

INFLATION IN CANADA

Spring 1979 Review

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Preface

Friedberg Mercantile Group proudly presents its second Annual Spring Review of Inflation in Canada, a monetary analysis of the ongoing depreciation of the Canadian Dollar.

We assume full responsibility for any errors of omission or commission that may appear on the following pages and thank profusely the statistical departments of the Bank of Canada, Statistics Canada and the IMF for the courteous information received in reply to some of our naive queries.

We also thank the enthusiastic effort put out by our staff and, in particular, the formidable statistical help provided by Mrs. Fuerh Tang without whose help the paper would not have been completed.

Certain conceptual matters were omitted in the 1979 report which were fully discussed in the 1978 analysis. Readers interested in obtaining the 1978 report entitled Inflation in Canada : a Monetarist Interpretation & Forecast, should address their written request directly to our office.

We hope that whatever criticism has been made is received in the same constructive manner that it has been presented. We also hope to have broadened the Canadian public's understanding of so serious a malaise which threatens the very fibre of our society.

Canada experienced during 1978 a rate of inflation of 8.9% (1), a performance decidedly worse than the 8% rate of 1977 and the 7.5% rate of 1976. Not only did price increase in 1978 record the second worst showing of the last half-century but the pace of it exceeded by a substantial margin private and public forecasts made in the early part of the year.

When analyzed against the backdrop of the largest fiscal deficit in history, the results were a bit more encouraging (2). As discussed in the Spring 1978 Review of Canadian Inflation (3) the financing of a CD\$ 11 billion prospective fiscal deficit could have translated itself into a depreciation of approximately 25%, manifested either in the external and/or internal value of the Canadian dollar.

Wherein lies this modest success? Just two paragraphs below our unconventional forecast of a 25% potential depreciation, we discussed a solution. Short of eliminating or reducing its \$10-11 billion fiscal deficit, "... the Government of Canada may decide to raise a substantial portion of its net financing requirements abroad. Provided that the foreign currency thus obtained is exchanged for CD\$... the net effect would be ... to diminish the potential monetization of the deficit, with beneficial side effects in the anti-inflation effort." The Government of Canada did go abroad to fund its activities with the result that net financing requirements including foreign exchange financing were cut almost in half, i.e. from \$11,814 to \$6,338 billion (4)

Footnotes:

- (1) As measured by the Consumer Price Index, All Items.
- (2) It should be noted, however, that adding the 9% rate of inflation for the U.S. to the 7% drop of the CD\$ vis a vis the U.S. dollar, yields a total depreciation of 16%, significantly worse than the 8.9% inflation figure. The rationale for this computation is, of course, the fact that the CD\$ dropped vis a vis a currency (namely the U.S.) which by itself lost a great deal of purchasing power. Therefore, the CD\$ depreciation was all the more serious.
- (3) Inflation in Canada: a Monetarist Interpretation & Forecast, page 14.
- (4) All figures, of course, are on a calendar rather than the fiscal basis.

Offsetting Factors

Having obtained the year over year increase in Money Supply, namely \$11.9 billion or 13.8%, we are able to estimate the rate of inflation provided we can ascertain the total increase in the supply of goods and services, and the income velocity of Money.

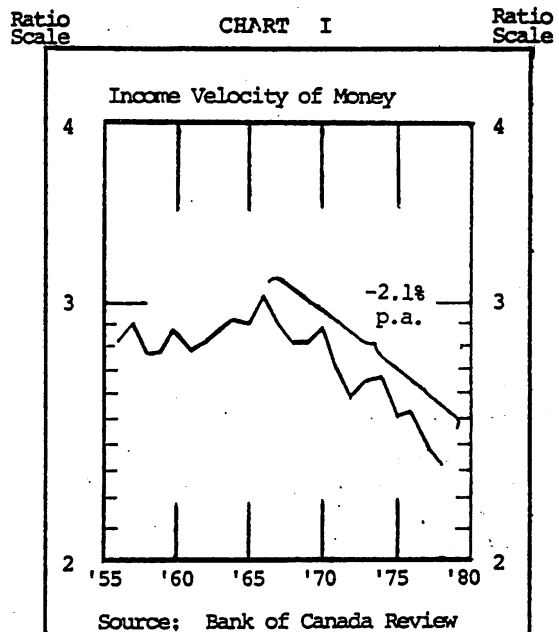
A fraction of the increase in Money Supply will finance a real increase in goods and services. For all of 1978, Gross National Product in real terms increased by 3.4%. Subtracting this 3.4% from 13.8%, we arrive at a potential monetary inflation of approximately 10.4%. Furthermore, since velocity has continued to decline at a predictable rate of slightly over 2% per annum, price inflation must have equaled 8.4%, a fair approximation to the CPI increase of 8.9%.

Velocity

As Chart I illustrates, the income velocity of Money has traced a fairly predictable & constant downtrend since 1966, a rather puzzling development given the relative acceleration of inflation over the past twelve years.

It would appear that Canadians have been lulled into holding larger money balances per dollar of income (8) despite the constant erosion of these balances - by the mere expedient of rising nominal rates of interest. Whereas the public at large has successfully economized non-interest bearing demand

deposits (as demonstrated in Chart II), the same cannot be said about interest bearing deposits despite the negative rates of return offered by current market rates of interest (9). The 'flight from currency' phenomenon so typical of latter stages of inflation has not occurred, as yet. In fact, public cupi-



* GNP/Total Money Supply,
Average Annual GNP,
Average Annual Total Money Supply.

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Table III

Government of Canada

Mln CD\$

	Net Financing Requirement		Reduction or increase (-) in Canadian \$ cash Balance	Canadian Dollar Financing Requirement met by:				
				Increase in holdings of Canadian \$ securities outside Gov't accounts				Total
	Excl. Foreign Exchange Financing	Incl. Foreign Exchange Financing		Banking System		General Public		
			Bank of Canada	Chartered Banks	Canada Savings Bonds	Marketable Securities		
1963	618	511	-352	863	155	562	513	-367
1964	-177	407	197	210	31	-228	480	-73
1965	-241	19	-147	166	356	18	253	-461
1966	610	254	-49	303	2	167	223	-89
1967	1,074	1,275	297	978	330	740	230	-322
1968	1,042	1,050	-59	1,109	135	943	40	-9
1969	-85	-399	-676	277	170	-480	324	263
1970	334	1,908	-84	1,992	183	1,510	714	-415
1971	1,449	2,162	-823	2,985	571	721	2,519	-826
1972	1,323	1,430	-127	1,557	587	-192	1,195	-33
1973	771	14	68	-54	572	159	-385	-400
1974	1,582	1,825	-2,360	4,185	1,014	831	2,445	-105
1975	5,674	4,967	1,024	3,943	841	-351	2,664	789
1976	4,129	4,676	556	4,120	572	872	775	1,921
1977	7,164	6,178	-1,619	7,797	1,853	894	1,660	3,390
1978	11,814	6,338	-1,746	8,084	1,740	286	1,974	4,084
1979 (e)	13,000	6,000	500	5,500	2,500	0	1,000	2,000

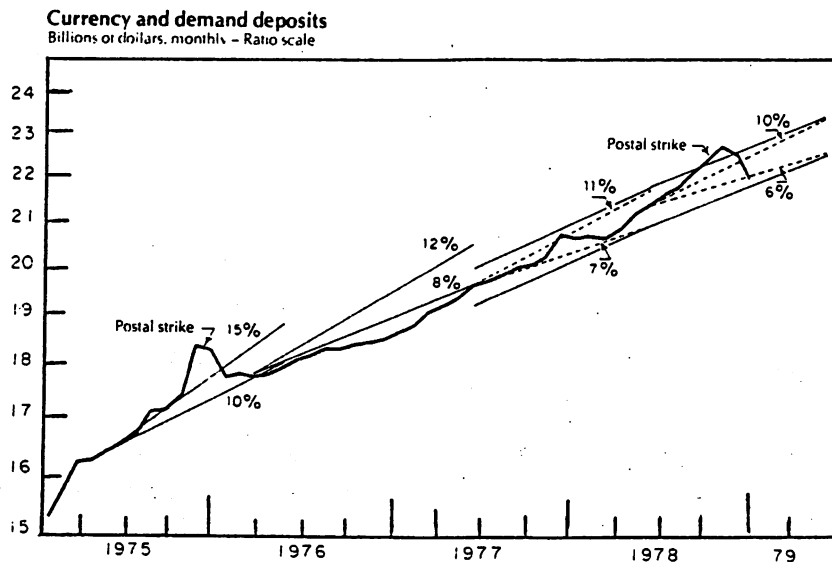
(e) : Our estimate

Source : Bank of Canada Review

Chart V

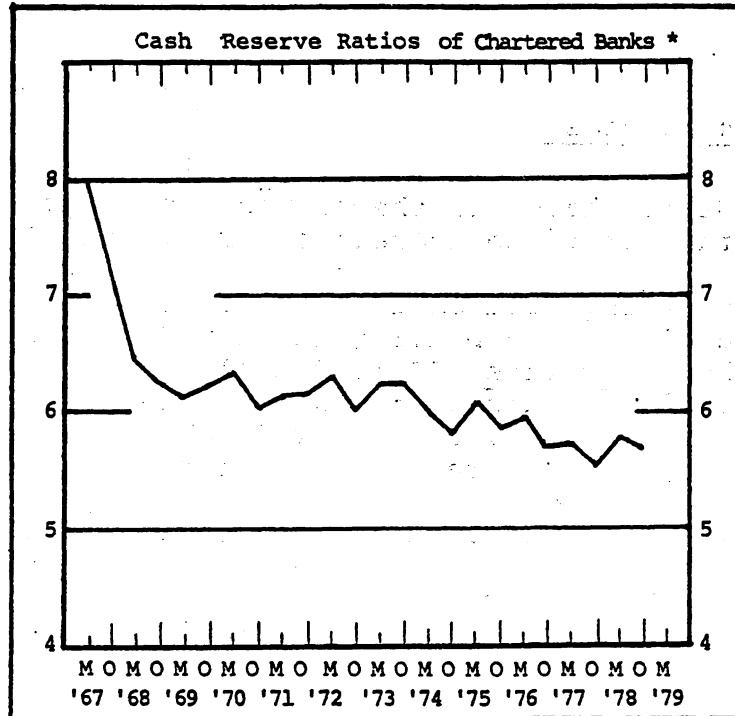
Money Supply and Target Growth Ranges

Seasonally adjusted



Source: Bank of Canada, Annual Report

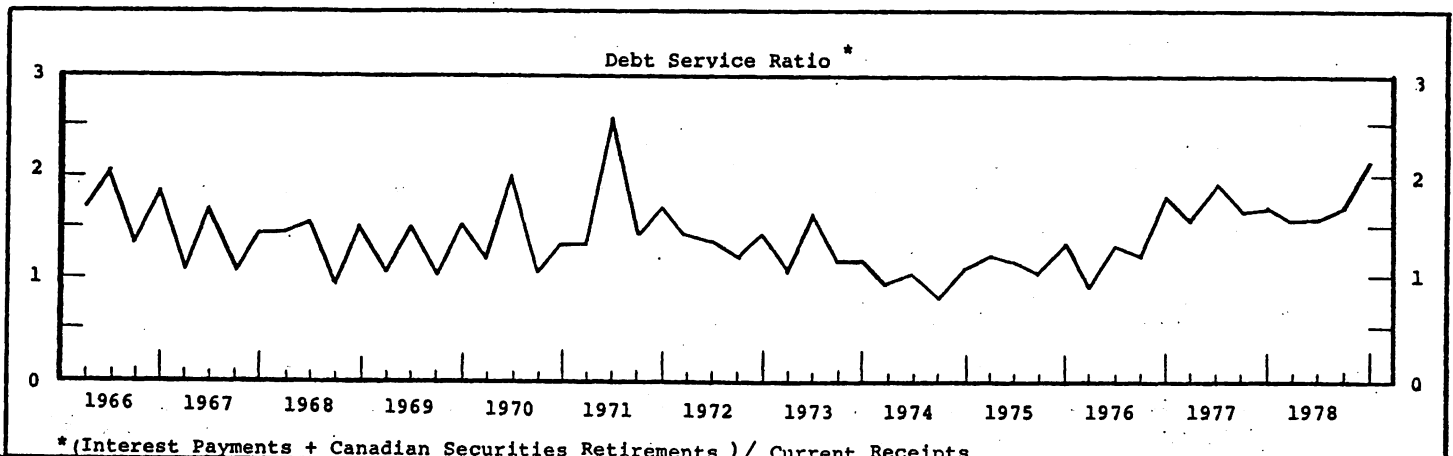
Chart VI



* Minimum Average Required (March & October Figures)

Source: Bank of Canada Review

CHART VII



*(Interest Payments + Canadian Securities Retirements) / Current Receipts

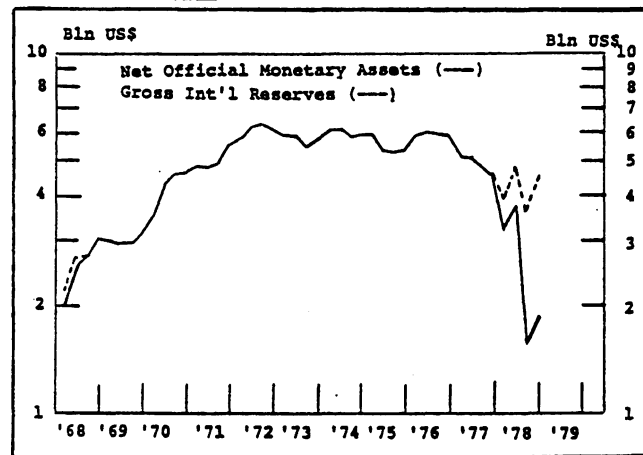
Sources : Bank of Canada Review, Statistics Canada

No doubt, the government of Canada has been borrowing too heavily in general, and the size of its net borrowing requirements is just too onerous for the long range health of the nation. Its operations abroad during 1979, however, have been commendable. In the first place, it has borrowed, for the most part, at interest rates substantially lower than the ones obtained in the domestic sector. Secondly, should some semblance of fiscal discipline appear on the horizon, the CD\$ could conceivably rise vis a vis the U.S.\$, the Yen, the SFr & the DM thus lowering the cost of the debt. Finally, external borrowings were responsible for Canada's relatively low rate of inflation, in that they freed the Bank of Canada from monetizing a larger share of the government's financing requirements.

Back to the original question. Is Canada's external debt too high? Chart VII illustrates the cost of servicing Canada's total external debt, i.e. interest and amortization, as a percentage of its earnings on current account(12). As it can be seen, present levels of indebtedness do not exceed levels attained in 1971 and just match the relative levels of 1966.

Are Canada's Int'l Reserves too low? In a pure floating-rate system, int'l reserves are superfluous. The nominal gross level of int'l reserves, however, is of some psychological significance to the foreign exchange markets and, no doubt, the Bank of Canada has responded to this "mirage" by managing to keep its nominal gross reserves almost unchanged (Chart VIII)

Chart VIII



A better way to look at international reserves is to compare Net Monetary Assets to the Gross Current Account. (Net Monetary Assets because Canada has indebted itself substantially in order to replenish its International Reserves). The comparison to the Gross Current Account, in a less-than-pure floating-rate system, should be seen in the context of affording a smooth transition between current inflows and outflows with the least disruptive effect on foreign exchange markets (i.e. a policy of foreign exchange stabilization).

(12) For a developed nation current receipts, in our opinion, are a far more meaningful proxy than exports.

Its rationale simply states that domestic credit demands may not exceed available domestic savings without inviting external savings, i.e. a Current Account deficit. Significantly even a small improvement in the rate of change of domestic credit demands vis a vis domestic savings will, with a short time lag, create an improvement in the Current Account.

Chart XII is instructive in this respect. Line a-b, showing a substantial deceleration of domestic credit expansion vis a vis domestic savings, creates the only Current Account surplus of the past 15 years. Line c-d is the precursor of trouble: the Current Account begins to deteriorate almost simultaneously with the re-acceleration of credit demands in excess of domestic savings, reaching a record CD\$ 4.7 billion deficit in 1975, at just about the time when we observe a small improvement in credit demands. Line e-f explains rather well the renewed deterioration of the Current Account, which now reaches a new record deficit of CD\$ 5.2 billion.

Line A-B has a foreboding configuration. Not only has Canada lived well beyond its means since the early 60's but it has done so in an accelerated fashion.

Our 1979 estimate (solid line) does not augur well for a sustained improvement in the Current Account. In fact, given present financial information, the Current Account should reach a new record deficit over the coming two years.

Can it be avoided? We believe it can provided that:

- a) the fiscal deficit is reduced substantially, perhaps by as much as 50-60% over the next few years.
- b) the government continues to fund a very substantial share of its financing requirements abroad during this transition period, and
- c) the Bank of Canada begins to adopt a real rate of interest policy, i.e. monetary policy tight enough to produce consistent and persistent real rates of interest so as to slow down private credit demands. A continued tight rein on the banking system's already low level of free liquid assets may accomplish this objective (see Chart IV).

Summary and Conclusion

There is no escaping the consequences of a loose fiscal and monetary policy. Parting with relatively well known pre-estimates of fiscal borrowing requirements and allowing for conservative guesstimates as to external borrowings and real growth, one arrives at an unconventional inflation forecast of 12.5%, average 1979 over 1978, and a rate of inflation of 17% for the latter part of 1979. Similarly, one can predict that, ex ante, the pieces of the puzzle are in place for a continued deterioration of the Current Account and, perhaps, more downside pressure on the CD\$ over the coming 18 months.

We pointed out that the Government must attempt immediately - at the risk of a massive crises- to reduce its gigantic fiscal borrowing requirements and must continue to fund externally a very substantial portion of these requirements. Furthermore, we pointed out that, at this stage, there is still little risk in increasing Canada's external indebtedness provided it is merely a transition to a more sensible fiscal policy. Whereas present international reserves were clearly inadequate to smooth out the in and out-go's of the Current Account, making for increasingly volatile foreign exchange markets, they did not present an insurmountable problem in a loosely-defined floating rate system. The Bank of Canada was seemingly responding well to the psychological needs of maintaining a relatively stable level of nominal gross International Reserves.

Aside from a substantial cutback in government borrowing requirements, we recommended that the Bank of Canada persevere in maintaining a tight monetary policy measured by the obtainment of a persistent real rate of interest, i.e. a nominal rate of interest higher than the rate of inflation as envisioned by the market place. At the present time, this rate may be in excess of 11% for short term money (90 day Finance Company Paper or Chartered Bank deposits); as inflation accelerates, of course, the rate must be forced higher in rapid order.

As suggested last year, the Government should consider floating a domestic issue of Cost-of-Living indexed bonds, - tax exempt of any 'inflation gains' - with a nominal 1% or 2% coupon as a way of funding its borrowing requirements with genuine savings and as a guide to other financial lenders and borrowers of the importance of real rates of return. As a side benefit, this Cost-of-Living indexed bonds would greatly alleviate the uphill battle facing private and public pension funds in their striving for the maintenance of constant purchasing power.

Albert D. Friedberg