liquidity of the banking system, and interest rates began to rise early in the year. Following the failure of a medium-sized finance company in June, the Bank of Canada temporarily eased the pressure on bank reserves to reassure the money and capital markets and requested the commercial banks to accommodate credit-worthy finance companies. As evidence of increasing inflationary strains continued to accumulate, however, the Bank of Canada allowed the banks' liquidity positions again to reflect the underlying strength of credit demand.

With commercial bank reserves under considerable pressure at most times during 1965 and supplies of credit and capital from nonbank sources somewhat reduced in comparison with the 1964 flow, the prevailing heavy demands for funds resulted in a rather steady upward movement of interest rates from the spring to the closing months of the year. In December, the discount rate was raised from 4¼ per cent to 4¾ per cent, partly in response to the change in credit conditions that had already occurred and partly in response to a concurrent ½ per cent increase in the Federal Reserve discount rate. Then, in March 1966, following further intensification of demand pressures, the Canadian discount rate was raised again, to 5¼ per cent. This most recent action was the first discount rate change since 1963 in which the timing was not associated with a change in the Federal Reserve discount rate, and was described by the Governor of the Bank of Canada as reflecting the Bank's view that some moderation of the growth of overall demand was desirable.

RECENT FISCAL DEVELOPMENTS

After several years of large and apparently intractable budgetary deficits, the federal government's budget, as recorded in the national income accounts, has moved into substantial surplus.[4] In both 1961 and 1962 the deficit amounted to almost $500 million. As the economy moved closer to full employment, however, the normal growth in revenues was reinforced by tax increases in

[3] In connection with Canada's exemption from the interest equalization tax, the Canadian authorities stated that it was not their intention to increase Canada's official international reserves through the proceeds of borrowings in the United States. Canada's exemption from the tax has been maintained since 1963, as has Canada's undertaking with respect to its reserve holdings. While the Canadian authorities must take the reserve agreement into account in the formulation of monetary policy, they have been able to pursue a monetary policy which was, in its broad lines, appropriate to the requirements of the domestic situation as it has developed since 1963.

[4] The government's fiscal position, as measured in the national accounts, differs significantly in definition from that shown in the regular budgetary estimates submitted to Parliament, which are comparable to the administrative budget used in the United States. Most importantly, government receipts on a national accounts basis record corporate taxes when the tax liability is accrued rather than when the tax payment is made. Moreover, the transactions of the old-age security and other social insurance funds are recorded on both the receipts and expenditures sides of the national income budget, but excluded from the regular budget. However, all borrowing or lending transactions are excluded from the national accounts budget, although included in the cash budget. Unless otherwise indicated, all amounts are stated in Canadian dollars.

the 1963 and 1964 budgets. These revenue gains, together with a moderation of expenditure increases, brought about a rapid shift toward budgetary balance. By mid-1964, government receipts (seasonally adjusted) exceeded payments for the first time in many years. This trend continued through the second quarter of 1965, when the surplus reached a seasonally adjusted annual rate of about $650 million. The emergence of a substantial and increasing surplus was felt to be inappropriate during a period when unemployment was still relatively high. In addition, the Canada and Quebec Pension Plans, scheduled to come into effect on January 1, 1966, were expected to result in substantial initial reductions in disposable consumer and business income.[5] Accordingly, in the April 1965 budget message, the Finance Minister said that the budget should be more expansionary and proposed to make it so through a flat 10 per cent cut in basic rates of personal income tax. Shortly after the tax cut became effective in July 1965, the advance in revenues slowed down and there was a moderate acceleration of expenditures. However, the tax cut itself helped to raise the level of taxable income, and for 1965 as a whole the surplus amounted to almost $500 million.

With the relatively high sensitivity of tax collections to increases in GNP, the federal government's revenues have been adequate to cover not only its own rises in expenditure, but also stepped-up transfers to the provinces, which have played an increasingly important role in the public sector in recent years.[6] However, in 1966, it was expected that the federal government's revenue gain would slow down, reflecting in part the difference between the full-year and part-year effects of the mid-1965 tax cut and in part an increase in income tax abatements to the provinces last January.

In his budget message to Parliament on March 29 of this year, the Finance Minister stated that, on the basis of then-existing tax rates and a prospective advance in GNP of more than 9 per cent, revenues were expected to rise by only 7 per cent to $8,229 million during the fiscal year ending March 31, 1967. With expenditures programmed at $8,450 million, or nearly 10 per cent above the 1965-66 outturn, there would have been a regular budgetary deficit of $230 million, compared with the actual deficit of $34 million in the preceding fiscal year. In terms of the national accounts, the transactions implicit in these forecasts would have resulted in a surplus of $370 million in fiscal 1966, compared with a surplus of almost $500 million in the previous year. Superimposed on an exceptionally large rise in planned business investment, these changes in the federal government's accounts in a period of increasing inflationary pressures were regarded by the Finance Minister as wholly inappropriate and calling for a program of restraint to moderate the boom.

The expenditure estimates submitted to Parliament reflected the government's decision not to undertake any substantial new programs or projects that were not already announced. Moreover, the authorities decided to cut outlays on construction programs in process in an effort to alleviate particularly severe strains in the construction industry. The Finance Minister also appealed to the provincial governments to defer some of the construction projects they had scheduled for the current year. But the scope for contracyclical reductions in expenditures is relatively small, and the government has relied therefore almost exclusively on tax increases to restrain aggregate demand.

In order to reduce the rate of increase in consumer expenditures, the Finance Minister proposed—and Parliament approved—the withdrawal of most of last year's cut in individual income taxes. Specifically, the present limit on the tax cut for any taxpayer was reduced, effective June 1, from $600 to $20 per year. To be sure, the basic rates of personal income tax were also lowered but, with the new limit of $20, only those taxpayers with lower-than-average incomes will benefit from this rate change. On the other hand, those with higher-than-average incomes will revert to tax levels only slightly below the levels that prevailed in 1964. The net effect of these changes will be to increase revenues by an estimated $140 million in the current fiscal year and by about $210 million on a full-year basis.

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[5] It has been estimated that employer and employee contributions to these plans would total some $570 million during 1966. However, the reduction in aggregate spending was expected to be well below this figure because: (1) part of the contributions would be financed by decreased personal and business savings, (2) tax liabilities would be reduced since contributions to the pension plans are deductible from personal and corporate income, and (3) provincial spending would probably increase since the Pension Fund reserves would be lent to the provinces at their request.

[6] Under Canadian constitutional provisions, the responsibilities of the provinces are centered in such areas as education, health, urban renewal, and resource development—all fields in which the needs and wants of the nation's population have been rising rapidly. Despite perennial rate increases for many of their own sales and property taxes and, more importantly, repeated shifts in the allocation of funds initially collected by the federal government, the net deficits of the provincial and municipal governments have remained around $300 million in recent years. The most important reallocations have taken the form of "abatements" to the provinces of certain taxes (mainly individual income taxes) collected on a nationally uniform basis by the federal government for itself and for the provincial governments under tax-sharing arrangements. In addition, there is a substantial amount of conditional and unconditional grants from the federal government to the provinces, including "equalization" payments, which are intended basically to give each province approximately the same effective per capita yield from the standard taxes subject to abatement.

With respect to business capital outlays, the government proposed three interrelated measures, each of which is designed to cut down, and stretch out, a prospectively large increase in business investment. The first of these measures, which is to become a permanent feature of the Canadian tax system, provides for the gradual elimination of the sales tax (currently 11 per cent) on machinery and equipment. The immediate removal of the tax in its entirety would have tended to reinforce the investment boom now in progress. However, the government's proposal, which has been approved by Parliament, calls for the reduction of the tax by only 5 percentage points in April 1967, and its complete removal by April 1968. The advance enactment of the reduction and eventual elimination of the tax was proposed deliberately, and clearly provides some incentive for businesses to defer the acquisition of investment goods for at least one year.

The government's other tax proposals are intended only as temporary measures, but will provide prompt pressures on businesses to defer capital expenditures. The first of these measures, which was put into immediate effect by the government through an amendment to the Income Tax Regulations, reduces the capital cost allowances that may be claimed on most kinds of new construction, machinery, and equipment acquired during the eighteen-month period ending October 1, 1967. In adopting this measure, the Finance Minister stated that, after several years of using increased capital cost allowances as inducements for accelerating business investment, it was now logical to use reductions in these allowances to induce business to defer a part of its investment.

The other temporary measure, a 5 per cent refundable tax, is a wholly new device in Canada and virtually without precedent elsewhere. The tax has a built-in time limit and, as described by the Finance Minister, is intended to "divert and immobilize temporarily a modest portion of the flow of funds that is the chief source of finance for the increasing capital expenditures of business". The refundable tax is essentially a levy on gross business profits, and is payable on a monthly basis for an eighteen-month period ending on October 31, 1967.[7] However, the amounts received under this measure would be repaid, with interest at 5 per cent, within eighteen to thirty-six months after receipt. The timing of the repayments within this range would be determined by the government in the light of economic prospects as assessed late in 1967.

The Finance Minister stated that, after allowance is made for the effect of these various tax changes, revenues would rise to $8,300 million, even though GNP would increase somewhat less rapidly than originally estimated. With expenditures unchanged at $8,450 million, the regular budgetary deficit would amount to only $150 million for the current fiscal year. As measured in the national accounts, federal transactions are now expected to result in an excess of revenues over expenditures of $615 million, compared with an estimated $370 million before the tax changes and an actual surplus of about $500 million in fiscal 1966.

CONCLUDING COMMENTS

In terms of its direct effect on income, the government's fiscal program will moderate the expansion of overall demands and, in the process, help to contain the advance in prices. The three measures affecting capital investment taken together are expected to cut the increase in business investment by a third of a billion dollars and would thus help to bring the increase in final demands much closer into line with the increase in the economy's productive capacity.[8] To be sure, GNP is still expected to rise by about 5 per cent in real terms and by something over 8½ per cent in current prices. While the estimated advance in GNP is only slightly less than last year's dollar increase of 9 per cent, the marginal effect of the new tax measures in the latter half of 1966 may be considerably greater than is suggested by the year-to-year comparison of growth rates—simply because the actual effect of the new measures will occur mainly in the second half of the year or later.

The fact that the temporary tax measures will be effective until October 1967 suggests that, in the government's view, fiscal restraint will be needed at least up to

[7] Specifically, the tax is payable on the taxable income of the company, as ordinarily estimated, less the regular income tax, plus capital cost and depletion allowances deducted in determining income. Any company would also be allowed to deduct from taxable income principal payments due on any debt which had an original term of three years or longer and which was contracted before April 1, 1966. Moreover, there would be a general deduction of $30,000 in order to mitigate the impact of tax on small businesses which do not have recourse to the capital market.

[8] As shown in the government's January investment survey, the prospective increase in business investment in 1966 over 1965 amounted to $1,250 billion, or 16 per cent. Thus, the estimated combined effect of the three measures would be to cut back the rise in business investment to 12 per cent. They may also help to restrain whatever increase in Canada's current account deficit that might otherwise occur.

that time. Of course there is always a possibility, however small, that the Canadian expansion might slow down before October 1967. If the economic situation should fail to bear out current expectations, or if the economic impact of the taxes proves larger than anticipated, certain elements of flexibility in the tax measures themselves could be utilized to advantage as needed. The Finance Minister has indicated that he would not hesitate to recommend the complete elimination of the sales tax before it is scheduled to expire, if it should become necessary to induce some acceleration of business investment. Similarly, the capital cost allowances could be quickly liberalized by still another amendment to the Income Tax Regulations. Finally, the authorities could disburse the receipts from the refundable tax if it became desirable to ease the pressures on the money and the capital markets.

At this particular juncture, however, the possible need for fiscal stimulus seems remote. Indeed, in recent months wage increases in some industries have risen much faster than productivity and have led to further substantial upward pressures on costs and prices. Nevertheless, Canada has clearly made a major effort to adapt general monetary and fiscal policy to the requirements of a strongly stimulated economy and has, in the process, broken new ground in the development of flexibility in fiscal policy.