INFLATION IN CANADA

Spring 1980 Review

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Preface

The fervor with which we undertake to analyze the propects for inflation in Canada can only be matched by the persistence of this insidious phenomenon. In fact, this is the third of such reviews, which have taken the form of some mythological spring rite. The plain truth is that these exercises strain the research statistical capabilities of our firm and, in particular, Mrs. F. Tang, without whose help, once again, this paper would never have come to print.

We also would like to thank the research staff of the Bank of Canada, Stastics Canada, Federal Reserve Bank of New York and the IMF as well as our staff for the patience and understanding they showed.

Readers interested in obtaining the 1978 report entitled Inflation in Canada : a Monetarist Interpretation & Forecast and the 1979 report entitled Inflation in Canada ; Spring 1979 Review, should address their written request directly to our office.

Albert D. Friedberg

INTRODUCTION

Canada's inflation during 1979 has variously been estimated to have run at 9.1% 9.6%** and 14.4%*** depending on which index is used. This performance has evoked a general feeling of complacency in this country particularly in view of the fact that the U.S. Consumer Price Index advanced 11.3% during the same period and has since been advancing at a rate at least 50% higher than the Canadian CPI.

Gauging the tempo of price increases can be a most frustrating and confusing exercise. Not all countries measure the same items nor are the same items as important in the consumer basket in one country as in another. Finally, it is almost impossible to adjust for different items in different countries that 'enjoy' price subsidies or price controls or are penalized by special excise taxes. One must make the heroic assumption that under fixed or relatively fixed exchange rates, inflation rates in different countries will equalize over some indeterminate period of time. Inflation differentials would then appear not in varying price performances but in the external sector. The greater inflationist of the two countries will suffer a deficit on current account, that, when neutralized, will become unsustainable and force in time a currency devaluation. If, on the other hand, the current account is allowed to contract the excessive monetary expansion, the deficit on current account will disappear; relatively excessive inflationary pressures will have subsided.

In a less than perfect world, where mobility of capital, goods, services and manpower are imperfect and exchange rates float (albeit not 'cleanly'), measuring relative inflation performance becomes an even more difficult task. Nevertheless, a cursory and rather naive comparison of inflation statistics relegates Canada to an unfavourable position.

Table I ranks the ten most industrialized countries by their CPI performance; Table II does the same for their Wholesale Price Index and Table III ranks these countries by the size of their current account as a percentage of their 1979 broad money supply. Canada ranks sixth, ninth and ninth.****

This review, is more about inflationary pressures, its causes and potential remedies than about inflation per se. In reviewing 1979, we have detected a slight ray of hope in the battle against inflation. At least one governmental body, the Bank of Canada, has carried out a valiant and determined anti-inflationary offensive. This effort, unfortunately , may be in danger of being drowned out by the red ink emanating from our Federal Government.

Table I

(1)	Switzerland	3.55
(2)	Japan	3.59
(3)	Germany	4.05
(4)	Netherland	4.23
(5)	Belgium	4.42
(6)	Canada	9.17
(7)	France	10.72
(8)	U.S.	11.30
(9)	U.K.	13.41
(10)	Italy	14.74

Table II

(1)	Netherland	3.48
(2)	Switzerland	3.85
(3)	Germany	5.00
(4)	Belgium	6.32
(5)	Japan	7.29
(6)	U.K.	12.20
(7)	U.S.	12.45
(8)	France	13.37
(9)	Canada	14.45
(10)	Italy	15.54

Table III

(1)	Italy	+2.23
(2)	Switzerland	1.78
(3)	France	0.55*
(4)	U.S.	-0.08
(5)	Germany	-0.98
(6)	Japan	-1.06
(7)	Netherland	-2.24
(8)	U.K.	-4.11
(9)	Canada	-4.33
(10)	Belgium	n/a

* as % of 1978 money supply

* C.P.I.

** GNP price deflator.

*** Industry Selling Prices.

**** We suspect that when figures become available for Belgium, Canada would drop one more notch in the last category.

The Government of Canada's fiscal position

A monetarist interpretation of inflation, such as this one purports to be, must perforce direct its attention to the government's fiscal position, or, more precisely, the government's recent financing requirements. As described in previous Reviews, the causal link works as follows : a 'large' budget deficit results in a 'large' financing requirement which cannot entirely be funded out of genuine domestic savings for fear of 'crowding out' private sector borrowers; the Central Bank, in this case the Bank of Canada, comes to the rescue by purchasing a portion of the government's newly issued or outstanding debt. The addition to the Bank of Canada's investment portfolio is paid for by creating funds out of 'thin air'. These funds increase the chartered banks' reserves enabling them, thanks to the fractional reserve requirement system, to expand bank credit and money supply. The process we have just described is called 'monetization of the debt' & it is,by far, the most important impulsive mechanism for monetary expansion.

Under a fixed, or relatively fixed,exchange rate, the Central Bank could monetize foreign currency inflows in an attempt to halt its own currency from appreciating or, vice versa, could induce a contraction of bank reserves should it act to sell foreign currency in an attempt to offset current and/or capital account outflows. International currency movements have had little impact on the net asset position of the Monetary Authorities* due to the latter's policy of maintaining a relatively unchanged level of Gross International Reserves.** Had the Monetary Authorities not been preoccupied with maintaining a specific level of International Reserves, it is quite likely that a larger portion of Canada's $14.620 billion deficit on current account accumulated over the past 3 years would have been financed out of a net drawdown of International Reserves, forcing a contraction in Canadian dollar chartered banks' reserves & deposits and, in the process, extinguishing latent inflationary pressures. In effect, under a relatively fixed exchange rate *** , the movement on current account acts as a safety valve and an indicator of excess monetary expansion and inflationary pressures.

Turning back to the Canadian government's fiscal position, one notes a net financing requirement excluding foreign exchange of $11.3 billion for calendar 1979, a slight decrease from 1978's $11.7 billion. A fortuitous set of circumstances which included a very bouyant stock market, particularly the oil & gas sector, and other direct investments in the energy sector coupled with a relatively high nominal level of interest rates vis a vis Europe & Japan, attracted a substantial amount of foreign capital. As a result, net capital movements (after net errors & omissions of - $4.4 billion) more than offset the deficit on current account and helped restore some health to the net level of International Reserves, but increased the government financing requirement by $525 million. Foreign exchange financing, thus, moved from creating a reduction in financing requirements of $5,476 million in 1978 to creating an increase of $525 million, a dramatic $ 6 billion reversal !

* Bank of Canada & Exchange Fund.
** See Spring Review 1979, page 11.
*** a situation that prevailed in Canada during 1979 & early 1980.

Table IV below summarizes the government's fiscal position including our 1979 estimate and the actual 1979 figures. The guesstimating exercise is useful only in so far as it enables us to measure the ex ante pressure on the Bank of Canada to monetize the government's debt requirements. In this respect, our estimate for the Bank of Canada's increase in its holdings of Canadian Dollar securities was clearly biased upwards by our pessimistic estimate of the government's overall deficit (an actual overestimate of approx. $1.6 billion) and our inability to project

Table IV — Government of Canada — Mln CD$

	Net Financing Requirement		Canadian Dollar Financing Requirement met by:					
				Increase in holdings of Canadian $ Securities outside Gov't Accounts				
					Banking System		General Public	
	Excl. Foreign Exchange Financing	Incl. Foreign Exchange Financing	Reduction or increase (-) in Canadian $ cash Balance	Total	Bank of Canada	Chartered Banks	Canada Savings Bonds	Marketable Securities
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	4,677	557	4,120	572	872	755	1,921
1977	7,164	6,178	-1,619	7,797	1,853	894	1,660	3,390
1978	11,759r	6,283r	-1,759r	8,042r	1,741r	284r	1,933r	4,084
1979*	13,000	6,000	500	5,500	2,500	0	1,000	2,000
1979**	11,367	11,892	4,052	7,840	1,708	248	-1,329	7,213

* our estimate (Spring 1979 Review)
** Actual

Source : Bank of Canada Review

the incredibly low level of government cash balances prevailing at the end of 1979. The forecasting error in foreign exchange financing and the General Public's holdings of marketable securities was not critical as one offset almost precisely the other and both responded to the Bank of Canada's adroit management of interest rates. In effect, the sharp and prompt upward interest rates' readjustments , induced foreign capital inflows, as explained above, obviating the need for official financing while, at the same time, induced heavy purchases of marketable bonds on the part of the General Public.

Estimating the Government of Canada's 1980 net financing requirements & its financing

At this juncture, it is much too early to obtain a precise estimate of the government's intended expenditures and potential revenues. The recently announced mini-budget provides a glimpse of what may turn out to be the complete abandonment of fiscal restraint. Unexpected increases in interest on the Public Debt and energy subsidies will swell the 1980-81 fiscal deficit by, at least, $2.7 billion. On the non-budgetary side, surpluses on pension, annuity & insurance accounts should provide an increase in the net source of funds of approx. $1.4 billion. As reported in the Globe & Mail of April 23, " Mr. MacEachen emphasized that the 1980-81 projections do not include any extra revenues or reduced outlays to come from the implementation of the new blended-oil pricing arrangements to take effect after June 30 ... these could reduce total outlays and borrowing requirements by $1 billion." On the other hand, it should be noted that even a mild recession (expected by most economic observers) will lower revenues dramatically and may force the government into a more aggressive expenditures program. Allowing for these cross-currents and the present government's strong interventionist stance, it would not be unrealistic to expect an increase of $1.0 billion over 1979's net financing requirements excluding foreign exchange transactions.

The looming row over energy pricing with the Western provinces as well as the yet-to-be determined outcome (a confrontation that will easily last well beyond May 15th) of the Quebec desire for some sort of independence, should take its toll on private capital inflows, with the possibility that, once again, the current account will necessitate official financing. With substantial and unused revolving lines of credit in place (over $ 6 billion) and some flexibility in mobilizing gold by selling significant quantities on the open market*, we do not foresee any difficulties on this score. It would then appear that net financing requirements including foreign exchange may amount to approximately $ 6 billion.

The extraordinary run-off of Canada Savings Bonds during 1979 seems to be as much a result of uncontrollable factors (a dramatic rise of open market interest rates) as a result of a policy decision to lengthen the maturity of the outstanding debt. A look at Table V will show the falling proportion of CSB's in the total outstanding and will also reveal that this trend began as far back as 1975.

Table V Government of Canada outstanding debt Source : Bank of Canada Review

Millions of dollars - par value

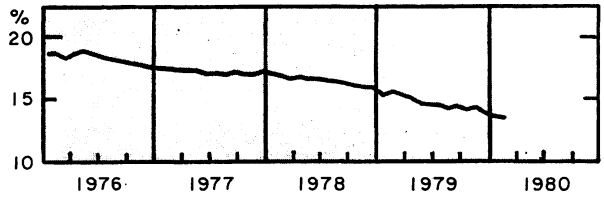
End of period	Canadian currency									Foreign currency			Total outstanding
	Treasury bills		Non-marketable bonds			Marketable bonds			Total domestic debt	Direct marketable bonds	Bank loans[1]	Total foreign debt	
	Amount	Per cent of domestic debt	Canada Savings Bonds[2]		Others[3]	Direct[2]		Guaranteed					
			Amount	Per cent of domestic debt		Amount	Per cent of domestic debt						
1970	3,625	14	7,397	29	491	12,846	51	1,043	25,402	344		344	25,746
1971	3,830	14	9,916	35	26	13,363	48	816	27,951	326		326	28,277
1972	4,160	14	11,111	38	33	13,437	45	810	29,551	322		322	29,873
1973	4,690	16	10,726	36	41	13,234	45	803	29,494	244		244	29,738
1974	5,630	17	13,171	39	49	14,305	42	596	33,751	196		196	33,947
1975	6,200	16	15,835	42	59	15,082	40	583	37,759	162		162	37,921
1976	7,845	19	16,590	40	70	16,911	40	574	42,006	162		162	42,152
1977	10,315	21	18,250	36	82	20,853	42	498	49,998	174		174	50,172
1978	13,135	22	20,183	35	94	24,260	42	492	58,164	2,683	3,463	6,146	64,310
1979	15,260	23	18,855	29	112	31,009	47	488	65,724	3,406	1,472	4,878	70,602

There is little doubt that from a debt management point of view, this is a healthy development. Should our assumption be correct, one would expect a further run-off in CSB's, unopposed by the Treasury, providing, of course, that the 'stream' does not become a flood. In view of the recent fall in open market interest rates, we expect CSB's to represent a net drain of funds in the order of $2.5 billion.

Another drain of funds will be the reconstitution of Government cash balances, now** at dangerously low levels. We estimate that at 1980 year end, government cash balance will stand at $3.5 billion, for a net increase in borrowing requirements for Calendar 1980 of approximately $ 1 billion.

Chartered banks' holdings of government securities will no doubt be influenced by their desire to re-establish a more normal level of liquid assets as a percentage of major assets (see chart 1) and the expected drop off in short term credit demands. Our estimate calls for an increase of $1.2 billion versus the relatively small increase of $248 million in 1979.

Chart 1 Chartered banks
Canadian liquid assets as a percentage of total Canadian dollar major assets



*At the end of 1979, official reserves included 22.2 million fine ounces of gold. In January 1980, 252,000 ounces were sold for US$ 174 million.
** At end of Feb. 80, they stood at $1.673 billion, down from $2.461 billion at Dec. 79 and 6.72 billion at Dec. '71.

The foregoing results in a borrowing requirement equal to $8.3 billion left to be divided up between the Bank of Canada and the General Public. On the one hand, the Bank of Canada has been remarkably sagacious in the conduct of its monetary and debt management policy during the course of 1979. Debt monetization amounted to barely 14.4% of the government's net financing requirements, a new recent low (see Table VI). The average term to maturity of direct and guaranteed bonds payable in Canadian dollars lengthened in 1979 by 22 months to 10 years 5 months. On the other hand, the absorptive capacity of the General Public may have reached its limit during 1979, a year which saw the culmination of a five-year buying splurge totalling no less than $17.3 billion worth of marketable securities.

Table VI

	Gov't of Canada Net Financial Requirements (incl. Foreign Exchange)	Bank of Canada Purchases	Purchase/ Requirements
	(millions of Canadian $)		
1966-68	2,578	471	18.3%
1969-71	3,671	925	25.2%
1972-74	3,269	2,173	66.5%
1975-77	15,822	3,266	20.6%
1978	6,283	1,741	27.7%
1979	11,892	1,708	14.4%

Source: Bank of Canada Review

In order to gain some perspective, Table VII , lists Personal Savings as well as Private Gross Savings* alongside net new security issues placed in Canada and abroad and increases in Marketable Government Securities held by the General Public.

Table VII

mln $	(a) Personal Savings	(b) Private Gross Savings	(c) Net New Issues	(d) Marketable Securities	d ÷ a	c ÷ b
1975	12,139	40,325	16,127	789	6.50%	39.99%
1976	12,836	46,143	20,001	1,921	14.97	43.35
1977	13,889	50,411	24,712	3,390	24.41	49.02
1978	16,042	57,497	29,552	4,084	25.46	51.40
1979 e	13,932	55,848	22,963	7,213	51.77	41.12

Sources: Bank of Canada, Statistics Canada

While total net new issues as a proportion of Private Gross Savings have remained relatively stable, Government Marketable Securities held by the General Public have gained spectacularly, taking up as much as 51.8 % of Personal Savings**.

The grim truth is that the Federal Government has been pre-empting the money and capital markets, crowding out slowly but irresistibly the private sector.

Table VIII

Although illustrative, Table VIII makes no adjustment for the fact that from 1969 to and including 1973 the non-bank public only absorbed a small percentage of the government's new issue market. Such an adjustment would no doubt verify the existence of a 'crowding out' phenomenon.

Mln $	Gov't of Canada		Provinces, Manicipalities, Other Institutions & Foreign Debtors		Corporations	
	Amount	%	Amount	%	Amount	%
1969	339	7.7	2,257	51.27	1,806	41.03
1970	1,844	30.41	2,368	39.06	1,851	30.53
1971	2,547	33.02	2,977	38.59	2,190	28.39
1972	1,599	21.96	3,478	47.76	2,205	30.28
1973	- 147	- 2.91	3,053	60.48	2,142	42.43
1974	4,212	37.44	4,450	39.55	2,589	23.01
1975	3,967	24.60	8,047	49.90	4,112	25.50
1976	4,233	21.16	10,312	51.56	5,456	27.28
1977	8,006	32.40	8,378	33.90	8,327	33.70
1978	10,480	35.45	7,603	25.72	11,481	38.83
1979	8,291	36.12	6,960	30.32	7,702	33.56

Source: Bank of Canada Review

What is most revealing, however, is the increasing reliance of the private non-financial sector on short term financing, possibly a result of the inability of the latter to compete with the Treasury's appetite for long and medium term debt. Table IX divides sources of funds between long term and short term capital.

* Derived by subtracting Gov't Savings from Gross Savings, Statistics Canada

** This statement does not imply a flow-of-funds but it is merely calculated to provide perspective of the magnitudes involved.

Table IX Sources of funds raised by private non-financial business

	Long Term(1)		Short Term(2)	
	Mln $	%	Mln $	%
1974	1,623	17.06	7,891	82.94
1975	3,144	42.24	4,299	57.76
1976	3,555	35.11	6,569	64.89
1977	6,580	54.67	5,455	45.33
1978	9,070	63.24	5,272	36.76
1979	4,862	23.75	15,607	76.25

Source: Bank of Canada Review

(1) Long Term : Canadian dollar & Foreign currency bonds, Common & Perferred stocks.
(2) Short Term : Commercial Paper, Bankers acceptances, Loans in Chartered Banks, sales finance companies, Affiliates of foreign banks, Federal Business Dev't Bank.

During 1980, the private non-financial business sector will attempt to tap the long term money and capital markets in an attempt to refund outstanding bank loans and regain some liquidity. Undoubtedly, the non-financial business sector will not be as accommodative to the Treasury during 1980 as it was during 1979. This is an additional reason why we think that the General Public category will not be in a position to absorb government debt on a scale of $7.2 billion, unless induced to do so by comparatively advantageous interest rates.

The task ahead is formidable. The Bank of Canada will be facing a non-bank public sector potentially saturated but no doubt satiated with long term government paper and ready to diversify and meet the financing needs of an illiquid, non-financial business sector. It is at this junction that we can appreciate the ex ante pressures put upon the Monetary Authorities as a result of runaway Federal spending. To have coped with the 1975-1979 string of government borrowing requirements without precipitating the country into a major foreign exchange crisis and/or runaway inflation deserves the highest marks. To escape 1980 unscathed will require extraordinary courage.

Our estimate assumes an increase in Bank of Canada holdings of government securities of approximately $2.34 billion leaving the General Public to absorb $6.0 billion.

Table X summarizing our estimate of the government of Canada's 1980 fiscal position.

Table X Government of Canada Mln CD$

	Net Financing Requirement		Canadian Dollar Financing Requirement met by:					
				Increase in holdings of Canadian $ Securities outside Gov't Accounts				
					Banking System		General Public	
	Excl. Foreign Exchange Financing	Incl. Foreign Exchange Financing	Reduction or increase (-) in Canadian $ cash Balance	Total	Bank of Canada	Chartered Banks	Canada Savings Bonds	Marketable Securities
1980(e)	12,367	6,400	-1,000	7,040	2,340	1,200	-2,500	+6,000

Money Supply

Table XI indicates that total Money Supply (all private chartered banks' deposit liabilities plus currency in the hands of the non-bank public) grew 15.48% in December 1979 over December 1978 and at 17% on the average of 1979 over 1978. These figures indicate a slight acceleration from the 1978 over 1977 figures but slightly less than our 1979 forecast of a 19.1% increase*. The relatively better than expected Money Supply performance is due to the substantially smaller expansion of assets of the Bank of Canada. In the first place, as pointed out earlier, debt monetization amounted to only $1,708 billion versus an expected $2.5 billion. Secondly, four other asset categories showed substantial

Table XI

	Total Money Supply*		
(mlns of $)	1978	1979	%
Jan.	93,072	108,243	15.9%
Feb.	93,314	109,743	17.6
Mar.	94,752	111,141	17.3
Apr.	96,198	111,922	16.4
May	97,300	113,817	16.98
Jun.	98,119	115,694	17.91
Jul.	99,808	117,877	18.10
Aug.	100,673	119,455	18.66
Sep.	102,574	120,458	17.45
Oct.	103,629	120,946	16.71
Nov.	106,379	122,657	15.3
Dec.	107,882	124,588	15.48
Avg.	99,475	116,378	16.99

* Average of Wednesdays
Source: Bank of Canada Review

* Spring Review 1979, page 10.

decreases, chief among them the Bank's holdings of foreign currency assets and a reduction of the float. In all, the 1979 increase in assets of the Bank of Canada totalled $640 million, representing a mere 4.2% annual increase over 1978 and the lowest year over year increase in a decade. (see Chart II and Chart III) This accomplishment can be called the monetary event of the year. Were it not for the continuing irresponsible direction of Federal Spending and the difficulty of seeing an end to this recklessness, one could argue that monetary policy and inflation in Canada have turned the corner.

Chart II

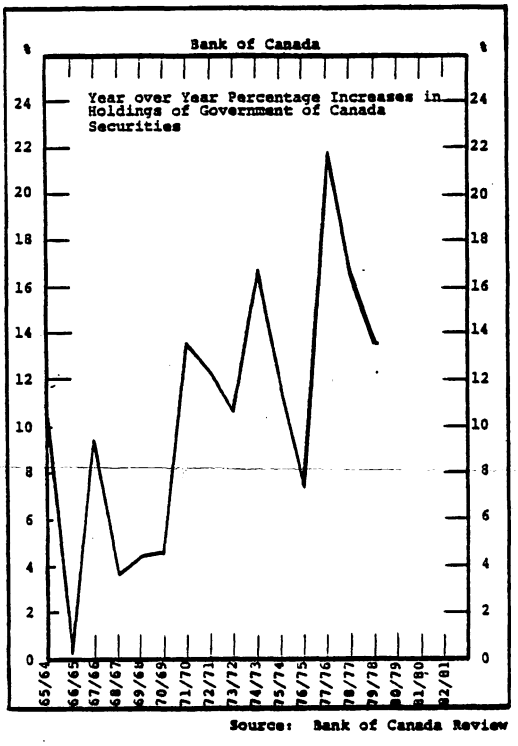
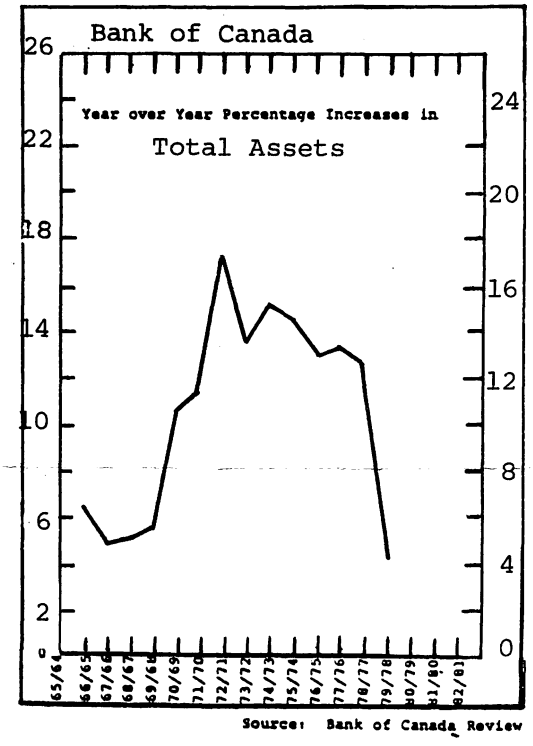


Chart III



Offsetting this reduced monetization, the monetary multiplier turned out to be higher than we had anticipated, the result of a very rapid shift of demand deposits into interest bearing deposits. Table XII includes our estimate for 1980.

Table XII	1975	1976	1977	1978	1979(e)	1979(Act.)	1980(e)
Multiplier *	6.93	7.14	7.42	7.45	7.60	7.86	8.29

* : Money Supply / Bank of Canada Total Assets. (e) : Estimate

Assuming that the Bank of Canada does not offset the $2.34 billion increase in government securities and therefore its average credit (i.e. assets) increases by $2.34billion average Money Supply during 1980 should total $133,307 million* a 14.4% increase over 1979.

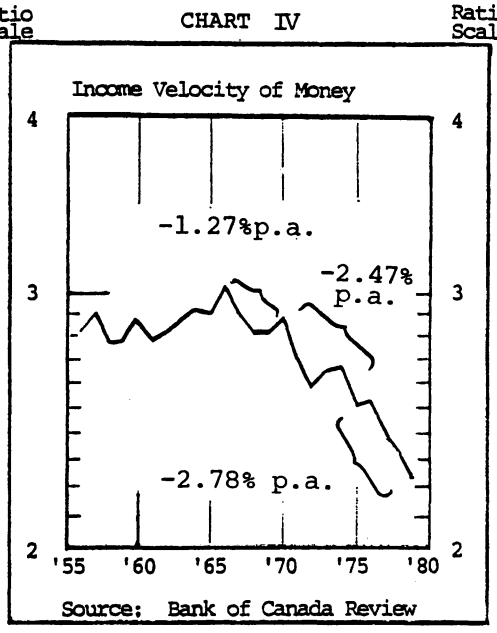
* Average Bank of Canada assets during 1979 : 14,813 million
Average monthly assets : $A_t = A_{t-1} +$ (2340/12)
Average Money Supply : $(\Sigma_{t=1,12} A_t) / 12 \times 8.29 = 133,307$

Real GNP

A nil real rate of growth is forecast for 1980, in line with present official views.

Velocity

The income velocity of money, GNP/Money Supply, also known as the reciprocal of the demand for money, has shown a puzzling down-trend since 1966. We have noted this phenomenon in previous Reviews but have been unable to find an adequate explanation.



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

Recent literature discusses the growing share of unreported income in industralized econimies, mostly with the intention of evading taxes. This underground economy has been estimated to represent as much as 33% of the present GNP in the U.S. and Canada.

If our estimate of the GNP is understated, and becomes increasingly more so each year then obviously velocity would be seen to be falling whereas in reality it is flat or may even be rising. It would require a GNP (in current dollars) of approximately $351 billion, or 35% greater than presently reported, to raise the velocity ratio (GNP/Money Supply) to 3.0, the ratio prevailing in the mid-60's. As a corollary, a falling velocity ratio implies an accelerated growth of the underground share of the economy, an entirely plausible occurrence given the growing 'tax wedge'.*

1980 Inflation forecast

A 14.4% average increase in total Money Supply offset by a 0% prospective increase in production and a 3% drop in the income velocity of money (i.e. a 3% increase in the demand for money),will turn out a 11.4% rate of inflation. Interestingly enough, a zero rate of real growth does add one percentage point to the rate of inflation.

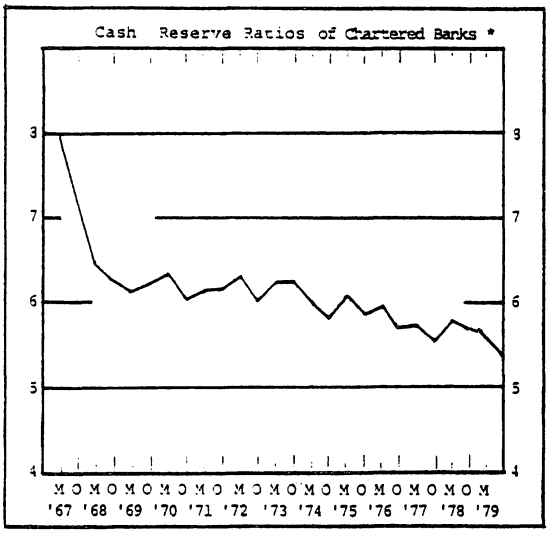
Chartered bank credit

During 1979, bank credit grew 20.5%, a slight acceleration from the 18.8% growth rate experienced in 1978. This inflationary increase came about despite the meager 8.5% increase in cash reserves, product of a restrictive Central Bank monetary policy. How did it happen ?

* If our explanation is correct, the drop in the income velocity of Money should only be included when adjusting for GNP-based inflation numbers, such as the GNP deflator ,but not when estimating the CPI and/or WPI.

The fractional reserve banking system with differentiated reserve requirements by type of deposit contains a powerful multiplier (the inverse of the cash ratio). As Chart V shows the cash ratio has been falling steadily since February 1968, year in which the Bank Act prescribed a dramatically lower reserve ratio for notice deposits (4%).

Chart V



* Minimum Average Required (March & October Figures)

Source: Bank of Canada Review

Despite the Bank of Canada's best efforts, chartered banks are in almost virtual control of credit creation. In effect, should loan demand grow beyond the level of cash reserves provided by the Bank of Canada, chartered banks bid for notice deposits. If they succeed in attracting funds lying in demand deposits, the cash ratio drops, accommodating the increased credit creation.

During 1979, the cash ratio dropped from 5.62 to 5.22 (second half of Dec. 78 to 2nd half of Dec. 79) while total reserves increased from $5,615 million to $6,097 million. Had total reserves remained unchanged at $5,615 million, total statutory bank deposits would nevertheless have increased from $99,911 million to $107,567 million. Such is the nightmare of a differentiated reserve requirement banking system.

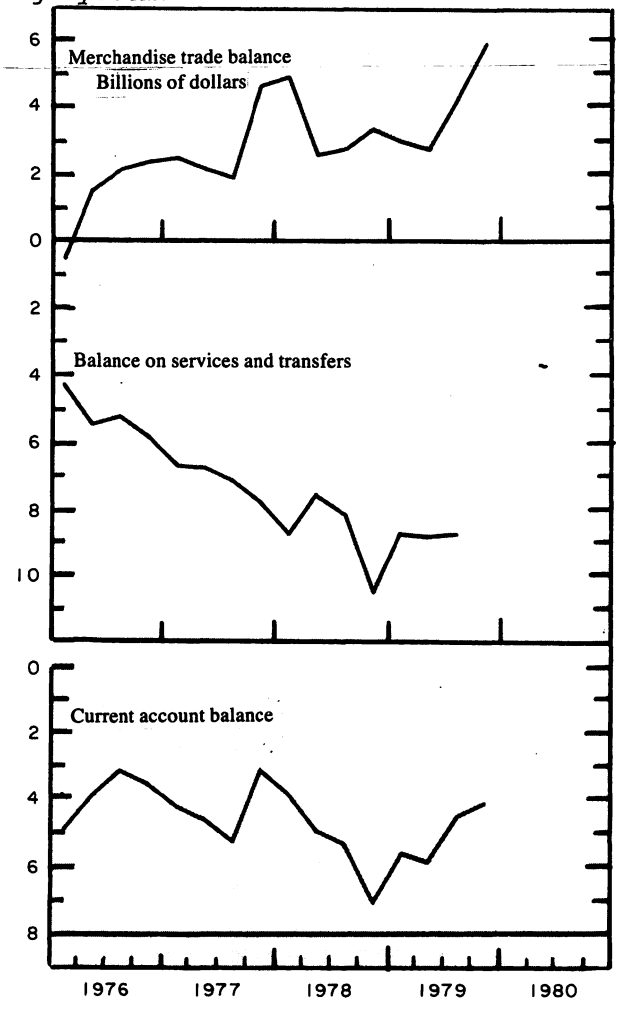
The external sector and domestic credit expansion

Domestic credit demands per force must be financed out of domestic savings or out of foreign savings (i.e. capital inflows). Foreign savings, then , are the counterpart of excess domestic consumption (or deficient domestic savings) producing the well-known deficit on current account.

Domestic credit demands originate from the private sector and/or the government sector. A monetary policy that maintains interest rates artificially low (defined, perhaps, as being negative in the real sense) accommodates an excessive growth of bank credit, rather than the transfer of genuine savings. As a result, consumption outpaces available domestic resources, spilling over the external sector. Trade deficits by themselves are not a sign of excess domestic demands; current account deficits, which include merchandise, services and transfers, are (Chart VI)

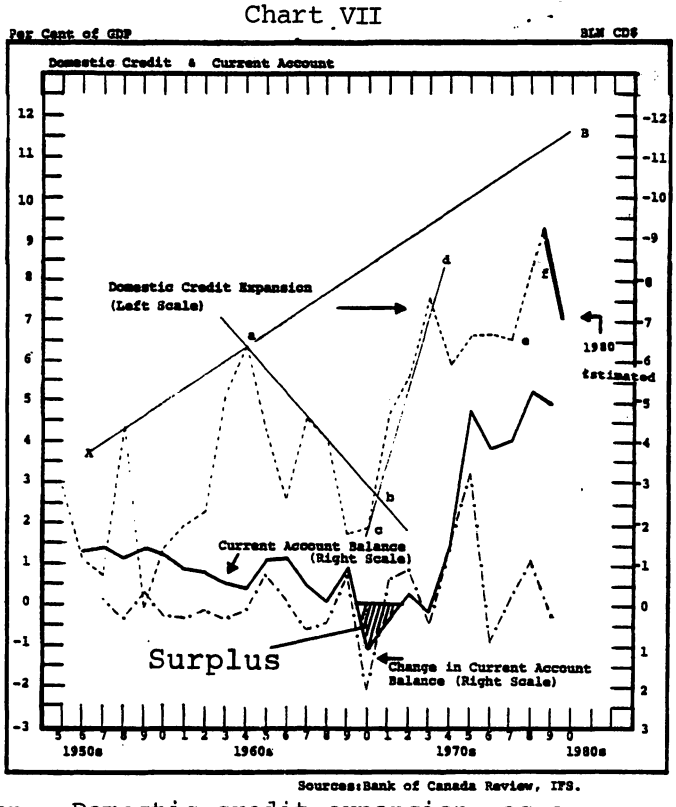
Can we measure excess domestic demand? Our first steps is to obtain the growth of total bank credit (including the Monetary Authorities'). We then proceed to match this credit growth with a proxy for genuine savings, in this case the GNP (assumes

Chart VI



a relatively constant savings function). Chart VII is a graphic expression of this exercise. It will be seen that domestic credit expansion has been outpacing the growth in GNP ever since the early 50's, producing an almost continuous deficit on current account. The sharp relative credit contraction begun in the late 60's (a-b) produced the only surplus of the period. Excess credit demands reached a new peak in 1972-73 (b-d) , producing a very substantial deficit on current account . The new high-level plateau reached in the mid-70's was being followed by new peaks in 1978 and 1979, mirroring exactly (and causing) the two largest back-to-back deficits on current account in Canadian history.

Chart VII



Sources: Bank of Canada Review, IFS.

In our forecast for 1980, we have assumed a slight deceleration of bank credit in both the private and government sectors. Total domestic credit expansion is put at $162.9 billion, a rise of $21.6 billion from 1979. The Gross National Product is estimated to run at a rate of $307.1 billion. Domestic credit expansion, as a proportion of GNP is seen to fall to the - 7% range, a small improvement from present levels. Based on this tentative estimate, we anticipate an improved current account balance.*

Summary and conclusion

Canada's price performance during 1979 was, not unexpectedly, poor. Setting aside the well-known difficulties inherent in facile statistical comparisons of price indices, we noted that Canada ranked well below the median of our sample of industrialized countries. In an attempt to measure inflationary pressures by means other than prices comparisons, we examined Canada's performance on current account and, here again, the conclusions have been disturbing.

Our analysis of prospects for the present calendar year focused necessarily on the Federal Government and its colossal encroachment on the nation's resources. Not only has the government's borrowing requirement been an engine of monetary expansion but it also has precluded the productive private sector from obtaining much-needed long term funding.

We accorded high marks to the Bank of Canada in its courageous attempt to cope with an onerous funding situation as well as its ability to lengthen the maturity of the Treasury's debt. Moving alternatively under the pretexts of either preserving normal U.S. - Canadian interest rates differentials or of containing the expansion of M1 to its predetermined target, the Bank of Canada achieved a relatively attractive level of interest rates. The result was a resounding vote of confidence on the part of the non-bank public who funded a great proportion of the public sector's borrowing requirements in a non-inflationary way.

Our forecast for 1980 contained a warning to the uncontrolled expansion of the Federal Government as well as a prayer of hope for the continued success of the Monetary Authorities. Total money supply and domestic credit expansion were expected to decelerate very slightly with beneficial effect on the deficit on current account (i.e. smaller). Finally, inflation was anticipated to rise to the range of 11.5-12% despite the slight improvement expected in inflationary pressures.

* Which, may, at some point in the near future offer excellent support for a 'politically' oversold Canadian dollar.