Bank of Canada

Report of the Governor - 1975

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General Observations

In Canada, as generally in the industrial world, the declining trend of economic activity that prevailed a year ago gave way in the course of 1975 to renewed expansion. The upturn came at about the same time in the major industrial countries, dating from the spring in Canada and the United States, somewhat earlier in Japan, and somewhat later in Germany. A few countries, notably the United Kingdom and Italy, have so far not shared much in this improving trend, but it nonetheless seems clear that the world economy is now firmly set on a path of cyclical recovery from the deepest and longest recession of the postwar period. The extent of the recession in Canada was relatively limited compared with other countries. The decline in real GNP during the recession was about 1½ per cent in Canada compared with over 6½ per cent in the United States and 5¼ per cent in Germany. Canada and Japan were the only major industrial countries in which the over-all output of goods and services at the end of 1975 appeared to be as high as it was before the recession began.

Another notable feature of 1975 was the moderating trend of inflation in the world at large. Though the decline in the general level of international commodity prices was surprisingly limited for a period of such depressed levels of world economic activity, the pressures on domestic prices stemming from international trade abated sharply during 1975. More fundamentally, the trend of domestic costs and prices in a number of major countries began to look much more favourable. This was especially true of Germany, Japan and the United States, which by the end of 1975 were experiencing rates of price increase in the 5 to 7 per cent range and trends in wages and salaries that appeared to be consistent with their improved price performance. In a number of other countries, including Canada, much less progress was made in this respect.

Indeed, wage and salary increases in Canada escalated even further in the early part of 1975, and, as the year progressed, the rapid uptrend of costs was reflected in a growing divergence between Canadian and foreign price trends. The Government's recognition of the dangers inherent in this situation was manifested in the programme of anti-inflation measures announced in mid-October.

A third dimension of economic developments during 1975 was a remarkable reduction in the huge imbalances in the structure of world trade that had developed in 1974 as a consequence of the earlier quadrupling of the world price of oil and the booming demand and prices for foodstuffs and primary materials. The industrial countries taken together moved from a combined current account deficit of over U.S.$30 billion in 1974 to an estimated deficit of some U.S.$5 billion in 1975. The counterpart of the improved position of the industrialized countries was a roughly comparable reduction in the large surplus of the OPEC countries as the volume of their oil shipments contracted and their imports rose sharply. Unfortunately, this striking shift towards greater balance in world payments was not shared by the poorer nations of the world, which found themselves caught in the pincers of high prices for oil and other imports and weak markets for their exports.

Canada did not share in the general move by other industrial nations towards greater external balance, but experienced instead a large increase in its current account deficit. We were adversely affected by the same factors as other exporters of raw materials, while the relative strength of domestic demand in Canada compared with our major trading partners kept our imports at high levels. In addition to these cyclical influences, more permanent changes such as a rapidly increasing dependence on imported oil and growing debt service payments began to weaken our international balance on current account. Our current account deficit increased from about $1½ billion in 1974 to about $5 billion in 1975, and at the same time our rising costs of production were further worsening our competitive position in international trade.

What stands out from this brief review is that economic developments in Canada have diverged to an unusual extent during the past two and a half years from those abroad, and particularly from those in the United States. The divergence between Canada and the United States is shown in more detail in the charts on pages 24 and 25 of this Report. Whether measured in terms of the growth of money incomes, output or employment, the buoyancy of the Canadian economy has been matched by few other countries. The relative strength of output and employment was welcome, of course, but the price tag attached is turning out to be high. That price includes a distinctly less favourable evolution of our domestic costs and prices, and of our balance of international payments.

A contributing factor to the divergence between economic events in Canada and in the other main industrial countries was that from late 1972 until well into 1974 the international economic environment developed in a way that was very favourable to us and very unfavourable to them. During that period the demand for foodstuffs and other primary products was very strong, and the prices of these commodities rose much more than the prices of manufactured goods. These circumstances added substantially to Canadian incomes and to the air of intense national prosperity that prevailed in Canada. The fact that the increase in income was initially very unevenly distributed served to strengthen greatly the scramble among groups in the country to share in it. The rising expectations of Canadians about the standard of living that they could attain were reinforced, and these expectations were not significantly dampened by the shock of the energy crisis that broke on the world at the end of 1973 because Canadians then regarded themselves as being largely insulated from that event.

For some time now developments in international markets have been much less favourable to Canada, but the change has been gradual and has not correspondingly altered expectations. The scramble for unreasonably large increases in money incomes has persisted long after the passing of the fortuitous circumstances that at first seemed to provide some justification for it.

Even in retrospect it is not easy to see how the large but temporary increment to incomes in Canada flowing from the world-wide boom of 1973 could have been prevented from causing economic distortions of some magnitude. No doubt a better appreciation of the inflationary risks inherent in the situation and more restraint on aggregate demand would have helped. Be that as it may, the country is left with the serious problem of restoring order to its structure of costs and prices and to its balance of payments.

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The basic principle underlying Canadian monetary policy continues to be that the money supply should grow along a path capable of accommodating a satisfactory rate of real economic growth accompanied by some slowing in the rate of increase of prices.

Until well into 1974, with economic activity in Canada still at full stretch and subject to intense spending pressures, the policy of the Bank of Canada had necessarily involved vigorous resistance to the economy's strongly growing appetite for money and credit. This had resulted in a persistent upward movement of short-term interest rates, which in turn had moderated the previously over-rapid pace of monetary expansion.

By the late summer of 1974, however, there were growing indications that demand pressures in the Canadian economy both for money and credit and for goods and services were at last beginning to fade in much the same way as they had faded some months earlier in the outside world. In these circumstances the Bank of Canada's concern about the trend of monetary expansion shifted: the problem became for a time one of trying to prevent too sharp or prolonged a slowdown in the rate of monetary growth. In the closing months of 1974 and early 1975, Canadian interest rates fell sharply in response to rapidly changing market expectations and a general weakening of demand pressures in credit markets – a decline accommodated by the operations of the central bank. The undesired sluggishness of monetary growth in the latter part of 1974 soon gave way to a renewed spurt of rapid expansion in the early months of 1975.

By the late spring of 1975 the resumption of rapid monetary growth had brought the money supply, defined as currency outside banks and demand deposits at the chartered banks, back up to a trend rate of increase (measured over the previous two years) slightly in excess of 10 per cent annually. Over the course of the summer the growth rate of the money supply accelerated strongly. With economic recovery apparently underway, the Bank came to the view that not only was the money supply growing at too high a rate, but also that Canada's underlying inflation problems were rapidly building up to critical proportions. Short-term interest rates were therefore allowed to move higher and early in September the Bank Rate was increased by three quarters of one percentage point to a level of 9 per cent – in terms of past experience, an unusual action on the part of the central bank at such an early stage in an economic recovery.

During November the Bank of Canada made public its views about how rapidly the money supply should be allowed to expand in Canada in the existing circumstances. Its views were expressed in terms of a range for the underlying growth rate of currency and demand deposits of not less than 10 per cent a year but not as high as 15 per cent a year. The Bank also indicated that, for monetary policy to be consistent with the objective of gradually bringing down the rate of inflation over time, this range too would have to be lowered gradually over coming years.

During much of the final quarter of 1975 and into the early weeks of 1976 the figures of money supply growth in Canada were greatly inflated by the effects of a nation-wide postal strike. In February, when it again became possible to get a useful reading of the figures, it appeared that the underlying growth rate of currency and demand deposits measured from the average level in the second quarter of 1975 was still on the high side.

The need to keep the growth of the money supply under control has involved the maintenance of levels of short-term money market rates in Canada well above those in the United States, and unprecedented spreads of around four percentage points have recently emerged. The widening of these spreads in recent months has resulted mainly from a sharp fall in rates in the United States. In the past there has usually been a fairly close correspondence between short-term interest rate movements in the two countries owing mainly to the fact that underlying economic and financial conditions have typically evolved along broadly similar lines and financial markets in the two countries have many inter-connections. More recently, however, the course of the Canadian economy has diverged remarkably from that of the United States, as noted above. Not only have trends in output, employment and prices diverged, but so have monetary and financial conditions. For some time now the demand for credit has been relatively much weaker in the United States than here, and the growth of the money supply in that country has been below, rather than above, the objectives set by the monetary authorities. In these circumstances it should not be surprising that a level of short-term interest rates in Canada that is higher than usual relative to U.S. rates is required to keep the money supply from expanding too rapidly. Nevertheless, market expectations that Canadian short-term interest rates would tend to follow U.S. interest rates appear to have been quite strong, and it has been necessary from time to time for the Bank of Canada to resist this tendency by keeping the cash reserves of the banking system unusually tight.

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I have referred already to some of the background leading up to the major anti-inflation programme announced by the Government in October 1975. It is of fundamental importance to the longer run welfare of all Canadians that the country manage to gear down the rate of increase in costs and prices – not just as a matter of international competitiveness but as an essential condition for economic, social and political stability. This must be accomplished one way or another; the only question is how.

One answer sometimes given to this question is that the Bank of Canada should do the job through a sharp and immediate reduction of the growth rate of the money supply to a rate approximately in line with the sustainable real growth of the economy. If that were to happen, it is asserted, inflation would readily come to an end.

The trouble with this prescription is not with the medicine but with the dosage, which would be so great that the patient would suffer excessively while it was working. It would sharply curtail the growth of spending on goods and services in the face of continuing large increases in production costs already built into the economy, and this would almost certainly result in extremely weak markets, widespread bankruptcies and soaring unemployment. It must be recognized that the annual rate of increase in average Canadian money incomes that is consistent with price stability is no higher than the trend rate of increase in national productivity, which is usually put at around two per cent per year, and we are a long way from that situation. All sorts of existing arrangements, including virtually all wage contracts, are based on the assumption of some continuing inflation. The attempt to force as rapid a transition to price and cost stability as this prescription involves would be too disruptive in economic and social terms to be sensible or tolerable.

In my opinion it is much wiser to gear down inflation more gradually and over a longer period. Any programme to this end that is to have a chance of working must certainly be firmly based on fiscal and monetary restraint, but time must be allowed for the various elements of inflation now built into the economy to be eliminated.

I also believe that in Canada's present circumstances it is useful to supplement financial discipline by direct action to restrain increases in incomes and prices. The price and income restraint programme exerts its influence on prices mainly through its impact on the various elements of cost (including profit) that enter into pricing decisions. Though it is essential to limit increases in all forms of income it must be recognized that the effectiveness of the programme will be largely determined by its success in moderating the increase in wages and salaries for the simple and inescapable reason that for the economy as a whole wage and salary costs are by far the largest element in prices. This approach can bring about the needed adjustment at less cost in terms of unemployment and lost output, and with less serious inequities, than would result from sole reliance on monetary and fiscal policies. It deserves the co-operation of all sectors of the community.

I welcome the recognition by the Government, in announcing the programme, that success will depend crucially on keeping the over-all level of demand in the economy growing at a pace consistent with successively lower rates of price increase. This is vital not only for the programme to have the desired impact while it is in effect but also to avoid a resumption of inflation immediately afterwards. An all-too-common theme running through the history of similar experiments in other countries has been the undermining of restraint by inappropriate monetary and fiscal policies.

I believe that the contribution of monetary policy to the control of inflation requires the exercise of moderation and steadiness in expanding the quantity of money. While the rate of monetary growth must be adequate to support a satisfactory rate of real economic growth over time, allowing the quantity of money to expand too rapidly merely ensures that its value will eventually fall. If excessive monetary expansion is allowed to become a recurrent phenomenon, the decline in the value of money will occur at accelerating rates. This is what has in fact been happening throughout the world over a period of many years. The time is overdue to call a halt to this destructive process and to set a firm course aimed at reversing it, gradually but steadily, over the years that lie ahead.

As I have already noted, the choice of a rate around which to try to stabilize the growth of the money supply at present must have regard to the high rate of inflation that now exists in Canada, but the rate of money supply growth should be steadily diminished in the years ahead as a key element in the programme to wind down inflation. I should also note that the pursuit of a policy of stable monetary expansion requires that interest rates and the exchange rate be allowed scope for such movement as may be needed in either direction, not only over the course of business cycles but also over shorter periods.

Steadiness in the trend of monetary growth will help to combat instability in the rate of aggregate spending in the economy. If, in the short run, national expenditure rises faster in response to pressures of various kinds than the trend of money holdings, money will become more expensive and more difficult to borrow, and firms and individuals will be induced to moderate their spending. In this way short-term bursts of excessively rapid growth in aggregate spending will be moderated by stability in the rate of monetary growth. The opposite sequence of events will occur if the level of national expenditure slackens temporarily but the quantity of money keeps growing on trend. In relative terms money will become more plentiful, and thus cheaper and easier to borrow. Sooner or later this will encourage firms and individuals to

increase their spending again. Stable monetary expansion will thus be accompanied by contra-cyclical movements in interest rates.

In recent years the monetary authorities in a growing number of countries have been moving towards a policy approach of this kind. Its main advantage is that it increases the prospects for stabilizing both the trend of output and prices over the longer run. In the past, the approach followed by most central banks was to try to offset undesired variations in national expenditure that were believed likely to occur in the immediate future by action which often involved wide swings in the rate of monetary expansion from one period to the next. Although intended to be stabilizing, this approach often had a de-stabilizing influence on the trend of expenditure growth in the economy. The reasons for this include the difficulty of making reliable short-term economic forecasts, the long and variable time lags involved in monetary policy, and the difficulty of making judgments about appropriate interest rate levels in periods when future inflation is expected. A further difficulty with this approach and one that limits the scope for using it as a stabilization device is that any escalation of the rate of monetary growth must be fully reversed in due course if the longer run trend of monetary expansion is not to accelerate over time. Escalated monetary expansion may appear an attractive option in the short run, but the obvious danger, particularly in an already inflationary climate, is that if it is sizeable and prolonged it will intensify inflationary expectations and behaviour. The reversal of the escalation will be difficult to achieve without adverse short-term effects on economic activity.

The current approach to monetary policy does not of course mean that indicators other than monetary aggregates are being ignored but rather that considerably more weight is being placed on stability in monetary expansion than was formerly the case. Some of the practical aspects involved in implementing such a policy are discussed later in this Report.

Many factors in addition to monetary policy affect financial conditions in Canada, including interest rates and the exchange rate. Among the most important of these are the borrowing requirements of all levels of government. The total amount of new money borrowed by governments through the issue of securities (other than to the Canada and Quebec Pension Plans) rose from a little below $2 billion in 1973 to $7 billion in 1974 and to over $10 billion in 1975. Included in these amounts were net placements of provincial and municipal securities abroad, which rose from about $½ billion in 1973 to $1½ billion in 1974 and to $3½ billion in 1975. In early 1976 there was an unusually heavy concentration of foreign borrowing by provinces and this was undoubtedly a factor in the sharp upward movement of the Canadian dollar that occurred in the exchange market.

An increase in borrowings by governments can be most readily accommodated without undue upward pressure on interest rates and without excessive monetary expansion during periods in which the growth of private spending and borrowing is slackening. Indeed, fiscal policy settings that involve increased borrowing requirements when private demands are cyclically weak can be an important element in helping to sustain economic activity.

Once private spending and credit demands begin to expand again as economic recovery proceeds, there is both less need and less room for government borrowing. If such borrowing nevertheless remains at a high level it may become increasingly difficult to accommodate credit demands in total, private as well as public, within a framework of reasonable monetary expansion without substantial upward pressure on interest rates. Depending on the level of external interest rates, there may be a substantial diversion of government and other borrowing to foreign markets resulting in upward pressure on the exchange rate as well, even with a very large balance of payments deficit on current account. Such a sequence of events could at some point prejudice a healthy expansion of the Canadian economy. The Bank of Canada can reasonably be expected to see to it that inappropriately high interest rates or an inappropriately high exchange rate do not arise from an unduly low rate of monetary expansion. However, the Bank should not be expected to attempt to deal with these matters by allowing the money supply to expand at an excessive rate since that would only shift the problem back to the domestic inflation of prices and costs.

Problems of this kind will be much easier to avoid if governments manage to reduce the size of their borrowing requirements as the private sector of the economy recovers.

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Discussions about reforming the international monetary system which have been carried on under the auspices of the International Monetary Fund over the past few years culminated in agreement on a number of major issues at a meeting of the Interim Committee held in Jamaica in January of this year.

Agreement was reached on the basis for a new exchange rate system that makes provision within the IMF Articles for both fixed and floating exchange rates. This will allow, for the first time, the formal acceptance within the rules of the IMF of the practice followed by Canada since 1970 of allowing its exchange rate to float.

I believe that the agreement reached on the exchange rate system should be welcomed because it in effect recognizes that reasonable exchange rate stability depends much more on the ability of individual countries to maintain domestic economic stability than on the choice between fixed and floating rates. Exchange rate policies of both types should be and will be subject to surveillance by the International Monetary Fund.

There was agreement to abolish the official price of gold and to remove its special status in international transactions. What will happen to the role of gold in the international monetary system over the longer run seems to me to depend largely on the degree of success achieved around the world in controlling inflation. If there is not confidence that reserve currencies and the SDR will retain their values reasonably well gold is likely to continue to be regarded by many countries as an asset worth holding.

The IMF will return one-sixth of its gold holdings to member countries and will sell a similar amount for the benefit of developing countries. Profits from gold sales are to be used, along with voluntary national contributions, to support the establishment of a Trust Fund which will provide balance of payments assistance on concessionary terms to countries with very low per capita incomes.

Agreement was also reached on enlarging the resources of the IMF; the total of members' quotas in the IMF is to be increased by one-third to SDR39 billion. Within this total, the relative share of the oil exporters as a group will be doubled while that of all other developing countries will not decline. While the share of the developed countries will be reduced the absolute amount of their quotas will rise. Canada's quota will be increased from SDR1,100 million to SDR1,357 million. Until the new quotas can come into effect access by member countries to IMF credit tranches will be increased by 45 per cent. The Special Oil Facility operated in the last two years will not be continued. The IMF has also decided to increase funds available under its Compensatory Financing Facility and to liberalize access to this facility by member countries. In these respects, and in establishing the Trust Fund, the IMF is shifting further from its original role of providing only temporary balance of payments support to that of extending longer term assistance to developing countries on concessionary terms.

Where necessary these various decisions will be incorporated into amendments to the Articles of Agreement of the IMF for submission to the participating countries for acceptance.

Practical Aspects of Monetary Control

Some of the practical problems involved in implementing a policy of stable money supply growth in Canada are discussed in this section.

The first of these problems is the need to choose which of a wide variety of possible measures of "the money supply" to use as a guide.

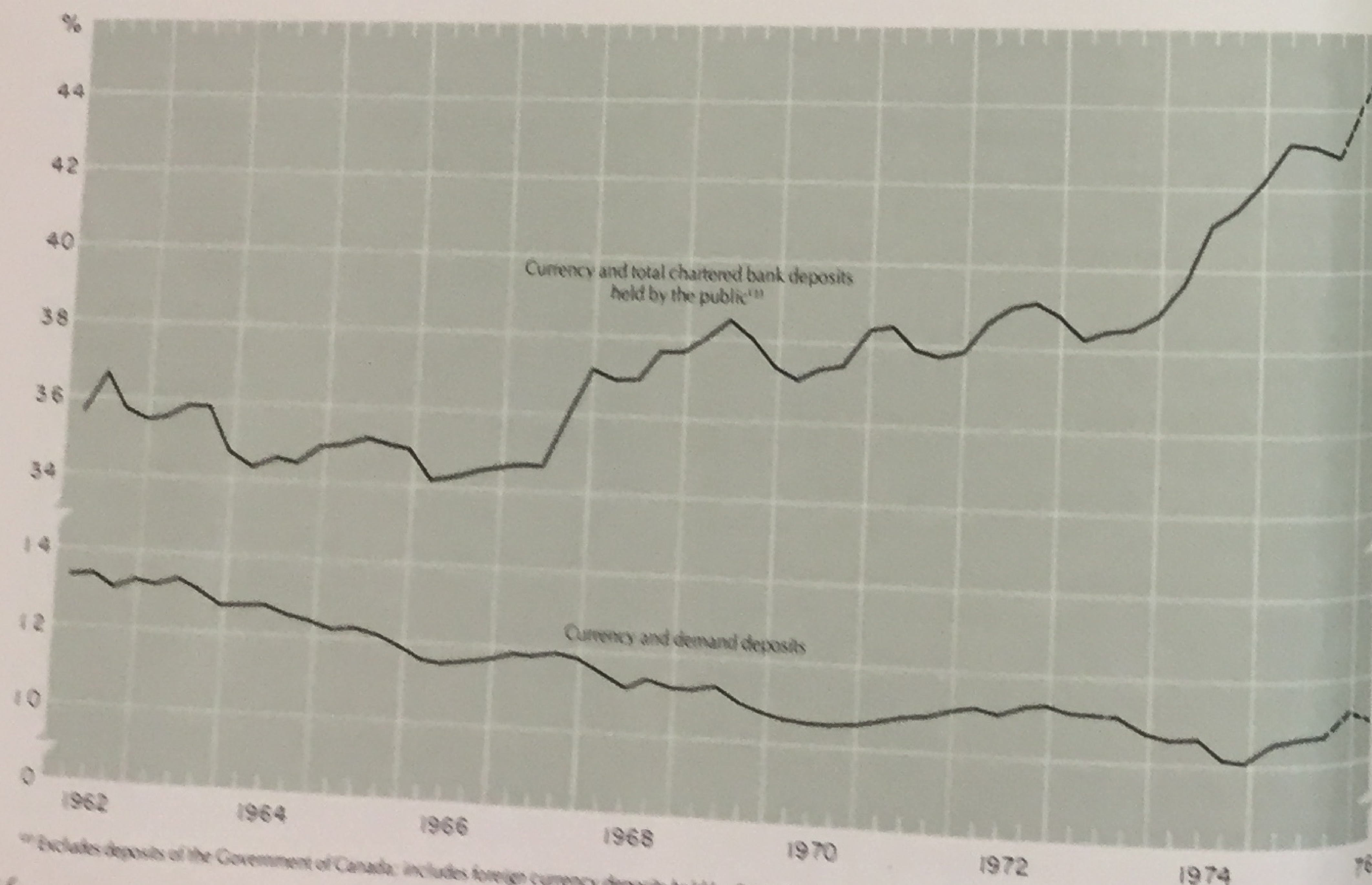
One possibility is to focus primarily on a narrow definition of the money supply that includes only those forms of money used directly as a means of payment in settling transactions, such as currency and demand deposits. Alternatively, the definition can be broadened to include savings and time deposits in bank accounts or broadened still further to include, for example, similar types of deposit balances at certain "near-bank" institutions. In the United States the Federal Reserve Board tries to spell out its monetary growth targets not just in terms of currency and demand deposits, but also in terms of the associated growth rates for a number of more broadly defined monetary aggregates. In Germany, on the other hand, the main focus of attention is on the monetary base, which is the total of currency and deposit balances at the central bank held by the public and the commercial banks.

The growth rates of all of these various monetary aggregates are related, and although they are all jointly influenced by the rate at which the central bank provides cash reserves to meet the requirements of the banking system, they can and often do follow paths that diverge considerably over time. The choice of a particular monetary aggregate to use as a guide is primarily a matter of selecting the one whose behaviour over time appears to be most systematically related to the trend of national expenditure and to short-term interest rate movements in a particular economy. It has nothing to do with alternative theories about the particular channels through which monetary impulses exert their influence on spending behaviour in the economy.

There is little to choose in this regard between narrowly-defined and more broadly-defined measures of the money supply in Canada for the period prior to the 1967 Bank Act Revision. In recent years, however, the chartered banks have had much more scope than in the past to vary the interest return offered on savings and fixed-term deposits; at the same time the public has been provided with a much wider choice of competing savings instruments, not only by the chartered banks but also by "near-bank" institutions and by government savings bonds and money market paper. As a result of these institutional changes it is now very difficult to find broad money supply measures whose behaviour appears to be closely related to that of Gross National Expenditure (GNE) and those short-term interest rates most directly subject to central bank influence. On the other hand, the growth of currency and demand deposits – a narrowly-defined measure of the money supply – bears a reasonably systematic relationship over time to the growth rate of aggregate spending in the economy, as measured by the dollar value of GNE, as well as to short-term interest rates.

The following chart shows the movements over recent years of the ratio of this narrow money supply measure to GNE and a similar ratio for a much broader definition of money.

Ratios of Selected Monetary Aggregates to GNE
Seasonally adjusted, quarterly average

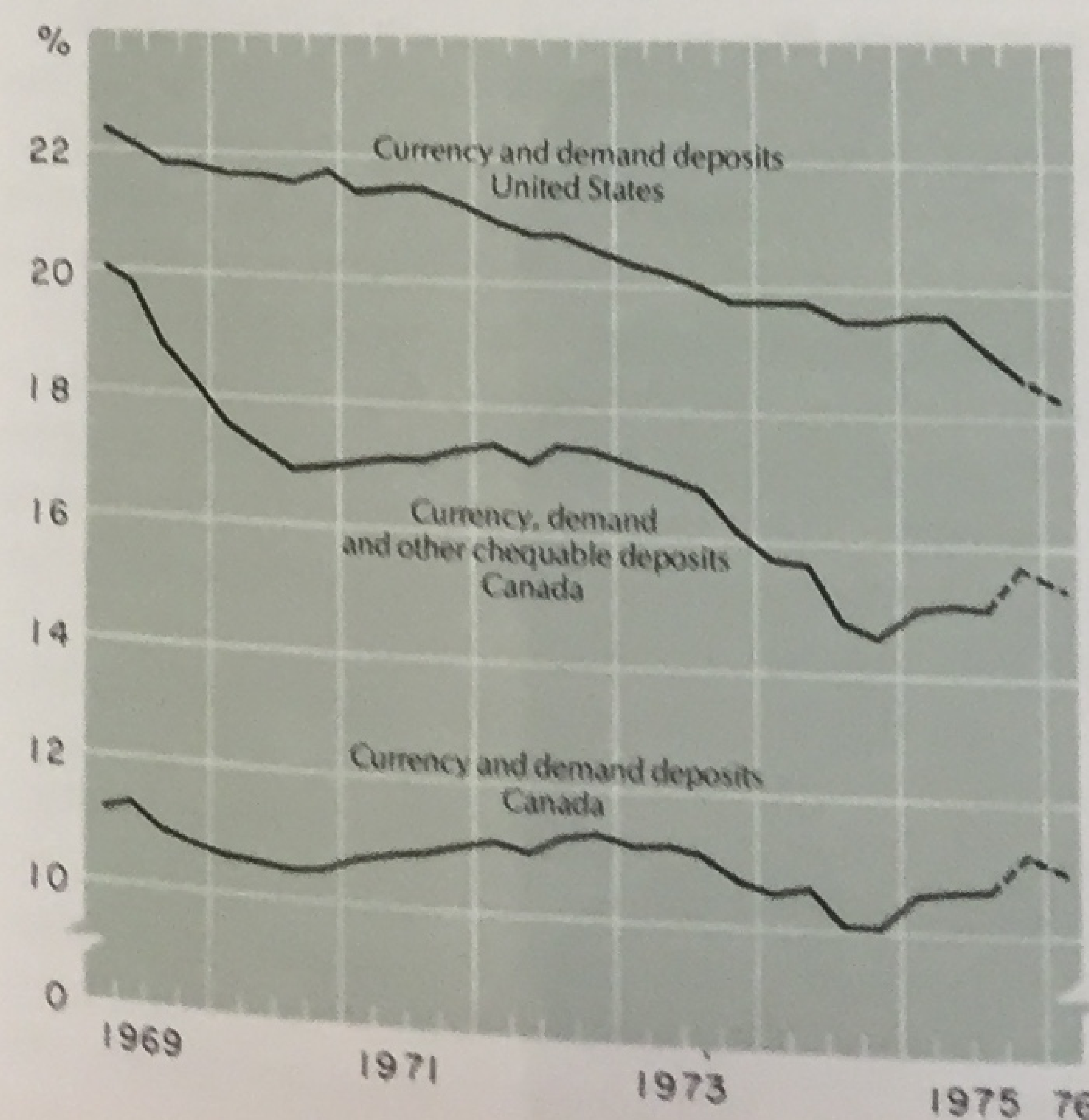


(1) Excludes deposits of the Government of Canada; includes foreign currency deposits held by Canadian residents.

On average since the beginning of the 1970s the relationship in Canada between the growth of the public's holdings of currency and demand deposits (M1) and the growth of national expenditure appears to have been close to one-for-one in the sense that, other things being equal, the public has tended to increase its M1 holdings by close to one per cent for each one per cent increase in the money value of GNE. The ratio of M1 to GNE has averaged close to 11 per cent over this period and its trend seems to have been declining very gradually if at all.

It should be noted that currency plus demand deposits is not as comprehensive a measure of the public's transactions balances in Canada – where cheques may also be drawn on certain types of interest-bearing savings accounts – as it is in the United States where virtually all chequable deposits are demand deposits. This is one of the main reasons why the trend rate of growth of M1 in Canada is substantially higher than that of M1 in the United States. The inclusion of these substantial but relatively slow-growing chequable savings account balances in the Canadian figures results in a series much more like M1 in the United States, and with a comparably lower rate of growth over recent years, as can be seen in the accompanying chart.

Ratios of Money Supply to GNE: Canada-United States
Seasonally adjusted, quarterly average



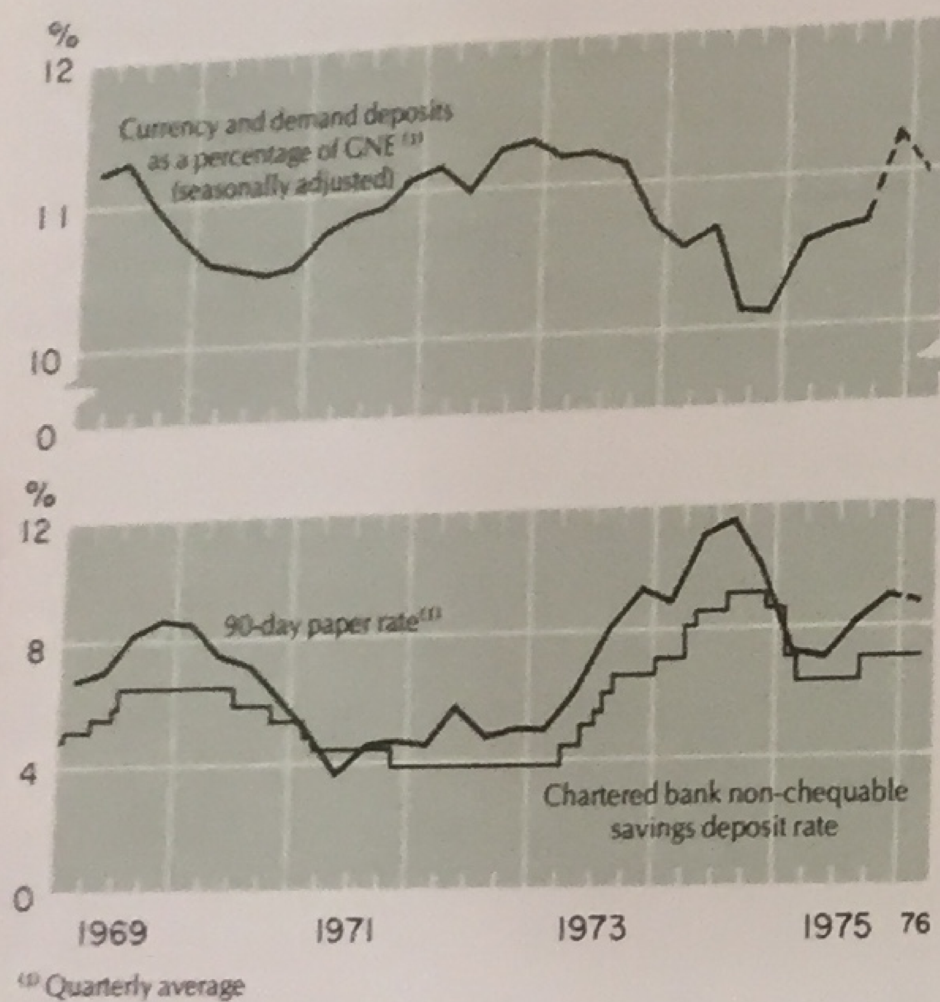
The existence of a rather stable average relationship between M1 and GNE in Canada over the longer run does not mean that their respective growth rates cannot diverge temporarily – and at times rather widely – over periods as long as a year or two. This is because M1 growth responds not just to the growth of GNE but also to changes in the level of short-term interest rates.

A rise in short-term interest rates makes it more costly for the public to hold non-interest-bearing balances rather than interest-bearing time deposits or similar financial instruments; as a result, a downward adjustment occurs in the average level of M1 that the public is willing to hold per dollar of GNE. A decline in short-term interest rates has the opposite effect. These effects could alternatively be described as changes in the velocity of money.

Thus during periods in which short-term interest rates have been rising, the growth rate of M1 has typically begun to slacken in relation to that of GNE and in time the ratio of M1 holdings to GNE has fallen. When short-term interest rates have been falling, the growth rate of M1 has in due course run ahead of that of GNE and the ratio of M1 holdings to GNE has risen again. This pattern of behaviour is readily apparent from the chart on page 18.

The existence of these systematic relationships gives the Bank of Canada the means of determining the trend growth rate of M1. Individual members of the public are, of course, free to decide for themselves how much of their financial assets to hold in the form of currency and demand deposits, but the Bank of Canada

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



(1) Quarterly average

can exert a strong indirect influence on these decisions – and thus on the trend of M1 – by virtue of its ability, through its cash reserve management, to influence the level of short-term interest rates. If the rate of growth of M1 is too high the Bank can, by tightening the supply of cash reserves to the banking system, cause short-term interest rates to rise, which will restrain the growth of M1. If, on the other hand, M1 growth is too low, the Bank can loosen its control of cash reserves, thereby causing short-term interest rates to fall and the growth of M1 to be stimulated.

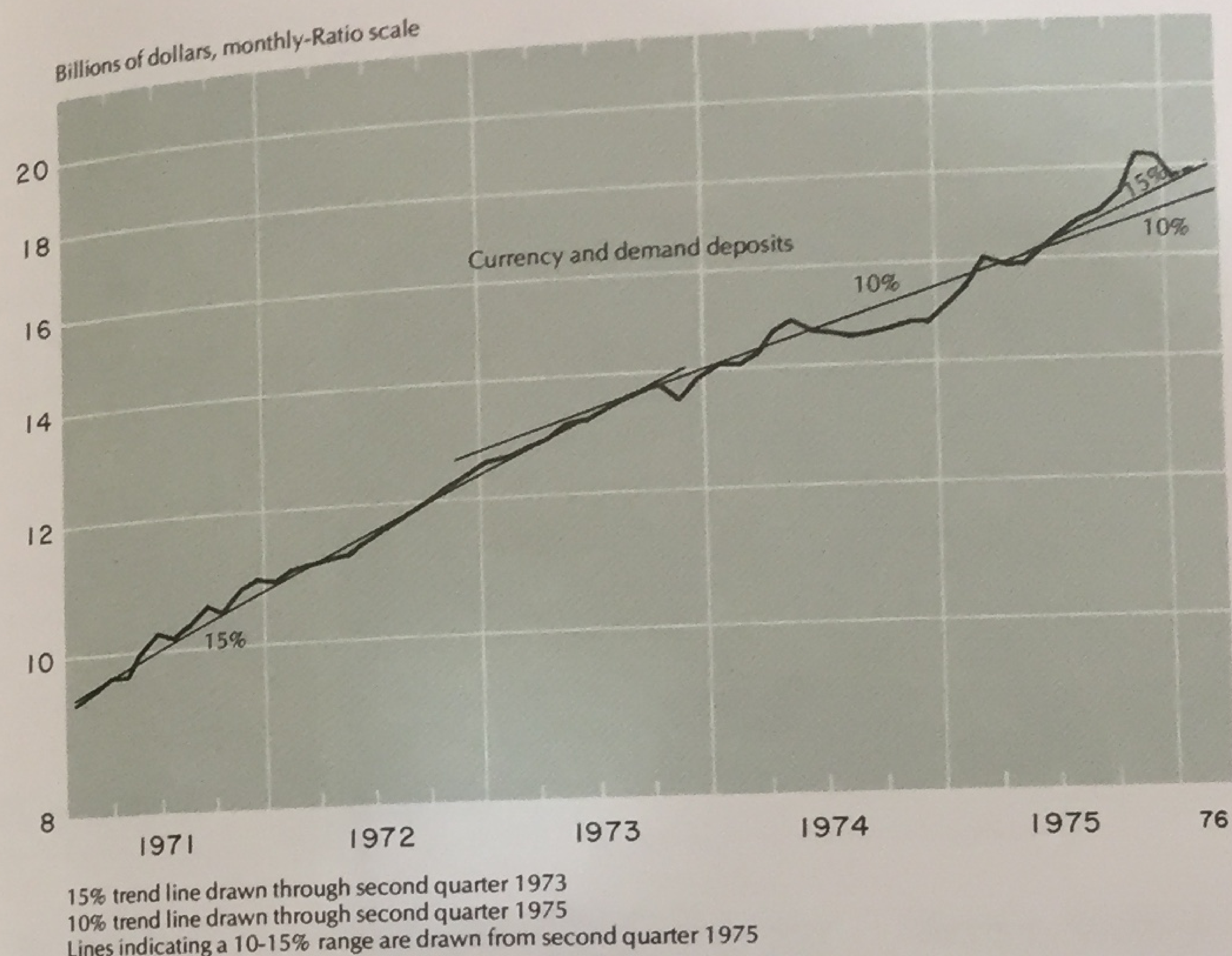
It is evident from this framework of operations that the Bank of Canada cannot, in a given environment, pursue unrelated short-run targets for the money supply and for short-term interest rates. To take a view about one implies a view about the other. Because of that, the use of a money supply target can be seen as throwing light on what the approximate level of short-term interest rates should be from one period to the next.

Conflicting considerations enter into the choice of a target figure or figures around which to try to stabilize the trend rate of increase of M1 over time. A growth rate of M1 of no more than five per cent a year would probably be sufficient to accommodate a continuation of real growth in the Canadian economy at close to its longer term trend rate under conditions of price stability, but it would certainly be much too low in present circumstances of substantial "built-in" inflation. On the other hand, a growth rate of M1 of 15 per cent a year or more would probably involve accommodating in full a continuation of the recent pace of inflation. The Bank of Canada's choice last year of an interim target range for M1 of below 15 per cent a year but not below 10 per cent a year resulted from a balancing of these considerations. As indicated earlier in this Report, this range will have to be lowered over time if the rate of monetary expansion is to be consistent with a gradual reduction in the rate of inflation. The recent record of M1 growth in relation to its current target range and to its trend over earlier years is shown in the following chart.

Particularly over periods as short as a few weeks or even months, the underlying trend of M1 growth in response to its basic determinants is often obscured to a greater or lesser extent by the impact of a variety of temporary random influences. In some cases the cause of these temporary disturbances is reasonably clear, as was the case when the mail service was interrupted in the spring of 1974 and again in the closing months of 1975.

In the Bank's view it would not be sensible to attempt to suppress month-to-month variations in M1 reflecting essentially short-run disturbances of this kind by taking action that would involve sharp temporary fluctuations in interest rate levels. The Bank takes a broader view, looking at the underlying trend of M1

Growth of the Money Supply (M1) since 1971
Seasonally adjusted



15% trend line drawn through second quarter 1973
10% trend line drawn through second quarter 1975
Lines indicating a 10-15% range are drawn from second quarter 1975

growth – over a period of months rather than weeks – in relation to a target path it has in mind stretching some time into the future. One consequence of this approach is that substantial variations in the growth rate of M1 either above or below its target range may persist for a time before strong corrective action is taken. Provided such deviations are not allowed to become cumulative over a lengthy period, however, their impact on spending behaviour in the economy is unlikely to be of more than marginal significance.

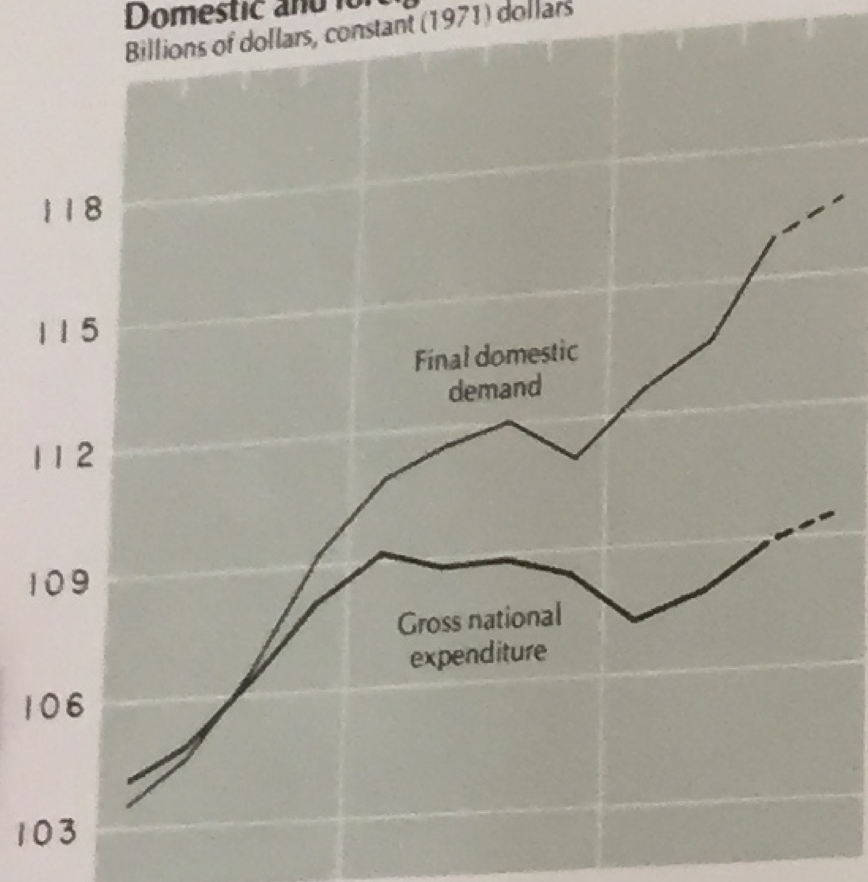
It should be borne in mind that M1 will provide useful information for policy purposes only so long as the public's behaviour with respect to its holdings of transactions balances per dollar of income continues to follow a reasonably predictable pattern. It is possible that the public's habits in this regard will change over time, perhaps in response to innovations in payments technology and in the characteristics of the various kinds of financial instruments offered by deposit-taking institutions and their close competitors. The Bank of Canada recognizes the need for careful monitoring of such developments and of their impact on the public's behaviour.

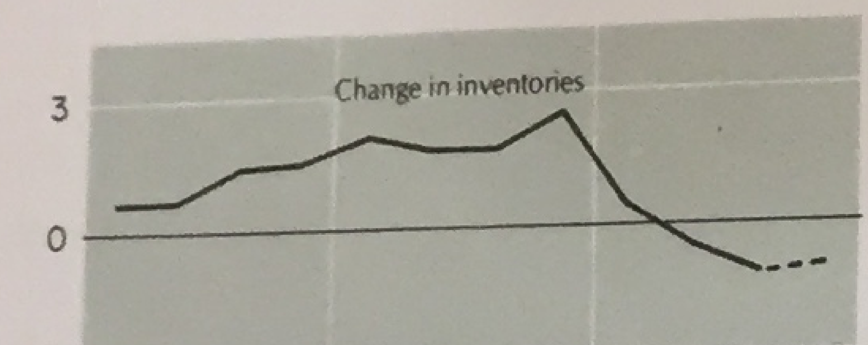
Economic Developments

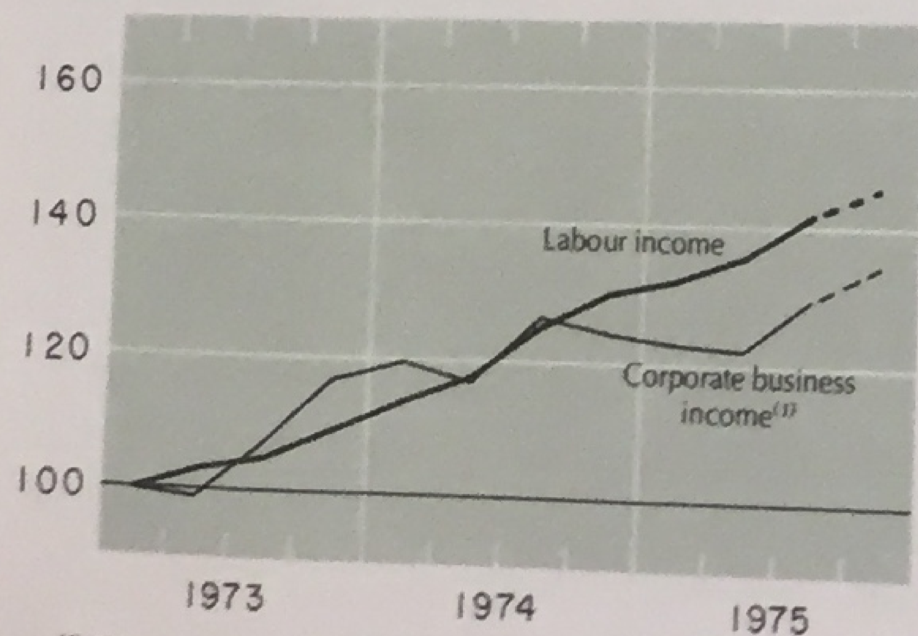
In the first few months of 1975 economic activity in Canada continued to display the weakness characteristic of most of 1974, but from the spring it began to show a gradual advance. As this Report is being written official estimates of the National Accounts for the fourth quarter are not available. However, the indications are that while real output in 1975 as a whole was virtually unchanged from the previous year, by the end of 1975 total production had risen to about the previous peak attained in early 1974.

Compared with the pace of recovery in the initial phases of expansion from previous economic slowdowns, the upturn in activity has been moderate to date. One major restraining element has been the slower pickup in exports than in earlier periods. Demand and output in the United States recovered vigorously in the latter part of 1975, but the improvement in the economies of most of our major trading partners overseas has been later or less rapid. Besides these external demand influences, the recovery of export volumes was restrained by domestic factors such as the phased reduction in the amount of oil sold abroad and supply limitations caused by work stoppages, particularly in the forest industries. Indeed, the record number of man-days lost through labour disputes in 1975 appears to have exerted a pervasive drag on the pace of recovery. In contrast to the sluggishness of exports, domestic demand for final goods and services provided major support to the economy throughout 1975. As the year progressed, the advance in real final domestic demand was increasingly translated into gains in output as the negative impact of the shift towards inventory liquidation, an effect which was particularly pronounced in the early part of the year, tapered off. With prospects for a continued firming of demand abroad in 1976, and evidence that by the end of 1975 Canadian businesses had worked off a major part of their excess stocks in relation to sales, both exports and inventory demand should become elements of support in contrast to their major restraining influence on economic activity through most of 1975.

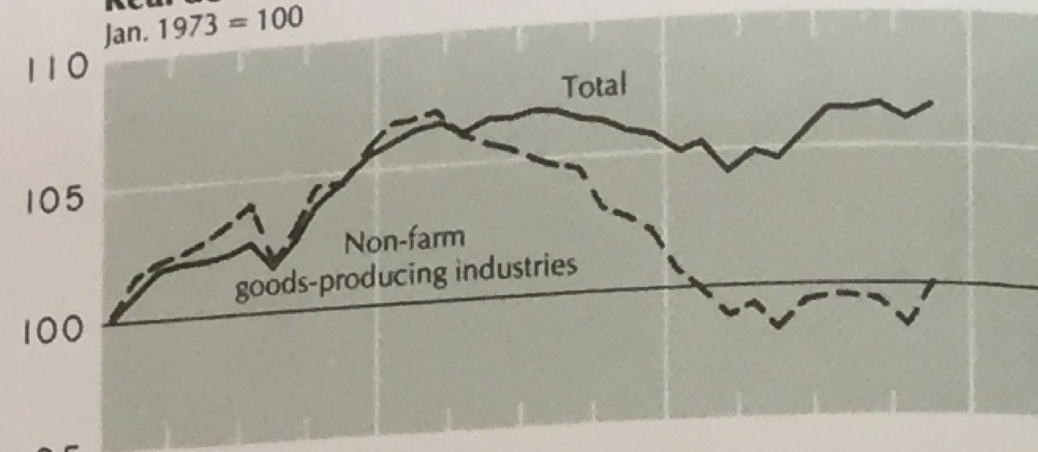
Major Economic Indicators
Seasonally adjusted

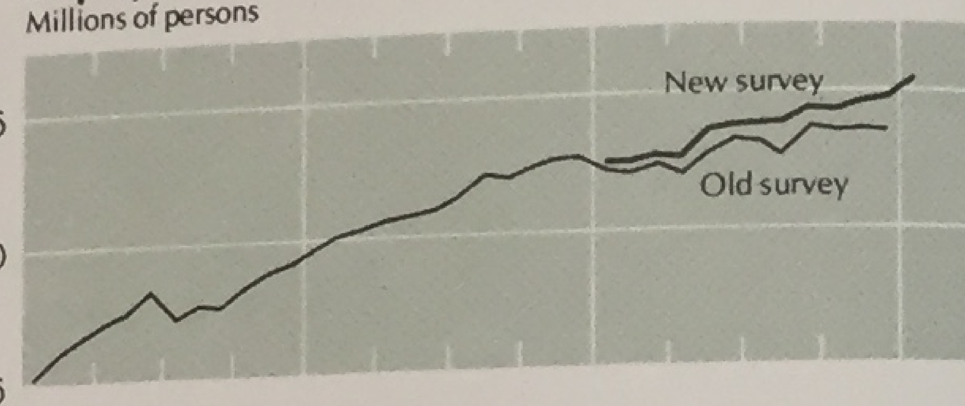


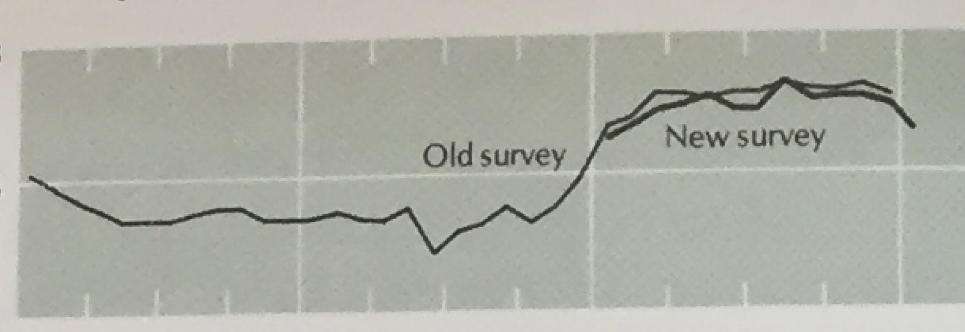


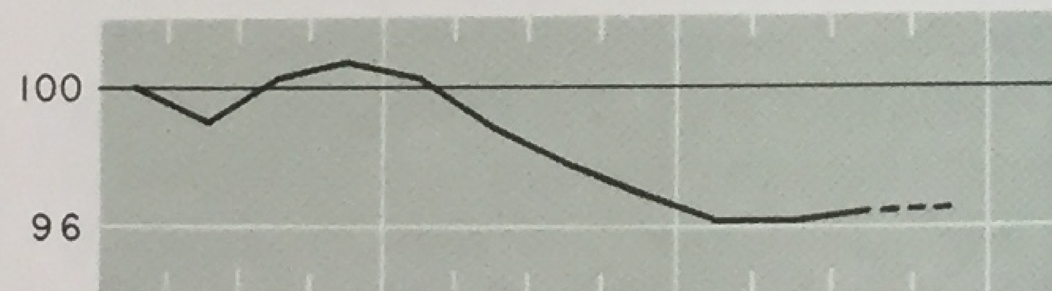


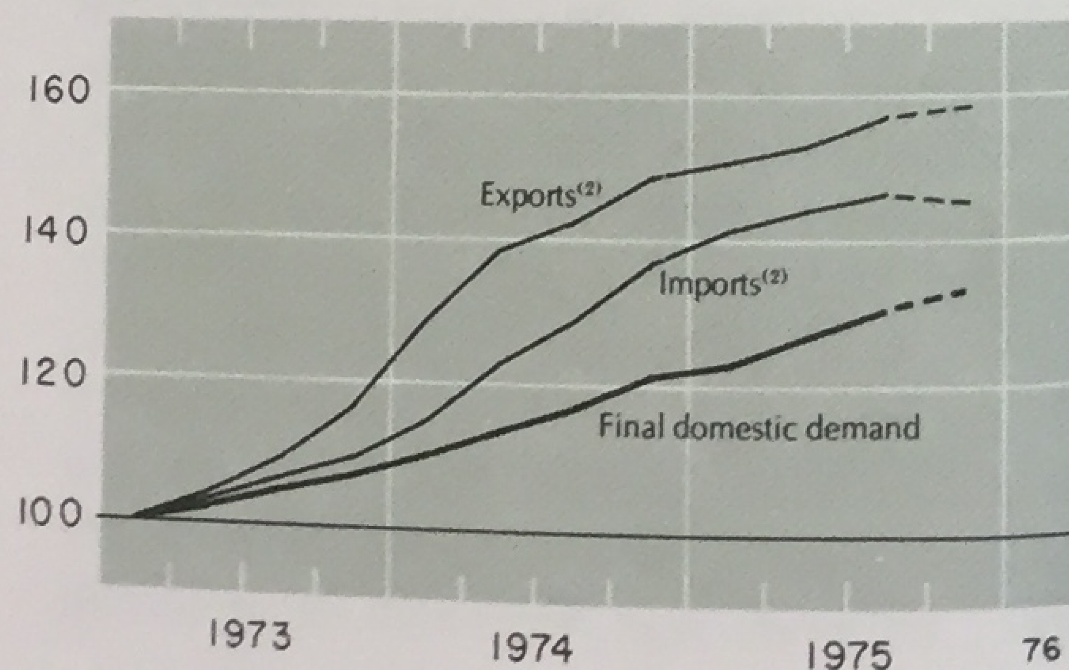
(1) Corporate profits, corporate capital consumption allowances and the inventory valuation adjustment.











(2) Goods and services

The price deflator for Gross National Expenditure, the broadest measure of the price of Canadian production, rose during 1975 at a somewhat less rapid pace than in the preceding year, but still apparently by some 10 per cent. This reduction in the over-all rate of inflation was essentially attributable to a much slower advance in external prices rather than to an improvement in the performance of domestic costs. The sharp slowing in the rise of import prices, from more than 25 per cent during 1974 to appreciably less than 10 per cent in 1975, was a key factor in reducing the rate of increase in consumer prices. However, in response to the upward pressure from domestic costs, the inflation over the year in the prices paid by Canadian consumers was still close to 10 per cent.

Reflecting the close economic links within North America, developments in the Canadian economy have in the past borne a close resemblance to the pattern in the United States. As noted earlier in this Report, however, over the past two years Canada's economic performance has shown some notable divergences, both in the pace of economic activity and in costs and prices. Many of these are illustrated in the charts on pages 24 and 25.

The amplitude of both the cyclical economic contraction and subsequent expansion has been considerably greater in the United States than in Canada. The drop in U.S. real GNP from its peak in late 1973 to the low point in the first quarter of 1975 was over 6½ per cent. Output in Canada began to turn down about three months later than in the United States and also reached its trough in early 1975, but the over-all decline was only about 1½ per cent. The major difference between the two economies was the extent to which final domestic demand was sustained in Canada. Here, the volume of domestic spending on final goods and services continued to advance, whereas in the United States it fell by over 4 per cent. As a consequence, output and employment were much better maintained in Canada, although the difference in demand conditions between the two countries was also a major factor in the substantial deepening in the deficit in Canada's external balance on current account.

Already in 1974 domestic costs and prices in the United States were showing evidence of being less subject to upward pressure than in Canada, particularly in the area of wages. Average money wages in the United States rose during 1974 at about half the rate recorded here. However, in that year the differential impact on domestic prices was largely masked by the greater cyclical downturn in labour productivity in the United States and the extreme price effects in both countries of the international commodity boom and oil price shocks. In 1975 international inflation was greatly reduced and output per worker recovered more in the United States than in Canada. In this environment the continuing divergence in the performance of underlying domestic costs showed up increasingly as the year progressed in a divergence in domestic rates of price inflation.

Domestic and External Demand

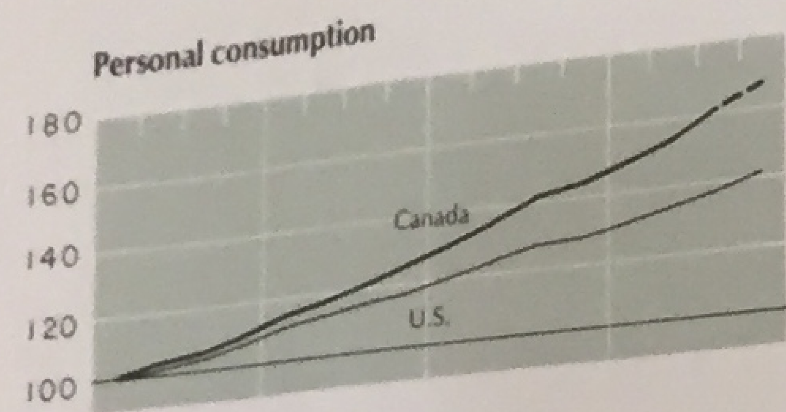
Reflecting the weakness in export demand and the initial sharp correction in inventories, Gross National Expenditure in current dollars rose at an annual rate of some 7 per cent in the first half of 1975, but for the remainder of the year the pace of advance was approximately twice as fast. During this latter period export demand showed some improvement, and while business inventories continued to decline the rate of liquidation remained fairly steady. Also, domestic spending on final goods and services expanded more rapidly – moving from an annual rate of increase of about 12 per cent during the first half of 1975 to above a 15 per cent pace in the second half.

A corresponding, though more muted, second-half upswing also occurred in final domestic demand in real terms. In part, the faster advance reflected the strength of consumer spending,

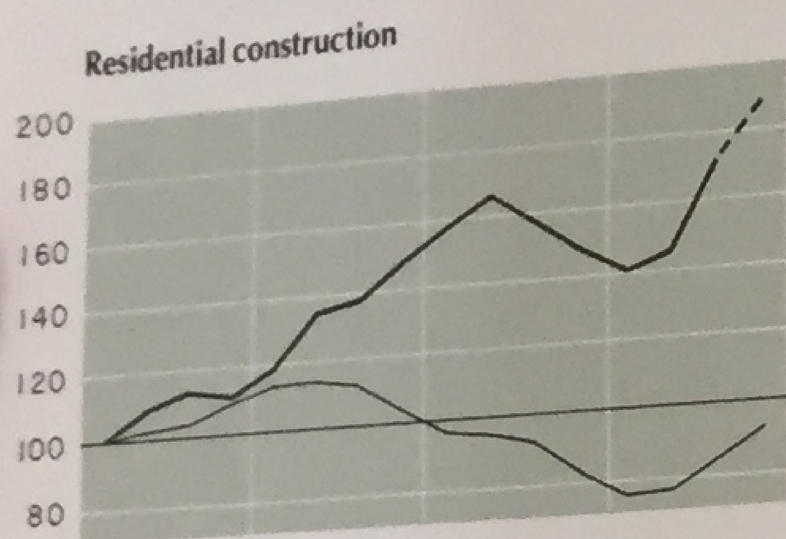
Nominal Demand: Canada-United States

Seasonally adjusted, IQ 1972 = 100 unless otherwise indicated

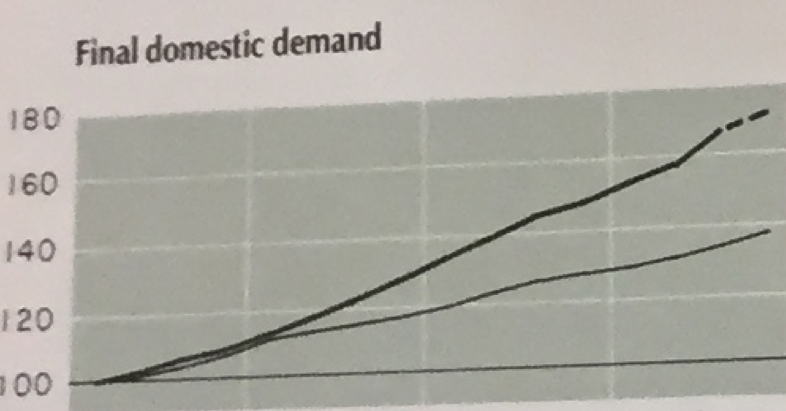
Personal consumption



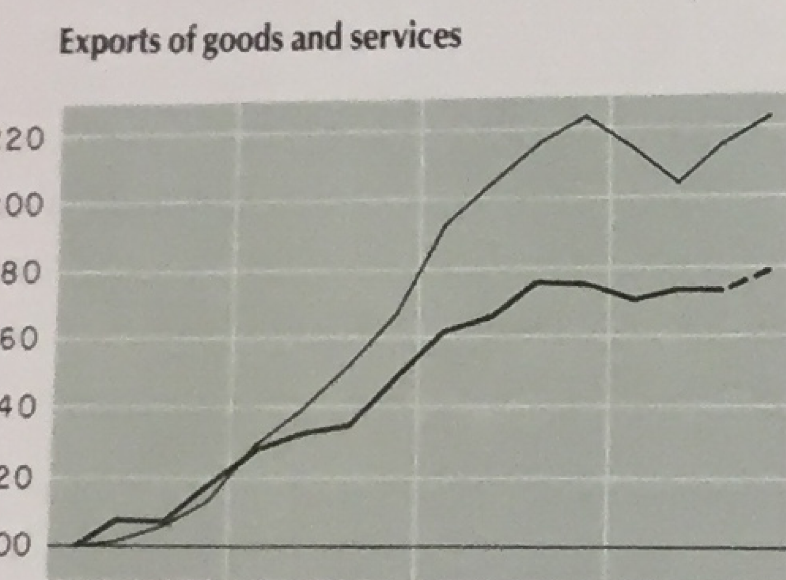
Residential construction



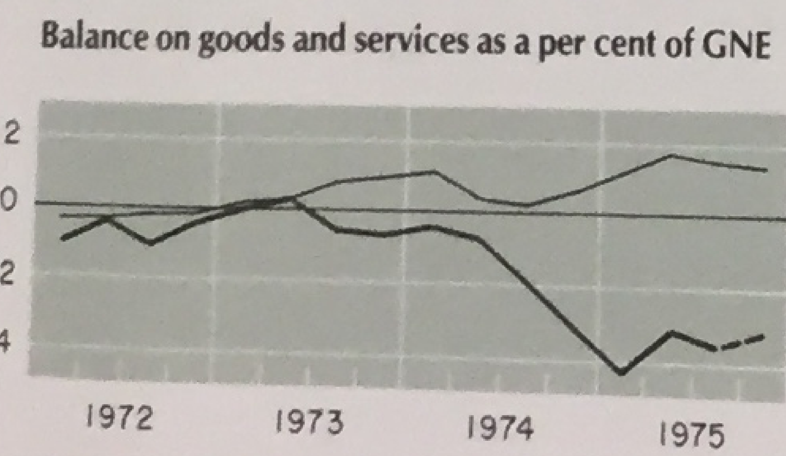
Final domestic demand



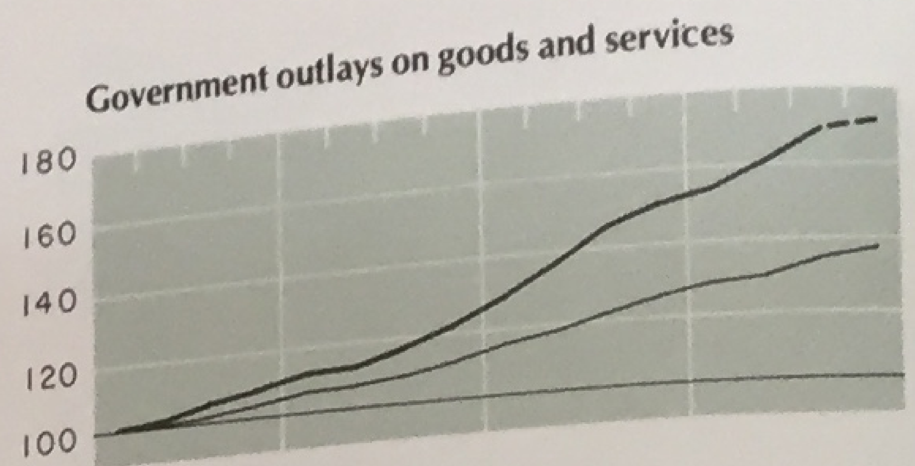
Exports of goods and services



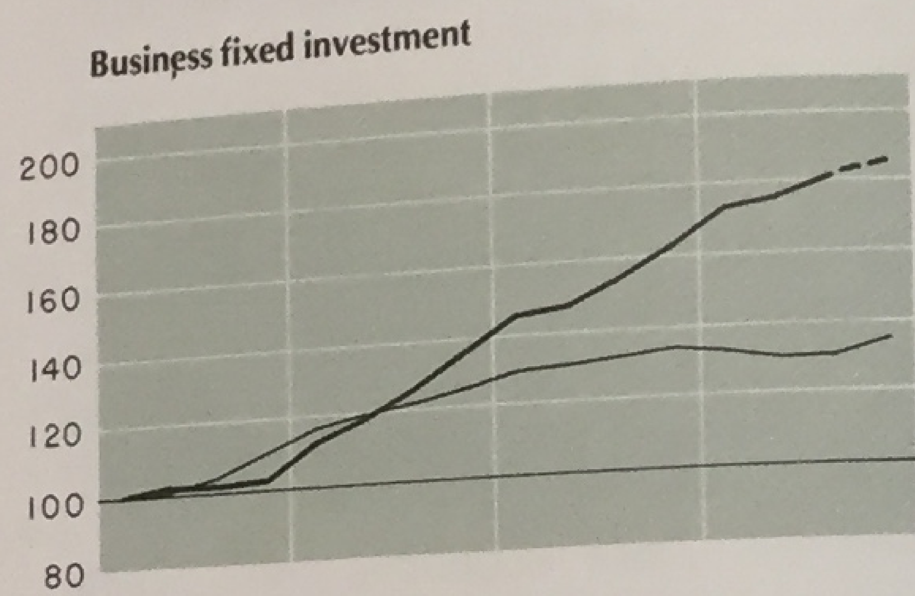
Balance on goods and services as a per cent of GNE



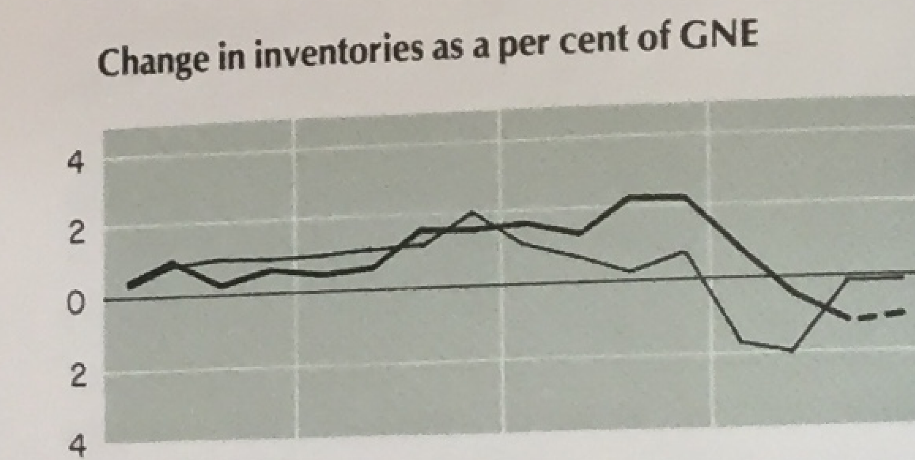
Government outlays on goods and services



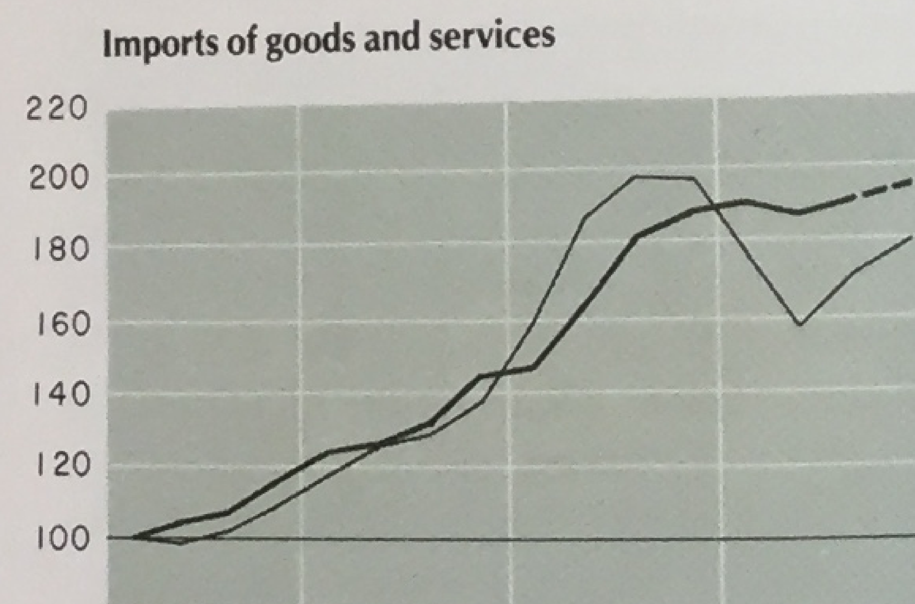
Business fixed investment



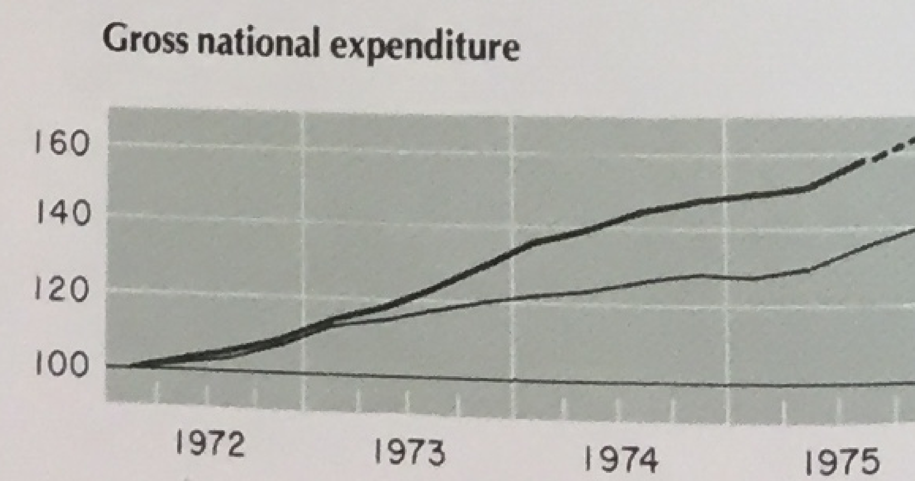
Change in inventories as a per cent of GNE



Imports of goods and services



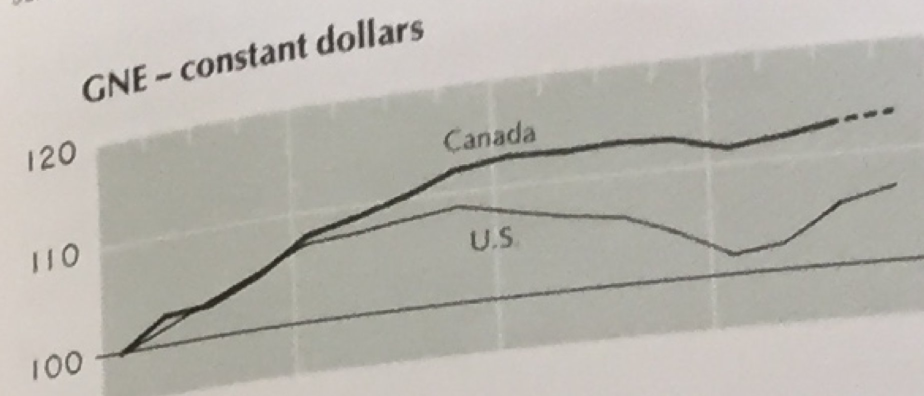
Gross national expenditure



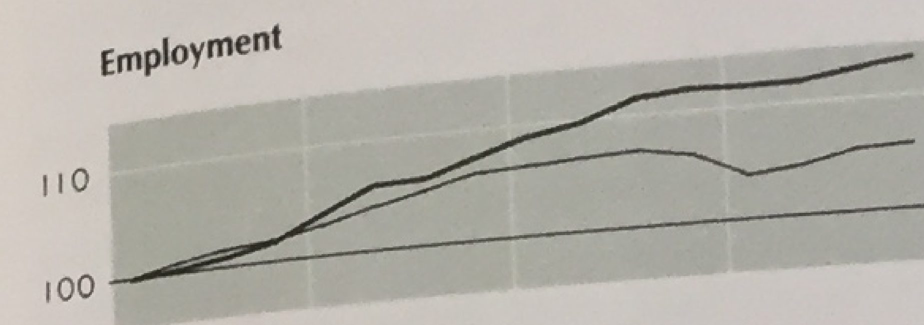
Selected Economic Indicators: Canada-United States

Seasonally adjusted, IQ 1972 = 100 unless otherwise indicated

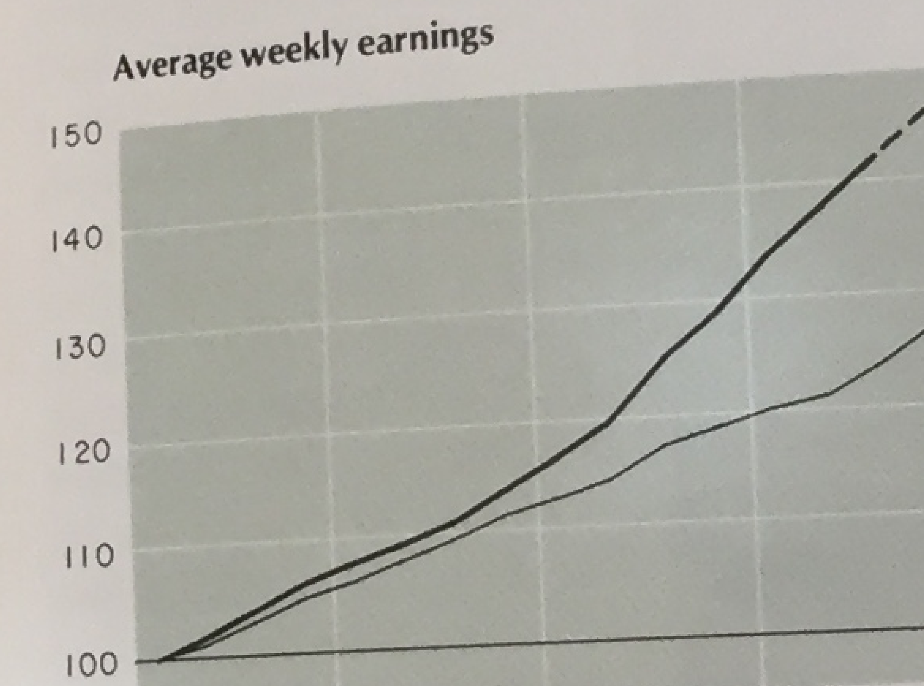
GNE – constant dollars



Employment

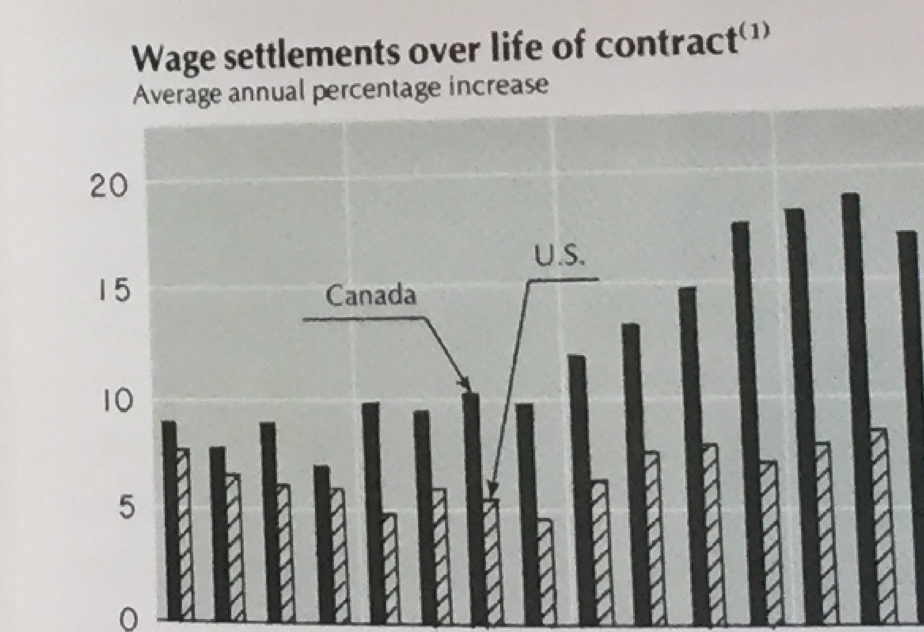


Average weekly earnings

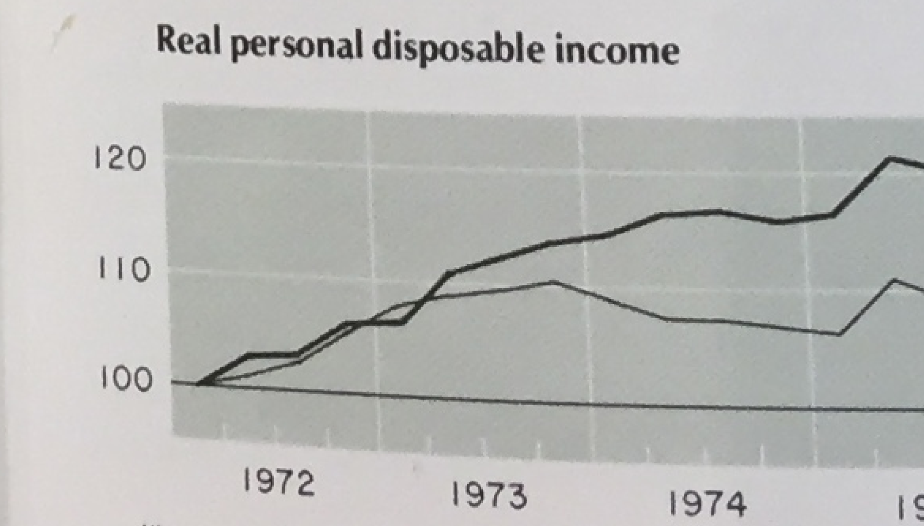


Wage settlements over life of contract[1]

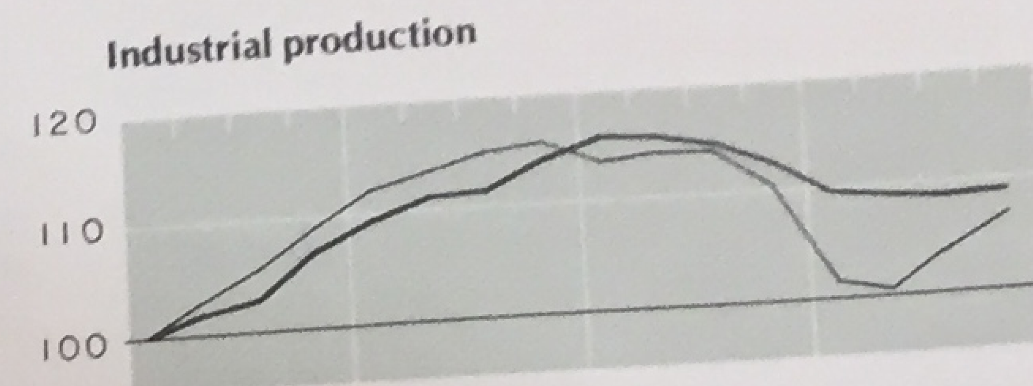
Average annual percentage increase



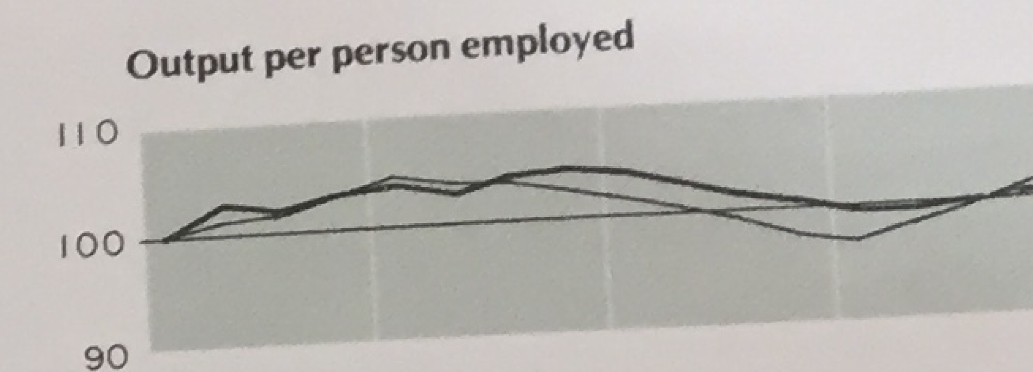
Real personal disposable income



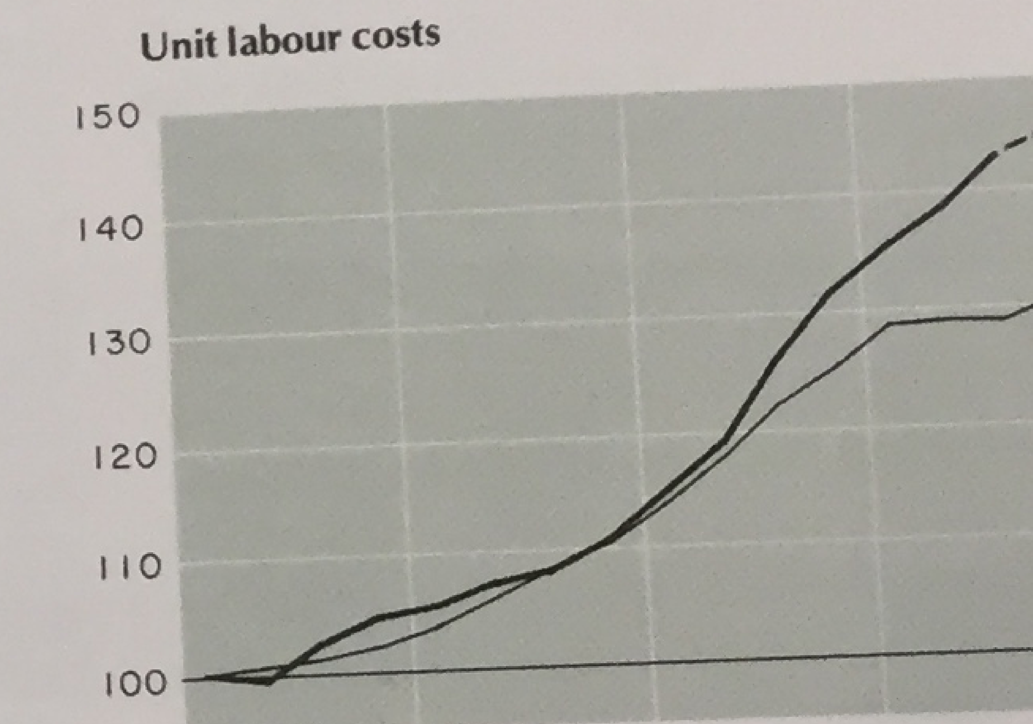
Industrial production



Output per person employed

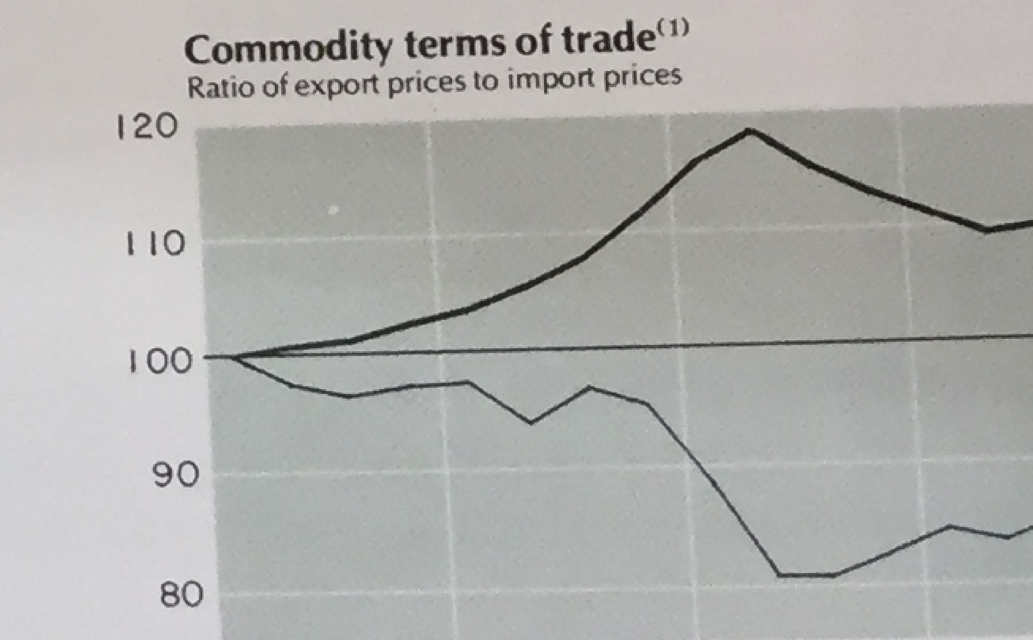


Unit labour costs



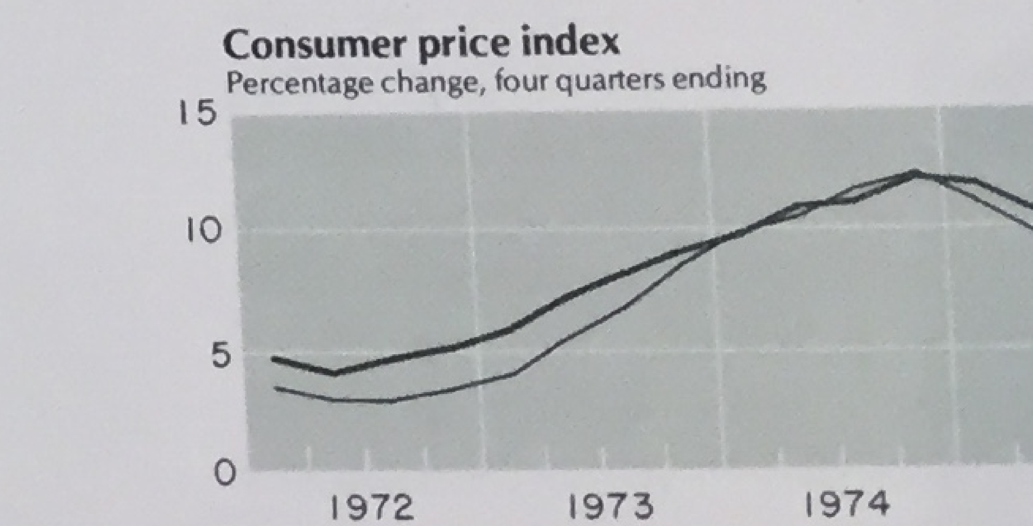
Commodity terms of trade[1]

Ratio of export prices to import prices



Consumer price index

Percentage change, four quarters ending



(1) Not seasonally adjusted

in particular a surge in buying of durables, including both cars and household items. Automobile purchases by Canadians reached a new record of close to a million units for the year, despite initially weak demand for the 1975 models. In the last months of the year, car sales evidently received a temporary boost from heavy buying in Ontario in anticipation of the restoration of the 7 per cent sales tax that had been removed earlier in the year. With the sharp upturn in housing starts earlier in 1975, residential construction activity also advanced very strongly in the second half of the year after declining steeply through most of 1974 and into 1975. The number of housing starts was very similar in 1974 and 1975, 220,000 and 230,000 respectively, and quite close to official target projections. Indeed, in the latter months of 1975 starts were running at an annual rate of close to 300,000 units.

Reacting to the sluggishness of profits and generally low operating rates, business fixed investment outlays in 1975 registered only moderate growth in real terms, and unlike consumption and housing appeared to weaken as the year progressed. The total was sustained by the special strength apparent in the area of energy-related investment. Fixed capital formation in other sectors of business activity fell off markedly.

The fiscal outturn in 1975 was strongly expansionary at both the federal and provincial-municipal levels. Outlays on goods and services, that part of government spending entering directly into Gross National Expenditure, appear to have risen less rapidly than in 1974. However, with further strong growth in transfer payments to persons and some selective tax cuts both federally and provincially, the over-all thrust of fiscal developments was to expand incomes and domestic demand. In combination with the dampening effect on tax collections from the generally slow pace of economic activity, the over-all outcome was a swing into record deficits at all levels of government and substantially increased borrowing requirements. On a national accounts basis, the position of the government sector went from a surplus of about $2 billion in 1974 to a deficit of some $4 billion in 1975.

In the face of the weakness of exports, and despite a slowing in the growth of imports in response to the sluggishness of total demand for much of the year, the deficit in the current account of the balance of payments was considerably larger in 1975 than in the previous year. The deficit in 1974 was just over $1½ billion, but it widened sharply through the year to an annual rate of $4 billion in the fourth quarter; through 1975 it ran at an annual rate of about $5 billion. The increase from 1974 to 1975 was due to a $2¼ billion swing from surplus to deficit in merchandise trade and to a $1 billion increase in the deficit on service transactions. With demand better sustained in Canada than among our major trading partners, cyclically related influences were an important determinant of the weakening of our payments position. However, one additional major element was the adverse movement in our balance of trade in energy products. The shift from surplus to deficit in the balance on crude oil was only partly offset by the higher prices received for exports of natural gas. The increase in the deficit on services reflected a substantial widening in the deficit on travel account and continuing growth in debt service payments.

Production and Employment

As of the end of 1975 total output, as measured by Real Domestic Product, had increased by about 2½ per cent from its low point in the spring. The recovery was, however, unevenly distributed across both regions and industries. For example, the adverse conditions affecting the forest and fishing industries had a marked restraining effect on activity in the Atlantic region and in British Columbia. In contrast, buoyant incomes from grain and mineral fuel production have sustained a high level of economic activity in the Prairie Provinces. On an industry basis, a notable feature of the recovery period has been the sluggishness of goods production compared with the continued growth of the service-producing industries. At year-end non-farm goods production, which is much more cyclically sensitive than activity in the services sector, was still some 7 per cent below the rates reached in the spring of 1974. Weak demand, especially for exports, was clearly the dominant influence, although the effects of strikes were also strongly apparent – particularly in the latter part of the year. The dislocations resulting from the record number of man-days lost in 1975 were by no means confined to goods-producing industries, nor indeed to the private sector of the economy.

Notwithstanding the decline in total output over the year to the spring of 1975, aggregate employment showed surprising buoyancy through this period. A divergence between the trend of output and employment is not unusual in periods of cyclical weakness, but on this occasion the drop in output per worker was particularly pronounced. In the second half of the year, labour productivity recovered relatively little, as the cyclical upturn in output was accompanied by further gains in employment.

Growth in the labour force tended to slow after the spring of 1975 and the over-all unemployment rate, which had begun to move up in the final months of 1974, reaching slightly over 7 per cent by the spring of 1975, stayed virtually unchanged through the remainder of the year. Unemployment declined sharply on a seasonally adjusted basis in January 1976, but it is not clear to what extent this drop reflected underlying trends in labour markets.[1]

[1]Beginning in January 1976 labour force data are based on the revised and more comprehensive survey which was introduced in 1975 and which ran concurrently with the old survey for one year. The new survey will provide a considerable amount of additional valuable information on labour market developments. However, since back data from the new survey are only available for 1975 and adjustments to eliminate seasonal variation are not well established, short-run changes must necessarily be interpreted with considerable caution.

Incomes, Costs and Prices

The slower rise in aggregate money incomes in 1975 was due mainly to a less rapid advance in labour income. It is evident that part of this slowing in labour income stemmed from the less rapid rise in employment. Nevertheless labour income continued to rise faster than total national income. Typical rates of pay continued to rise very rapidly in 1975. While most of the broader measures of average earnings did rise somewhat less rapidly as the year progressed, it is not clear whether this represented an easing in the underlying trend or other influences such as shifts in the composition of employment. Newly negotiated wage settlements, the most direct available indicator of wage rate changes, were even higher through most of 1975 than in the previous year. Settlements under major collective bargaining agreements (excluding construction) provided for average annual increases in base rates over the life of contracts of close to 17 per cent, compared with about 14 per cent in 1974 and under 10 per cent in 1973. Taking account of the potential impact of cost-of-living clauses, both the 1975 and 1974 numbers would be more than a percentage point higher still. A new element in 1975 was the very large increase in the size of newly negotiated wage settlements in the non-commercial sector. For several years previous, base rate settlements in this sector had averaged slightly below those in commercial industries, but in 1975 they were some 5 percentage points higher. The difference would be less, but still appreciable, if account were taken of the more widespread use of cost-of-living clauses in the commercial sector.

The effect of the compensation guidelines of the Anti-Inflation Program announced in mid-October could not be expected to be discernible in available measures of aggregate earnings, given the short space of time that has elapsed. The operation of the Program with regard to compensation should in principle be recorded most promptly in the statistics on newly negotiated wage settlements. In fact, settlements

in the fourth quarter of 1975 were lower than for any other quarter after mid-1974. However, it is not clear at this stage to what extent the introduction of compensation guidelines might have affected the size of negotiated settlements in the final months of 1975.

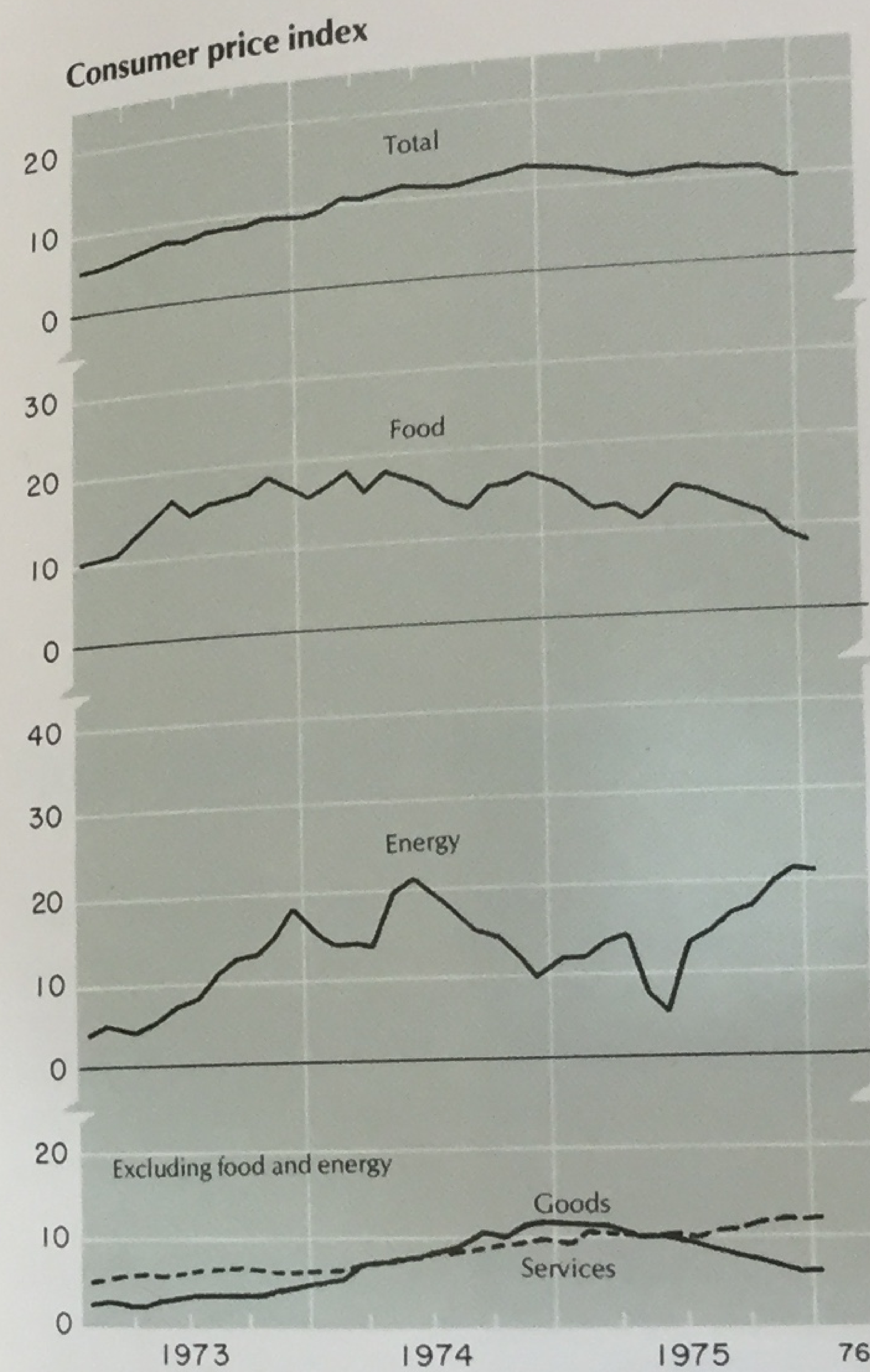
Nor is there any basis at the present time for commenting on the possible effect of the anti-inflation guidelines on the behaviour of other forms of income in the final months of 1975. After declining moderately through the recession, corporate income appears to have increased somewhat with the upturn in the economy in the second half of the year. The accrued net income of farm operators apparently stayed relatively flat in 1975. Total gross farm income continued to increase on account of the larger grain crop and higher prices for some commodities such as hogs and dairy products, but the rise in expenses kept abreast of gains in receipts.

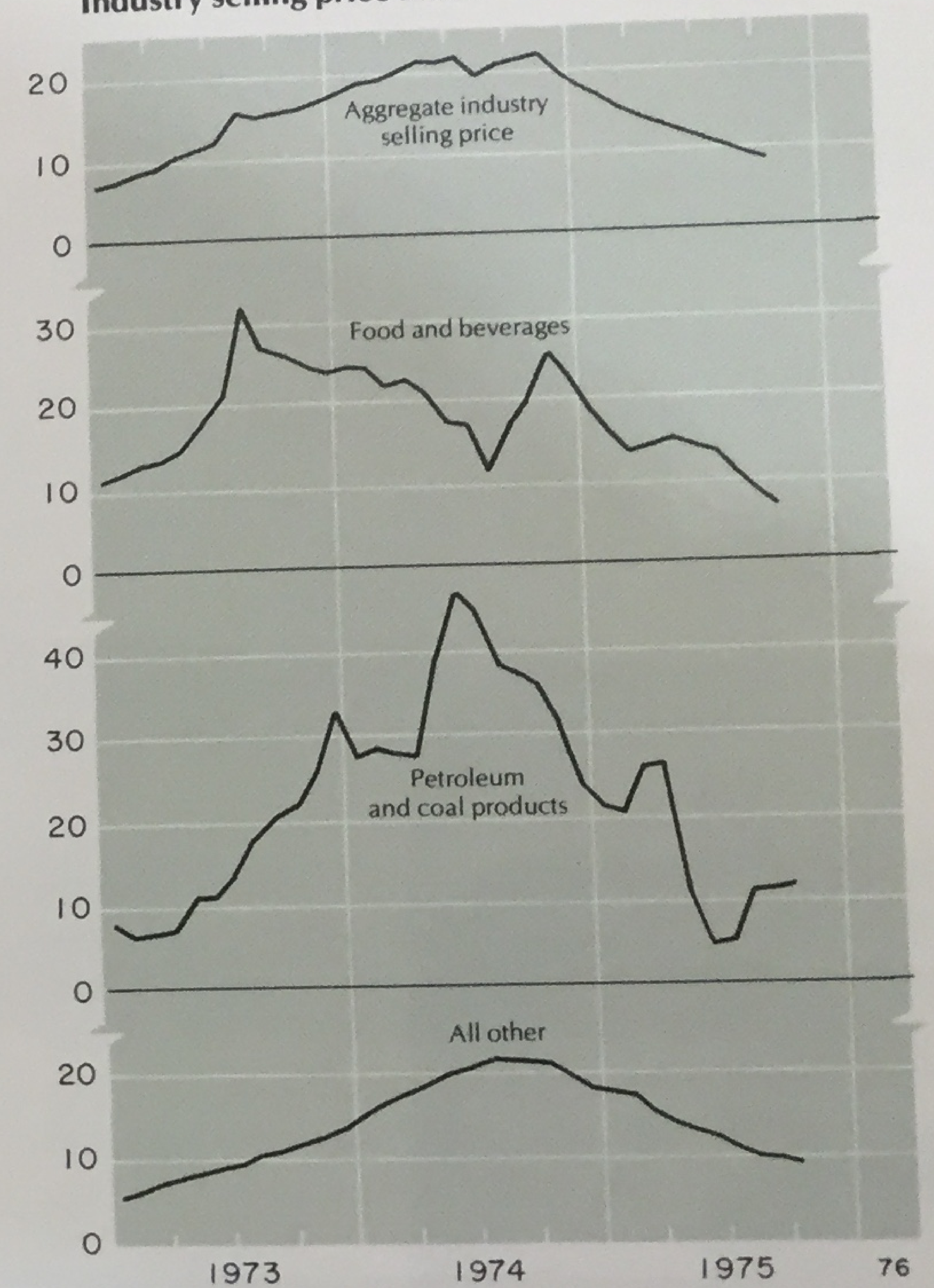
Industry selling and wholesale prices, which had begun to rise less rapidly in 1974 reflecting the easing of basic commodity prices, continued to advance at a slower rate in 1975. However, the increase of about 9 per cent for the aggregate of industry selling prices was still high by historical standards. Although demand conditions were generally soft, the extent of the price slowdown was limited by energy and labour cost increases.

Over the 12 months to December 1975 the total Consumer Price Index rose 9½ per cent. This was the first annual change of less than 10 per cent since early 1974 and represented an appreciable deceleration from the 12½ per cent rise during 1974. A major element in the slowing was the considerably less rapid rise in food prices, although the deceleration in Canada was not so marked as in the United States. Energy prices increased faster than in 1974, under the impact of further upward adjustments of domestic oil and natural gas prices towards international levels, but the prices of goods other than food and energy items rose less rapidly. Both the trend of import prices and the desire to reduce inventories probably contributed to this development. In contrast, the increase in the cost of services continued to accelerate during the year. By the end of 1975 the index of the price of consumer services was 11½ per cent higher than a year earlier.

Rates of Increase in Domestic Prices

Percentage increase, 12 months ending





Financial Developments

The broad strategy of monetary policy was discussed in the first section of this Report. In this section the movements of monetary aggregates and of interest rates are described in more detail, and there is a discussion of credit flows to major borrowers.

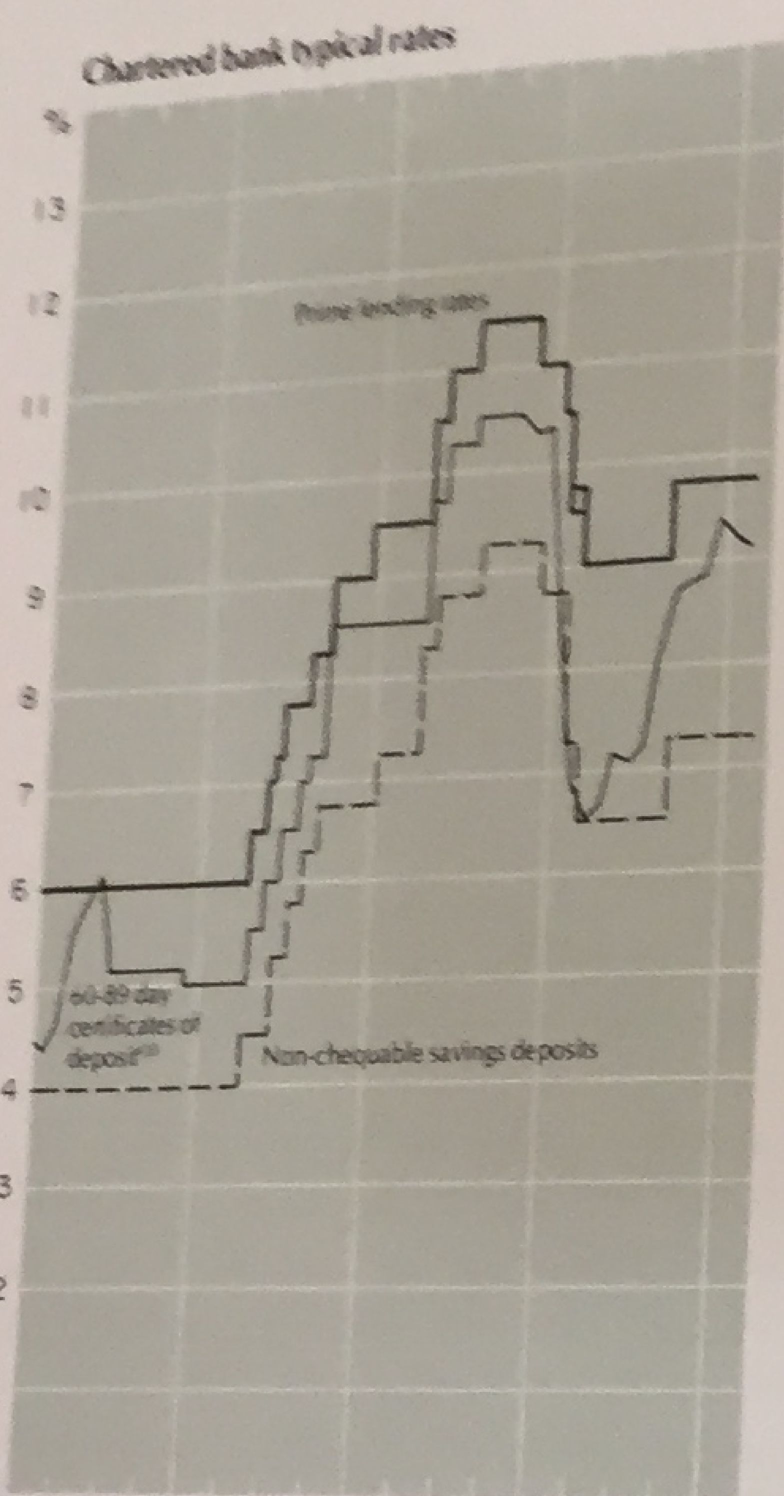
Monetary Aggregates and Interest Rates

During the course of 1974 the demand for money and credit moderated as the growth of aggregate income slowed. By the late summer of that year interest rates in Canada, as in the United States, had begun to decline, and in the last half of the year monetary expansion, as measured by the rate of growth of currency and demand deposits (M1), decelerated sharply. The Bank of Canada responded to these changing conditions by managing the cash reserves of the banking system so as to facilitate the downward adjustment in interest rates and encourage a resumption of monetary expansion. In mid-November the Bank Rate was lowered by one half of one percentage point to 8¾ per cent. The decline in short-term interest rates in Canada was interrupted briefly late in the year, but there was a further sharp fall in rates over year-end and during the opening weeks of 1975, partly in response to developments in the United States and Europe. Rates on 90-day finance company paper, for example, declined from about 10½ per cent in December to about 8½ per cent in January. The Bank Rate was lowered by another one half of one percentage point to 8¼ per cent in mid-January, and this was followed by further downward movements of administered rates by banks and by other financial institutions to the lowest levels since late in 1973. The banks' prime lending rates declined from 11½ per cent in late 1974 to 9 per cent by early March while the rates on non-chequable personal savings deposits were reduced from 9¼ per cent to 6½ per cent; in the money market, the 90-day finance company paper rate declined sharply to 6¾ per cent.

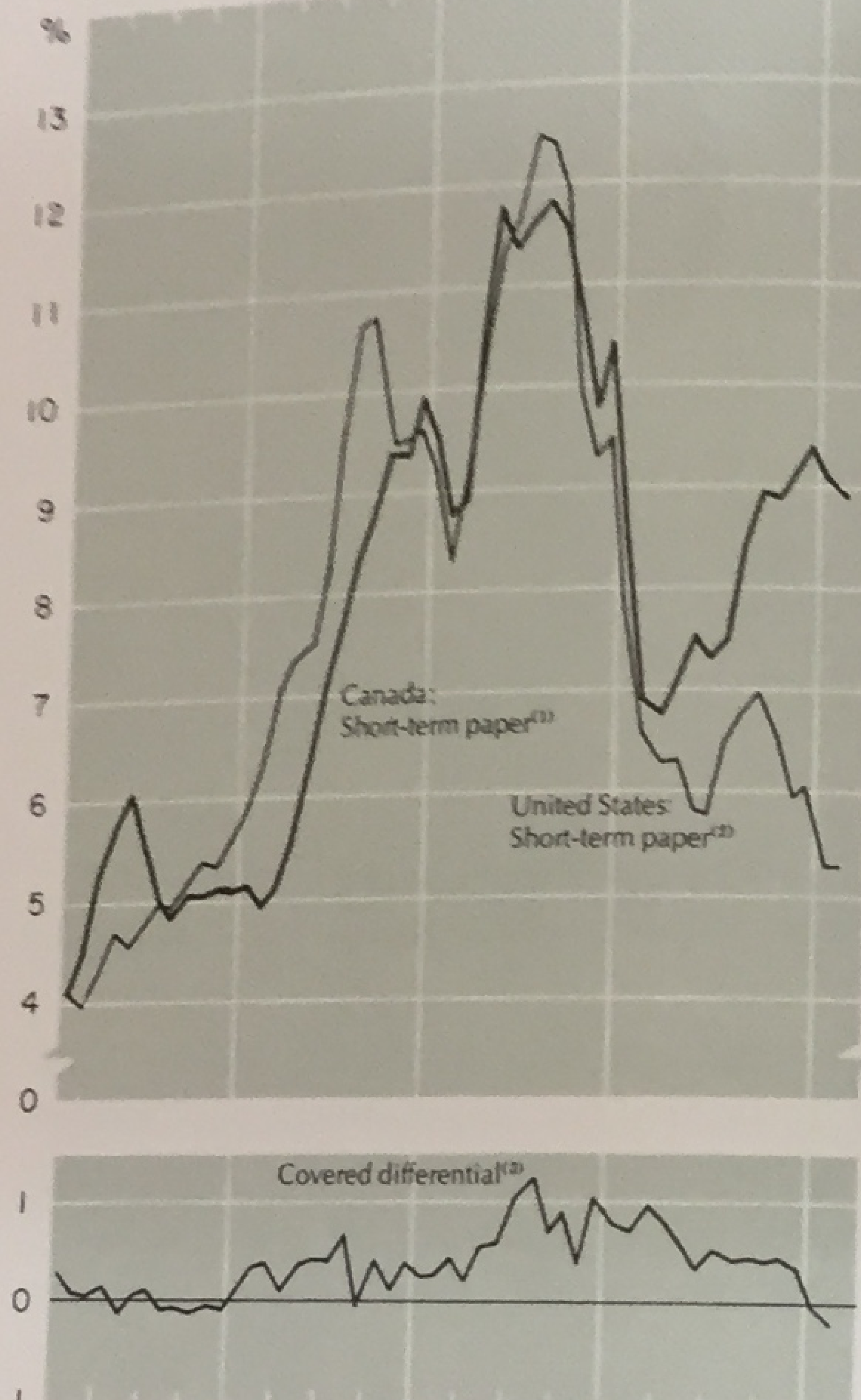
Despite continued weakness in the growth of aggregate income in the first quarter of 1975, this dramatic reduction in interest rates contributed to a resumption of very rapid growth in currency and demand deposits during this period. As shown in the chart on page 33, which plots

Interest Rates
Monthly

Short-term

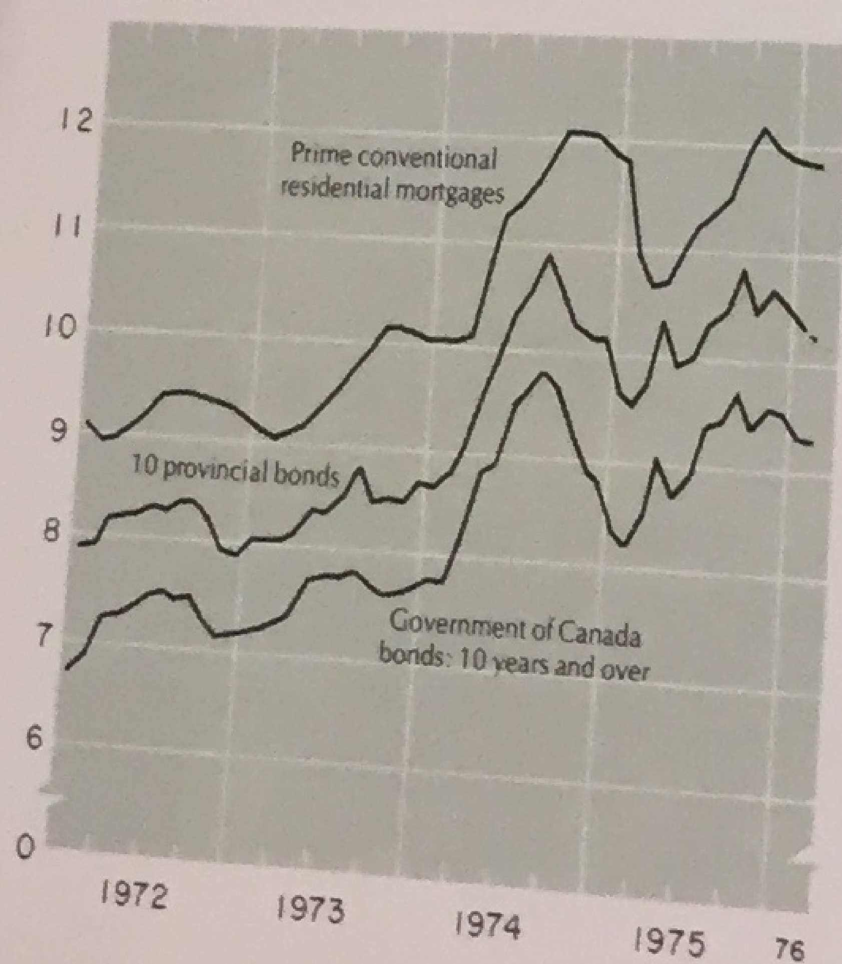


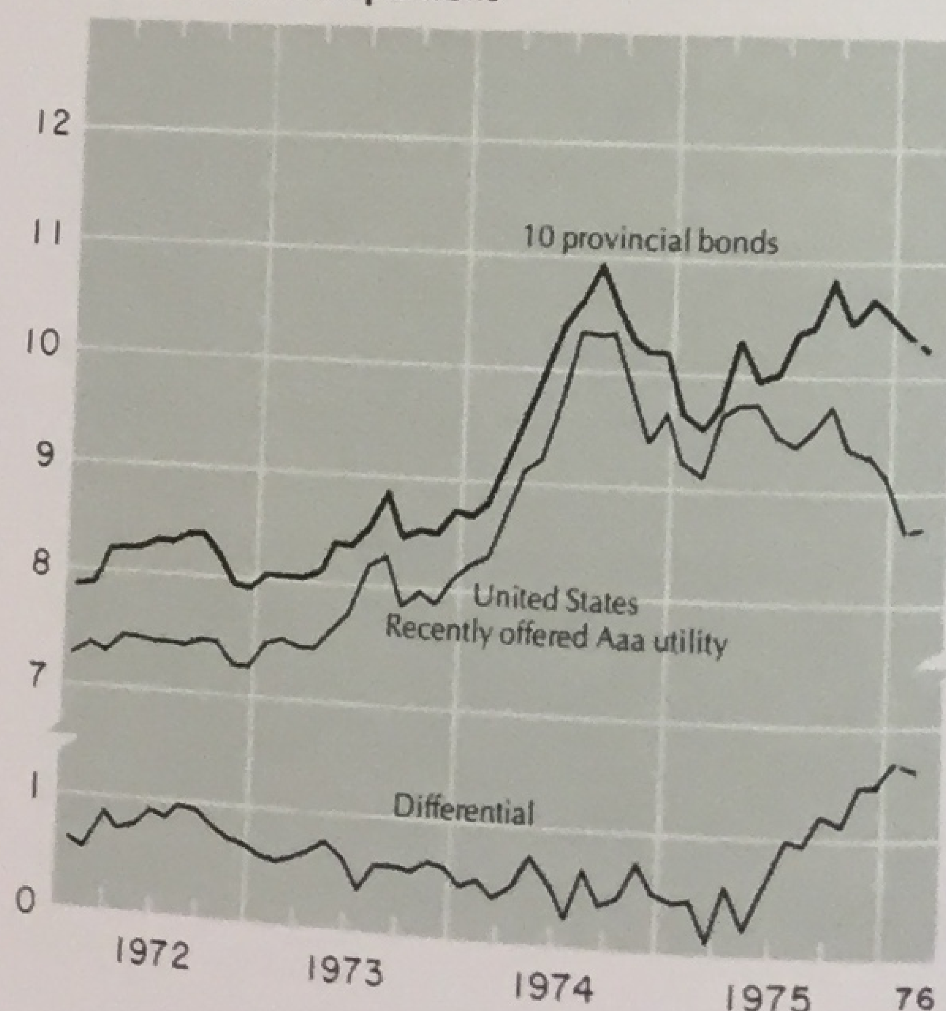
(1) Between June 1972 and October 1974, rates prevailing under the Winnipeg agreement.



(1) Finance company paper.
(2) Dealer-placed commercial paper.
(3) The spread between Canadian and U.S. rates after allowance for the forward premium or discount on the U.S. dollar in Canada.

Long-term



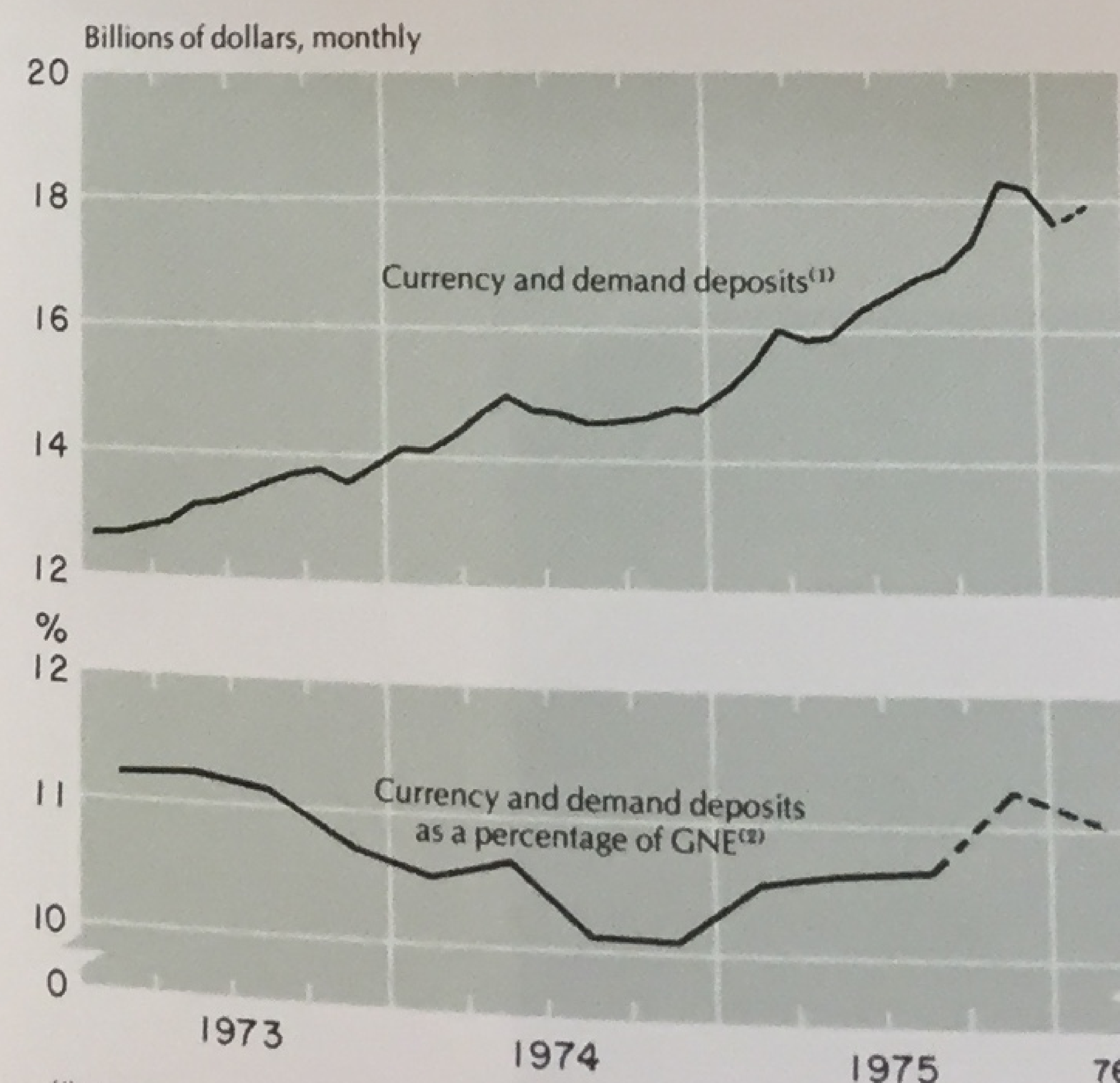


the level of money holdings (narrowly-defined) as well as the ratio of this aggregate to Gross National Expenditure in money terms, this burst of rapid monetary growth early in 1975 reversed much of the decline that had occurred in the trend of monetary expansion relative to the growth in income over the previous year or so.

In the light of the evidence that the downward adjustment in interest rates had proceeded far enough the Bank of Canada's approach to the provision of cash reserves to the chartered banks had become more restrictive and beginning in March interest rates again began to move upward. Initially the upward movement was rather moderate, but it occurred in the face of a continued decline in U.S. short-term rates until about mid-year. By the summer a turnaround in U.S. money markets and the strengthening pace of economic activity in Canada had begun to exert renewed upward pressure on short-term rates. This upward trend in interest rates was not resisted by the Bank of Canada because of its growing concern that the money supply was again expanding too rapidly. Indeed in the three months ending in August, M1 grew at a seasonally adjusted annual rate of 25 per cent. In early September the Bank Rate was raised from 8¼ per cent to 9 per cent, and the main borrowing and lending rates set by financial institutions were also adjusted upward by similar amounts. The banks' prime lending rates were increased to 9¾ per cent and the rates paid on non-chequable savings deposits at banks were moved up to 7¼ per cent while similar adjustments were made in personal term deposit rates at both banks and near-banks. Between June and September the 90-day finance company paper rate rose from 7¼ per cent to about 9 per cent.

In the fourth quarter the Bank's operations were directed towards maintaining the levels of short-term interest rates within the higher range established in the autumn. The combination of this policy stance and an apparent continuation of the strong growth in aggregate income resulted in short-term rates moving up somewhat by year-end despite the downward pressure exerted by a renewed decline in rates in the United States. At the end of December typical 90-day finance company paper rates were at the 9⅜ per cent level while similar instruments in the United States were yielding about 5¾ per cent. The main influences affecting money supply in the fourth quarter were not so much these movements in income and interest rates but rather the interruption to mail service between late October and early December. This development severely distorted the normal pattern of payments and led to a temporary ballooning in the public's holdings of money balances. As a consequence, the narrowly-defined money supply in November was on average about $850 million larger than in October on a seasonally adjusted basis.

Currency and Chartered Bank Demand Deposits
Seasonally adjusted



(1) Average of Wednesdays
(2) Quarterly average

It took some time after the end of the mail strike for these influences to reverse themselves since many payments were further delayed by the Christmas season, but by early February it was evident that the effects of these distortions had been unwound. Measured over the whole period from the second quarter of 1975 through to February, the annual rate of increase of M1 was of the order of 15 per cent, somewhat above the range that was being pursued.

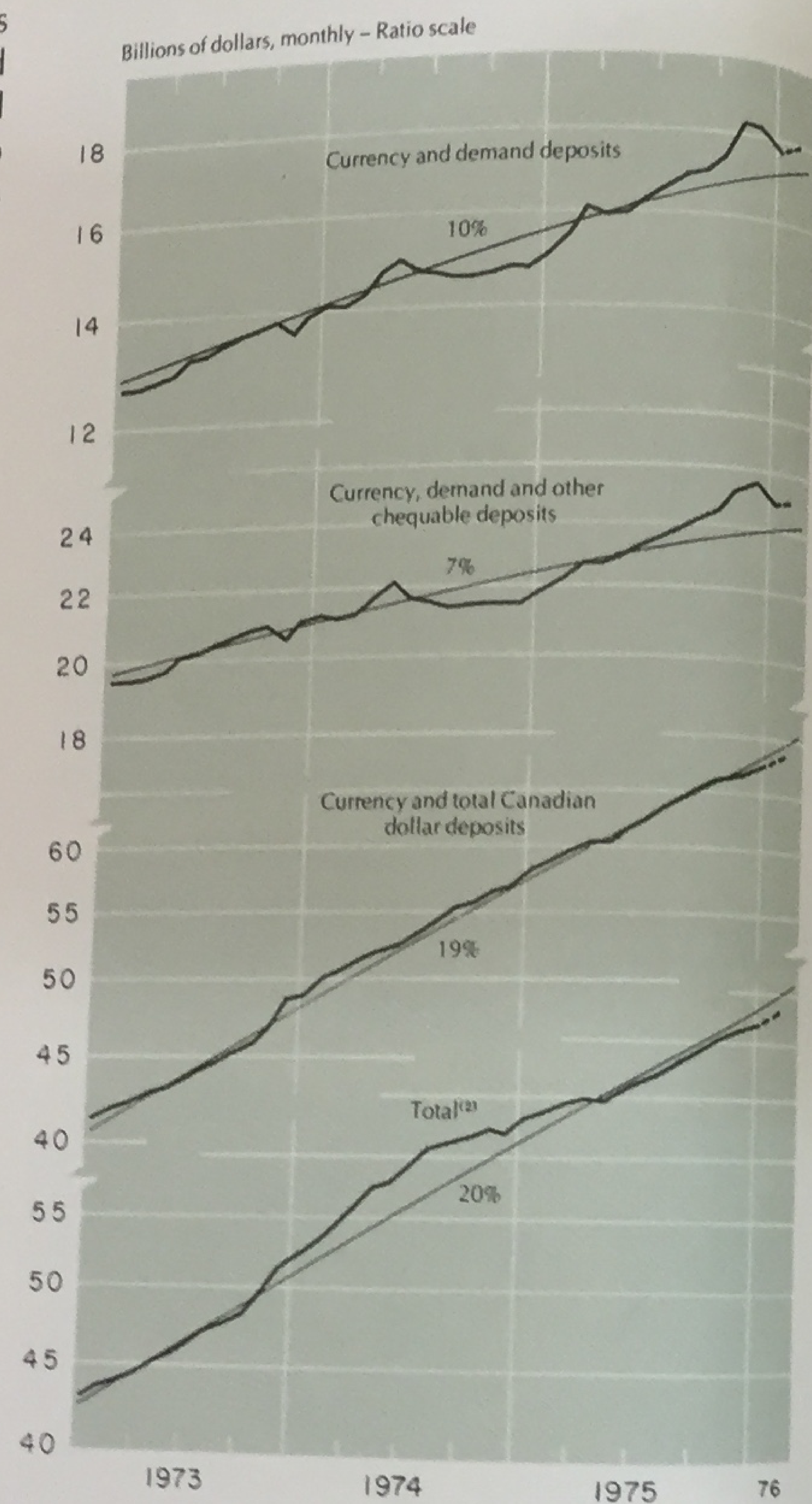
Long-term interest rates followed much the same pattern as short-term market rates during the first nine months of 1975, although the upward movement during the second and third quarters, as with the earlier downward movement, was somewhat less pronounced; yields on long-term bonds increased by about 1¼ percentage points over this latter period compared with nearly 2¼ percentage points on short-term money market instruments. In the mortgage market, the decline in rates during the opening months of the year was also very marked, reflecting the reduction in deposit costs at major institutions as well as seasonal influences. Thereafter, as mortgage financing activity began to pick up strongly, rates began to rise and continued on an upward trend until early in the fourth quarter, when rates on conventional residential mortgages reached a range of 12–12¼ per cent.

During the final months of the year long-term interest rates tended to edge downward, largely reflecting developments in U.S. financial markets. Mortgage rates followed the same general pattern. This movement in long-term rates continued into the opening weeks of 1976. Short-term rates also declined over year-end but during February both short-term and long-term rates levelled off and some money market rates moved up again. By the end of February the typical rate on conventional residential mortgages had declined to 11¾ per cent.

The following chart compares the recent movements in a number of different monetary

Currency Outside Banks and Chartered Bank Deposits Held by the Public[1]

Seasonally adjusted



Trend lines are based on the average rate of growth from 2nd Q 1973 to 2nd Q 1975.

[1] Excludes deposits held by the Government of Canada.
[2] Includes foreign currency deposits held by Canadian residents.

aggregates, including currency and demand deposits. The trend rates of growth of the broader aggregates have been higher than for the narrow definitions; however, unlike the narrow aggregates, the rate of growth of the broad aggregates has not accelerated since the latter part of 1974. Indeed, the growth of these broad measures has if anything decelerated somewhat. The broad definitions of money supply tend to be strongly affected by changes in the extent and pattern of financial intermediation. During the two years prior to 1975 the portion of total credit which flowed through financial intermediaries was higher, and the banks' share of that business larger, than in 1975.

Credit Markets and Financial Institutions

With demands for credit increasing throughout the year, the total amount of funds raised by major non-financial borrowers in credit markets over the year as a whole was somewhat larger than in 1974. As shown in the table on page 36, there were some important shifts both in the sectoral demands for funds and the ways in which these demands were met in 1975. Borrowing by the federal Government (which is discussed in detail in the following section of this Report) declined only slightly from the high level recorded in the previous year. Unlike 1974, however, when a very large part of the increase in total funds raised by other borrowers was accounted for by the private sector, in particular non-financial businesses, the increase in borrowing in 1975 was more than accounted for by the financing activity of the provincial and municipal governments and their enterprises.

Within the private sector the volume of mortgage borrowing, after slackening in the last half of 1974 and early 1975, rose sharply and reached a record high for the year as a whole. The sharp recovery in new housebuilding in the second half of the year was a major factor but there was a substantial pickup in the turnover of the stock of existing houses as well. Consumer credit outstanding grew at about the same pace over 1975 as in 1974, with a large part of the increase also occurring during the second half of the year as a consequence of the upsurge in purchases of automobiles and other consumer durables. Borrowing by non-financial businesses in 1975, on the other hand, was well below the record amount of funds raised in 1974. This reduced demand for financing, despite some decline in corporate profits, reflected the very moderate growth in business investment in 1975, compared with the previous year. Moreover businesses relied much less heavily on bank loans and other short-term sources of financing in 1975 and turned to the long-term bond market for a much higher proportion of their requirements for funds in an effort to lengthen the term structure of their debt.

Financing activity of the provinces and municipalities and their enterprises increased very considerably during 1975. In contrast with private business, fixed investment outlays by provincial enterprises continued to rise strongly and the deficit at the provincial-municipal level widened very sharply. Virtually all of the increase in this sector's financing requirements was met through the issue of bonds.

The high levels of long-term financing by non-financial businesses and by provincial and municipal governments resulted in record levels of new Canadian bond issues being placed both in Canada and abroad; in total these borrowers raised nearly $4½ billion through net new bond issues in this country and about $4 billion in foreign markets. The total amount of borrowing through new bond issues was substantially greater in 1975 than in the two previous years combined and the proportion of these funds provided by non-residents increased.

The increased borrowing in foreign markets in 1975 was in part the result of a substantial widening of long-term interest rate differentials between Canada and the United States after the first quarter. This wider differential also attracted foreign investment in outstanding Canadian bonds. Further encouragement to corporate

Funds Raised by Major Non-financial Borrowers

	Billions of dollars 1973	1974	1975
Non-financial Businesses			
Increases in loans			
chartered banks	3.8	4.3	3.2
other institutions	1.3	2.2	0.4
Net new issues			
bonds — issued in Canada	0.8	1.1	2.0
— issued abroad	0.0	0.1	0.4
stocks	0.4	0.4	0.7
short-term paper	0.0	1.6	0.3
Direct investment from abroad	0.7	0.6	0.5
Total	7.0	10.3	7.6
Mortgage Borrowers[1]			
Trust and mortgage loan companies[2]	2.7	2.4	2.7
Chartered banks	1.2	1.5	1.7
Other private institutions	2.4	2.3	2.1
Total	6.3	6.1	6.5
Consumers			
Chartered banks	1.7	1.9	2.3
Other sources	1.1	0.9	0.8
Total	2.8	2.9	3.2
Total Private Borrowing	16.1	19.3	17.3
Provinces and Municipalities[3]			
Net new bond issues			
purchased with CPP funds	1.0	1.2	1.4
other issues in Canada	1.4	1.4	2.4
issued abroad	0.6	1.6	3.5
Net treasury bills and short-term paper issues	− 0.1	− 0.1	0.2
Chartered bank loans	0.4	0.3	0.4
Total	3.3	4.5	8.0
Government of Canada			
Net new issues			
treasury bills	0.6	0.9	0.6
Canadian dollar marketable bonds	− 0.2	0.8	0.7
Canada Savings Bonds	− 0.4	2.4	2.7
Total	− 0.1	4.2	4.0
Total Borrowing	19.4	27.9	29.3

(1) These are principally mortgages secured by residential property. The figures exclude net mortgage lending by governments and their agencies, notably CMHC, which is reflected in the financing requirements of the respective governments.
(2) Includes mortgage loan companies associated with chartered banks.
(3) Includes government enterprises. Loans from the Government of Canada are excluded.

borrowers to seek foreign sources of funds was provided by the removal of the 15 per cent federal non-resident withholding tax on new issues of corporate bonds of five years and over.

The sharp rise in borrowing in long-term capital markets abroad in 1975 was large enough to finance most of the growth in the current account deficit, which rose from $1.6 billion in 1974 to about $5 billion in 1975. During the first eight months of the year, and especially in the second quarter, the Canadian dollar tended to weaken. In the remaining four months of the year the Canadian dollar strengthened, largely as a result of the very heavy volume of sales of Canadian bonds abroad. This trend continued into the first two months of 1976 as the pace of foreign borrowing increased, and the Canadian dollar rose above the level that had prevailed at the beginning of 1975.

Short-term capital transactions in 1975 gave rise to very large net capital inflows in the first quarter, and on balance some outflows during the remainder of the year. Although the differential between short-term rates in Canada and the United States widened dramatically after the first quarter, the incentive for short-term capital to flow into Canada was largely offset by the increased cost of forward U.S. dollars on hedged transactions.

Net inflows from non-residents amounted to more than $4½ billion in 1975, about $3 billion more than in the previous year. While U.S. investors continued to be the largest source of foreign funds entering Canada, a significant volume of funds from OPEC countries was also invested in Canada as these countries sought to diversify their investments across a broader range of maturities, currencies and debtors.

Major Assets of Financial Institutions[1]

	Billions of dollars Dec. 1975	Annual rates of change: Years		Half-years[2]	
		Dec. 1973 to Dec. 1974	Dec. 1974 to Dec. 1975	Dec. 1974 to June 1975	June 1975 to Dec. 1975
Deposit-taking institutions					
Chartered banks[3]	67.5	19	13	12	15
Trust and mortgage loan companies and Quebec savings bank	22.1	16	17	17	18
Credit unions and caisses populaires	12.4	16	25	29	22
Sub-total	102.0	18	16	15	16
Contractual savings institutions					
Life insurance companies	21.5	7	9	11	7
Pension funds	20.0	12	12	14	10
Sub-total	41.5	10	11	12	9
Sales finance and consumer loan companies	9.7	16	8	6	11
Total	153.2	16	14	14	14

(1) Figures for December 1975 are estimated, except for banks.
(2) Seasonally adjusted except for trust and mortgage loan companies and sales finance companies.
(3) Canadian dollar major assets; average of Wednesdays.

The counterpart to the very large amount of direct bond market financing and the heavier reliance on foreign sources in 1975 was a relative decline in the importance of financial intermediation. In contrast to 1974, when private financial institutions in total had provided fully two thirds of all funds raised by major non-financial borrowers, these institutions supplied just over half of the funds raised in 1975. This decline in intermediation was almost entirely accounted for by reduced flows through the banking system. The rate of growth of the banks' Canadian dollar major assets slowed to 13 per cent in 1975 from about 19 per cent in the two previous years. The other deposit-taking institutions, however, grew somewhat more rapidly in 1975 than in the previous year, in line with the acceleration in the growth of mortgage loans and the continued fast growth in consumer loans which together account for the bulk of their assets.

The slowdown in the expansion of the banking system was shared by most asset categories. During the latter part of 1974 the banks had added very substantially to their holdings of Canadian liquid assets. In 1975 they responded to the more restrictive cash reserve settings by reducing these assets through the first nine months of this year; however, there was some rebuilding during the fourth quarter, and over the year as a whole liquid asset holdings were about unchanged. As a result, the "free" Canadian liquid asset ratio declined by nearly 1½ percentage points to about 8 per cent at the end of 1975. As mentioned earlier, businesses reduced their borrowing and relied much less heavily on bank loans in 1975 than in the previous year; chartered bank business loans increased by 13 per cent in 1975 compared with 20 per cent in 1974. Bank lending to consumers continued to expand at much the same rapid pace as in the previous year, with strength particularly evident in the second half of the year. On the other hand, growth in their mortgage loan portfolios slowed somewhat from the high pace that has prevailed in recent years. Nevertheless, the banks' share of financing in both of these markets continued to increase appreciably.

Chartered Bank Selected Assets

	Billions of dollars	Annual rates of change				
		Years			Half-years[1]	
	Dec. 1975	Dec. 1972 to Dec. 1973	Dec. 1973 to Dec. 1974	Dec. 1974 to Dec. 1975	Dec. 1974 to June 1975	June 1975 to Dec. 1975
Canadian liquid assets	12.7	3	14	–	– 2	2
(Canadian liquid assets, and other short-term Canadian assets[2])	(13.8)	(1)	(19)	(1)	(–10)	(13)
Loans, mortgages and other investments	54.8	25	21	17	15	19
Canadian dollar loans	43.4	27	19	16	13	19
General loans	40.3	26	19	16	12	20
— unsecured personal[3]	13.2	24	22	22	19	25
— business[3]	23.2	27	20	13	11	15
Mortgages	7.6	34	33	28	28	28
Provincial, municipal and corporate securities[4]	2.9	4	7	17	43	– 3
Canadian dollar major assets	67.5	19	19	13	12	15
Memo:						
Bank business loans and foreign currency loans to residents plus commercial paper and bankers' acceptances[5]	30.0	26	33	14	14	14

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

Bank of Canada Operations

This section of the Report provides a summary record of the operations of the Bank related to the implementation of monetary policy and to its operations as agent for the Government of Canada, both in the management of the public debt and in connection with the activities of the Exchange Fund Account.

Monetary Policy Operations

As has already been indicated elsewhere in the Report the Bank of Canada managed the cash reserves of the banking system and conducted its open market operations during 1975 and early 1976 with a view towards achieving rates of monetary expansion that would accommodate economic expansion with some slowing in the rate of inflation.

A record by reserve period of the excess cash reserve positions of the chartered banks as a group, of advances to chartered banks and of purchase and resale agreements with money market jobbers appears in Appendix Table II. Taken by themselves these figures provide only a partial insight into the policy followed by the Bank. For various reasons, the response of the banks to a particular level of excess cash reserves varies from one averaging period to another and thus there is no precise relationship during a period between the level of excess cash reserves and the changes in bank deposits and assets. Factors that influence the response by banks include expectations about the trend of interest rates, which may encourage banks to be more or less aggressive in acquiring or disposing of securities, the strength of the demand for loans and the unevenness of the distribution of reserves among banks. Moreover, in making its day-to-day decisions about the appropriate level of excess cash reserves the Bank reacts continuously to developments in the securities market and to what it sees happening to the growth of bank assets and bank deposits.

Open market operations, that is, the purchase and sale of securities in the market by the Bank

of Canada, are often used for purposes other than the management of cash reserves. Market operations may be conducted to bring a more direct influence to bear on interest rate developments in the market. On occasion purchases or sales of securities, or switches of some maturities for others, may be made in order to facilitate current or prospective Government of Canada debt management operations. Other techniques must be used to offset any undesired effects of open market operations on the level of cash reserves. Some of the more interesting periods in which open market operations were implemented other than solely for cash management purposes are described below along with references to cash reserve management.

On December 30, 1974 the Bank announced a reduction in the minimum secondary reserve ratio from 7 per cent to 6 per cent. In the period immediately following the announcement the Bank of Canada purchased in the open market $232 million of treasury bills, absorbing about half of the secondary reserve assets freed by the reduction. As has already been noted in the previous section, the Bank Rate was cut from 8¾ per cent to 8¼ per cent effective January 13, 1975. The reduction followed a decline in short-term interest rates that had been occurring over the previous few weeks. In the second half of January short-term interest rates continued to drop sharply paralleling a similar movement in the United States and the Bank moved to tighten its provision of excess cash reserves to the banking system in order to moderate the rate of decline. Bankers' acceptances purchased by the Bank in December to assist cash management over the seasonal peak in note circulation were allowed to run off and were not replaced and a portion of the treasury bills that had been acquired following the secondary reserve reduction were fed back into the market, primarily by net reductions to the Bank's holdings at the regular weekly tenders.

In February the Bank of Canada continued to maintain a restrictive excess cash reserve policy and the decline in interest rates came to an end. On February 28th, a further reduction in the minimum secondary reserve ratio to 5½ per cent was announced and the consequent increase in bank liquid assets was partially offset through open market purchases of some $119 million of treasury bills by the Bank and through cash management policy. In mid-March, a deteriorating market environment developed at the time of a new offering of Government of Canada bonds and the Bank provided substantial support to the market by buying for cash $84 million in short and medium-term bonds, including two of the issues contained in the new offering and not delivered until April 1st. Excess cash reserve settings were also eased at this time. In April the upward pressure on interest rates intensified and both cash reserve management and open market operations were designed to moderate the pace of this change in rates. In this period the Bank concentrated its open market operations in the treasury bill market with net purchases of $130 million.

In May interest rates stabilized and even declined a bit. The Bank intensified a switch programme initiated in April of selling short and medium-term bonds against the purchase of nearby maturities. During the month $51 million of these switches were completed. As well as providing some resistance to downward pressures on interest rates, the switches built up the Bank's portfolio of nearby maturities for debt management purposes and provided some term lengthening for the market. They also served to improve trading activity in the market for Government of Canada bonds.

In June renewed upward pressures on interest rates began to emerge and these pressures continued through the summer. In this period the Bank acted on occasion to moderate the pace of the upward movement in interest rates, but its over-all policy with respect to cash management and open market operations was designed to let interest rates move up in a reasonably orderly manner.

The Bank Rate was increased from 8¼ per cent to 9 per cent effective September 3rd. The size of the increase was interpreted by the market as a clear signal of a further tightening of monetary policy and generated an immediate sharp upward movement in interest rates. In order to moderate this movement in rates the Bank eased its cash reserve posture for a short while and added substantially to its bill holdings at tender and in the open market.

In mid-September short-term interest rates began to turn down and early in October the Government of Canada bond market began to strengthen. In response to these developments the Bank of Canada embarked on a programme of bond switches involving some lengthening of term for the market. As the month progressed and the downward pressure on interest rates intensified the Bank became an outright seller of bonds for cash and this selling continued into the first week of November. Over this period the Bank sold $162 million in short and medium-term bonds against a similar amount of very short-term bonds and sold outright for cash a further $149 million in short and medium-term bonds; the Bank also reduced its holdings of treasury bills at the weekly tenders. This programme was complemented by a tighter management of chartered bank excess cash reserves, an offset of which was to generate strong inventory financing pressures on money market jobbers, particularly in the latter part of November and in December.

In December the Bank purchased both treasury bills and bankers' acceptances. These purchases were related almost entirely to partially offsetting the seasonal increase in note circulation that occurs towards year-end. In order to avoid encouraging any downward movement in short-term interest rates a lesser amount of bankers' acceptances was purchased than during the same period of the previous year. All of the bankers' acceptances acquired in December plus a small amount acquired in early January had matured by mid-February.

Early in 1976 substantial downward pressure on interest rates again appeared. To counter this pressure the Bank tightened its cash management policy sharply and sold $177 million in short and medium-term bonds for cash to the market through January and early February. To provide additional resistance to the declining trend of interest rates the Bank at times reduced its holdings of treasury bills at the regular weekly tenders.

The monthly record of Bank of Canada transactions in Government of Canada securities and bankers' acceptances during 1975 is presented in Appendix Table III. In 1975 the Bank's par value holdings of Government of Canada bonds, treasury bills and bankers' acceptances increased by $745 million. This increase includes net open market operations as well as changes associated with new issues of treasury bills and bonds and net transactions with Government accounts and other clients.

Open market operations accounted for $452 million of the total increase in the Bank's holdings of securities. A net amount of about $610 million in treasury bills was acquired by the Bank in the open market during 1975 and the Bank was a net seller of about $60 million of Government of Canada bonds. These figures do not reveal the extent of bond switches consummated with the market during the year, which amounted to $273 million. The largest portion of these switches, as noted earlier, involved the Bank of Canada buying very short-term bonds that were scheduled to mature in 1975 and early 1976 against other issues maturing generally in 1 to 5 years. The Bank's holdings of bankers' acceptances declined by about $98 million in 1975.

The Bank of Canada increased its holding of foreign currency assets by $513 million over the year as a result of temporary swap transactions with the Exchange Fund Account. The Bank uses such temporary swap transactions to assist in its management of cash reserves and to provide flexibility in the timing of its transactions in

Government of Canada securities. For example, on occasions where the Bank was a heavy net seller of bonds in the market the immediate effect of such sales on the level of chartered bank cash reserves was offset through increases in the amount of the temporary swaps with the Exchange Fund Account. On the other hand, the Bank's net acquisitions of bonds on the occasion of four of the five new marketable bond issues in 1975 and on the occasion of the new issue dated February 1, 1976 led to reductions in the amount of temporary swaps.

Debt Management

In 1975 Government of Canada financing involved a net increase of $4,005 million in the par value of its outstanding Canadian dollar securities and a reduction of $1,537 million in its Canadian dollar cash balances.

A net total of $570 million was raised through additions to the outstanding amount of treasury bills, of which $495 million was obtained through additions to issues of 3-month and 6-month treasury bills and $75 million was raised through additions to two of the four one-year treasury bill issues offered at quarterly auctions.

Over the year the outstanding amount of direct marketable bonds of the Government of Canada payable in Canadian dollars increased by $768 million. (Details are given in Appendix Table IV.) The Government borrowed in the bond market on five occasions, four of them at the maturity of outstanding issues. On three of these occasions the Government raised funds in excess of the amount of maturing issues, while on December 15, 1975, $325 million of bonds were sold against a maturing issue of $334 million. On August 15, 1975, when there was no maturing bond issue, the Government raised $400 million in new funds.

Of the amount of new marketable bond issues sold in 1975, 33 per cent was in the form of short-term maturities (due in three years or less), 45 per cent in medium-term maturities and the remaining 22 per cent in long-term bonds. On July 1st, a $100 million issue maturing in 1994 with a 9½ per cent coupon was offered. That issue was reopened on August 15th for an additional $100 million. On October 1st, a $150 million issue maturing in 1995 with a 10 per cent coupon was sold. The latter issue was also reopened on December 15th for an additional $175 million. In addition bonds with extendible options were offered on three occasions. The average term to maturity of outstanding unmatured marketable direct and guaranteed bonds shortened by one month over the year to five years, three months.

The terms of the 1975/76 series of Canada Savings Bonds were announced on September 11th. This series offered investors a nine-year bond with interest of 8¾ per cent in its first year and 9½ per cent in each of the remaining eight years for an over-all yield to maturity of 9.38 per cent. The bonds proved very attractive to investors and the series was withdrawn from sale effective the close of business November 14th. Gross sales of the new issue less redemptions in the fourth quarter amounted to $3,242 million and at the end of 1975 the outstanding amount of Canada Savings Bonds was $2,667 million higher than a year earlier.

Holders of an issue of 7¼ per cent marketable bonds due December 15, 1975 had the option in the six month period from December 15, 1974 to June 14, 1975 to exchange their holdings into an equal par value of 8 per cent bonds maturing December 15, 1985. In total, $116 million of the bonds were exchanged, leaving $334 million of the original issue to mature in December 1975.

In March 1975 the Government cancelled $1 million of 9½ per cent bonds due June 15, 1994 and $7 million of 5½ per cent bonds due August 1, 1980 which it had previously acquired under the purchase fund provisions of these issues. In September the Government redeemed at maturity the remaining U.S.$28 million of a 2¾ per cent bond issue originally issued on September 15, 1950.

Foreign Exchange Operations

In 1975 the Canadian dollar traded in a slightly wider range than in 1974, falling from a high of U.S.$1.0095 at the beginning of the year to a low of U.S.$0.9615 in mid-August and rising again to U.S.$0.9843 by year-end. It continued to strengthen in the first two months of 1976 and at the end of February was U.S.$1.0140.

As agent for the Exchange Fund Account of the Minister of Finance, the Bank of Canada operated in the foreign exchange market to smooth short-run fluctuations in the exchange rate of the Canadian dollar. These operations accounted for most of the U.S.$500 million net decline in Canada's official reserves that occurred in 1975. Other factors that contributed to the decline in reserves were a U.S.$27.8 million repayment of a Government of Canada bond issue which matured in September and, owing to a decline in the value of the SDR in terms of the U.S. dollar, a reduction of U.S.$99.5 million in the U.S. dollar value of Canada's holdings of gold and other SDR-denominated assets. In addition, Canada completed in 1975 an undertaking made in 1974 to make a maximum of Cdn.$300 million available to the International Monetary Fund's oil facility. This had the effect of reducing Canada's official holdings of U.S. dollars by U.S.$132.4 million and of increasing its holdings of SDR-denominated assets by a like amount. At the end of 1975 Canada's total official holdings of international reserves stood at U.S.$5,325.6 million. There was an increase of U.S.$552 million during the first two months of 1976.

Exchange Rate and Official Reserves