Bank of Canada · Banque du Canada Ottawa K1A 0G9

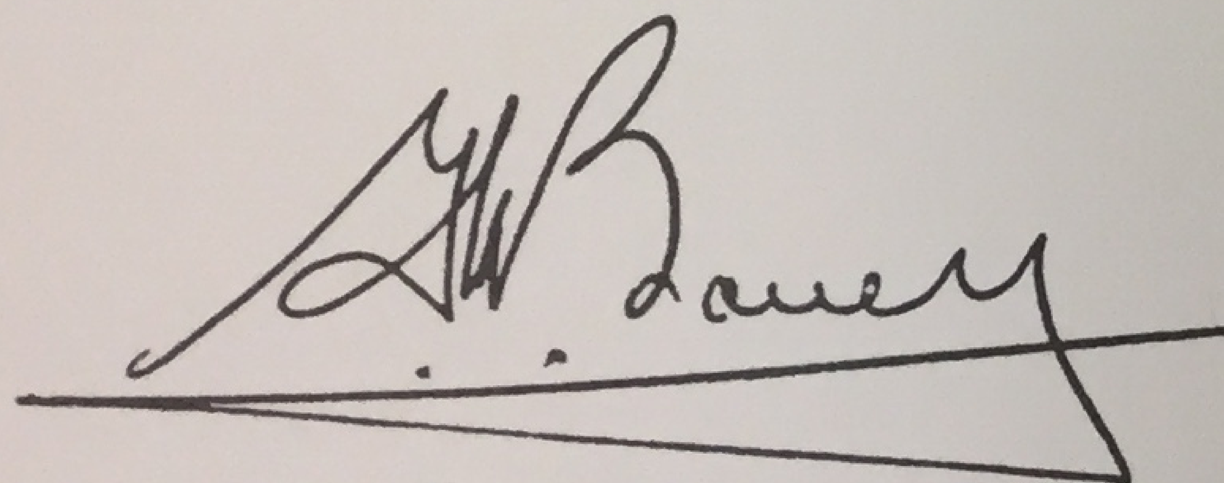
February 28th, 1977

The Hon. Donald S. Macdonald, P.C.,
Minister of Finance,
Ottawa.

Dear Mr. Macdonald,

In accordance with the provisions of the Bank of Canada Act I am transmitting herewith my report for the year 1976 and a statement of the Bank's accounts for this period, signed and certified in the manner prescribed in the by-laws of the Bank.

Yours sincerely,



Governor

Bank of Canada

Report of the Governor - 1976

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General Observations

I want to begin this Report by putting economic and financial developments in Canada during 1976 into perspective for I believe the economy's performance can be properly assessed only within a longer time-frame than a single year.

In my opinion the events of 1976 should be seen as the first part of the story of this country's struggle to recover from a severe attack of inflation, to rid itself of inflationary attitudes and behaviour, and to regain the internal economic balance required for its future prosperity.

Since the epidemic of inflation was international in scope, a similar struggle is going on in many other countries. The virulence of inflation at its peak differed considerably among countries, and there has also been much variety in the nature and vigour of the steps taken to restore stability. Some countries, notably Germany, the United States and Japan among the larger industrial countries, have already achieved considerable success, and I regard it as by no means an accident that economic prospects now appear a good deal brighter in these countries than in most. Within these countries there is continuing strong concern to avoid action that will reverse the movement towards price stability, and even within those that have done less well it now seems to be widely accepted that a much better cost and price performance is a prerequisite for their economic and social well-being. Although the struggle in the outside world to regain cost and price stability will not be easily won, Canadians must recognize that it will continue and that the countries that do best in this respect will set the pace in international trade. This is the sort of world in which Canada will have to live.

In this country a co-ordinated national program to wind down inflation was announced in October 1975. By that time inflationary behaviour had taken a firm grip on many aspects of economic life. Public and private attitudes in Canada had gone dangerously far towards the belief that Canadian prosperity was automatically assured and that the economy could be relied upon to generate enough real income to permit a continuation of the unusually rapid increases of recent years in both private and public consumption. This was of course an illusion, but it was commonplace to see people acting as though they believed it. The situation in Canada as of October 1975 was serious indeed, and it was obvious that the road back to economic balance was going to be a rough one.

The strategy of the Canadian attack on inflation is the strategy of gradualism. It relies mainly on the management of financial policy to ensure an economic climate sufficiently competitive to discourage the inflationary pricing of labour and output. This is the heart of the program, and it is intended that it continue indefinitely. In order to speed up the required deceleration of money incomes, a system of direct controls over increases in the main forms of income was included in the program. It is intended that this element of the program be temporary.

The strategy of gradualism in winding down inflation has much to commend it. Its main advantage is that it avoids the severe economic disruption and concentrated social strain that would be involved in an all-out attack designed to produce quick results. That advantage is well worth seeking. But the price of effective gradualism is patience and persistence, and that price cannot be escaped. The struggle must go on, not for months but for years.

That, briefly, is the perspective within which the economic events of 1976 must be assessed. There is not much point in looking at them against ideal standards. By the end of 1975 the Canadian economy was much too far out of joint to warrant any realistic expectation that it could perform well by ideal standards in the years immediately ahead. The important question to ask about 1976 is – have we made reasonable progress within the strategy of gradualism? Have we made yards towards restoring the conditions essential to our future prosperity?

I believe that the short answer to that question is – yes, we have. In this sense 1976 was, despite its shortcomings, a good year.

I recognize of course that in terms of output and employment the performance of the Canadian economy in 1976 fell short of what we might in happier circumstances have expected at this point in the business cycle, or what we ought to aim to achieve if we can succeed in eliminating from our society practices that persistently push up – or prop up – costs and prices without much regard for economic realities. Moreover, the performance of the economy was uneven from one region to another, with the levels of activity and unemployment being particularly unsatisfactory in some parts of the country. But considering the existing circumstances both within Canada and abroad – and here I am thinking of the rather subdued expansion of economic activity after the early months of 1976 in the United States and in overseas countries – the levels of output and employment in Canada as a whole were bound to be lower than one would have liked to see.

The most encouraging feature of 1976 was the slackening of the rate of price and cost inflation. It is true that the underlying trend of prices in Canada improved less than the broad price measures indicate because of various transient factors such as the striking reversal of the upward trend of food prices. But after due allowance for such factors, one can, I think, regard the trend of prices in 1976 as good in the circumstances, and "on track".

New wage and salary settlements under major collective agreements, though still high, have moderated steadily. They have recently been averaging less than 10 per cent a year over the life of contracts, a great improvement over the average rate of around 18 per cent in the first nine months of 1975. Some welcome slowing of the high rate of increase of unit labour costs in Canada has already become apparent. Profit margins weakened sharply in 1976 but, while this development made some contribution to the easing of price inflation, it also contributed to blunting the ability and willingness to invest in plant and equipment.

* * * *

The Bank of Canada adopted the strategy of gradualism in its conduct of monetary policy some time ago. In its search for a policy guide that would help it keep the pace of monetary expansion sufficiently moderate to maintain downward pressure on the rate of inflation

without unduly hampering the growth of employment and output, the Bank began to pay increasing attention to the rate of growth of the money supply narrowly defined as currency and chartered bank demand deposits. The Bank decided that the achievement of its basic objectives would be helped by the use of an interim target for the growth of the money supply so defined. The initial target range would be set high enough to accommodate some but not all of the continuing growth in the demand for money arising out of the existing high rate of price inflation, and the target range would be adjusted periodically over time to provide for less and less financing of inflation.

The Bank of Canada began to conduct monetary policy with this emphasis on the trend of the money supply around the middle of 1975, and it has continued to do so since then. The rationale for this approach was explained at some length in last year's Annual Report and I shall not repeat it here, though some discussion of why we have paid more attention to the trend of the narrowly-defined money supply than to broader definitions appears later in this Report. As it is being practised in Canada this approach throws useful light on how the level of short-term interest rates should change from time to time to be compatible with a gradual return to monetary stability, and the Bank uses this information in the daily conduct of its affairs. It is the short-term interest rates that flow from this approach that are its cutting edge in influencing economic decisions, and their influence is in the direction of stabilizing over time – with a diminishing margin for price inflation – the trend rate of growth of total spending in the economy.

The first target range for money supply growth was a trend rate of increase of not less than 10 per cent but well below 15 per cent measured from the average level over the three months centred on May 1975. During the latter months of 1975 the money supply was temporarily greatly inflated by a prolonged postal strike, and it was not until some weeks into 1976 that the Bank judged that the money supply figures were no longer being seriously distorted. By the end of February 1976 the Bank came to the conclusion that, with due allowance for the effects of the postal strike, the underlying trend of money supply growth was too high, and on March 5 it announced an increase in Bank Rate from 9 to 9½ per cent. This action had a pronounced initial impact on the expectations and behaviour of financial markets, and for a time the Bank had to operate vigorously to contain excessive interest rate reactions. By early April a calmer atmosphere had been restored and short-term market interest rates had fallen back into a more normal alignment with Bank Rate.

After a temporary dip in the total of currency and demand deposits early in the second quarter, the growth rate of this aggregate from the base period ran around the lower end of the Bank's then existing target range during the summer months.

In late August the Bank of Canada announced an up-dating of its target range for the growth of currency and demand deposits. The new range was from 8 per cent to 12 per cent a year measured from the three-month average level centred on March 1976. This base period was chosen because at that time the growth rate from the previous base was close to 12 per cent, roughly the mid-point of the previous range. The reduction in the upper and lower limits of the range was in accordance with the Bank's strategy of gradually moderating the rate of monetary expansion in order to encourage and consolidate the gradual reduction in Canada's inflation rate that was by then clearly underway.

By late autumn it was clear that the growth of the money supply had become unduly sluggish in relation to the Bank's targets and required corrective action. After the termination of the annual Canada Savings Bond campaign the Bank announced on November 19 a reduction of Bank Rate from 9½ to 9 per cent. On December 21 it announced a further reduction to 8½ per cent, and on January 31, 1977 another to 8 per cent.

This sequence of Bank Rate reductions and the associated decline in short-term interest rates were intended to help bring the trend of the money supply back up within the target range in due course. They also reflected the Bank's judgement that there was room for a considerable decline in short-term interest rates given the slower trend of growth in economic activity that had emerged and the progress being made in moderating inflation.

The January 1977 Bank Rate reduction was accompanied by a reduction in the minimum secondary reserve ratio required of the chartered banks from 5½ per cent to 5 per cent. In the Bank's judgement there is no need in present circumstances for the chartered banks to be required to hold secondary reserves as large as 5½ per cent of their deposit liabilities, and since a reduction in the ratio for February 1977 was manageable, it was effected.

The preceding comments on monetary policy, and those to be found later in this Report, indicate that for more than a year and a half the Bank has placed a good deal of reliance on the trend of the narrowly-defined money supply as an operating guide. In retrospect I would say that the results of this have on the whole been good. It is our intention to continue to conduct monetary policy along these lines. At the same time we recognize that this approach is based on relationships that are not as precise as one would like to see, and that it is therefore by no means devoid of problems. The relationship between the growth of money supply narrowly defined, the growth of total spending in the economy and changes in interest rates can be affected both by random influences in the short run and by gradual shifts in behaviour over longer periods. It would appear, for example, that the growth of the money supply from the recent base to the present has been somewhat less than one would have forecast on the basis of past relationships. Partly for reasons of this kind, we do not follow the money supply indicator blindly but subject our policy decisions to much broader tests, and we shall continue to do so. While our approach is pragmatic rather than doctrinaire, we shall not relax in our determination to reduce over time the trend rate of monetary expansion in Canada to one more compatible with price and cost stability.

* * * *

If, as I believe, there are valid grounds for drawing encouragement from the degree of progress achieved during 1976 in moderating inflationary attitudes and behaviour in the Canadian economy, there are certainly no grounds in the present situation for complacency. On the contrary, we in Canada have a long way yet to go, and the path ahead does not look easy.

Recovering from a severe bout of inflation is never easy. Experience with inflation undermines the confidence of people in the fairness of economic processes and leads them to feel a need to be aggressive in the defence of their interests. It erodes that willingness to be moderate and responsible upon which free societies rest. That is why tolerance of inflationary practices is not an effective way of pursuing social goals. It is also why it is difficult to recover from an inflationary experience; confidence and moderation are qualities that grow slowly.

Our present difficulties are increased by the economic uncertainties arising out of the political strains that have developed within confederation. While I believe that these strains will ultimately be resolved in favour of keeping our country united, they are in the meantime bound to have some depressing effects on economic activity.

The performance of the economy continues to be seriously prejudiced by a relatively high rate of inflation of our costs and prices. We are still paying ourselves larger increases in money incomes than our performance as producers warrants. In recent years the average money incomes of people employed have risen much more rapidly in Canada than in the United States without there having been any greater increase in our output per worker. In this way we have become a high cost country. There is no shortage

of evidence that our costs have risen too rapidly to allow us to compete effectively with the United States and some other foreign suppliers in many areas where we do not have some important natural or historical advantage. And the relative deterioration in our domestic costs of production does not yet seem to have come to an end. So long as this continues there can be no stable basis for lasting growth of the employment opportunities upon which our future prosperity depends.

The consequences of our relatively high rate of domestic cost inflation are apparent in our international trade and payments. Despite the fact that our economy was not physically overloaded in 1975 and 1976 we nevertheless incurred very large deficits in our international balance of payments on current account. It is true that our exchange rate during this period reflected the efforts we were making to moderate domestic inflation, but in the circumstances the unusually large size of our current account deficits strongly suggests that we were losing jobs in Canada, and that this was basically because we had priced ourselves out of markets at home and abroad and were continuing to do so. The practice of drawing on foreign resources and increasing our foreign debt may be appropriate when we are pressed for resources because we are adding to our productive facilities at an unusually rapid rate, but to do it to supplement final consumption on the scale that we have in the last two years is to build up problems for the future. Our own interest requires that we put our external economic balance into better order.

The unsatisfactory state of our external trade and payments situation is largely a direct result of the inflation of prices and costs in Canada. It is the external manifestation of our domestic economic problem. Fundamentally, its correction requires the correction of the situation at home. For the downward movement of the exchange rate of the Canadian dollar from last November to February to lead to any lasting improvement in our competitive position, it will be necessary for us to gain better control over our domestic prices and costs.

Since the root of our current employment and trade difficulties lies in the persistence of inflationary practices, it would be extraordinary to suppose that they could be cured by financial policies so expansionary as to encourage inflationary behaviour, or for that matter by protectionist policies. Such policies would simply make things worse.

A much more promising approach for increasing employment in Canada and correcting our foreign trade position is to continue the process begun in 1976 of moderating the rise of Canadian production costs. This means continuing to moderate the rate of increase of money incomes. It means following financial policies consistent with the strategy of gradualism.

I have referred to the fact that I am much encouraged by the lower rate of escalation of money incomes that occurred in 1976. Many factors no doubt contributed to this result. Anti-inflationary public policy has weakened the expectations of inflation and has contributed to a more competitive economic environment, making it more difficult to raise prices and making employees less inclined to press for, and employers less willing to accept, inflationary wage and salary settlements. I believe that the direct controls on income administered by the Anti-Inflation Board have been helpful in this process. The value of these controls is, at the time this Report is being written, under debate, with many voices calling for their early termination. While it will be difficult to judge the right moment and right method for lifting the controls, and we should be preparing to live without them, a major criterion for withdrawing them earlier than was originally envisaged should be whether costs and prices in Canada are likely to be lower without controls than with them. To the extent that groups in the economy are in fact looking to the ending of controls as the moment for a substantial upward push in their money incomes and prices the case for terminating the program early is weakened.

The economic welfare of Canadians will be further improved to the extent that the effect on costs of a moderating trend of rates of money income is supported by improvements in our national productivity, that is, in our productive efficiency. In the private sector the requirements for productivity growth include a skilled and energetic work force, competent and dynamic entrepreneurs, and the availability of capital to finance the plant and equipment needed for more efficient production. The requirements also include the prospect of sufficient profit to warrant the risks of undertaking new investments. If, for whatever reason, that prospect is denied the desired growth in efficient production will not occur.

Improvements in productivity in the public sector of the economy are equally desirable, and involve many of the same requirements.

Monetary policy has a key role to play in restoring a solid basis for sustained growth. There can be no lasting prospect of good price and cost performance if the rate of monetary expansion is excessive. I have been trying for quite some time to make it clear that the Bank of Canada fully recognizes this, and that it is unreservedly committed to act accordingly. All Canadians should base their decisions on the expectation that the longer run trend of monetary expansion in Canada will move over time towards a rate compatible with inflation-free growth of the economy. No group in the community should count on the Bank of Canada to float off its inflationary activities with a wave of monetary expansion, and it is particularly important that this point should be borne in mind when Canada enters the period of dismantling direct controls.

If Canadians continue to respond positively to the strategy of gradualism, if they act in a way that takes account of the market environment they face, the moderating trend in costs and prices will continue, the economic situation will improve, and monetary developments will reinforce the process. Less rapid inflation will reduce borrowing requirements and the demand for money balances and will lead to lower interest rates. Reduced fears of future inflation will reinforce the decline in longer term interest rates. These developments will encourage investment in physical facilities, increased efficiency of production and increased employment in Canada. They will also encourage a correction of Canada's external payments imbalance by reducing the amount of Canadian borrowing abroad and the deficit in the current account of the balance of payments.

If, on the other hand, Canadians do not continue to respond positively to the anti-inflationary climate, things will go in the opposite direction. If there is any widespread tendency for groups in the community to push up their prices and incomes excessively in the mistaken expectation that inflation will be accommodated by monetary policy, part of the flow of spending that would otherwise have stimulated increased output and employment in the economy will necessarily be absorbed in paying these higher costs and prices. The result will be less employment either in the industries concerned or elsewhere in the economy. Thus the economic situation will deteriorate and the opportunity we now have to build a solid basis for sustained economic expansion will have been lost, perhaps for some time.

The touchstone for responsible economic policy and conduct in the years immediately ahead should thus be – will it help Canada to reduce inflation, to increase its economic efficiency and to regain its international competitiveness? The economic initiatives of all groups in the community should be judged by this standard. All groups should be expected to accept some responsibility for Canada's performance in this regard. Canada's underlying economic advantages are so great that there can be no doubt that we can earn and sustain a high and rising standard of living in a strongly competitive world if we will consider what is required and then do it.

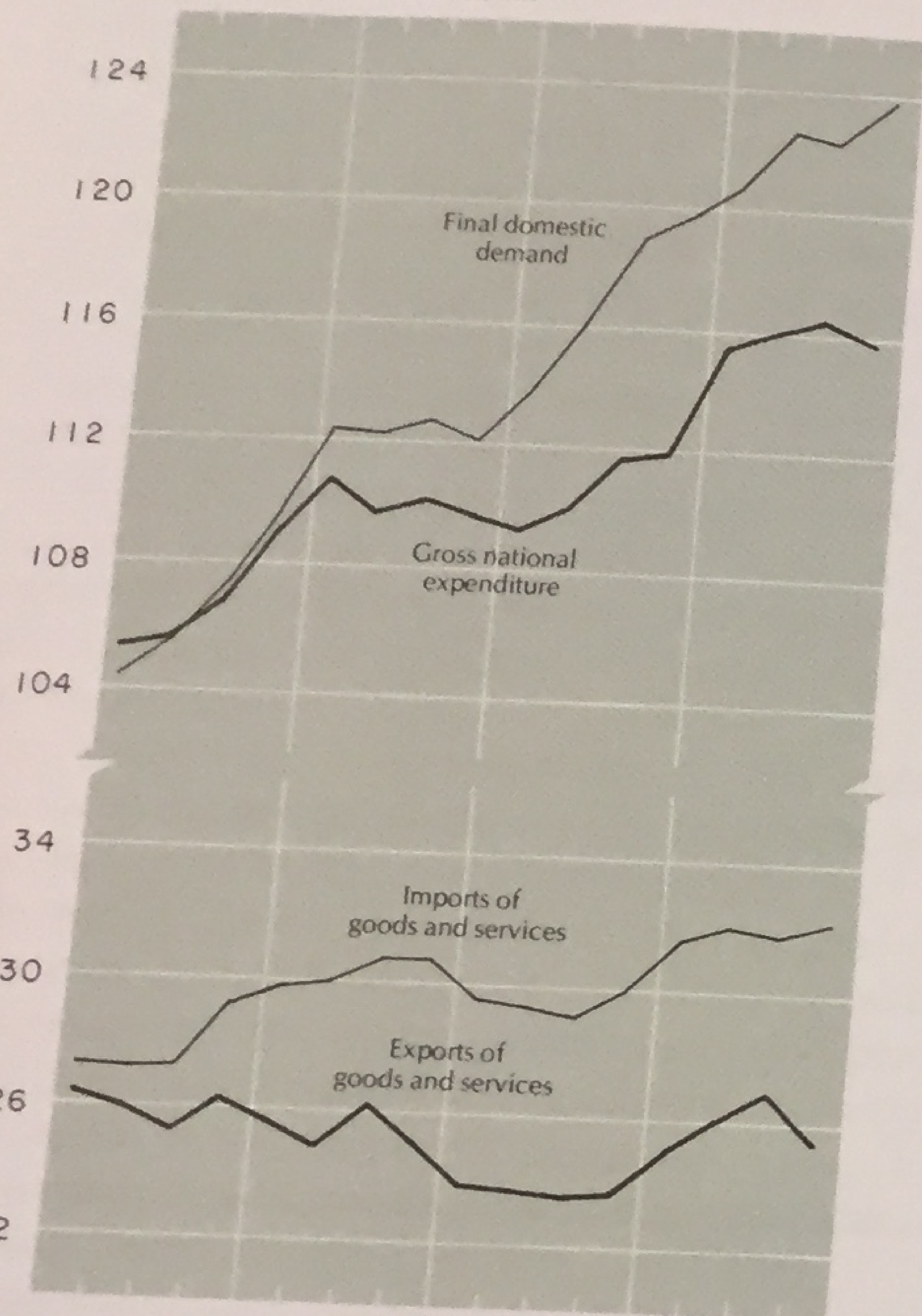
Economic Developments

Economic developments in Canada during 1976 were shaped by the hesitation that occurred in recovery abroad and by strains, uncertainties and difficult adjustments – for the most part related to inflation – at home. Nonetheless, significant gains in output and employment occurred in the early part of the year, and very substantial headway was made in gearing down the spiral of wages and prices. Wage increases came down markedly in the course of the year despite the initial difficulty of bringing settlements into conformity with the guidelines under the anti-inflation program. The economy's price performance, as measured by the Consumer Price Index, was actually better than envisaged for the first year of the program as a consequence of the unexpectedly favourable evolution of food prices. Thus Canadians, on average, obtained another sizeable increase in their real disposable incomes. But as in the previous year this was accompanied by developments elsewhere in the economy that do not appear to be sustainable indefinitely – large budgetary deficits at the various levels of government, a sharp decline in farm income, a deterioration in the climate for private investment, and a heavy net reliance on imported goods and services financed by long-term borrowing from foreigners on an unprecedented scale. Although some cyclical reduction in the external deficit on current account did occur in 1976, the evidence on cost trends suggests that the progress made against inflation was still not sufficient to keep Canada from losing further ground in terms of its competitive position vis-à-vis its main trading partner.

Nominal GNP was still rising at an annual rate of over 15 per cent in the early part of 1976 but its

Major Economic Indicators
Seasonally adjusted

Domestic and foreign demand
Billions of constant (1971) dollars



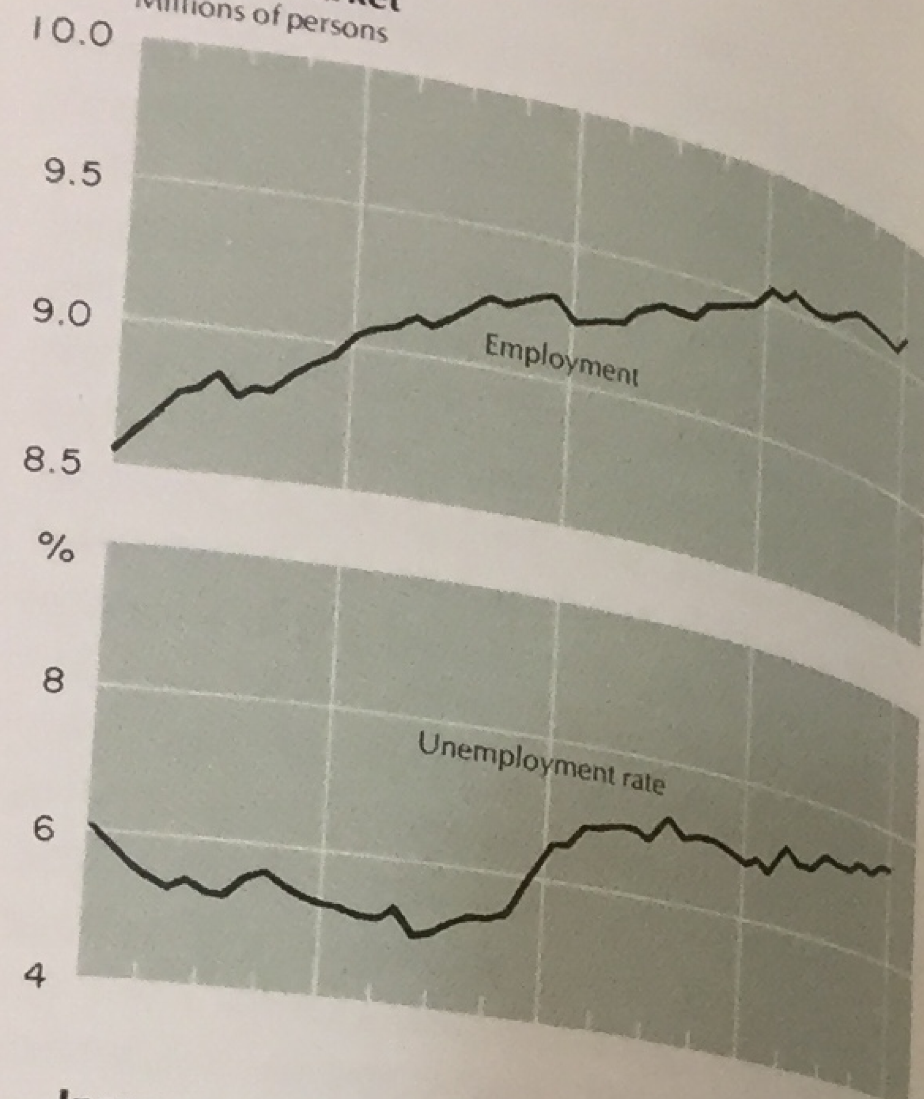
Percent of GNE

External balance on goods and services

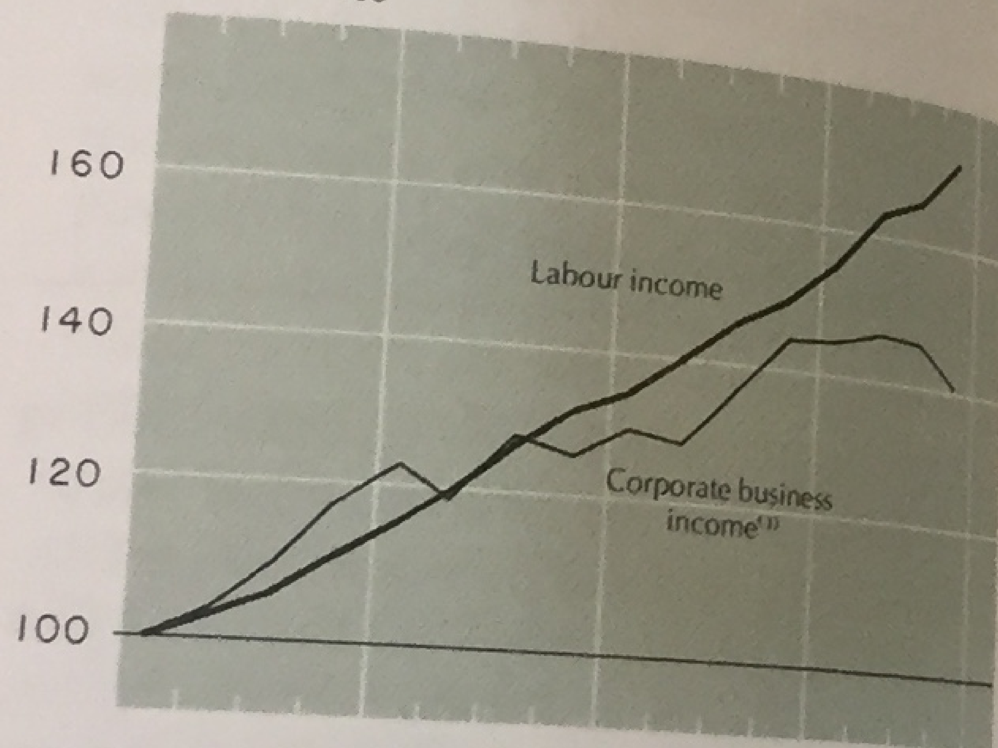
Change in inventories

1973 1974 1975 1976

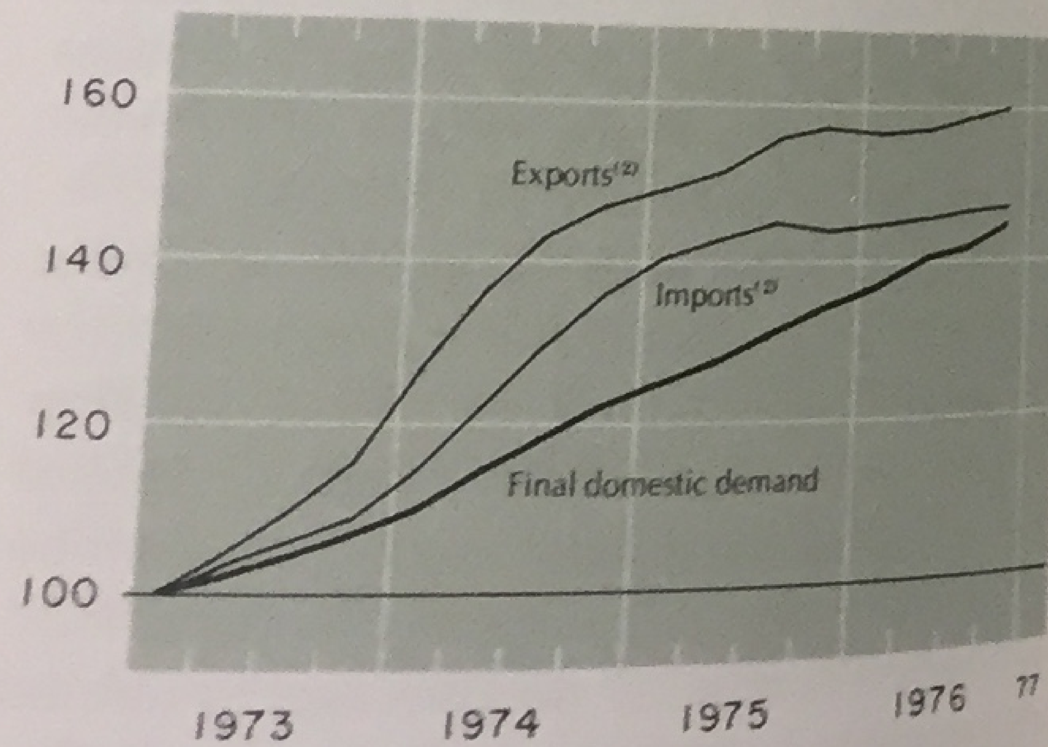
Labour market
Millions of persons



Income aggregates
1 Q 1973 = 100



Price deflators
1 Q 1973 = 100



1973 1974 1975 1976 77

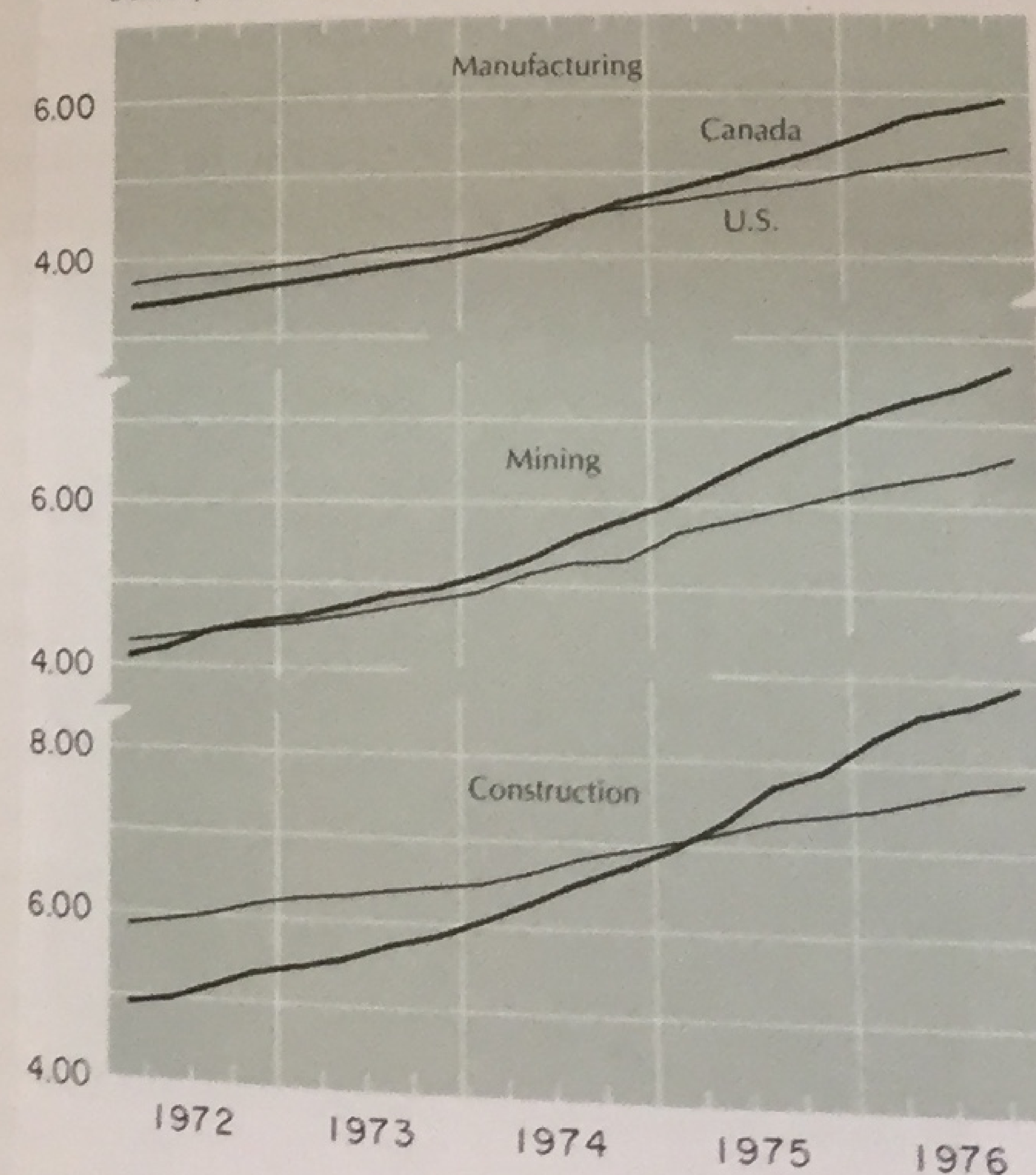
(1) Corporate profits, corporate capital consumption allowances and the inventory valuation adjustment
(2) Goods and services

pace of advance had slackened by the latter part of the year to an average of under 10 per cent. Spending and output were buoyed in the first quarter by a sharp accumulation of inventories and a strike-delayed recovery in exports. Subsequently, the volume of exports rose less rapidly and then declined mainly in response to the weakening pace of recovery abroad, and domestic demand also became more subdued. In particular, business investment weakened appreciably. At the same time, however, the slowing in spending was accompanied by a clear easing of inflation. The increase in the GNE deflator, the broadest measure of Canadian prices, was less than 10 per cent for the first time since 1973. A major factor in this outcome was the special effect on food prices of exceptional agricultural supplies, together with the continued moderation in export and import price trends. While the improvement in underlying domestic costs tended to be masked by large retroactive wage and salary payments, average weekly earnings did rise less rapidly in the course of 1976 than in the preceding year, and the effect on labour costs and prices was reinforced by an increase in output per worker – the first of any significance since 1973.

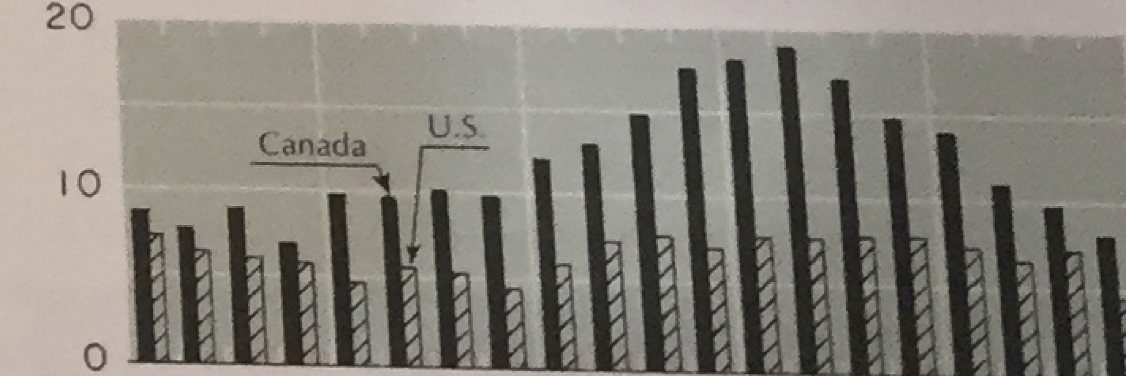
Despite the improving trend, labour costs in Canada still rose appreciably more in 1976 than such costs in the United States. While only an approximate indicator of international competitiveness, the sharp divergence in recent years of trends in labour costs between Canada and the United States nevertheless provides a good illustration of the more difficult relative position that has faced Canadian producers.

Wage Developments: Canada-United States
Seasonally adjusted unless otherwise indicated

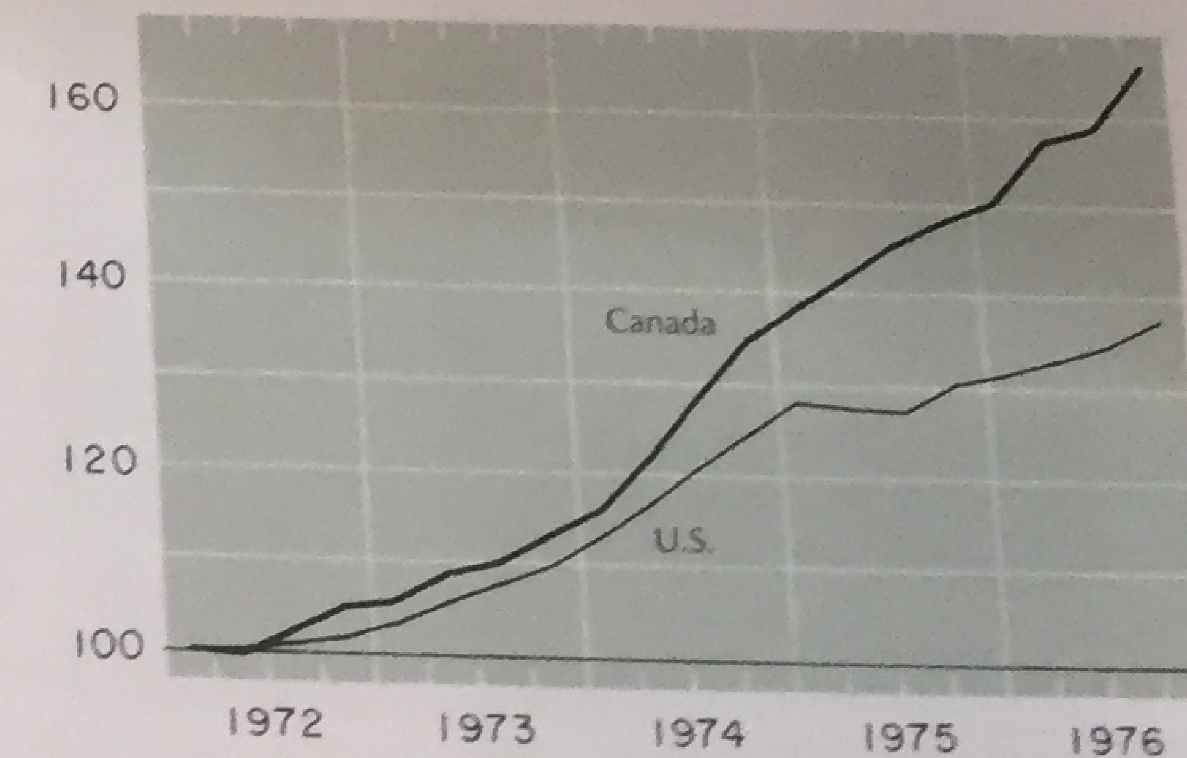
Average hourly earnings
Dollars per hour (national currency)



Wage settlements over life of contract
Average annual percentage increase



Unit labour costs(1)
1 Q 1972 = 100



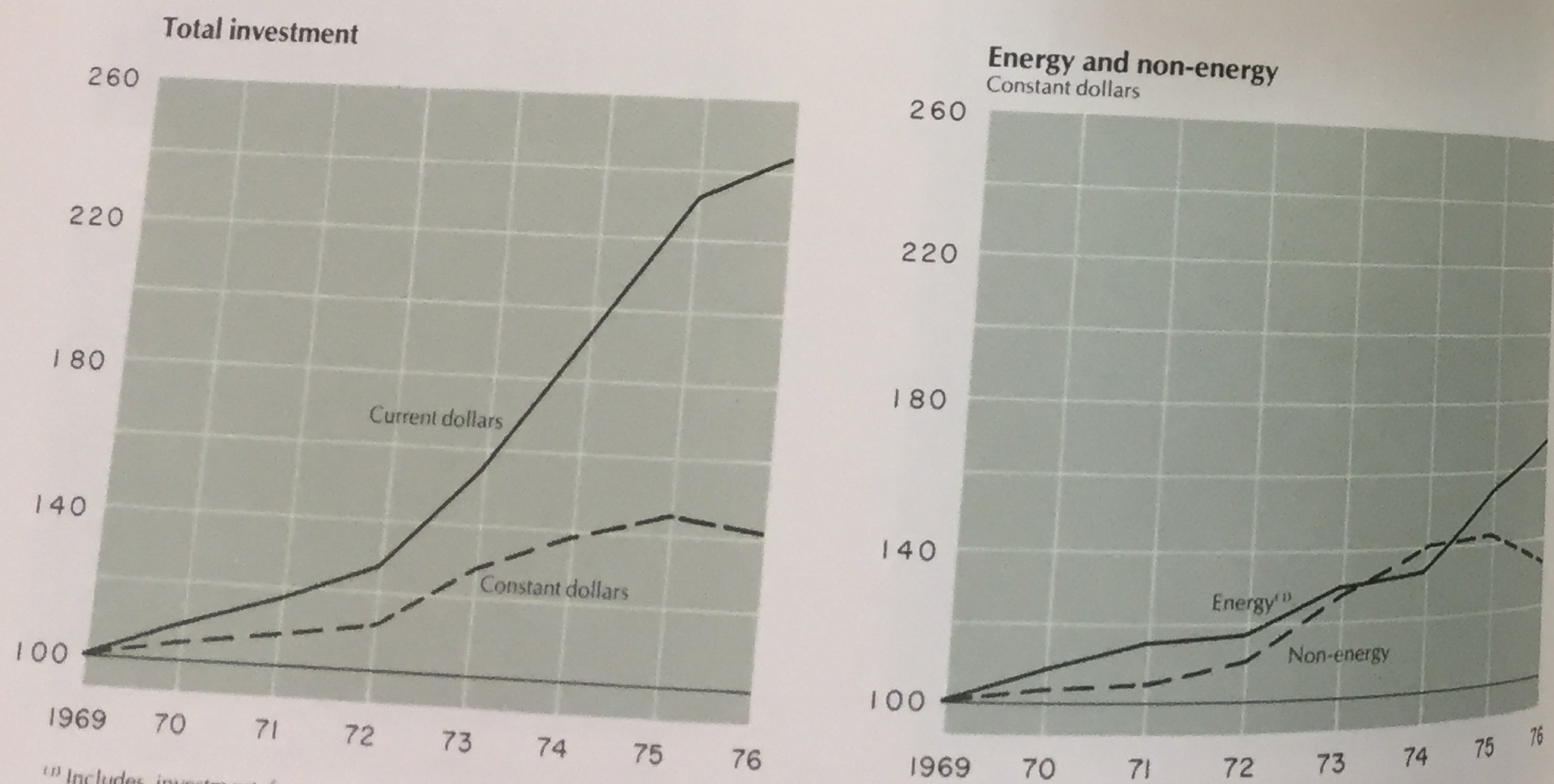
1972 1973 1974 1975 1976

(1) Wages, salaries and supplementary labour income per unit of real GNP

Domestic and External Demand

The value and volume of final domestic sales advanced during 1976 at a slower pace than in the preceding year, and less rapidly in the second half of the year than in the first. Over the four quarters of 1976 final domestic demand expanded by close to 3½ per cent in volume terms. The rise over this period was virtually the same as that of total real Gross National Expenditure but the path of real final domestic sales was considerably steadier.

While the advances during 1976 in real consumption and residential construction outlays were less than in the previous year, they were nevertheless greater proportionately than that of total real GNE. Although the expansion in real personal disposable income was not so large as the year before it was still 4½ per cent, and consumer demand was further sustained by the tendency for personal saving rates to recede from earlier peaks – perhaps reflecting the easing of inflation as well as the normal offsetting response of personal saving to short-run shifts in disposable income. The slower advance in housebuilding was more a reflection of the very steep climb in construction activity during 1975. In 1976 activity was maintained at the very high rate reached at the beginning of the year. Indeed, housing starts attained a new record of more than 270 thousand units, a considerably stronger outcome than had been generally expected, or targeted, at the beginning of the year. One important stimulative element was the range of government sponsored housebuilding programs aimed at expanding the supply of lower cost units. Furthermore, mortgage funds were in good supply throughout the year. However, by year-end there was growing doubt whether housing demand would be forthcoming on a scale sufficient to absorb smoothly the large volume of units scheduled for completion in the first part of 1977. Latterly, mortgage rates have been moving down and there is some evidence of an easing in the prices of existing housing, possibly reflecting not only an imbalance between supply and demand but also a lessening of the relative attractiveness of real estate as an asset with the general moderation of inflation.



(1) Includes investment for petroleum and natural gas extraction, manufacturing of petroleum and coal products, electric utilities and pipelines.

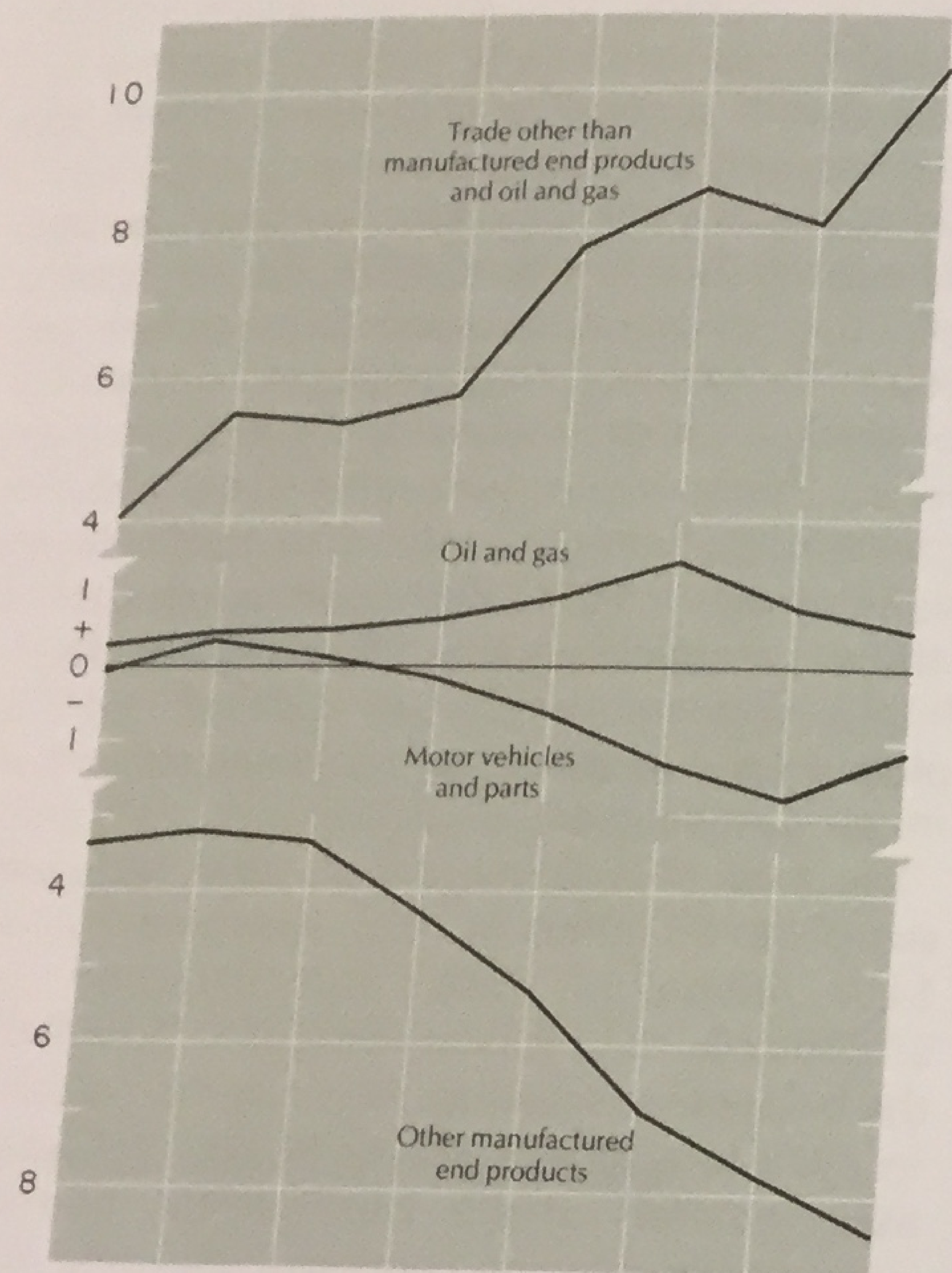
In the face of considerable unutilized capacity and sluggish profits, business fixed investment was weak throughout 1976 and appeared to become weaker as the year progressed. Strikes in the construction industry were at times an important element hampering investment realizations but do not appear to have been the predominant influence in determining the overall outcome. Actual dollar outlays increased somewhat in 1976, but this was more than absorbed by higher costs; the rate of fixed capital formation in real terms was lower at year-end than at the beginning. Energy-related investment, where longer run considerations are relatively important and where a large share is undertaken by government business enterprises, continued to register strength in 1976, while in other sectors, where the growth of real investment had already tapered off in 1975, capital formation underwent a sizeable decline. Investment in manufacturing activities, where competitive cost pressures have been particularly prominent, was especially weak.

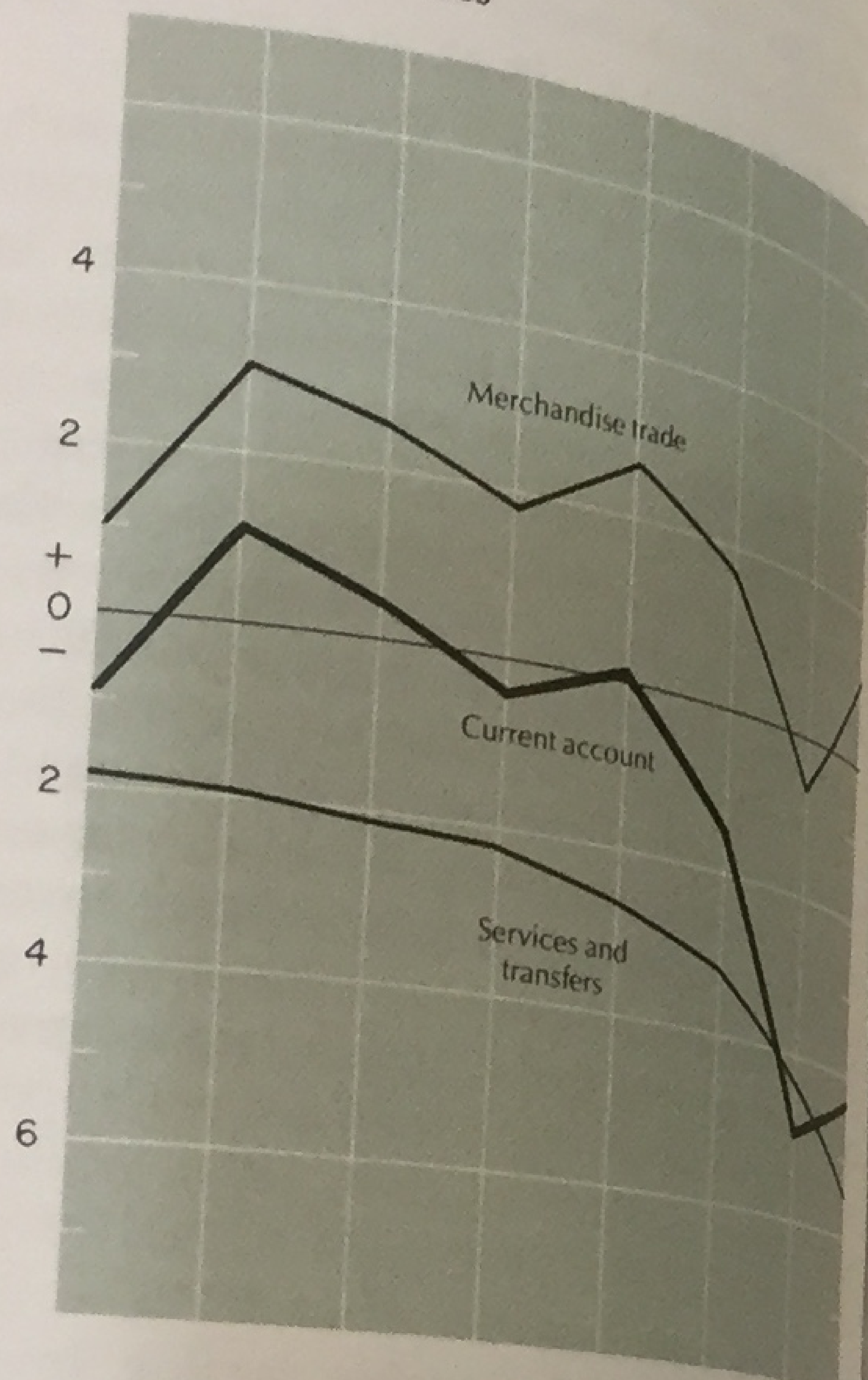
Purchases of goods and services by governments, that part of public spending entering directly into GNE, rose relatively strongly during 1976 with very large increases at the provincial-municipal level. However, the rate of growth of total outlays for all levels of government was less rapid in the course of 1976, reflecting in particular a slower rise in transfers to persons, and was only slightly more rapid than the increase in nominal GNE. For the federal Government alone the increase was proportionately less than that of GNE. The national accounts position of all levels of government remained broadly unchanged in 1976 following a swing from a surplus of over $2 billion in 1974 to a deficit of some $4 billion in 1975. The deficit did not increase significantly from 1975 to 1976 because in the latter year tax collections grew more strongly, in part reflecting budgetary actions.

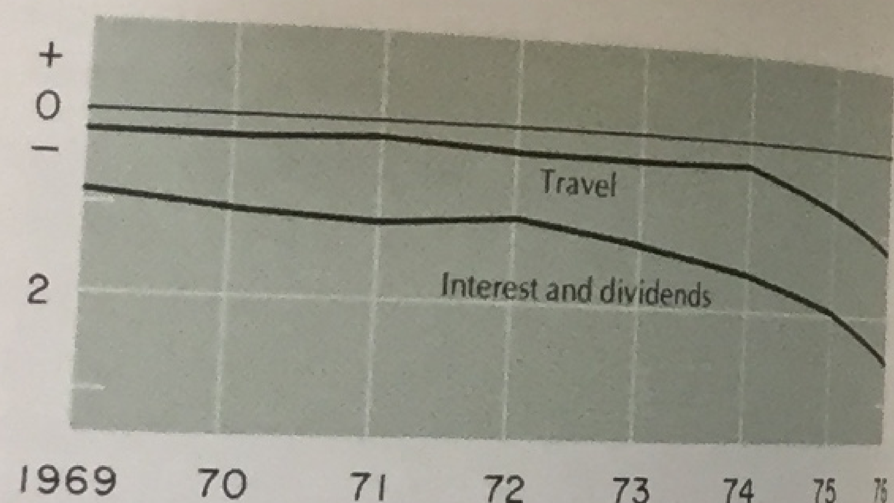
Stronger external demand, particularly in the United States, led to a rise in export volumes in 1976 despite a sharp reduction in shipments of oil. However, this improvement was not accompanied by any major upturn in export prices. Indeed, the increase during 1976 was very small, reflecting international price developments as well as the maintenance for most of the year of a relatively high external value for the Canadian dollar. Import prices were also stable and the commodity terms of trade did not change significantly in 1976, thus holding most of the strong cumulative gain realized since 1972. Import volumes, which had declined in 1975, picked up in response to consumer rather than investment demand.

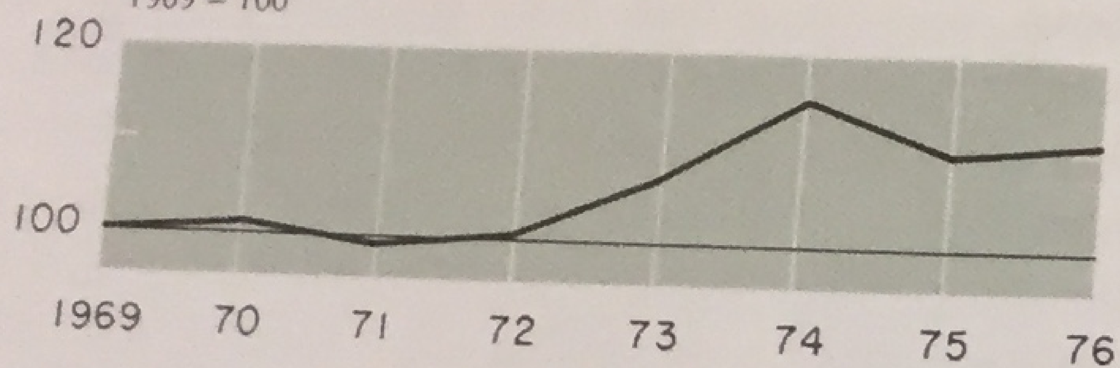
The current account deficit, after increasing sharply to $5 billion in 1975, narrowed to about $4¼ billion in 1976. This reduction was attributable to a cyclical swing of $1¾ billion in the balance on merchandise trade, from a deficit in 1975 to a surplus of over $1 billion. Close to three quarters of this improvement, however, was absorbed by the continued widening of the deficit on services. Net interest payments rose by about a half while Canadian payments for foreign travel, particularly to the United States, also increased sharply. Indeed, over the period from 1973, the combined deficit on interest, dividends and travel has increased by over $2 billion, thus accounting for nearly half the expansion of about $4½ billion in the current account deficit in this same period. There was a negative swing of more than $1½ billion in the merchandise balance over this period, with a particularly weak performance for manufactured goods. Over the last three years the trade deficit for finished manufactured goods (including motor vehicles and parts) has increased by a further $3½ billion to a level of close to $10 billion.

Current Account of the Balance of Payments
Billions of dollars unless otherwise indicated





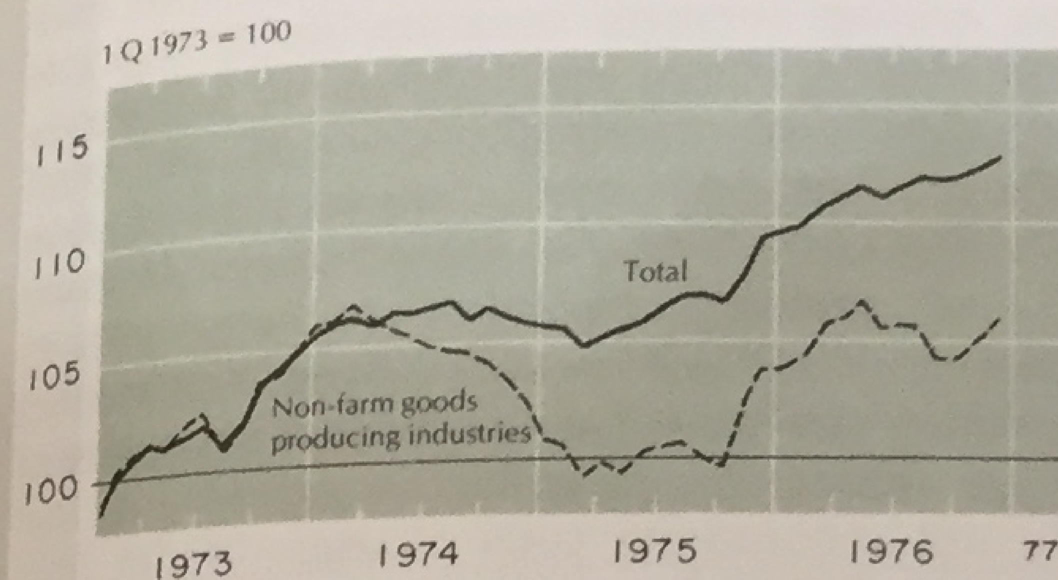




Production and Employment

The cyclical upturn in the output of non-farm goods producing industries (chiefly manufacturing, construction and mining) that got underway in the autumn of 1975 continued until late spring when production in these industries regained its previous peak of early 1974. From that time however, an easing of demand, compounded by the effects of industrial disputes including lengthy province-wide shutdowns of construction in British Columbia and Quebec, resulted in a generally sluggish pattern for the balance of the year

Real Domestic Product
Seasonally adjusted, monthly



For the service sector, which accounts for approximately three fifths of total domestic output, cyclical factors are much less prominent, and while the effects of work-related stoppages were also in evidence in this sector they were not sufficiently pronounced to disrupt the profile of steady, if moderate, advance. The volume of agricultural production rose strongly in 1976, registering the largest gain for five years. Crops were generally excellent, in particular a record wheat crop was harvested, and livestock output also increased. In both instances, however, the expansion of supplies, which was a feature of the U.S. farm scene as well as the Canadian, led to downward pressure on prices and producer incomes.

Notwithstanding the stronger rise in output than during the two previous years, the growth of total employment was relatively small in 1976. Employment had been remarkably well sustained in 1974 and 1975, precluding any advance in aggregate output per person employed. Accordingly some cyclical improvement in labour productivity, as did in fact occur during 1976, seemed overdue. Weakness in employment was particularly marked among younger people, and this may also have been a factor in the decline in that age group's rate of participation in the labour force after several years of sharp increases. Labour force growth over-all was in fact very small in 1976 – 1½ per cent for the four quarters ended with the final quarter of 1976 or less than the growth of the population of labour force age – and the total unemployment rate, which averaged just over 7 per cent, was only fractionally higher than in 1975. By year-end, however, the seasonally adjusted rate was up to 7½ per cent, and on a regional basis there were pronounced increases in measured unemployment rates in the Atlantic Provinces and Quebec, raising them still further above the national average.

The sharp rise over several years in the proportion of young persons participating in the labour force is one aspect of the major shifts in job market structure that have occurred over the last decade. Combined with the strong expansion in the share occupied by women, this has meant that adult males, who have a relatively stronger attachment to the labour market and therefore generally lower measured rates of unemployment, have been constituting a progressively smaller share of the labour force. Thus in 1966 men aged 25 years or more accounted for 55 per cent of the labour force and 43 per cent of the total reported as unemployed, but by 1976 these proportions had dropped to 48 per cent and 28 per cent, respectively.

Accordingly, while recent measured rates of unemployment are very high by historical standards, it should be noted that any single measure of unemployment that does not make allowance for changing demographic and institutional factors will not be an accurate indicator over time of the degree of slack in labour markets. In particular, it is clear that largely because of the shift in the demographic composition of the work force and the liberalization of unemployment insurance benefits in the early 1970s, the rate of measured unemployment associated with a given degree of labour market tightness is certainly considerably higher now than some years ago.

Incomes, Costs and Prices

While the rise of about 12 per cent in aggregate money income (GNP) in the course of 1976 was the same as the year before, a distinct slowing occurred from the first to the second half; in the latter period the increase ran at an annual rate of under 10 per cent. A similar slowing was evident for labour income, which accounts for about three fifths of total GNP. Both corporate business income and book profits were appreciably lower by the end of 1976 than a year earlier, while the net accrued earnings of farm operators sustained another drop from the peak reached in 1974.

A special factor in the strength of labour income in 1976 was the heavy incidence of retroactive payments resulting from the delayed settlement of new wage contracts. These were particularly prominent in the Quebec public sector in the second and final quarters of the year. Since such payments properly accrue to earlier periods, their concentration in 1976 exaggerates slightly the rise in average income per worker attributable to that year. Still, even after setting aside extraordinary retroactive payments, labour income per worker in 1976 averaged close to 12 per cent more than in 1975.

Short-term movements in average weekly earnings are somewhat erratic, complicating the detection of shifts in trend, but a deceleration in the rate of increase does appear to have developed in the course of 1976. In the second half of the year the rise in average weekly earnings in the private non-farm economy slowed to an annual rate of 10 per cent, the lowest rate of increase since late 1973.

A slower advance in average earnings would be expected to ensue from the pronounced downward trend that had developed earlier in the size of newly negotiated wage settlements under major collective bargaining agreements. In the first nine months of 1975 these settlements provided for average annual increases in base rates of pay over the life of contracts of 18 per cent, with first-year increases averaging 22 per cent. Since the autumn of 1975, when the anti-inflation program was introduced, the average size of new wage settlements has diminished with each quarter. In the final quarter of 1976 the average increase over the life of contracts was slightly above 8 per cent, with a first-year adjustment of marginally under 10 per cent. Since wage settlement statistics cannot take account of the potential impact of cost-of-living clauses, they tend to understate the increases in earnings implied. However, it may be noted that a sharp deceleration is also evident in the size of wage settlements in collective agreements that do not incorporate such clauses. In the fourth quarter of 1976 the average increase over the life of contracts for such agreements was down to 9½ per cent.

Thus there is clear evidence that increases in money wages have been brought progressively into conformity with the guidelines being implemented by the Anti-Inflation Board. What the path of money wages, and therefore prices, would have been in the absence of controls cannot of course be established with certainty, but there is reason to believe that the increase in average wages for at least the most recent months has been smaller than would otherwise have occurred.

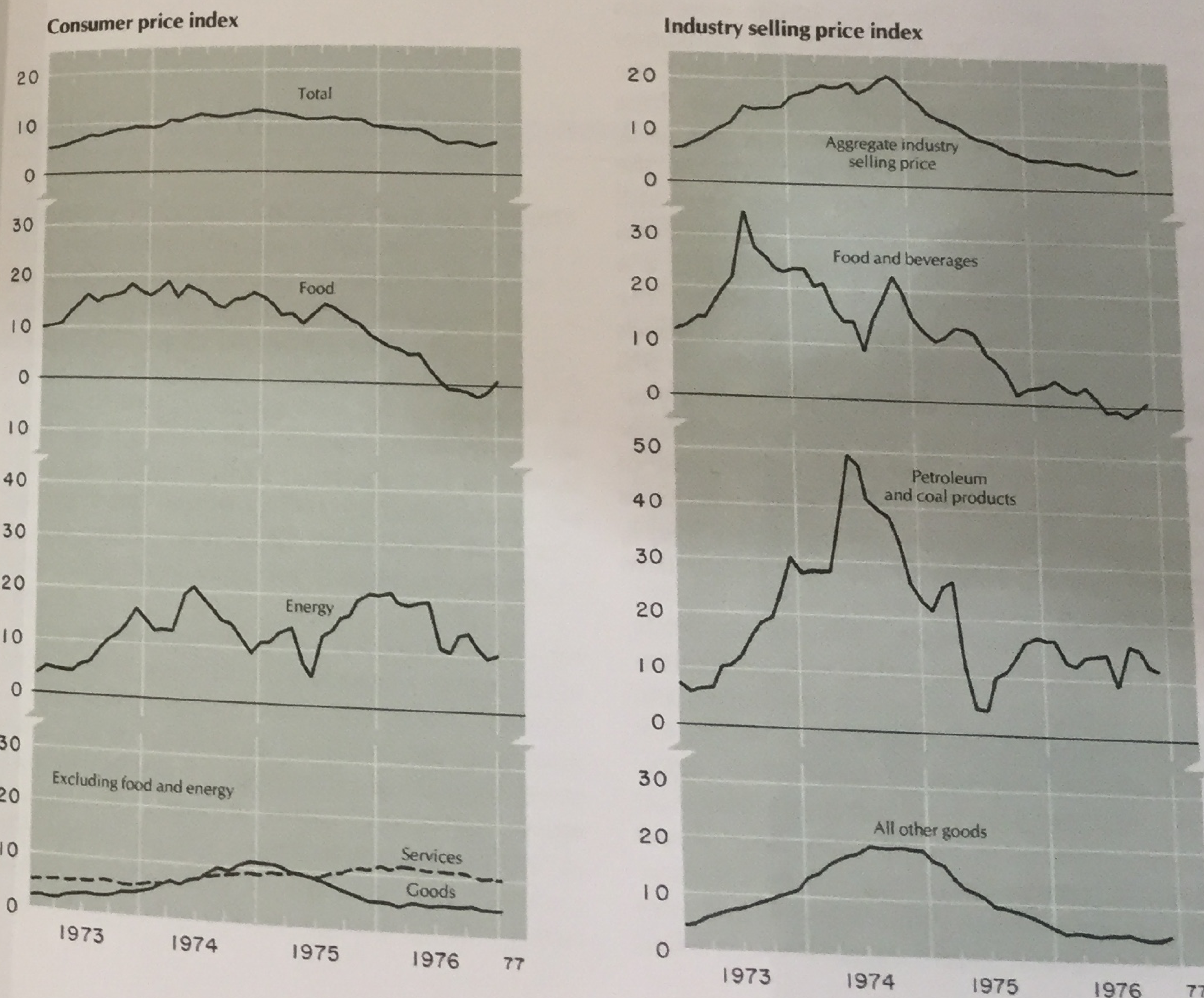
Part of the sluggishness in business earnings in 1976 is clearly attributable to the existence of limitations on cost passthrough and profit margins. However, the indications are that for the most part businesses were operating some distance below these limits, implying that demand and cost conditions were the critical factors restraining profits. Soft markets appear to have been particularly important in the weakness of earnings in capital goods industries. Also the effects of industrial disputes, in terms of man-days lost running at record rates at least up to the autumn, were bound to depress profits.

As a result of the better productivity performance, the uptrend of unit labour costs appears to have moderated slightly in 1976 if allowance is made for the effect of retroactive wage and salary payments; excluding these the rise in

wages and salaries per unit of output over the four quarters of 1976 was 10¼ per cent compared with an advance of 11½ per cent during 1975. The major impetus to the improvement in the domestic price performance came from the special impact for consumers of exceptionally large supplies of food for the domestic market, together with the easing of the prices of internationally traded goods.

Those commodity prices that are relatively sensitive to demand conditions on balance drifted down further in 1976. There was a brief spurt in the spring and early summer, particularly apparent in metal prices in response to expectations of a firming of world industrial demand, but in the second half of the year a further moderate decline took place. With the perceived slackening in the growth of industrial activity, metal prices tended to recede from mid-year peaks, and this coincided with weakness in meat and grain prices reflecting increased supplies. These downward pressures

Rates of Change in Domestic Prices
Percentage change, 12 months ending



more than offset the strength that was evident to various degrees in other areas, notably some tropical food products and natural fibres. Prices of finished goods entering international trade also rose more slowly in 1976. In this environment, given the relative firmness of the external value of the Canadian dollar through most of the year, both export and import prices, and therefore the prices of Canadian domestic production sensitive to world trading conditions, showed relatively modest increases.

These developments exerted a dominant impact on Canadian industry selling prices which continued to show progressively smaller rates of increase during 1976. In the last quarter of the year the total index was only 4 per cent higher than a year earlier. The same forces were also very evident in the movement of consumer prices. By the end of 1976 and early 1977 the twelve month increase in the Consumer Price Index was down to approximately 6 per cent, having been as low as 5.6 per cent in the autumn. However, retail food prices were still about the same level as a year earlier, and excluding food the rise in the CPI was about 8½ per cent compared with 9¾ per cent in the course of 1975. The cost to consumers of goods other than food or energy products was only 5¼ per cent higher at the end of 1976 than a year earlier but the prices of services, where labour costs are a comparatively large component of total costs and where direct pressures from international competition are relatively weak, were still running about 11 per cent higher than twelve months before.

Monetary and Financial Developments

Monetary Policy and Money Growth Targets

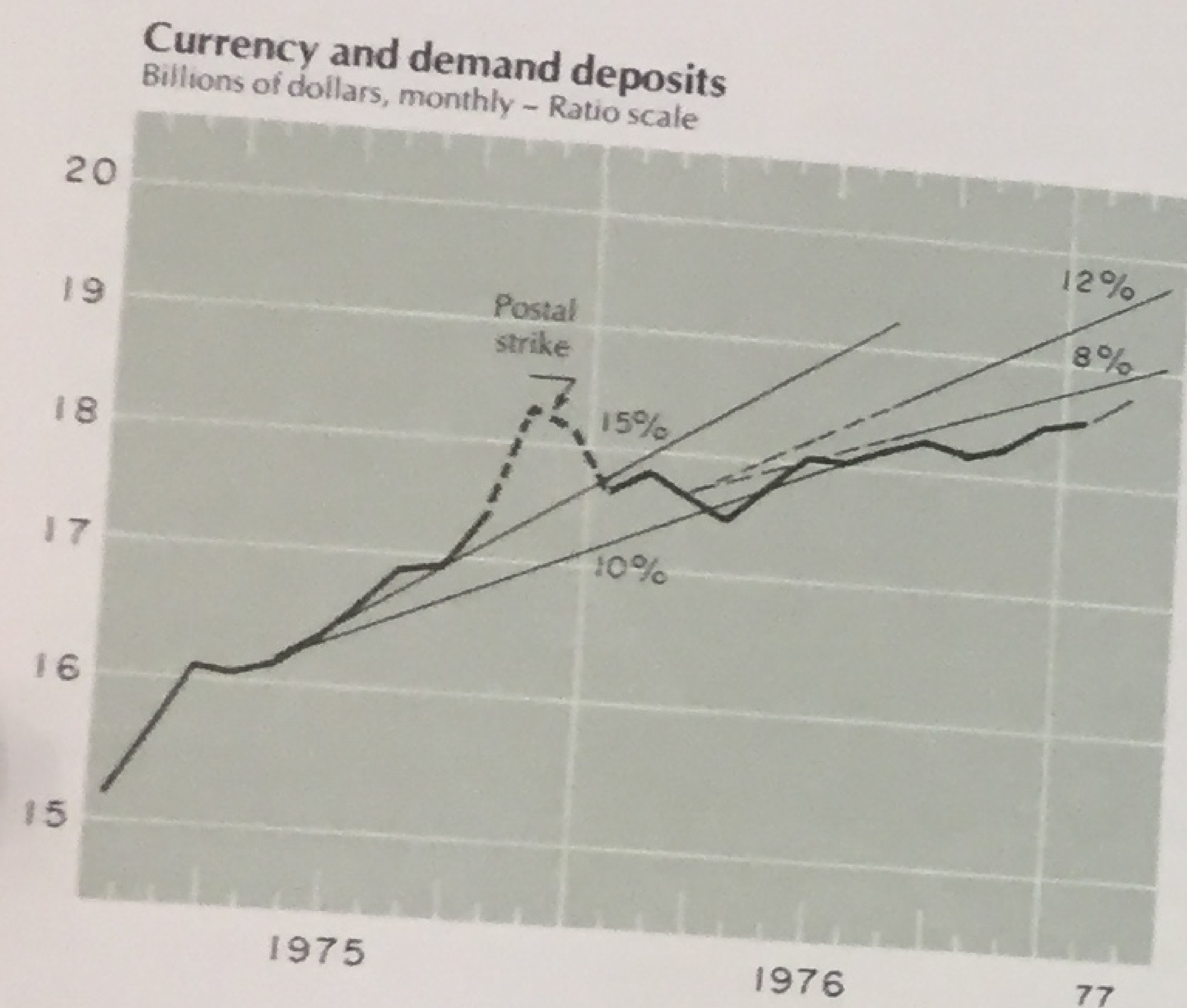
For some time now Canadian monetary policy has been directed towards maintaining a rate of monetary growth sufficient to accommodate a reasonable rate of economic expansion accompanied by declining inflation. In practice the pursuit of this objective has been regarded as involving a gradual but continuing decline in the trend rate of growth of currency and chartered bank demand deposits or M1 – a definition of the money stock essentially limited to the basic forms of money used for making payments in Canada.

In the autumn of 1975 the Bank of Canada for the first time announced publicly a target range for monetary expansion. The Bank initially undertook to try to keep the trend rate of growth of M1 well below 15 per cent a year but not lower than 10 per cent a year. This target range reflected the Bank's wish to avoid too sudden or drastic a reduction in the rate of monetary expansion. The moderate nature of this initial target is illustrated by the fact that an annual rate of money expansion no higher than 4 to 5 per cent would probably be adequate to accommodate the long-term average rate of growth of output in Canada if there were no inflation.

On the basis of past relationships, monetary growth at about the mid-point of the target range – say 12 per cent a year – was judged to be sufficient to accommodate a continuing rate of growth in the dollar value of national income of roughly 13 to 14 per cent at unchanged interest rates. Whether or not a flow of aggregate spending of this magnitude would in fact generate a satisfactory rate of growth of output and employment would depend essentially on the behaviour of wages and prices. If increases in wage costs and prices continued at undiminished rates, the level of aggregate spending would tend to be higher than could be accommodated by the growth of money at the target rate and interest rates would have to rise. In these circumstances higher interest rates would

Money Supply and Target Growth Rates

Seasonally adjusted



tend to restrain the growth of spending and thereby moderate the rate of price increase. To the extent that existing rates of wage and price increase slackened, however, interest rates would not have to rise; indeed, if progress in reducing inflation were sufficiently rapid, they would decline, and production and employment would be encouraged to grow more rapidly.

What actually happened over the period from the second quarter of 1975 to the first quarter of 1976 was that the dollar value of GNE rose at an annual rate of more than 17½ per cent. Under these conditions the public's desired holdings of currency and demand deposits also rose very strongly and throughout the period there was a persistent tendency for the growth rate of the money supply to exceed the upper limit of the Bank's target range. The action taken by the Bank to counteract this tendency consisted of two successive upward adjustments of the level of short-term interest rates in Canada – the first early in September 1975 and the second early in March 1976.

During the second quarter of 1976 the growth rate of the money supply slowed abruptly, and this brought its trend rate of increase since the base period down from around 15 per cent a year to around 10 per cent a year, the lower limit of the then existing target range, where it remained through the summer months. In part this slower growth of the money supply reflected the fact that after the first quarter the rapid rate of increase in the dollar value of GNE also slowed down considerably through to the end of the year.

The downward revision of the Bank's monetary growth target announced in August envisaged a trend rate of growth of currency and demand deposits, measured from a base period level centred on March 1976, of between 8 per cent and 12 per cent a year. This revised target reflected the judgement that if past relationships continued, M1 growth in this range would be consistent with reasonable growth of real output together with a continuing decline in the rate of inflation.

Shortly after the announcement of this new target range it became apparent that the actual path of M1 growth was running below the lower limit of the range and this trend persisted through the balance of the year. Although the slowing of the growth of M1 during the latter part of 1976 was somewhat more pronounced than could be attributed solely to the weakening economic situation, there was no doubt that some corrective action was needed. This action took the form of three successive downward adjustments of short-term interest rates in November and December 1976 and in February 1977. As of late February it was still much too early for these interest rate reductions to have had their full impact in raising the trend of money supply growth more closely into line with the Bank's economic objectives. The growth of M1 from the March 1976 base period to January 1977 amounted to an annual rate of 6 per cent; a preliminary estimate of the level of M1 for February is somewhat closer to the target range.

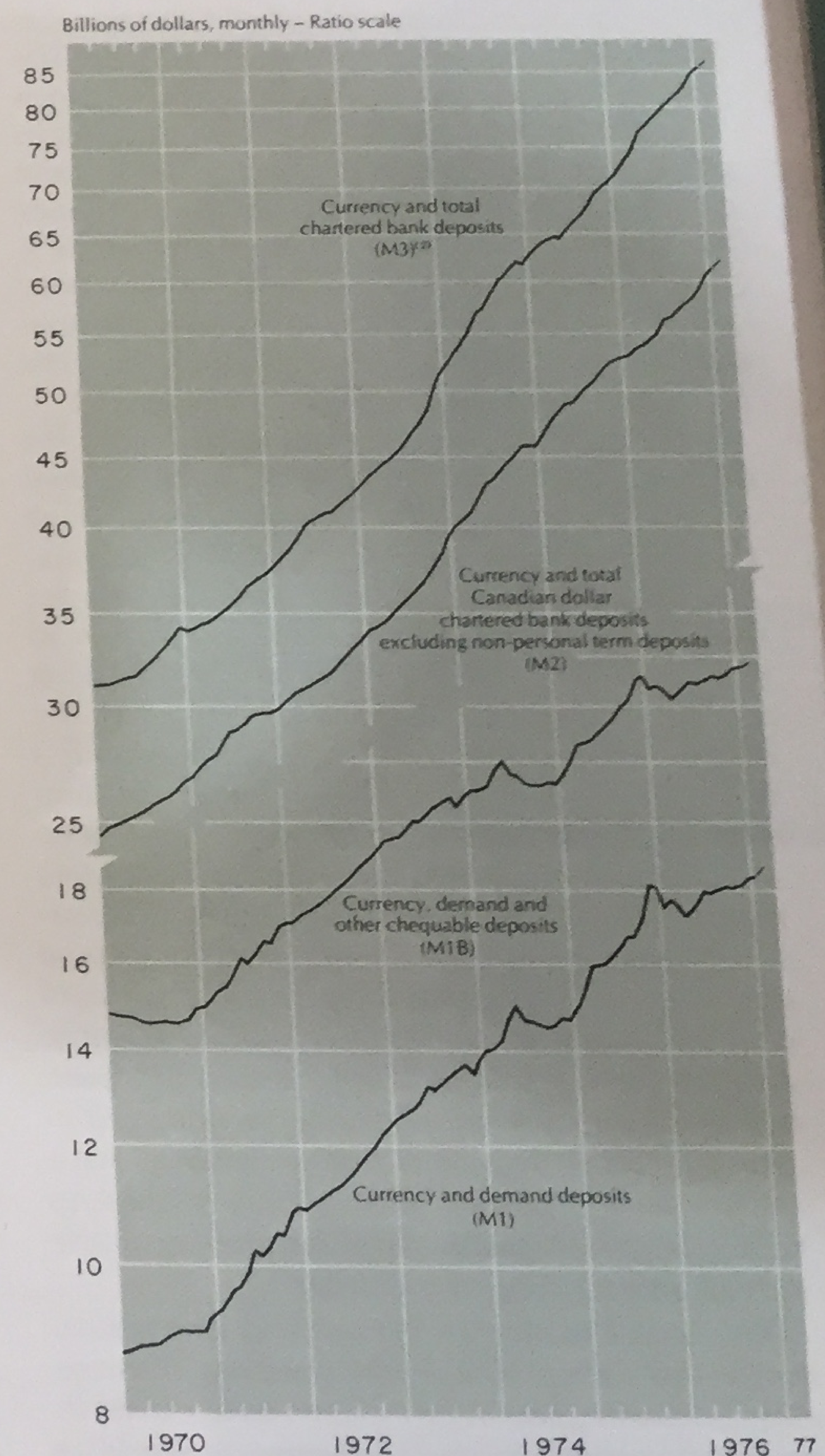
Given the levels of GNE and short-term interest rates recorded over the course of the year, the demand deposit component of the M1 series displayed a growing tendency during 1976 to fall somewhat short of the levels that might have been expected on the basis of our knowledge of past relationships. A similar tendency has been apparent for some time in the behaviour of demand deposits in the United States. There is thus some reason to suspect that the average amount of demand deposits per dollar of income that the public finds it convenient to hold for transactions purposes may have been declining a bit faster recently than it was in earlier years. Although the reasons for this are not entirely clear at this time, the inference is that the recent shortfall of M1 below target may be of less economic significance than a literal reading of the figures would suggest. In the months ahead the Bank of Canada will be watching carefully to see whether this tendency appears to be a continuing phenomenon or merely a transient aberration. If this faster than usual decline in desired money balances per dollar of income reflects a lasting change in the public's money-holding habits, the changed relationship to income will have to be taken into account in setting future targets for monetary expansion.

The Trend of Broader Monetary Aggregates

The behaviour of the broader measures of the money supply that include savings and time deposits at chartered banks in addition to currency and demand deposits was in marked contrast to that of M1 during 1976. The growth rates of these more broadly-defined monetary aggregates were not only a great deal higher than that of M1 but they also showed little if any deceleration over the course of the year. The growth of three more inclusive monetary aggregates is compared with that of M1 during recent years in the accompanying chart. It will be immediately apparent that the addition of chequable savings deposits at chartered banks to M1 balances (in a monetary aggregate labelled M1B)

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

Seasonally adjusted



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

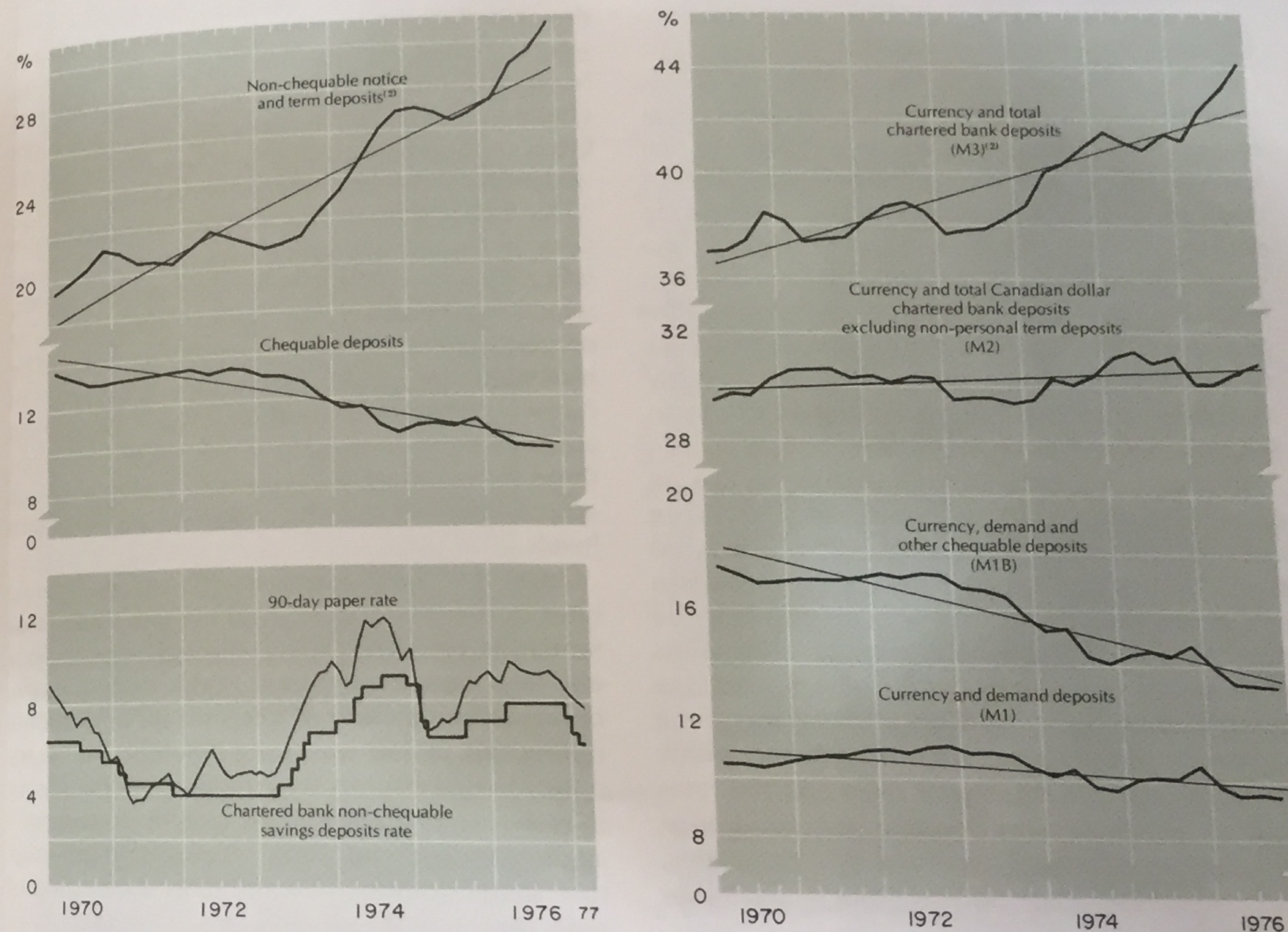
merely lowers the trend rate of increase of the "money supply" without significantly changing its growth pattern over time. The further inclusion, however, of all other types of savings and term deposits at chartered banks in an aggregate (labelled M3) greatly changes the picture. The trend rate of increase of this broad aggregate is not only very much higher than that of M1 but its pattern of growth over time is also quite different. An intermediate definition of money labelled M2, which includes all chartered bank personal savings deposits as well as currency and demand deposits but which excludes non-personal term deposits, displays much the same behaviour over time as the broadest aggregate.

To highlight the very different behaviour of the two main components of broadly-defined monetary aggregates, the ratio of chartered bank savings and term deposits to Gross National Expenditure is contrasted with a similar ratio for chequable deposits over the past seven years in the chart on page 25. There are two striking features of the comparison. The first is the strongly rising trend over time of the public's holdings per dollar of GNE of savings and term deposits, the interest rates on which have been set at levels designed to keep them more or less competitive with the rates available on alternative money market instruments. This is in marked contrast with the downward trend, per dollar of GNE, of the public's holdings of chequable deposits, on which the interest return has been typically either zero or relatively low and seldom changed. The inference is that as incomes have risen over this period most people wished to hold a larger proportion of their income in the form of interest-earning deposits.

The second feature is the marked divergence during the period in the way holdings of these two categories of monetary claims have varied in the short-run around their longer run trends, a divergence that clearly has been related to their very different responses to movements in the general level of short-term interest rates. When the general level of interest rates has been rising, the public has been prepared to reduce its holdings per dollar of income of low-yielding chequable deposits more rapidly than usual in order to take advantage of the higher return available on other interest-earning financial claims. The banks have usually been faced with an accelerating demand for loans in periods of rising interest rates and have responded to slackening inflows of chequable deposit money by stepping up their efforts to attract inflows of higher cost savings and term deposits. In the process the banks have tended to bid up the interest rates they were prepared to pay for deposit money. The public has been induced by these attractive bank deposit rates to increase its holdings of chartered bank savings and term deposits per dollar of income at the expense of both transactions balances and holdings of other forms of liquid financial claims. Although the rapidly rising cost of deposit money has been largely passed along to bank borrowers, the process typically seems to have resulted in a temporary expansion of the banks' share of the total market for credit. When the general level of interest rates has been moving downward these trends have been reversed. The banks became less eager to attract high-cost deposit money and offered less competitive rates on savings and term accounts. The public's response was to increase its holdings of liquid financial claims issued by others and also to be less concerned by the interest returns foregone in holding transactions balances per dollar of income larger than they otherwise would to meet their immediate needs for effecting payments.

The outcome of these conflicting short-run influences on deposit growth has been reflected in the behaviour of the broader monetary aggregates which, unlike M1, normally have grown at somewhat higher rates than that of GNE and typically have grown even faster during periods of generally rising interest rates. In view of the rate at which the money value of national income was increasing during 1976 despite a weakening economy, and given the interest rate

Chartered Bank Deposits and Monetary Aggregates[1] as a Ratio of GNE
Seasonally adjusted, quarterly averages except for interest rates



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

increases on bank deposits that occurred in September 1975 and March 1976, it should not be too surprising that the broadly-defined monetary aggregates continued to grow at rates well in excess of 15 per cent a year during most of 1976.

The fact that the more broadly-defined aggregates are composites of several distinct kinds of monetary claims that respond in substantially different ways to changes in income and interest rate levels means that their behaviour is relatively complicated both to interpret and to predict.

So far the Bank has not found it feasible to make much use of these broader aggregates as operating guides for monetary policy and has found them much less useful than the simpler aggregate, currency and demand deposits.

Interest Rate Developments

During the winter and early spring of 1976, interest rates were affected by two opposing forces: a declining trend in interest rates in the United States and the restraining pressure of Bank of Canada actions to moderate the strong demand for money and credit. An initial decline in short-term interest rates was reversed by early February and rates began to increase under pressure from Bank of Canada operations. This move to higher rates was reinforced in early March by an increase in the Bank Rate from 9 to 9½ per cent on March 8.

Following the Bank Rate change there was an upward adjustment in the lending and borrowing rates of financial institutions. The chartered banks' prime lending rates were increased by ½ of a percentage point to 10¼ per cent while the rates paid on non-chequable savings accounts were raised, eventually by ¾ of a percentage point, to 8 per cent. As a result there was some narrowing of the interest rate margins on which the banks operate. Mortgage rates and the rates paid on personal term deposits, including trust company guaranteed investment certificates, also increased but not as much as other institutional interest rates.

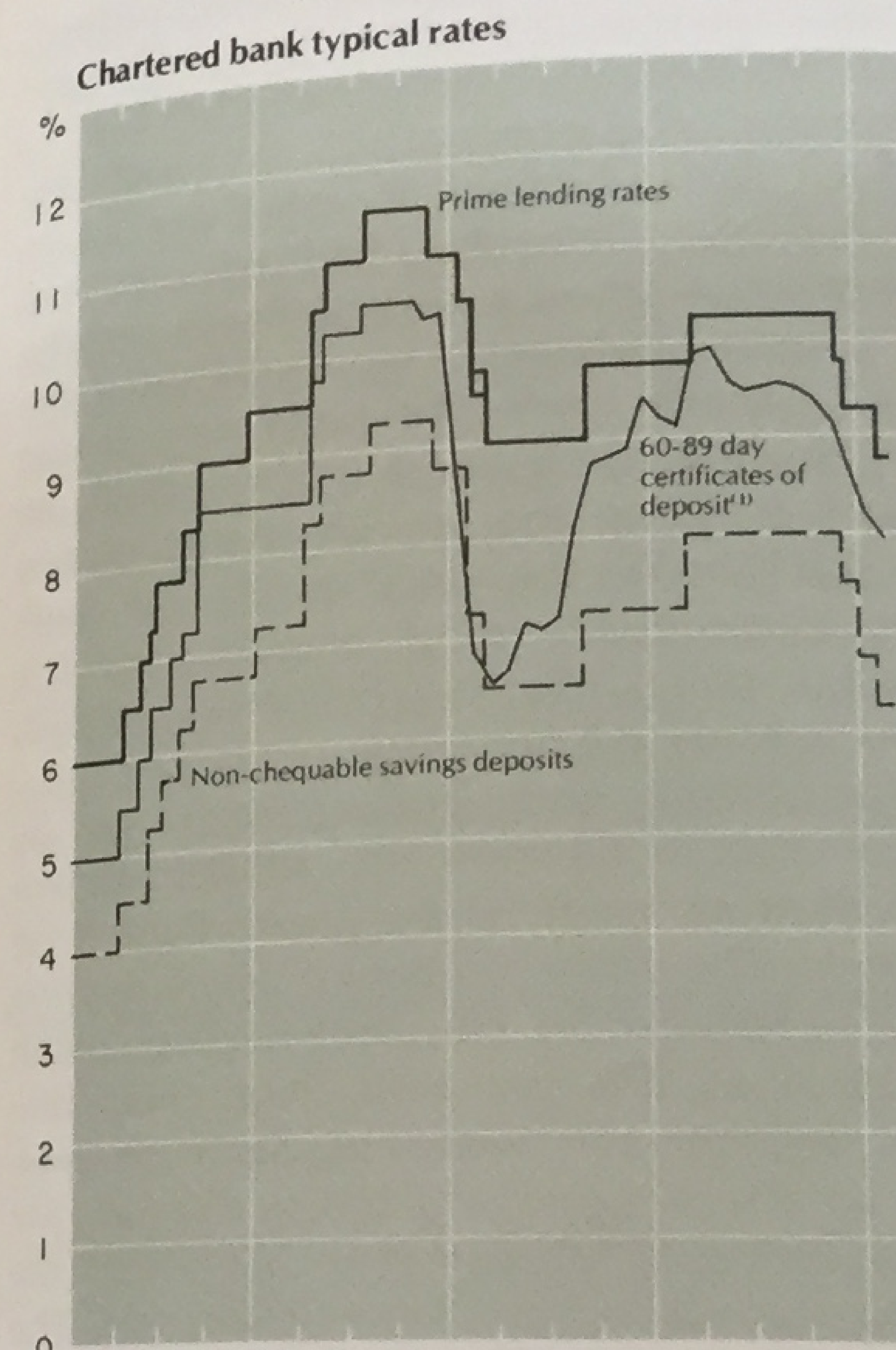
The demand for bank loans was rather strong in this period; businesses in particular needed to finance the large first quarter accumulation of inventories. The chartered banks responded to the strong loan demand and to their rapidly diminishing liquidity by bidding vigorously for large non-personal term deposits. The rates on these deposits increased by almost a full percentage point to as high as 10¼ per cent and in the process pushed short-term market interest rates sharply higher. The reduced attractiveness of commercial paper rates caused borrowers in that market to fall back on their lines of credit at the chartered banks thereby increasing still further the demand for bank loans and raising expectations of another increase in prime rates. For a time Bank of Canada operations were directed towards resisting this rise in market interest rates. By the second week in April, however, this resistance had taken effect and chartered bank term deposit rates for large blocks of funds fell back to about 9¾ per cent, with other short-term interest rates following.

The movement to higher levels of short-term rates in the early months of 1976 brought to a halt a downward trend in long-term bond yields, which by February had fallen about ½ of a percentage point from the 1975 peak. The increase in the Bank Rate and the expectations of further increases caused a temporary upward adjustment in long-term bond yields but once those expectations had subsided yields fell back and in April were only slightly above February levels.

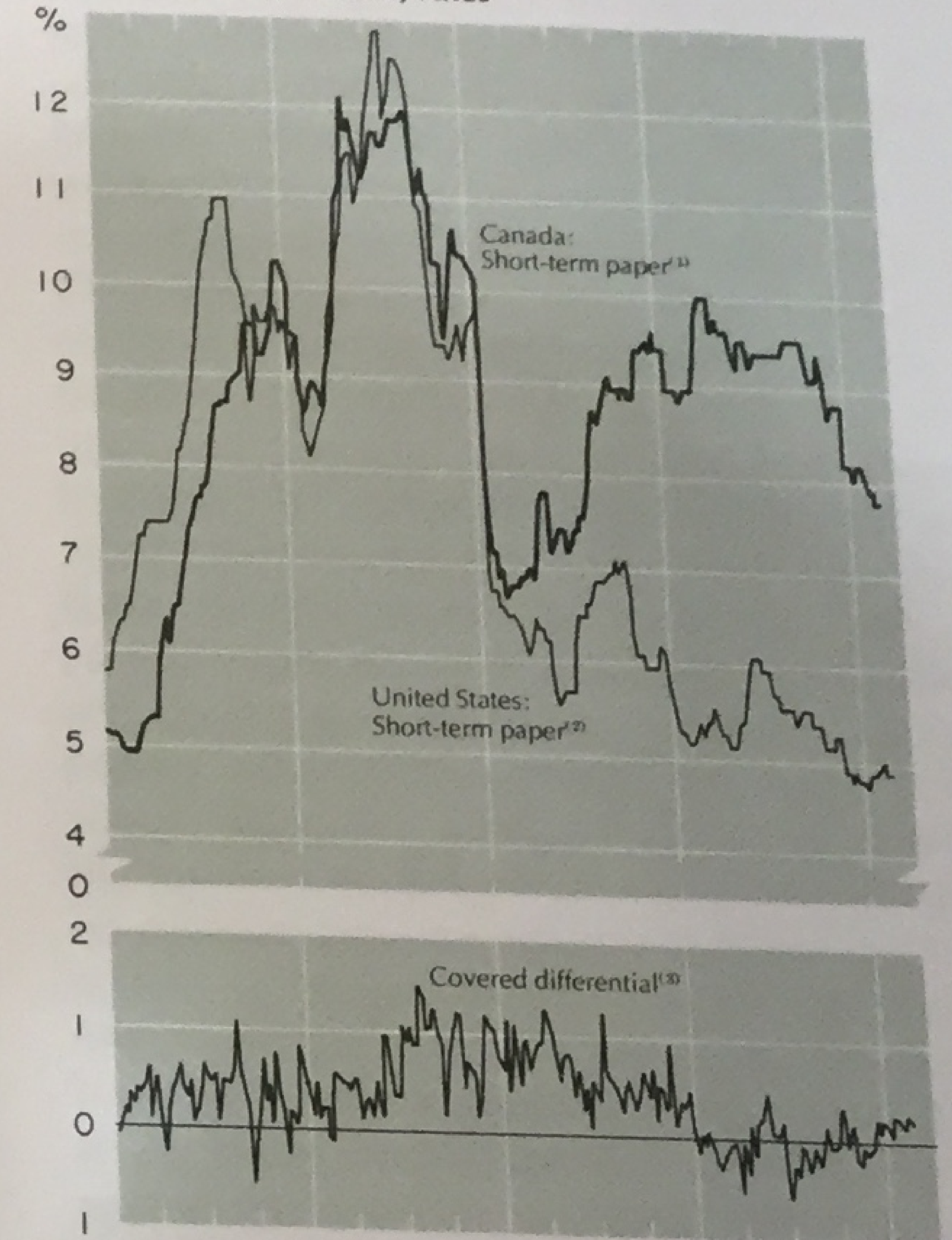
Once the fluctuations in short-term interest rates during March and April abated, these rates remained relatively stable through the summer and into the early autumn. In the United States, however, the pattern of interest rate movements during this period was quite different. Monetary policy in that country was tightened in the spring in response to a more rapid growth in monetary aggregates and short-term market interest rates rose sharply during May and June. By the end of June, however, the growth rates of the aggregates had moved back inside the target ranges set by the Federal Reserve Board and interest rates began a decline that continued to the end of the year. This decline in U.S. rates widened substantially the spread between short-term interest rates in Canada and the United States and exerted downward pressure on Canadian rates. Central bank operations in Canada during the summer were designed to moderate this pressure. At the same time, however, the forward discount on the Canadian dollar in the foreign exchange market offset the more attractive

Interest Rates

Short-term

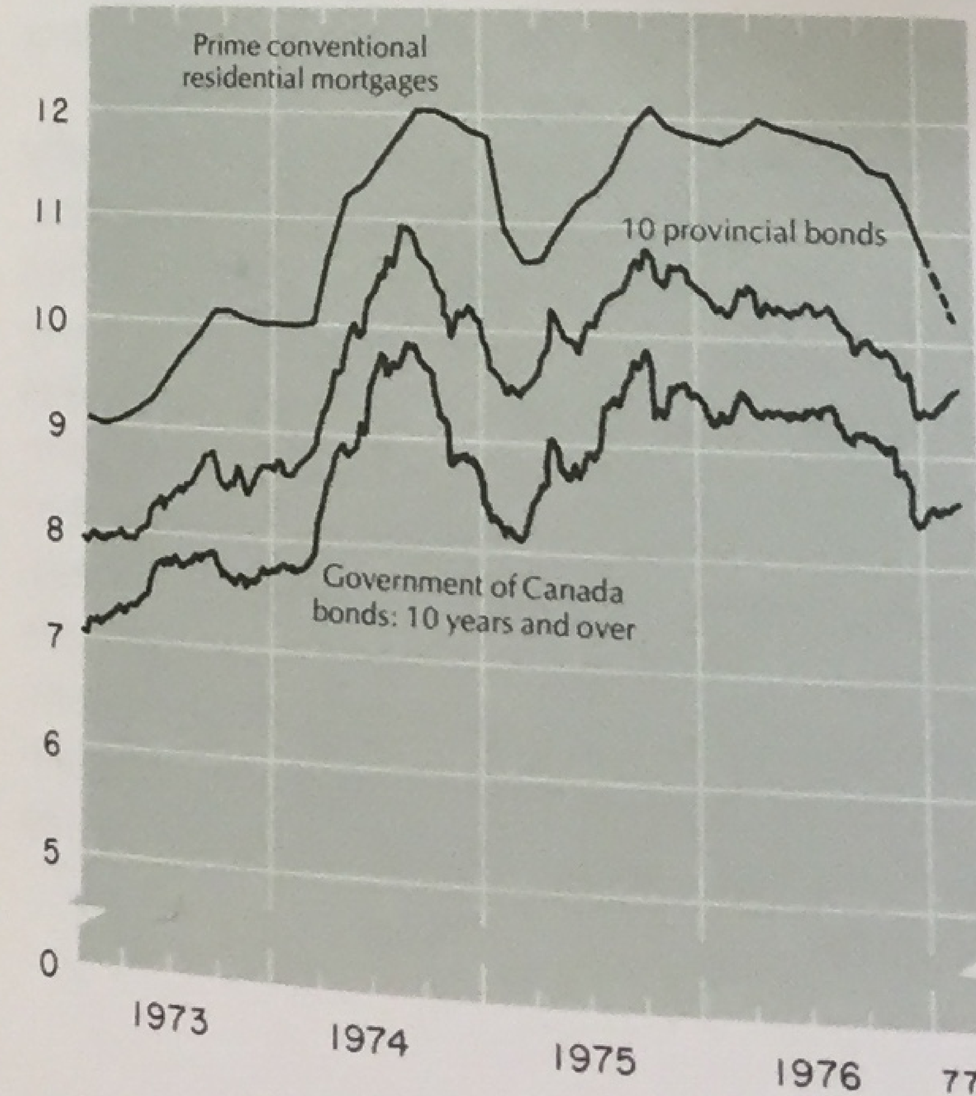


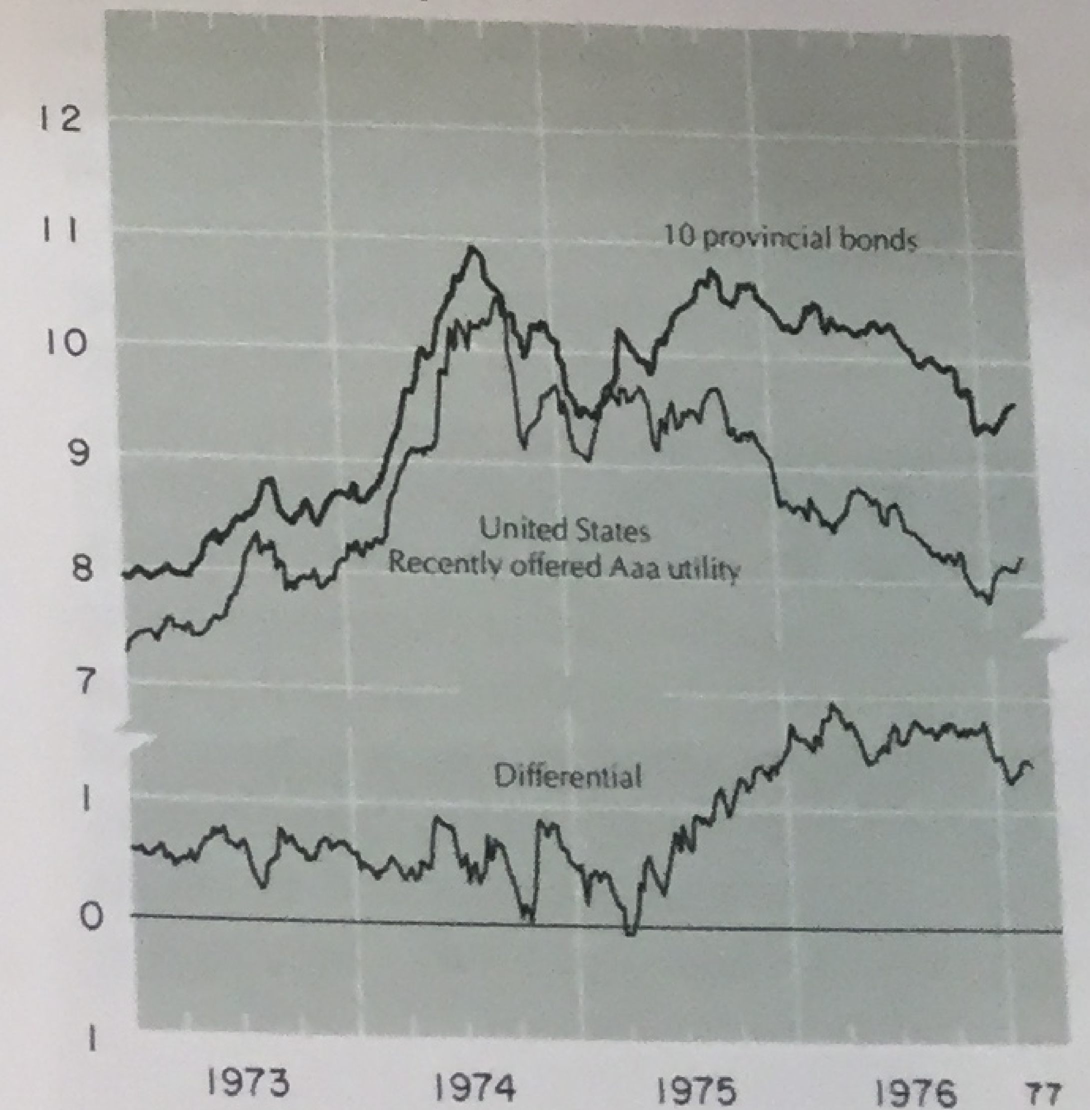
(1) Prior to November 1974, rates prevailing under the Winnipeg agreement.



(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





short-term interest rates in Canada and as a result there was no continuous incentive during this period for inflows of short-term funds from abroad that were covered for exchange rate risk.

Long-term interest rates in Canada were also stable through the spring and summer. However, long-term rates began to fall in late August in line with a decline in U.S. rates that lasted until December. While there were some fluctuations during the year in the differential between Canadian and U.S. long-term interest rates, the spread that had developed by the first quarter of 1976 was in general maintained until late in the year. The attraction of lower interest rates abroad, given the size of credit demands of Canadian borrowers, resulted in a greatly increased reliance on foreign investors as a source of financing in 1976. This inflow of funds contributed to the downward movement of interest rates here and to the upward pressure on the exchange rate for much of the year.

In the final months of 1976, the sluggish growth of the economy and the related slow growth of M1 caused the Bank to withdraw some of its resistance to the tendency of interest rates to decline. With the Canada Savings Bond campaign in progress, however, further action to lower interest rates would have been difficult. By November 22, the desired quantity of funds had been raised and the bonds were withdrawn from sale. At the same time, the Bank Rate was reduced from 9½ to 9 per cent. The decline in short-term market rates as indicated by rates on 90-day finance company paper was about ¾ of a percentage point from the beginning of October to the final week of November. This sharp fall in interest rates, in conjunction with the uncertainty that followed the Quebec election in mid-November, contributed to a major readjustment in the Canadian dollar exchange rate in an environment in which the Canadian dollar had been widely regarded as being overvalued in view of the size of the current account deficit. For a time both foreign exchange and domestic financial markets were unsettled. Once somewhat more orderly markets were re-established, a second reduction in the Bank Rate to 8½ per cent was announced effective December 22.

At the end of January 1977, although the impact of the reductions in interest rates in November and December had not yet had sufficient time to exert a strong influence on the public's desired holdings of money balances, the Bank of Canada made the judgement that a further decline in interest rates would be necessary to bring the growth of the money supply back inside the target range. The Bank Rate was reduced a third time by ½ of a percentage point, effective February 1, 1977, bringing it down to 8 per cent.

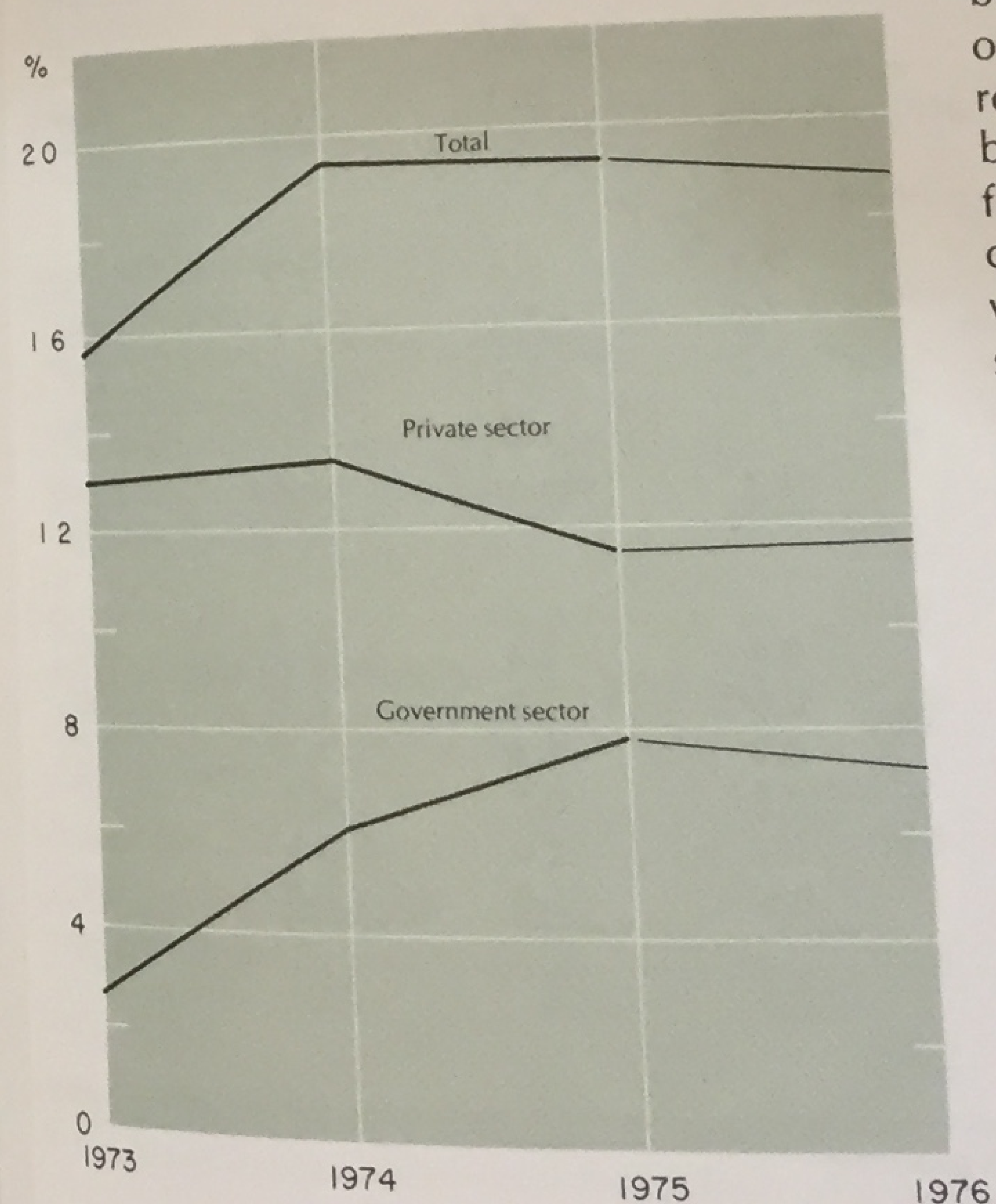
The borrowing and lending rates set by financial institutions were also adjusted downward following each of the three Bank Rate reductions. The chartered banks' prime lending rates were reduced by 1½ percentage points in three steps to 8¾ per cent. Non-chequable savings deposit rates were cut, again in three stages, by 1¾ percentage points to 6¼ per cent and personal term deposit rates offered by the banks were lowered by the same amount. The banks thereby widened once again the interest rate margins which had been narrowed the previous March. Residential mortgage rates declined by 1½ percentage points in this period, bringing the typical rate on conventional mortgages to 10¼ per cent and on NHA mortgages to 10 per cent.

Short-term market interest rates also generally declined in line with the Bank Rate reductions. Measured from the point in October when short-term market rates began to fall to early February, the drop in most of these rates was approximately 1½ percentage points. Long-term bond yields dropped rather sharply in December in response to movements in short-term rates. More recently, however, long-term rates have not followed the further reduction in short-term rates but have instead tended to move up again in a climate of rising long-term rates in the United States.

Credit Flows and Financial Institutions

The total amount of new borrowing undertaken by the major non-financial sectors in the economy increased in 1976 at about the same rate as the growth of Gross National Expenditure. However, the level of new borrowing as a proportion of GNE has been rather high by past standards following a sharp increase in 1974. The main reason for the increase in the ratio of total borrowing to national expenditure in 1974 was the large increase in the borrowing requirements of the various levels of government and their enterprises. In 1975 government financing needs again increased significantly in absolute terms and maintained the ratio of total borrowing to national expenditure close to the high 1974 level despite lower private sector borrowing. This past year, however, the increase in the dollar volume of borrowing undertaken by the major non-financial borrowers was largely accounted for by the private sector and in particular by corporate business borrowers. The moderate increase in business fixed investment combined with a substantial swing in inventories in the first quarter of the year in the face of a small accumulation of internally-generated funds contributed to increasing the borrowing requirements of non-financial corporations in 1976 by $1.6 billion. While these corporations also increased their holdings of financial assets and undertook some restructuring of their outstanding debt, this was not sufficient to restore liquidity ratios to pre-1974 levels.

Funds Raised by Major Non-financial Borrowers
As a percentage of GNE



The most striking development with respect to the flows of credit in 1976 was a marked change in the relative importance of major sources of financing. The proportion of total financing obtained from abroad by major non-financial borrowers, which had increased from 9 per cent of total financing in 1974 to 16 per cent in 1975, rose to 22 per cent in 1976. At the same time, borrowing involving intermediation by domestic financial institutions increased from 61 to 68 per cent. Increases in these two sources of financing were accompanied by a decline in the direct security purchases of domestic investors.

The widening of long-term interest rate differentials between Canada and abroad, which occurred in 1975 and was maintained for most of 1976, provided a large incentive for Canadian borrowers to issue securities outside Canada and for non-residents to invest in domestically-issued securities. In addition, the continued high level of total borrowing requirements encouraged Canadian borrowers to turn to foreign markets in order to place new security issues in the desired size and quantity. Although the net amount of marketable securities issued in Canadian markets in 1976, taking account of financing by both financial institutions and other borrowers, surpassed the record levels of 1975, the total

Funds Raised by Major Non-financial Borrowers

Borrowers	Billions of dollars 1973	1974	1975	1976
Non-financial businesses				
loans	5.1	6.4	4.0	6.3
short-term paper	– 0.2	1.4	0.3	0.4
bonds	0.7	1.2	2.3	2.6
stocks	0.4	0.4	0.9	0.9
direct investment from abroad	0.8	0.7	0.6	– 0.5[e]
Mortgage borrowers[1]	6.3	6.2	7.2	7.8[e]
Consumers	2.8	2.9	3.3	3.9[e]
Sub-total private borrowers	15.9	19.3	18.5	21.4[e]
Provinces and municipalities[2]				
loans	0.4	0.3	0.4	0.1
short-term paper and treasury bills	– 0.1	– 0.1	0.3	– 0.2
bonds — purchased with CPP funds	1.0	1.2	1.4	1.5
— other	2.0	3.1	6.5	7.9
Government of Canada				
treasury bills	0.6	0.9	0.6	1.6
marketable bonds	– 0.2	0.8	0.7	1.8
Canada Savings Bonds	– 0.4	2.4	2.7	0.8
Sub-total government	3.3	8.7	12.6	13.4
Total Borrowing	19.2	28.1	31.1	34.8[e]
Channels of financing				
Financial institutions				
loans — banks	7.1	8.0	7.7	9.8[e]
— other institutions	7.0	7.3	6.7	7.9[e]
security purchases — banks	0.0	1.4	– 0.0	1.5[e]
— other institutions	2.5	2.1	4.5	4.4[e]
Sub-total financial institutions	16.6	18.8	18.9	23.7[e]
Securities purchased directly by domestic investors				
non-marketable	– 0.4	2.4	2.9	0.9
other	– 0.6[e]	1.5[e]	0.7[e]	– 0.4[e]
Securities purchased by non-residents	0.5[e]	1.8[e]	4.5[e]	8.2[e]
Direct investment from abroad	0.8	0.7	0.6	– 0.5[e]
Financing from government sector	1.7	2.0	2.6	2.3
Bank of Canada	0.6	1.0	0.8	0.6
Total Financing	19.2	28.1	31.1	34.8[e]

e: estimate
(1) These are principally mortgages secured by residential property. The figures exclude mortgage lending by governments and their agencies, notably CMHC, which is reflected in the financing requirements of the respective governments.
(2) Includes borrowing by government enterprises. Loans from the Government of Canada are excluded.

amount of net new security issues placed abroad by Canadians increased to more than $8 billion, twice as much as in 1975. While the major share of the funds raised in foreign markets came from the United States, about one third came from net new issues placed in the rapidly growing Euro-market, in large part by financial institutions and provincial enterprises. Canadian borrowers were attracted to that market partly because funds were available at somewhat longer term than in previous years and also because a market had developed for bonds denominated in Canadian dollars. In addition foreign investors purchased about $1½ billion of securities in the Canadian market; OPEC countries accounted for an important part of these purchases. Not all of the proceeds of the long-term foreign currency borrowing were immediately converted into Canadian dollars. There were large increases during 1976 in foreign currency bank deposits of residents; at least in part these increases represented the proceeds of foreign borrowings being held to meet future requirements for U.S. dollars or, in some cases, balances that were perhaps being held in anticipation of a depreciation of the Canadian dollar.

The usual net inflow of direct investment capital from abroad became a net outflow in 1976, reflecting the relatively less attractive investment climate in Canada and some large purchases of foreign holdings in the Canadian oil, potash and aircraft industries by Canadian public agencies.

Major Assets of Financial Institutions[1]

	Billions of dollars Dec. 1976	Annual rates of change Years Dec. 1972 to Dec. 1973	Dec. 1973 to Dec. 1974	Dec. 1974 to Dec. 1975	Dec. 1975 to Dec. 1976
Deposit-taking institutions					
Chartered banks[2]	79.3	19	19	13	17
Mortgage loan companies associated with chartered banks	2.5	64	20	28	38
Trust and mortgage loan companies	22.9	21	16	17	18
Credit unions, caisses populaires and Quebec savings bank	15.9	24	16	23	21
Sub-total	120.6	21	18	15	18
Contractual savings institutions					
Life insurance companies	24.2	9	7	11	11
Pension funds	23.5	14	13	15	14
Sub-total	47.7	11	10	13	12
Sales finance and consumer loan companies	10.3	18	16	9	6
Total	178.6	17	16	14	16

(1) Figures for December 1976 are estimated, except for banks.
(2) Canadian dollar major assets; average of Wednesdays.

The net inflow of funds resulting from long-term borrowing abroad was larger than required to finance the substantial deficit on the current account of the balance of payments; as a consequence, the Canadian dollar continued strong until late in 1976. Thereafter, given the underlying balance of payments position, declines in interest rates as well as the initial market reaction to the results of the Quebec election contributed to a downward adjustment of the dollar.

The main reason for the larger degree of domestic financial intermediation in 1976 was the increased proportion of total borrowing accounted for by private sector borrowers, particularly business corporations, who typically channel more of their financing through financial institutions than do government borrowers. The higher level of borrowing by non-financial business corporations was largely in the form of increased bank loans. In addition, financial institutions increased their net purchases of securities last year, with the chartered banks accounting for most of the increase. About one half of the banks' security acquisitions was made up of corporate bonds and short-term paper. Although the remaining security purchases by the banks were Government of Canada bonds and treasury bills, this addition to the banks' liquid assets was not sufficient to prevent a fall in their combined free liquid asset ratio from 8.1 to 7.3 per cent during 1976. Security purchases by non-bank financial institutions in 1976 remained at the high level registered in 1975; it appears that for some institutions at least the somewhat slower growth of their mortgage disbursements during the last two years may have encouraged them to direct more of their funds to enlarging their security portfolios.

The growth in the assets of the major financial institutions taken as a group accelerated from 14 per cent in 1975 to 16 per cent in 1976 mainly because of the more rapid growth of the chartered banks. The mortgage loan companies associated with chartered banks were the only other group of institutions to expand substantially more rapidly in 1976 than in the previous year. The accelerated growth of their assets occurred despite a slower rate of growth of total residential mortgage lending in 1976 and these companies increased their share of that market.

Bank of Canada Operations

This section of the Report provides a summary record for 1976 and early 1977 of Bank of Canada operations related to the implementation of monetary policy and to the Bank's role as agent for the Government of Canada in the management of the public debt and in connection with the Exchange Fund Account. Note is also taken of the Bank of Canada's participation in recent international monetary arrangements.

Monetary Policy Operations

The Bank of Canada carries out its daily operations in the light of its views from time to time about the levels of short-term interest rates that will be most helpful to the achievement of its policy objectives. During 1976 cash reserve management on a daily basis was conducted in a more vigorous way than often in the past in order to have a more immediate impact on the level of short-term interest rates. The size and frequency of open market operations were also instrumental in providing direct resistance, when appropriate, to movements in interest rates and in facilitating orderly adjustments in financial markets to changes in the Bank Rate. A record of cash management by reserve periods is provided in Appendix Table II and the monthly record of Bank of Canada transactions in securities is presented in Appendix Table III.

During January and February 1976 the Bank of Canada pursued an increasingly stringent excess cash reserve policy in order to limit the decline in short-term interest rates in Canada, which was in part being induced by a downward trend in interest rates in the United States. Further restraint was introduced by net sales of short and medium-term bonds to the market from the Bank's portfolio and by reducing the Bank's holdings of treasury bills. The decline in interest rates was arrested in late January. They began to edge upward again in early February. This upward trend became stronger in late February and early March and the Bank Rate was raised from 9 per cent to 9½ per cent effective March 8, 1976. Short-term market rates immediately moved sharply higher and strong expectations of further increases developed. The Bank reacted by purchasing a sizeable amount of treasury bills in the market in an attempt to stabilize short-term market yields at the higher level. At the same time the amount of excess cash reserves provided to the banking system was increased significantly.

From mid-March through early April, the Bank intensified its resistance to further upward pressure on money market rates by purchasing a large amount of bankers' acceptances from the market. The level of excess cash reserves provided was also substantially increased for the second half of March and was kept very high in the subsequent averaging period, particularly at the beginning. Despite this high level of excess cash reserves and the substantial open market purchases by the Bank, money market rates continued to increase during the last half of March, led by rapidly rising rates on chartered bank certificates of deposit, and remained at these high levels into early April. This development

was related at least in part to a sharp decline in the liquid assets of the chartered banks during March and to a continued strong demand for loans. Moreover, expectations of another round of increases in the Bank Rate and in chartered bank prime loan rates became quite prevalent in the financial community. By the second week of April, however, the steps taken by the Bank of Canada were having their desired impact; upward pressure on interest rates abated and, with the banks bidding less aggressively for large deposits, most money market rates dropped back and then stabilized. As chartered banks began to rebuild their liquid asset positions and bought treasury bills, yields on bills began to decline. The Bank of Canada resisted this decline and became a seller of bills to the market in April.

In contrast to the upward movement of near-term money market rates during the spring, downward pressure on short-term Government of Canada bond yields had developed after mid-March, primarily as a result of sizeable purchases by non-resident investors in the market. As a result, during April, May and early June the Bank of Canada became a net seller of short to medium-term Government of Canada bonds.

From June through October the Bank's operations were designed to maintain the prevailing level of money market interest rates. This required restraint in the management of cash reserves throughout most of the summer as a decline in U.S. interest rates heightened anticipation by the market of lower rates in Canada. However, in late July and early August the Bank purchased short-term treasury bills from the market to temper a rise in treasury bill yields. In the latter part of August, when bill yields started to move downward again, the Bank provided resistance to this trend by selling bills. Short-term interest rates began to decline towards the end of October. The Bank of Canada eased its restraint on chartered bank cash reserve management and interest rates continued to decline gradually.

The Bank Rate was reduced effective November 22 by ½ of one percentage point to 9 per cent. The pace of decline in short-term rates had accelerated in anticipation of the Bank Rate change and, with rates continuing to move down afterwards, excess cash reserve settings were tightened. Over a four-day period straddling the end of November, however, the Bank purchased from the market very short-term treasury bills and bankers' acceptances in order to relieve some acute temporary pressures in the banking system. These acquisitions, together with further purchases of treasury bills and bankers' acceptances in mid-December, also served to offset some of the effect on cash reserves of the seasonal increase in note circulation.

Effective December 22, the Bank Rate was reduced by a further ½ of one percentage point to 8½ per cent. This second reduction came sooner than the financial community generally had anticipated. The yield on treasury bills immediately fell by about ⅜ of one percentage point and interest rates on other short-term market instruments dropped by ½ to ¾ of one percentage point. Strong expectations that a third reduction in Bank Rate would soon be made emerged in the financial community. While the Bank favoured a movement towards lower short-term interest rates, it wanted to pace the decline, and its management of excess cash reserves was therefore tightened sharply for the remainder of December. In addition, as the downward pressure on short-term interest rates intensified, the Bank sold a very large volume of short and medium-term bonds and treasury bills to the market.

In the first half of January 1977, the Bank continued to resist further decreases in the level of short-term rates through stringent management of chartered bank excess cash reserves and through open market sales of treasury bills. By mid-January, interest rates had stabilized.

The Bank Rate was reduced by a further ½ of one percentage point to 8 per cent effective February 1, 1977. At the same time the required minimum secondary reserve ratio* of the chartered banks was reduced from 5½ per cent to 5 per cent of deposits effective in February 1977. This ratio had been as high as 9 per cent some years ago but had been lowered in a series of steps to 5½ per cent by early 1975. Short-term interest rates declined by ¼ to ½ of one percentage point at the beginning of February and then remained little changed through the rest of the month.

As presented in Appendix Table III, the par value of the Bank's holdings of Government of Canada bonds and treasury bills and of bankers' acceptances increased by $633 million in 1976. This amount includes changes resulting from open market operations as well as those associated with purchase and resale agreements, net acquisitions of new issues of treasury bills and bonds at the time of issue and net transactions with Government accounts and other clients. A total of $172 million of Industrial Development Bank debentures, now obligations of the Federal Business Development Bank, matured during the year, reducing the Bank of Canada's holdings to $858 million.

Holdings of foreign currency assets by the Bank of Canada as a result of temporary swap transactions with the Exchange Fund Account increased by $288 million over the year. These swap transactions, which are initiated by the Bank of Canada with the concurrence of the Department of Finance, are used to assist in the management of cash reserves and to provide flexibility in the timing of the Bank's transactions in Government of Canada securities. These are reversed as the opportunity arises to add to the Bank's portfolio of securities, such as at the time of new bond issues or treasury bill auctions or in the course of open market operations.

*As defined in the Bank Act, the secondary reserves of a chartered bank are its holdings of Government of Canada treasury bills and day-to-day loans to investment dealers plus that part of its holdings of notes of, or deposits with, the Bank of Canada which is in excess of the minimum cash reserve requirement. The secondary reserve ratio expresses, in terms of a percentage of a chartered bank's Canadian dollar deposit liabilities, the minimum amount of secondary reserves that it is required to hold on average during a month.

Debt Management

In 1976, Government of Canada financing resulted in an increase of $3,473 million in the par value of outstanding marketable securities payable in Canadian dollars and $755 million in the outstanding amount of Canada Savings Bonds. The Government's Canadian dollar cash balances declined by $585 million.

A net total of $1,645 million was raised through additions to the outstanding amount of treasury bills, of which $1,420 million was raised through additions to the weekly auctions of 3-month and 6-month treasury bills. The remaining $225 million was raised through additions to the quarterly auctions of one-year bills. A notable development was the increase in the holdings of treasury bills outside the banking system from $559 million to $1,429 million.

The outstanding par value amount of direct and guaranteed marketable bonds of the Government of Canada payable in Canadian dollars increased by $1,828 million. (Details are given in Appendix Table IV.) Of the total amount of new marketable bond issues sold in 1976, 44 per cent were medium-term and 40 per cent were long-term bonds. The marked shift towards the longer end of the maturity structure lengthened the average term to maturity of outstanding unmatured marketable direct and guaranteed bonds by thirteen months to six years, five months; this was the first lengthening in over ten years. The six new Government of Canada offerings during 1976 were virtually identical in structure, each comprising three tranches: short, medium and long-term bonds.

The terms of the 1976/77 Series of Canada Savings Bonds were announced on September 9. The average yield to maturity in 1985 was 9.13 per cent – 8½ per cent for the first year and 9¼ per cent for the remaining eight years. The limit for purchases by individuals was reduced from $25,000 to $15,000. The bonds were well received and, with the sales objective met, were withdrawn from sale at the close of business November 22. Gross sales of the new issue

amounted to $2,171 million. After allowing for redemptions the amount of Canada Savings Bonds outstanding increased by $1,629 million in the fourth quarter of 1976 and by $755 million over the whole year.

Holders of an issue of 9¼ per cent marketable bonds due February 1, 1977 had the option on or before November 1, 1976 of exchanging their holdings into an equal par value of 9¼ per cent bonds maturing February 1, 1982. In total, $593 million of the bonds were exchanged, leaving $7 million of the original issue to mature in February 1977. Holders of an issue of 7 per cent bonds maturing July 1, 1977 had the option in the six month period from July 1 to December 31, 1976 to exchange their holdings into an equal par value of 7½ per cent bonds maturing July 1, 1982. Only $1.2 million of these bonds were exchanged.

In March 1976 the Government cancelled $5.4 million of 5½ per cent bonds due August 1, 1980 and $5.3 million of 9½ per cent bonds due June 15, 1994. In December 1976 the CNR cancelled $9.1 million of government guaranteed bonds. All of the bonds had been acquired under purchase fund provisions.

Foreign Exchange Operations

In 1976 the Canadian dollar was on average some three per cent higher than in 1975 and the exchange rate was considerably more volatile than has been typical of recent years. The exchange rate for the Canadian dollar reached a high of U.S.$1.0389 in June and a low of U.S.$.9588 in November, closing at U.S.$.9913 at year-end compared with U.S.$.9843 at the end of 1975. Both the strength of the Canadian dollar and its greater volatility in the course of the year were a reflection of the heavy, but sometimes uneven, inflow of long-term capital. In late November a narrowing of interest rate differentials between Canada and the United States and the uncertainties arising from the Quebec election led to expectations that borrowing abroad by Canadians would be reduced while the current account deficit remained large. The exchange rate fell sharply. Following a temporary turnaround in December, the rate declined again through January and February. At the end of February the exchange rate was U.S.$.9563.

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. Canada's official reserves rose by U.S.$517.8 million in 1976 and amounted to U.S.$5,843.4 million at year-end. They declined by U.S.$572.6 million during the first two months of 1977.

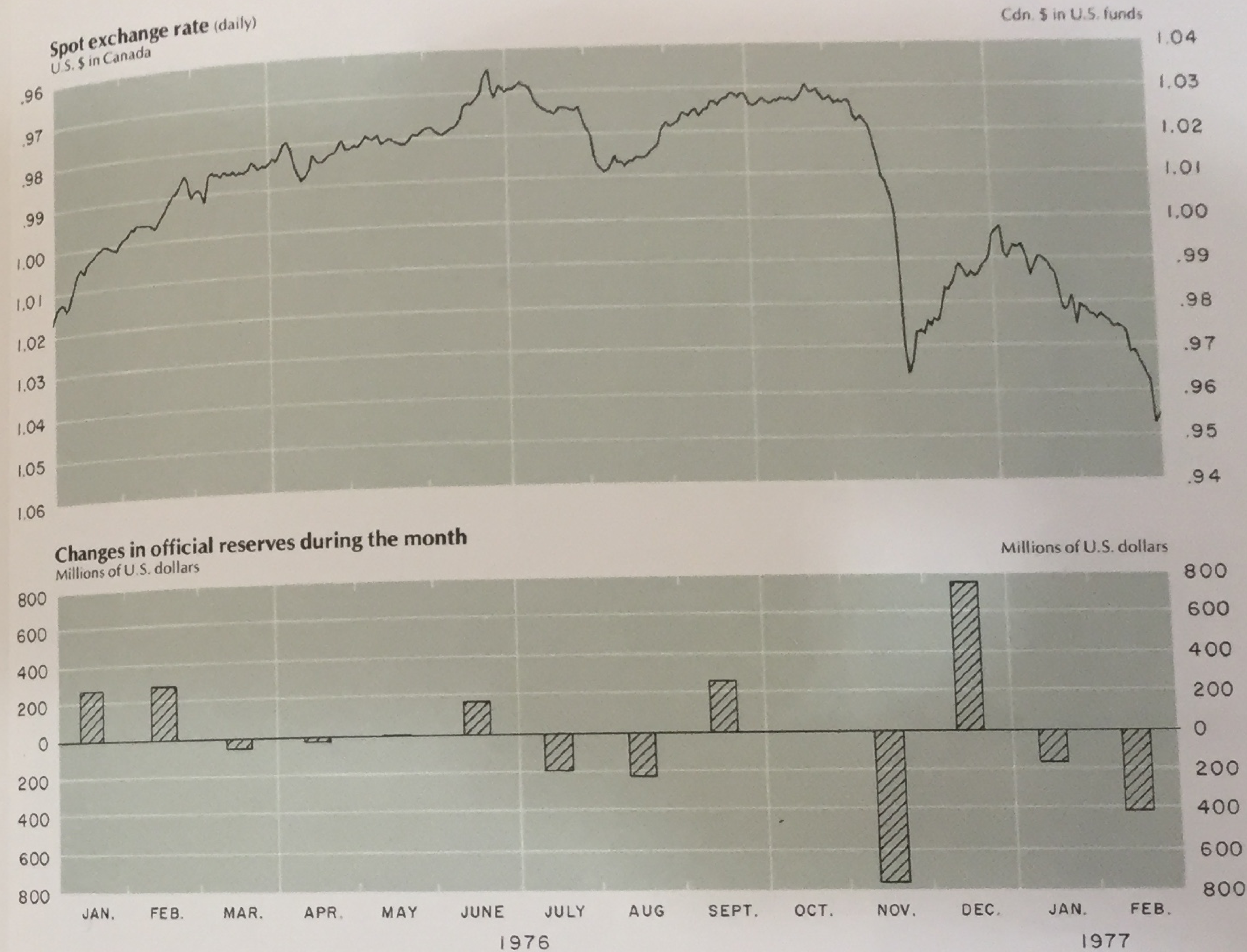
International Monetary Co-operation

In the context of international monetary co-operation the Bank of Canada has in the past year participated in two financial arrangements involving the United Kingdom.

The first such arrangement was entered into on June 7, 1976. It consisted of a short-term standby credit facility for a total amount of U.S.$5.3 billion made available to the Bank of England by monetary authorities of the Group of Ten countries, Switzerland and the Bank for International Settlements. The Bank of Canada's participation in this arrangement amounted to U.S.$300 million, of which a total of U.S.$90 million was drawn down. These drawings were repaid and the arrangement terminated on December 9, 1976.

The second arrangement, which came into effect on February 8, 1977, consists of a U.S.$3.0 billion medium-term financing facility to deal with the possibility of future declines in officially-held sterling assets. The arrangement provides for the financing, in certain circumstances, of reductions in outstanding official sterling balances by the Bank for International Settlements backed up if necessary by renewable short-term credit facilities from the monetary authorities of 11 major industrial countries. The Bank of Canada, acting on behalf of the Government of Canada, has undertaken to participate in this facility to the extent of

Exchange Rate and Official Reserves



U.S.$100 million. The Managing Director of the IMF has agreed to assist in the implementation of the arrangement.

The purpose of the arrangement is to protect official reserves of the United Kingdom from the impact of future declines in official sterling balances. Holdings of these sterling balances have at times declined sharply and this has had disruptive effects on the economic policies of the United Kingdom and been a source of instability in the international financial system. The arrangement provides a shield against such disturbances and is additional to the program undertaken by the United Kingdom in connection with the SDR3.36 billion (U.S.$3.9 billion) standby credit agreed with the IMF on January 3, 1977. As part of the arrangement the United Kingdom intends to offer securities in the form of foreign currency bonds to present official holders of sterling balances.