INFLATION IN CANADA

· 1982 ·

SPRING REVIEW

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

"The budget should be balanced.
The treasury should be refilled.
The public debt should be reduced.
The arrogance of officials should be
tempered and controlled.
Assistance to foreign lands should be
curtailed lest we become bankrupt.
The unemployed should be forced to
work and not depend on the
government for assistance."

— Marcus Tullius Cicero
106-43 B.C.

Has Anything Changed?

Are we harping on the subject? We think not. Ancient Rome's greatest orator, Cicero, sounded the warning over 2,000 years ago. We continue with his crusade. For five consecutive years now, we've published this special report on inflation and its effects on the Canadian economy. We analyze the problem. We pose solutions. And despite the persistent promises, claims, and counter-claims emanating from the ethereal realms of Parliament Hill, inflation remains a problem — a big one. And it's getting worse.

Monetary policy in this country has been a dismal failure. The Bank of Canada faces tremendous pressure to "do something"; yet all of its alternatives seem politically unpalatable. What to do? As in previous years, we again offer our analysis, our appraisal, and suggest a way out of this year's inflation-induced quandary. We continue with our critique of the monetary authorities' muddled monetarism and hope that our contumacious attitudes have some effect in high places — as Cicero would have wanted.

The Bank Excuses Itself

Double-digit inflation continued to afflict Canada during 1981. This dismal performance was recorded despite reassurances from the Bank of Canada that strict adherence to monetarist tenets would slow down the rate of price increases. Once again, the Bank of Canada has had to contend with apparent failure. In it's Annual Report the Bank defends itself in three ways. In the first place, it blames the resurgence of inflation on *external* facts such as the ". . . cyclical upswing in the US, the pressure on productive capacity in a number of Canadian industries . . . the decline in productivity . . . the second shock from world oil prices . . . ."[1] Incredibly enough, the US economy experienced the same pressure while recording a substantially lower rate of inflation than Canada. To be fair, the Bank of Canada includes in the above list the earlier substantial decline in the foreign exchange value of the Canadian dollar. Currency depreciation, however, can hardly be categorized as an nonmonetary factor. Clearly, as we shall see, it results from a lack of monetary discipline.

Another counter-argument used by the Bank of Canada is to state that "what monetary restraint did was to prevent the inflation rate from shooting upwards. This is certainly not failure . . . The inflation rate would be much higher than it is . . . ."[2]

The Bank's main line of defence, however, rests on the argument that it has had to adopt a gradualist policy of restraint and that, perhaps, this gradual approach will be crowned with success once everyone believes that the Bank is serious in its resolve to defeat inflation.

The Bank admits that it could have applied shock therapy and brought down the rate of monetary expansion from the initial 10 to 15 per cent per annum range to, perhaps, 4 to 8 per cent per annum over a shorter period of time than seven years. It goes on to say that a more gradual approach would minimize the disruption of the economy in the adjustment to a lower rate of inflation. ". . . More time would permit a more orderly change. Since 1975, the Bank has frequently reminded people that the adjustment to a less inflationary climate must occur and that the Bank would increasingly resist any tendency for high rates of inflation to continue. It hoped that this warning would lead people to avoid situations that would be unmanageable in less inflationary circumstances."[3]

Although we can sympathize with the Bank's predicament, we would question the wisdom of pursuing a policy that has no effective time limit or that, in fact, did not show *any* appreciable progress over seven long years. Could it be that the Bank of Canada's approach would never work? More fundamentally, one would have to question the validity of monetarism and/or the Bank of Canada's brand of monetarism. Last year, faced with this same problem, we demonstrated that while monetarism does work if applied correctly, gradualism is literally a waste of time and M_1 is not a proper proxy for money supply. This year, our conclusions remain basically unaltered, though we do not directly address the issue of gradualism.

Monetarism — The Bank of Canada's Version

In 1975 the Bank of Canada embarked on a gradual reduction in the rate of monetary expansion in Canada. The aggregate chosen by the Bank, M_1, was a narrowly-defined one, namely, currency and demand deposits at chartered banks held by the general public. In the words of the Bank, its "... decision to make particular use of M_1 is based on two main characteristics of this aggregate. One is the fairly stable and systematic relationship that has been observed between upswings and downswings in the rate of growth of the dollar amount of total spending in the economy and in the growth rates of money holdings defined in this way. When total spending in the economy has accelerated, whether because of more rapid increases in the volume or prices of transactions, the public has typically sought to hold larger money balances to facilitate its payments, and these actions have raised the rate of M_1 growth.

"The second characteristic is that M_1 can be steered along a target path more readily than the larger aggregates. The steering mechanism used is the influence the Bank of Canada can exert on the level of short-term interest rates. For example, an increase in short-term interest rates encourages holders of currency and demand deposits to economize on these non-interest-bearing balances, thereby slowing M_1 growth."[4]

The Bank's rationale seems faulty. In the first place, if narrow money balances are determined by the rate of total spending in the economy, then manipulating these money balances will not have any effect on the volume or prices of transactions any more than manipulating a thermometer will have an effect on the patient's fever. One would have to affect total spending, *somehow*, to affect M_1. Is the Bank saying that M_1 is a better indicator than total spending in respect to determining whether total spending is accelerating or decelerating? It would appear to be a circuitous way to obtain some basic statistical information.

Furthermore, there is little empirical evidence to show that the public, in periods when total spending accelerates, has sought to hold larger money balances, thus raising the rate of M_1 growth. If anything, as the Bank concedes, the increase in short-term interest rates encourages holders of currency and non-interest-bearing demand deposits to economize. This economization does not in any way indicate that spending has slowed down.

The Bank struggles a great deal with the question of velocity (i.e., economization of non-interest-bearing deposits) in an attempt to rationalize its continued use of M_1 targets. The Bank "is aware of this development" and during periods of increasing velocity (owing to improved cash-management facilities offered by banks) "the growth of M_1 was a less reliable guide for monetary policy." The Bank must constantly take into account these opportunity-cost related shifts. Not surprisingly, the Bank can only estimate the shift *after* the shift has taken place. Instead of admitting that the target was inoperative for the past year, the Bank promises to take the additional shift into account in its *next* adjustment to the target range for M_1. The Bank is, so to speak, constantly chasing its own tail. Nevertheless, it remains confident that "it will be possible to identify and take sufficient account of shifts to preserve the usefulness of M_1 as a longer-run policy target."[5]

In our opinion, it is entirely possible that these *shifts* have more than offset the target reduction in M_1. In effect, it would appear that on a shift-adjusted basis, the rate of M_1 growth was never reduced, thus helping to explain why seven years of monetarism have not produced any results.

For some strange reason, the Bank of Canada is not satisfied with couching its monetarist leanings in terms of setting M_1 targets. Perhaps, in an attempt to ward off accusations of being "too rigid" or too committed to abstract and cold monetarist ideas, it wants us to believe that, indeed, it retains a good deal of flexibility in the conduct of monetary policy. In summarizing his approach, the Governor of the Bank states that "... we believe

that we can reconcile the overriding need to control the rate of monetary expansion over time with some freedom to respond to short-term disturbances of either foreign or domestic origin that affect the economy. During 1980 and 1981 this freedom of manoeuvre, though limited, has allowed the Bank to moderate the effects on Canada of sharp swings in US interest rates and sharp swings in flows of capital across our borders. I believe that this pragmatic approach by the Bank has helped in the pursuit of the longer-run objective of reducing inflation in Canada with the least possible economic disruption."[6]

Intelligent individuals who read these words will be at a loss to understand how this policy has helped "in the pursuit of the longer-run objective of reducing inflation in Canada." Surely, everyone knows that for the past four years, inflation in Canada has accelerated from 8.9 to 9.1 to 10.1 and to 12.5 per cent in 1981. Is it possible that this very flexibility was responsible for the lack of progress evidenced to date?

Understanding the Monetary Approach

In order to understand the classical monetarist position, one must be able to differentiate between nominal and real monetary balances. Assume that everyone is content with holding no less and no more than $1,000 in monetary balances, readily available for spending. It can then be said that the level of desired real balances is equal to the purchasing power of $1,000. Assume, further, that the Canadian Air Force has been engaged to "drop" from the sky newly printed $1,000 bills, so that everyone in Canada would be in possession of $2,000 of readily spendable balances.

There is no reason to suppose that overnight every Canadian would want to hold $2,000 worth of purchasing power instead of the previously satisfactory balance of $1,000. Make one further (and unrealistic) assumption: Canada is a closed economy with no possibilities of trading with the rest of the world.

While individuals would be able to dispose of their extra $1,000 bonanza, the economy as a whole would not — the loss of one individual would represent the exact gain of another. How, then, could all Canadians satisfy their desire to reduce *real* spendable balances from $2,000 to $1,000?

It stands to reason that increased purchasing interest, in the face of a relatively steady supply of goods and services, would drive up prices. If prices double (a likely outcome given the doubling of the supply of money), the real *purchasing power of the dollar is cut in half.* Canadians, as a whole, would still be holding $2,000 in nominal balances; in real terms, however, their monetary balances would have been reduced to $1,000. It thus can be demonstrated that as opposed to nominal variables (an increase in per capita money supply from $1,000 to $2,000), monetary authorities cannot change real variables, such as real spendable monetary balances.

Changing our assumption that Canada is a closed economy to the more realistic case of an open economy introduces a slight modification in the "absorption" mechanism. Foreign trade would act as an escape valve: Some of the excess monetary balances would find their way out of the country in search of cheap goods and services. In effect, *at a fixed rate of exchange,* Canadians with $2,000 in spendable balances rather than $1,000 would, overnight, become relatively wealthy in relation to, say, Americans.

Canadians would be in a position to purchase condominiums in Florida at relatively low prices (at least in relation to their newly increased purchasing power) as well as Japanese-made cars, German-made machinery, OPEC oil, and so on. This bargain hunting, however, would necessitate the purchase of foreign currency, thus threatening to deplete the country's international reserves.

Excess nominal balances would be "absorbed" by purchases of foreign currency. If the Bank of Canada were in possession of a relatively healthy level of international reserves, it may acquiesce in the loss of foreign

currency. Canadian domestic prices may not rise after all: firstly, because the excess of monetary balances would disappear through the foreign exchange window of the Bank of Canada; secondly, because large quantities of imports would place an effective lid on most "tradeable" items.

Alternatively, if the Bank of Canada refused to make foreign exchange available out of its reserves, Canadians would try to obtain foreign currency on the open market (a floating-rate system would in effect be in operation) by bidding up the price of US dollars, Japanese yen and German marks. The relative depreciation of the Canadian dollar would raise the cost of foreign purchases, such as Florida condominiums and Japanese cars. In effect, real balances, as opposed to nominal balances, would once again be automatically reduced to the desired level.

We have posited the existence of real monetary balances. These balances are dictated, among other things, by income levels, tastes, technology, and liquidity preferences; they are not subject to government fiat nor are they likely to change drastically over short periods of time. Increases in nominal quantities of money have no impact on real balances; these increases are likely to be reduced either by way of price increase and/or purchases of foreign exchange (when deposits are in fact sterilized and extinguished) and/or currency depreciation.

Monetary authorities may choose a "mix," but if they attempt to control prices, the entire burden of the adjustment would be taken on its reserves or, alternatively, on the external value of the currency. Clearly, it would be futile to combat inflation (i.e., increases in the nominal quantity of money) by way of controls. The community, flooded with excessive liquidity, will seek to rid itself of this excess and reattain the desired level of real balances.

Monetary Policy Gone Awry

The Bank of Canada has shown a commendable restraint against the background of Ottawa's chaotic and extravagant fiscal posture. Chart 1 continues to show progress: the Bank finances an increasingly smaller share of government net financing requirements. As a result, Bank of Canada credit shows a distinct downward bias, as shown on Chart 2. The Bank can be faulted for not refusing to finance any government obligations, i.e., by applying shock therapy. Nevertheless, the results do indicate a tightened and disciplined approach to a delicate political problem.

The heavy line on Chart 2 shows the rate of growth of the monetary base, a proxy for Bank of Canada intentions.* The trend is somewhat misleading, for it does not adjust for the continuous expansion of the chartered banks' deposit multiplier. Chart 3 depicts this phenomenon, caused by the public's shifting from high reserve-requirement demand deposits to low-requirement (interest-bearing) time and notice deposits. Changes in the recent Bank Act will further the expansion of the multiplier, complicating the overall job of monetary restraint.

The dotted line in Chart 2 shows the monetary base, taking into account this shifting effect. As can be seen, despite the goodwill and intentions of the Bank of Canada, the adjusted monetary base shows an accelerated upward trend in recent years, although the year-on-year growth figures remain well below those attained in the mid-70s. Since (a) the Bank cannot (and, indeed, should not) control shifts in deposits and (b) since a lowering of reserve deposits is laudable in that it cheapens the cost of credit intermediation, it behooves the monetary authorities to try to offset, via open market operations, the expansionary effects of the deposit/reserve ratio.

*The monetary base is high-powered money, which only the Bank of Canada can create.

	Government of Canada Net Financing Requirements	Bank of Canada Purchases	Purchases/ Requirements
	(in Millions of Canadian Dollars)		%
1966 - 68	2,578	471	18.27
1969 - 71	3,671	925	25.20
1972 - 74	3,685	2,182	59.21
1975 - 77	17,817	3,268	18.34
1978 - 80	34,039	5,788	17.00
1981	7,243	1,125	15.53

Source: Bank of Canada Review

Chart 1

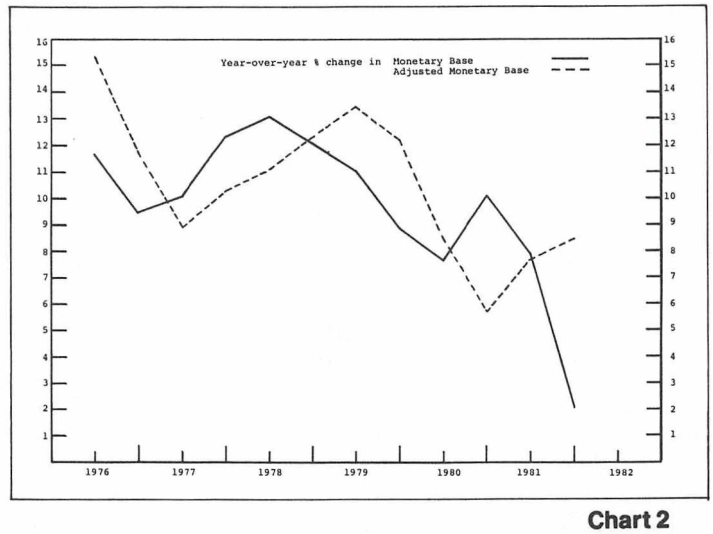


Chart 2

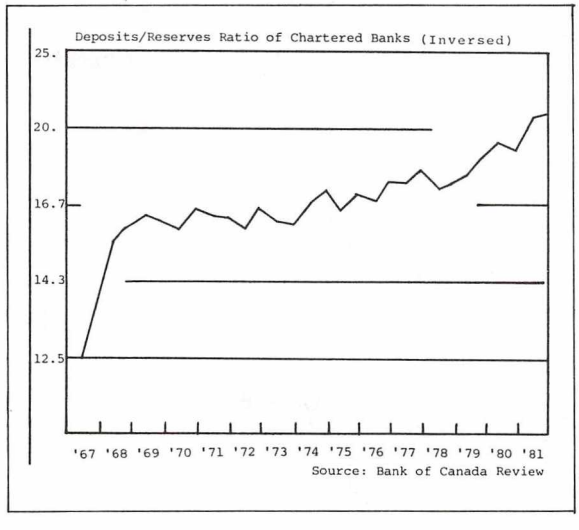


Chart 3

Monetary Inflation During 1981

Was monetary inflation excessive in 1981? Relative to its other trading partners, and depending on which yardstick we chose, the answer can be both positive and negative. Chart 4 shows the net official monetary movement for the past twelve years. Clearly, if monetary inflation during 1981 was expansive, it was not apparent in a loss of reserves as was the case during 1980. It should be noted, however, that the entire gain (and then some) in Canada's balance of payments took place in the last quarter of 1981, and that for the first three quarters, Canada suffered a balance of payments deficit. The fourth quarter improvement was most probably due to the very successful Canada Savings Bonds campaign, which swelled government balances at the Bank of Canada, tightening credit and causing M_1 to fall at an 18 per cent annual rate.

Chart 5 shows the price action of the Canadian dollar throughout 1981. Here again, a depreciation in mid-year, caused primarily by expansive monetary inflation, was fully reversed towards the end of the year, leaving the exchange rate almost unchanged from January to December. If there was excessive monetary inflation during 1981, its adjustment did not take place via a depreciating exchange rate.

Chart 6, on the other hand, does show some adjustment to an excessive rate of monetary inflation. Prices, measured by the Consumer Price Index (CPI), show an accelerating upward trend as well as a widening differential vis-à-vis the US rate of inflation. To a certain extent, this result was predictable (as we stated last year) in view of the expanding 20 per cent-plus devaluation that took place in the 1976-1979 period. The disturbing aspect of the CPI performance was the slight acceleration in cost and prices over the 1980 period. *This acceleration must be attributed to the adjustment sought by the community in its effort to rid itself of excessive monetary balances.*

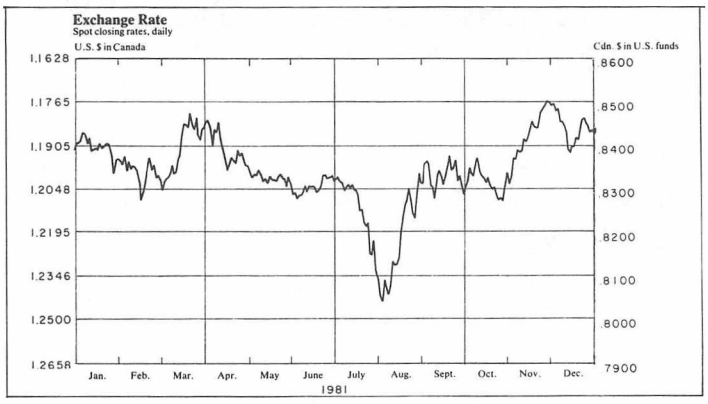
Chart 4

Net Official Monetary Movements

Millions of CD$

1970	1,663
1971	896
1972	336
1973	- 467
1974	24
1975	- 405
1976	522
1977	- 1,421
1978	- 3,299
1979	1,908
1980	- 1,280
1981	1,426

Source: Bank of Canada Review



Bank of Canada Annual Report 1981

Chart 5

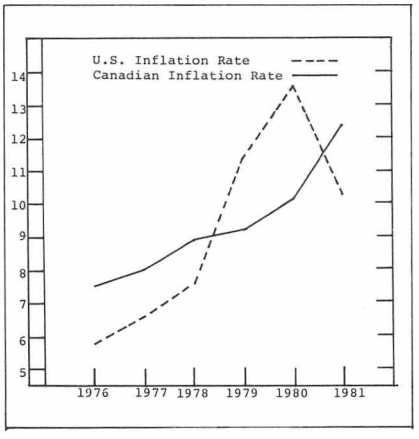


Chart 6

The Classical Monetarist Model in Operation

As we have seen, losses in net international reserves or a drop in the external value of the currency or a combination of both act as shock absorbers in that they reduce inflationary pressures on prices. If our argument is correct, we should find that years beset by excessive monetary inflation would invariably leave their mark by some combination of a negative movement in international reserves, a falling rate of exchange and an inflation rate greater than the US inflation rate.

We undertook to verify this point empirically. As a proxy for monetary inflation we computed the expansion of domestic credit (DCE)* as a proportion of Gross National Product (GNP) for each year of the 1960-1981 period. Four groups were constructed on the basis of one standard deviation on either side of the mean (the average DCE/GNP ratio). Groups A and B, showing the lowest DCE/GNP ratio, represent years of restrained monetary expansion; conversely, Groups C and D, showing the highest DCE/GNP ratio, represent years of excessive monetary expansion. Chart 7 summarizes our findings and provides a ranking for those groupings in terms of overall performance.

The results lend credence to our hypothetical model. Groups A (1961, 1962, 1964, 1969, 1970) and B (1963, 1965, 1966, 1967, 1968, 1971) rank best and are well ahead of Groups C (1972, 1973, 1974, 1975, 1976, 1977, 1980) and D (1978, 1979, 1981). Curiously, "tight" monetary policy and good economic growth are not incompatible: Groups A and B enjoy the highest rate of growth in the 20-year period, far surpassing the growth rates achieved during the inflation years encompassed by Groups C and D. Inflationists, please note.

It would appear that a steady expansion of domestic credit equal to, but not exceeding, 4 per cent of GNP would yield the best results. Since domestic credit expansion in recent years has exceeded 10 per cent, one must conclude that the Bank of Canada has not been able to achieve an optimum monetary policy. Worse yet, the 1975-1981 period, the very same period covered by the Bank of Canada's avowed monetarism, ranks in terms of overall performance as the worst period in the past 20 years. The losses experienced in international reserves as well as the significant exchange rate depreciation and high relative rates of inflation seen during those years are symptomatic of an easy monetary policy.

These findings clearly run counter to the Bank's assertion that monetary policy has been progressively tightened in recent years. Almost certainly, velocity increases associated with rising interest rates and technological (banking) innovation are more than offsetting quantitative reductions in the control variable. While the Bank, in its Annual Report, concedes that the "use that can be made of M_1" has been "complicated" by velocity consideration, it nevertheless "expects" that it will be possible to identify and take sufficient account of shift to preserve the usefulness of M_1 as a longer-run policy target. Our analysis indicates that this has not been the case, that is, the Bank has not been able to properly "identify and take sufficient account of shifts" due to banking innovation and rising interest rates.

Why has there been such an expansionary drift** in domestic credit expansion? And why does monetary policy feel "tight" — as witnessed by relatively high real rates of interest — when in fact it has been "easy"? To answer these questions, we must turn our attention to fiscal policy.

*A very broad measure of money supply. For a detailed explanation of domestic credit, see our last year's report *Inflation in Canada: Spring 1981 Review.*

**Most of the past half-dozen years are included in Groups C and D.

INFLATION PERFORMANCE

Group	Net Official Monetary Movements (Mln of CD$)	Monetary Movements/ GNP	DCE/GNP	CD Inflation Rate as a % of U.S. Inflation Rate	Exchange Rate	Real GNP (% growth)	Ranking*
A	507.6	0.768%	1.686%	82.31%	-1.26%	4.88	7
B	201.5	0.25%	3.94%	105.23%	0.44%	5.77	7
C	-384.43	-0.16%	6.47%	107.46%	-0.65%	3.73	13
D	103	-0.06%	10.4 %	104.08%	-3.95%	3.22	13

Group A - 1961, 1962, 1964, 1969, 1970
Group B - 1963, 1965, 1966, 1967, 1968, 1971
Group C - 1972, 1973, 1974, 1975, 1976, 1977, 1980
Group D - 1978, 1979, 1981

* Ranked from one to four, with the lowest number indicating the best result in each category - Monetary/GNP, relative inflation, exchange rate performance, rate of growth of real GNP. All points are then added.

Mean DCE/GNP for all years = 5.16%
1 Standard Deviation = 2.97%

Sources: Bank of Canada Review
International Financial Statistics

Chart 7

The Fiscal Connection

Chart 8 summarizes the budgetary balance as well as the government's total financial requirements in the 1961-1981 period. In order to gain a perspective of the magnitudes involved, we have also expressed these balances as a percentage of GNP. Chart 9 does the same for Groups A, B, C and D, referred to in the previous section. The evidence is overwhelming, pointing to more than just a passing coincidence. Large fiscal deficits lead to excessive domestic credit expansion, which in turn, as we have seen, leads to inflation, currency depreciation, and the loss of international reserves.

The upward drift in domestic credit expansion has been forced upon a reluctant Bank of Canada,* as well as the banking system, by the massive fiscal deficits produced by the federal government. In fact, government financing needs represent a significant portion of the excess domestic credit expansion (see Charts 7 and 9).

High interest rates are primarily a product of the collision between the public sector, the private sector, and their respective borrowing requirements. The balance can be explained away by pointing to the relatively "low" rate of after-tax real rate of return† as well as the persistence of inflation in recent years and its effects on expectations. In short, interest rates can be high and monetary policy can feel "tight" but overall credit expansion can remain excessive.

*Which, except for 1972-1974, as seen on Chart 1, has shown a dogged determination not to monetize a substantial portion of the fiscal deficit.

†Now negative, at the marginal tax rate of 50 per cent.

Government of Canada

	Budgetary Surplus or Deficit (-) (mln CD$)	as % of GNP	Financing Requirement* (mln CD$)	As % of GNP
1970	- 163	- .19%	- 585	- .68
1971	- 723	- .77	- 1,443	- 1.53
1972	- 31	- .03	- 1,108	- 1.05
1973	- 6	- .01	- 753	- .61
1974	- 434	- .29	- 1,824	- 1.24
1975	-4,833	- 2.92	- 5,829	- 3.53
1976	-5,048	- 2.64	- 4,338	- 2.27
1977	-8,208	- 3.93	- 7,650	- 3.66
1978	-13,247	- 5.75	-12,165	- 5.28
1979	-11,504	- 4.39	-10,719	- 4.09
1980	-12,512	- 4.32	-11,155	- 3.85
1981	-11,373	- 3.46	- 7,243	- 2.20

*Excluding Foreign Exchange Transactions

Source: Bank of Canada Review

Chart 8

Group	Budgetary Surplus or Deficit (-) (mln CD$)	As % of GNP	Financing Requirement* (Mln CD$)	As % of GNP
A	- 238.8	- 0.67	- 451.6	- 1.03
B	- 524.8	- 0.79	- 761.3	- 1.08
C	-4,348.4	- 2.02	-4,665.3	- 2.32
D	-12,041	- 4.53	-10,039.3	- 3.50

* Excluding Foreign Exchange Transactions

Source: Bank of Canada Review

Chart 9

Socializing the Economy

The state can outbid the private sector for real resources in three ways: It can tax, it can inflate, or it can outborrow. The recent budget, with its continuation of indexation, and the reduction of marginal tax rates has indicated that further socializing of the economy's real resources will not come by increasing taxes*. The Bank of Canada, in no uncertain terms, has vowed to achieve monetary stability: "there can be no turning back . . . the broader objectives of our societies cannot be pursued effectively without the help of money that can be trusted"[7] and ". . . the Bank of Canada has no responsible option but to continue to restrain the rate of monetary expansion in Canada . . . it cannot back off from that policy."[8] Here again, the private sector is not likely to give up real resources to the state through accelerated inflation — at least not for the moment.

If monetary policy tightens, however, as it should if it is to arrest inflation, then the state will have expropriated real resources from the private sector, *provided it continued to run massive deficits.* Through high and rising interest rates and their effect on capital values, the private sector accommodates the wealth-grabbing operation of the treasury. Furthermore, the private sector must yield resources, for it is unable to compete with the gilt-edged quality of government obligations.

*Except in the energy area.

Policy Implications

The Bank of Canada must stop fixing monetary policy around M_1 and should start paying some attention to domestic credit expansion, a much broader measure of money supply.

In changing policy objectives, the Bank must first find that rate of growth of the monetary base that is compatible with a domestic credit expansion not in excess of 4 per cent of nominal GNP. Given that the present DCE/GNP ratio is excessive (over 10 per cent), the Bank would probably have to lower the growth in the adjusted monetary base to half of the present pace.

Our analysis bears other significant implications. While the deficit on current account does not matter, *so long as the country is able to borrow abroad on terms as good as, or better than, domestic ones,* the loss of international reserves raises a danger flag because it signals that monetary inflation is excessive. A devaluation may reduce real balances even further and thus avoid losses in international reserves* *but only at the expense of rising prices and wages.* If, however, wage and price controls are imposed si-

*It should be noted that Canada's net international reserves have risen over the past three years, and therefore there should be no good reason to devalue.

multaneously, real balances can only be reduced vis à vis losses in international reserves — defeating the original raison d'être for the devaluation. The Bank must accept the consequences of excessive monetary inflation. There is no easy way out.

The Balancing Act

We have learned that inflation — a disease characterized by excessive monetary expansion — can be manifested in a number of ways, including price increases, currency depreciation, and the loss of international reserves. While monetary inflation ultimately leads to higher prices, currency depreciation and the loss of international reserves may act as shock absorbers and repress visible signs of inflation for a considerable time. In this context, we have seen how ineffectual monetary policy has been in recent years. We have concluded that to achieve price stability or, better yet, monetary stability, monetary policy must fix on domestic credit expansion, and that under no circumstances should it exceed 3 to 4 per cent of GNP.

Responsibility for the upward drift in credit expansion, however, should be placed squarely on the shoulders of the treasury. There is absolutely no other way to bring inflation under control, without further socializing the private sector, than by balancing the budget. It should be clear, however, that in a noninflationary monetary environment, every dollar of deficit is a dollar extracted from the private sector. As opposed to taxation, financing the deficit is a voluntary act on the part of the investing public. It can be argued, however, that rising inflation rates depreciate capital values involuntarily and financing the deficit is therefore no different than taxation.

Aside from the question of the aggrandizement of the state, large fiscal deficits in the context of a noninflationary monetary policy may be so painful to the *business* sector that the latter may ultimately force the Bank of Canada to succumb to the temptation of inflation.

And there is one more self-evident truth. The sooner the government is able to balance the budget — primarily by cutting expenditures — the sooner Canada will attain price stability and full employment.

Notes

1. Bank of Canada, Annual Report. Gerald Bouey, Governor, p. 7.
2. Ibid.
3. Ibid. p. 6
4. Ibid. p. 29
5. Ibid. p. 31
6. Ibid. p. 8
7. Ibid. p. 5
8. Ibid. p. 10

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