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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

The Canadian Economy on the Eve of the Nixon-Trudeau Meeting

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
April 1972

INTELLIGENCE MEMORANDUM

THE CANADIAN ECONOMY ON THE EVE OF THE NIXON-TRUDEAU MEETING

Summary

1. Canada's economy grew rapidly in 1971 as inflationary pressures abated, but unemployment remained at a high level. Although its bilateral trade and basic balance with the United States declined somewhat from 1970, both accounts remained in substantial surplus.

2. In what will probably be an election year, Ottawa faces continuing larger-than-normal unemployment, which it fears will be aggravated by US action to reduce its balance-of-payments deficit. In addition, pressure is mounting for control over foreign investment, despite a continuing need for additional funds to further Canadian development.

Discussion

The Economy in 1971

3. Canada's economy in 1971 recovered rapidly from its recent recession. Gross national product (GNP) increased 9.1%, in current prices, compared to a 7.4% increase in the United States. The price level rose only 3.4%, almost 1 percentage point less than in 1970, and 1.2 percentage points less than in the United States. Canadian real GNP increased 5.4% (see the table), more than in any other OECD country except Japan. This was a sharp improvement over the 1970 rate of 3.3% and the largest annual gain since 1966.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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Canada: Selected Data
1971

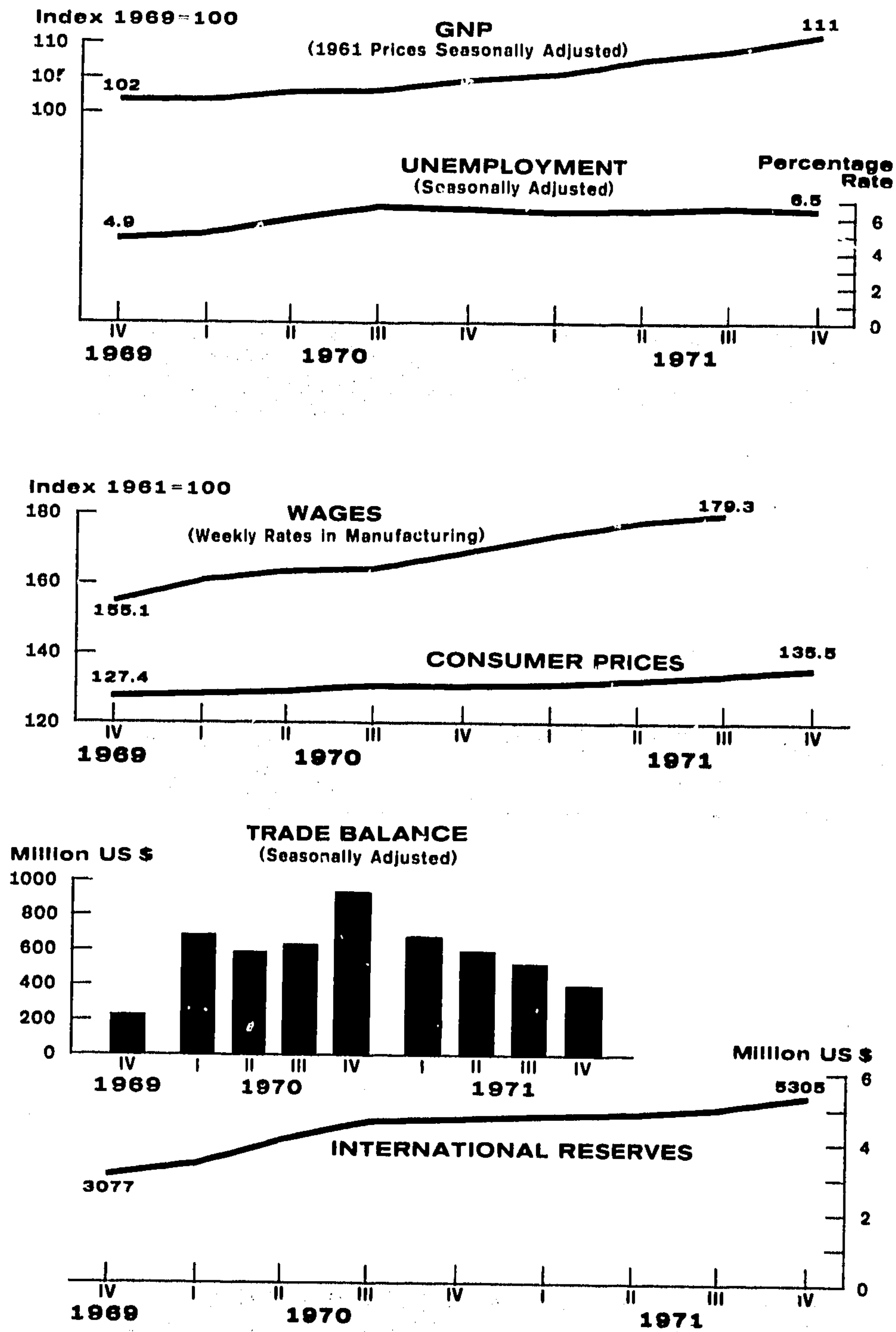
Gross national product (GNP) (Billion US $)	91.2
GNP per capita (US $)	4,200
GNP real growth (Percent)	5.4
Population (Million)	21.7
Exports (Million US $)	
Total	17,569
To the United States	11,883
Imports (Million US $)	
Total	15,396
From the United States	10,794

4. An almost 16% increase in consumer spending on automobiles and other durable goods was a major factor in the recovery. New housing outlays also showed marked strength, increasing almost 23%, compared to an 8% decline in 1970. But because of unused capacity and investor uncertainties, gross fixed capital formation by business increased only 2.3%. Rising consumer demand boosted corporate profits 16% and labor income 10%.

5. Canadian monetary and fiscal policies were aimed at stimulating demand. Credit conditions remained easy in 1971: long- and short-term interest rates were well below levels reached a year earlier, and central bank policy permitted the banking system's assets to rise rapidly. Ottawa cut taxes on low and moderate incomes, and total government spending increased about 24%.

6. Despite the economic improvement, unemployment remained a persistent problem (see the chart). The unemployment rate remained in excess of 6% throughout the year, and exceeded 7% in September. Although the number of persons employed grew 2.5% during 1971, this was insufficient to absorb the 3.1% increase in the labor force.

CANADA: Selected Economic Indicators



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Balance of Payments

7. Canada's trade and payments position remained strong in 1971. Although Canada's trade surplus fell by nearly $1 billion from the record 1970 level, the $2.2 billion 1971 surplus still is the second largest ever recorded. The decline in the surplus largely resulted from increased imports reflecting the country's rapid economic growth. The Canadian dollar's appreciation of 8.5% since May 1970 appears to have had little impact on Canada's foreign trade in 1971, and the effects of the US New Economic Policy after August 1971 appears to have been limited to temporary uncertainty and delays in contract signings. Canada continued to be favored by a net inflow of long-term capital of $475 million, and the 1971 basic balance showed a substantial surplus – $700 million.

8. The bilateral trade surplus with the United States declined moderately – by $100 million – to $1.1 billion in 1971. Because of increased payments for services and transfers, the bilateral current account deficit rose from $13 million in 1970 to $364 million in 1971. Nonetheless, the bilateral basic balance continued in surplus – $340 million – as Canada obtained most of its long-term capital needs from the United States.

9. Canada had a net short-term capital inflow for the first time since 1965, and international reserves rose $1 billion to $5.5 billion at yearend. A 46% increase in reserves since the beginning of the float in May 1970 contradicts Ottawa's claim of a "clean" float. About 70% of Canada's reserves are held in US dollars; many of these recent purchases were an attempt to slow the appreciation of Canada's floating dollar.

Economic Problem Areas

Unemployment

10. The greatest economic problem facing Ottawa during the 1970s will be the creation of enough new jobs for those seeking employment. Canada has the fastest growing labor force of any industrialized country, and the Economic Council of Canada estimates that the economy must grow at least 6% annually in real terms if unemployment is to be reduced. The Trudeau government looks to the expansion of manufacturing to provide many of the required jobs. Growth in manufacturing will provide more jobs than will expansion of resource-based industries, which are relatively capital-intensive. Having exhausted the easiest opportunities for import-substitution in the 1950s, Canadian manufacturing development has become increasingly export-oriented. The country's population – only 22 million – is insufficient to permit both product diversity and efficient manufacturing runs in most technically sophisticated industries. The major market for these exports has to be the United States.

Foreign Investment

11. Foreign investment plays a greater role in Canada than in any other industrialized nation. The more that $45 billion in Canadian assets owned by foreigners includes over 50% of the assets in Canadian manufacturing, oil and gas, and mining and smelting, and virtually 100% in industries such as automobiles and rubber. The United States is Canada's principal source of foreign investment, accounting for about 80% of the total.

12. Foreign investment in Canada is a contentious domestic issue. Many Canadians feel that the large degree of foreign control is a threat to their country's independence, and fear that economic decisions affecting the national well-being are formulated by corporate directors outside Canada. A recent Gallup poll indicated that 69% of Canadians believe there is presently enough US investment in Canada. This compares to 62% who held this view in 1970, and only 46% in 1964.

13. On the other hand, many provincial leaders favor obtaining additional foreign investment to combat unemployment. They feel that there is not adequate domestic investment to alleviate the employment problem and develop key resources, such as hydroelectric power. Many provinces grant lucrative incentives to promote foreign investment – for example, a combination of federal and provincial grants, low-interest loans, and tariff concessions induced Michelin to build two plants for the production of radial tires in Nova Scotia. About 80% of Michelin's output will be exported to the United States.

14. The Trudeau government is now in the process of formulating a foreign investment policy. This policy will probably provide for the establishment of an agency to screen future foreign investments in Canada. But whatever institutional change is made, the government faces a dilemma. Although Ottawa would like to increase Canadian ownership, future development – particularly in the capital-intensive resource industries – requires vast infusions of foreign capital. If investment inflows are limited severely, the problem of creating new jobs will be exacerbated and this will have serious political repercussions in many provinces. Thus, while foreign investment will probably receive increased scrutiny – and may be constrained where domestic funds are available – the new investment policy is unlikely to be applied in such a way as to significantly hamper the investment inflow.

Bilateral Balance of Trade

15. The US-Canadian trade balance has changed drastically in recent years. In 1966 the United States had a $0.7 billion surplus which, by 1971,

had turned into a deficit of $1.1 billion. This basic change in US-Canadian trade relations has come about largely because Canada has increased its exports of manufactured goods -- particularly automotive products – while continuing to expand exports of raw materials, US resources of which are becoming increasingly scarce.

16. To improve its trade position, the United States has asked for Canadian action in three areas: to increase the duty-free allowances for Canadian tourists to make them more comparable with US allowances; to honor its commitments under the Defense Production Sharing Arrangement; and to recognize that the transitional safeguards in the automotive agreement are no longer required. Thus far, Ottawa has shown little desire to meet US demands, being particularly resistant to any meaningful modification of the auto pact. The issue, furthermore, has taken on considerable political coloration. This will probably be an election year in Canada, and Trudeau does not want to be accused of selling out to Washington, or of taking actions that might result in the loss of Canadian jobs.

Dollar Float and Its Impact

17. Canada's dollar has been floating almost two years. Since it was freed from its peg of $1 Canadian = $0.925 US in May 1970, it has appreciated to about parity with the US dollar. This float has created a dilemma for the Canadians. Needed foreign capital inflows and growing raw material exports tend to force the Canadian exchange rate up. But this, in turn, makes it more difficult to expand manufacturing output, as Canadian manufactures are less competitive in foreign markets while foreign manufactures are more competitive in Canada. The float has had little impact so far, however, because most Canadian exports are either sold under long-term contracts or are produced by subsidaries of US companies which continue to use their existing capacity in Canada.

18. Moreover, the December agreement on new international parities eased Canada's situation. At that time, Canada's currency was devalued relative to the currencies of all of its major trading partners, and the exchange rate vis-a-vis the United States did not change. Canadian export sales to Europe and Japan will consequently be given a boost while European and Japanese products will be less competitive in Canadian markets.

Prospects for 1972

19. For 1972 the most important determinant of Canadian trade will be the rates of economic growth in Canada and the United Statess – by comparison the impact of the exchange rate changes will be small. Canada's economic growth will probably accelerate in 1972. According to most

Canadian forecasts, GNP, in current prices, will probably grow about 10%, surpassing $100 billion. Real GNP should increase about 6%, with prices probably increasing about 4%. At this real growth rate, unemployment will be reduced somewhat, but will still be in the 5.5%-6% range through most of the year. Consumer and government spending will lead Canada's growth in 1972 as they did in 1971, probably rising 10% and 15%, respectively. Business investment probably will still be sluggish, rising by only 4%, because unused plant capacity still exists.

20. Canada's balance of payments will probably remain favorable in 1972. Imports will rise along with the country's rapid economic expansion, but exports are also expected to climb because of the US economic recovery and economic recoveries in Japan and Western Europe. Altogether, Canada's global trade and basic balance surplus is expected to improve somewhat, and its surplus with the United States will remain essentially unchanged.