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# Canada: What ails the dollar?

Since the end of 1976, the Canadian dollar has depreciated by almost one third vis à vis its US counterpart. In the following articles we explore the reason for this frustrating slide. As we isolate the cause of this remarkably long malaise, we provide the reader with some analytical tools, which, we hope, can be used to peer into the always uncertain future.

Two of our contributors, Neil Reynolds, Editor-in-Chief of *The (Kingston) Whig-Standard* and Dr. Steve Hanke, chief economist of FCMI, dissect the patient. Mr. Reynolds' colorful anecdotal evidence and Dr. Hanke's analytic approach combine to enable our readers to identify the problem — and its solution — quite clearly.

In the third article, we provide a numerical perspective of the pressures operating on the dollar and an easy-to-understand 'model' of the trade-off between a falling dollar and rising domestic interest rates.

## The great money migration

**By Neil Reynolds**

In the Roaring Twenties, by the hundreds of thousands, Canadians packed up their old kit bags and moved to the States. It wasn't that things were cataclysmally wrong at home — merely that things were better across the border. With only their sweat to invest, entreprenurial Canadian workers emigrated in vast numbers to earn a higher rate of return on their labor.

By whatever means, President Ronald Reagan has duplicated the conditions that persuaded many Canadians, 60 years ago, to invest their energy in a foreign land. We are now, however, a richer and more sophisticated population. And we cannot now simply walk across an international bridge, even if we wanted, and begin a new life. As a consequence, many Canadians — more than ever before — are hustling their savings southward, in their stead, to the nation that is again the land of great expectations. Largely closed now to the entry of Canadian muscle, the border remains open — so far, at least — to the entry of Canadian money.

### Mulroney's boast irrelevant

When he proclaims in self-congratulatory fashion that Canada is doing better now than it has in many years, Prime Minister Brian Mulroney's boasts appear irrelevant, strangely separated from reality and, frankly, out-to-lunch. He earnestly seeks our applause for waving a sparkler while behind him, to the south, Mr. Reagan presides over a fireworks display that fills the sky.

Within Canada itself, people probably do believe that things are better now. The Conservative government has done a few things that needed to be done.

So what? In stark contrast with the United States, our currency is weaker. Our interest rates are higher. Our governmental debt is proportionately higher. Our tax rates are insanely higher — and our personal return-on-labor less. Our unions are more belligerent. Our productivity is worse. Our work ethic is worse. Our unemployment rate is worse. Our market-place is more regulated. And our basic expectation is that none of this will change by very much in the years immediately ahead.

From primitive economic instinct alone, one can now simply assume that individual Canadians are dispatching kit bags full of cash across the border in unprecedented numbers. One can advance the assertion only as a thesis, of course, not as indisputable fact. Yet it is a thesis supported by anecdote, statistics, and one eloquent economist at the Bank of Canada. At almost the same time that Mr. Mulroney was telling the nation that his government had to "burn the speculators," this economist was saying in private that under current conditions in Canada, "every investor must become a speculator." Readers will understand why I do not use his name.

We are not talking here about the normal cross-border shipments of money for all of the usual corporate, institutional, and governmental reasons. We are talking here about individual Canadians who — many of them for the first time in their lives — are investing in the United States. They are doing so legally, for the most part, and by sober calculation. Together, they are granting new US citizenship to billions of Canadian dollars.

## The exchange-rate paradox

It is an apparent paradox. With the Canadian dollar at 71.5 cents, who can "afford" to move money across the border? Who wants to "lose" a big hunk of his savings in exchange-rate transactions before he can invest it? It is a perplexity that explains why some Canadians remain resolutely convinced that the fallen dollar, by itself, precludes investment in the US. "I would rather earn 12% on 100 cents," one man — a successful businessman — told me, "than 10% on 7 cents." In the real world, however, the lower our currency falls, the more frequent will be the trek of the Canadian dollar to sanctuary in America. For the individual person, by and large, will respond in essentially the same way as the multinational corporation, although he will perhaps act sooner. He will seek to invest his money to gain the highest real rate of return. And it is hard to calculate a *real* rate of return — let alone collect it — in Canada. This is, after all, a country with a currency that loses its intrinsic value in such a sure and steady succession of steps that its future erosion appears inevitable.

## Panic movement of money

From Washington's perspective, the figures are different but indicate the same Canada-US money flow. In 1985, for which Canadian figures do not yet exist, the American books show the arrival of 3.6 billion Canadian dollars in small-scale Canadian transactions, and a US Treasury official told me that Washington detected last year, for the first time, some evidence of the "panic movement" of money from Canada to the States.

These figures measure what StatsCan used to call "errors and omissions," and the agency insists that they really cannot be used to explain anything at all. Canada's capital account is supposed to measure the movement of capital — direct investments, portfolio investments, bank term deposits, foreign aid — in and out of the country. In reality, StatsCan measures large transactions and extrapolates from them to produce a national total. Our current account measures the money we make from our exports, the money we pay for our imports, and the value of our trade in services. The accounts never balance, however, and it is the plus-or-minus discrepancy at year's end that gives a solid clue to the small-scale movement of Canadian cash.

## Unrecorded flows provide clues

The Bank of Canada, for one, regards these figures in precisely the same way that they are used here — as evidence of unrecorded flows of money out of Canada. The Bank of Canada economist with whom I spoke confidentially says that the "statistical discrepancies account is most definitely a guide to the movement of money from Canada." And, if anything — given the nature of personal and private transactions — it probably understates the flow of money from Canada in a significant way.

StatsCan itself doesn't even try to estimate the amount of money Canadians take out of the country as individuals simply because it is too huge a job. The agency essentially tracks the transactions of the banks and large corporations. When an individual moves money across the border, the transaction will almost never be reflected in the national statistics of either country.

It is not that these transactions go unrecorded, leaving no trace — merely that they are recorded in such a multitude of places that no statistical agency has found a way to collect them. When a Canadian buys a farm in Vermont, and borrows funds in the States, the transaction escapes StatsCan. (If a Canadian buys a condo in Florida, StatsCan may or may not pick up the information: It does try to monitor "hot spots" of Canadian investment.) When a Canadian buys securities directly through an American company, the transaction escapes StatsCan. When a Canadian transfers money from his Canadian account to a small American bank, the transaction escapes StatsCan. The agency doesn't even catch on, in statistical terms, if the Canadian ultimately pays tax on his American earnings.

And when a Canadian travels to the States as a tourist, StatsCan will estimate his spending based on voluntary interviews with a small sample of travellers. If the tourist leases a shopping centre while on vacation, the statisticians will never know.

From an investment perspective, the primary targets for individual Canadians — real estate, stocks and bonds — are largely invisible transactions to Statistics Canada. The agency concedes: "Except for a sample of tourist spending, we do not track individuals at all."

## Terrorist statistics

Mr. Wilson is a captive of what might be described as terrorist statistics. At the moment, he has identified his captor as the 69-cent dollar, and he consequently has worked out an heroic strategy for his escape. At public expense, he will ransom himself. At another moment soon, however, the ransom paid, his captor will pass him on to another — deficit statistics first, perhaps, and later interest rate statistics and perhaps, finally, tax-rate statistics. These are always crisis statistics. They preoccupy the public, and dominate the front pages of newspapers. In harmonious chorus, the Opposition enthusiastically expoits them.

The Canadian dollar is in its 10th year of decline. Since November 1976, and the election of the Parti Quebecois, the Canadian dollar has fallen, on average, two cents a year. The Fall is not an episode — it is a phenomenon, an annual occurrence like the increases in postal rates and gasoline taxes. The proclamations of the Prime Minister notwithstanding, Canadians do not believe that this particular area of wealth-erosion has ended. In the absence of strong evidence to the contrary, why should they?

## Going to the dogs

This is an example of what an economist describes as negative extrapolative expectation. It is an example of wha

ordinary citizen describes as going to the dogs. Both phrases suggest the same thing, and express a pervasive sentiment that — based upon our assessment of the past — we do not trust the future. The Conservative government has failed to persuade Canadians, either through real policy change or through rhetoric, to alter their basic belief that the worst is yet to come. Finance Minister Michael Wilson's national alert for his Feb. 26 budget — get all of your affairs in order — sounded as grim as death itself and will not help to develop economic vitality.

For anecdotal evidence that Canadians are moving money out of the country, I offer the immigrant restaurateur who occasionally serves me coffee and toast. After years of trading on the Toronto Stock Exchange, he made his switch last October. Now he doesn't own stock in a single Canadian company and trades exclusively in the American marketplace (and, by the way, did very well recently with IBM call options). He trades through a Canadian broker, and is one of the people who pushed Canadians' recorded purchases of US securities upwards toward $3 billion in 1985. In 1982, the comparable figure was $600 million. (In 1983, $1.2 billion; in 1984, $1.9 billion.) These figures are dramatic, and indicate a fundamental change in opinion.

I also offer as anecdotal evidence:

☐ The small businessman, whom I know well, who has invested the bulk of his savings through several small financial institutions in the States. Although he didn't need to do so (given the laudable absence of currency controls in this country), he moved a portion of this money across the border in the trunk of his car.

☐ The Ontario doctor who has established and equipped an office — still not used, but ready to go — in northern New York State.

☐ And the woman I know who always carries US currency in her wallet because it makes her "feel more secure."

## Government acts on useless information

These last three examples illustrate money motion that will not be measured by Statistics Canada. They are all "recorded," in one way or another, some place, but they all escape StatsCan. The consequence: Mr. Mulroney and Mr. Wilson are acting on all kinds of information that they don't really need to know and do not know the one piece of information on which they need to act.

There are statistics, however, that do provide some help — the numbers in our national account books that fall under the heading of "statistical discrepancies." Using these numbers as a rough guide, Canadians started to exile larger and larger amounts of their savings in 1981, the year that Ronald Reagan assumed office as President and radically altered the rhetoric, if more modestly the reality, of the American economic environment.

Before 1981, individual Canadians and small companies moved roughly $500 million a year to the States. In 1981, however, they moved a staggering $7.4 billion. In 1982, $3.2 billion. In 1983, the trend inexplicably reversed itself, and Canadians brought home $1 billion. In 1984, however, the exodus resumed, and another $2 billion crossed the border.

In the words of Statistics Canada, we are experiencing "a persistent negative bias" in these personal, small-scale, statistically-unrecorded transactions. The Americans, as the whole world knows, are experiencing a potent bias of a reverse kind. In 1984, the Americans recorded a "statistical discrepancy" in their favor of $25 billion and, in 1985, had already surpassed that amount by the end of the third quarter.

As important as it is, however, the exchange rate is not, by itself, of terminal importance. Nor is the interest rate. Nor the level of the federal deficit. The central question is this: In the economic environment, as it is understood by the individual Canadian of average intelligence, what rate of real return can a person expect a specific investment to earn? It is abundantly clear that at the moment, large numbers of Canadians have determined to their personal satisfaction that the American environment will produce higher rates of real return on their investments in the years ahead. It is not necessarily a universal judgment, and it could very well be proven wrong. But out there at the margin, where invisible acts by unknown individuals pass silent judgment on the whole burden of government policy, people are putting their money where their expectations dictate.

## Higher taxes, lower dollar

"Life can only be understood backwards," Kierkegaard said, "but it must be lived forwards." Looking now at the Conservative government's caution over many months, Canadians have no rational reason to expect the policy changes necessary to liberate our economy. We can, however, rationally anticipate higher and higher levels of taxation. Whatever Mr. Wilson may do for a particular constituency, we *know* that taxes are going higher. And we have plenty of reason to believe that the dollar has not yet hit bottom. We confront the prospect of quickened expropriation of our wealth as we earn it, and persistent erosion in the value of the savings we have. It is not strange that many ordinary Canadians are on a money migration. From the beginning of time, people have moved to preferred economic environments whenever they could. From the beginning of time, so has money. And Canadian money, after all, is only human.

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# Maple leaf capitalism

**By Steve H. Hanke**

After being shocked by the depth and duration of the 1981-82 recession, Canada's business and government elites have once again become complacent, if not mildly optimistic, about the state of the economy. Their mood has been shaped by Canada's economic indicators, which, when viewed from afar, haven't been too bad. Indeed, with the exception of a ballooning federal budget deficit and a stubbornly high unemployment rate, popular economic aggregates indicate that the Canadian economy is performing reasonably well: Gross national product, industrial production and total employment are growing; the balance of trade is in surplus; and since the 1981-82 recession, inflation, and consequently long-term nominal interest rates, have fallen dramatically.

However, Canada's broad economic indicators, if not accompanied by an analysis of the economy's underlying fundamentals, are illusory. During the post-World War II era, Canada has, in large part, followed Western Europe's lead in the economic policy sphere. In consequence, Canada has embraced socialistic policies, which have been rotting the economy's timbers. This fact is partially obfuscated because Canada's economy is highly integrated with the United States'. As a result, Canada's broad economic indicators tend to mirror the strength of the United States' economy, and mask, to some extent, the underlying economic problems that have been imported from Europe. This explains, for example, why Canada's 1981-82 recession, while severe, was not as serious as Europe's (but more severe than that of the United States), and why the Canadian recovery has been more powerful than Europe's (but not as buoyant as the United States').

## Government takes 55% of GNP

We begin our analysis of the Canadian economy with an examination of the public sector and its claim on the nation's resources. During the past 20 years, public spending in Canada has been growing at a super-rapid rate. For example, even though public spending in the United States has exploded, Canada's public spending growth rate has exceeded the United States' by 65%. In consequence, if we include Canada's Crown Corporations, the government's share of the economy is some 55% of gross national product. Although this claim does not yet match some of the European countries, it is far greater than that of the United States.

The growth of the public sector's claim on the nation's resources is important because it creates waste and reduces the yield generated by the country's resources. In consequence, it reduced the nation's productive potential, it is a drag on the economy, and it cuts into the average citizen's standard of living. A comparison between Canada and the United States is revealing. Only 10 years ago, Canada's real per capita income was slightly higher than that of the United States. But, by 1985, Canada's real per capita income had slipped to only about 95% of the United States'. (Note that to avoid distortions caused by changes in the exchange rate between the US and Canadian dollar, these comparisons have been made on a purchasing power parity basis. If purchasing power parity had not been used, the deterioration in the Canadian standard of living, relative to that of the United States, would appear to be substantially greater because the Canadian dollar has depreciated against the US dollar since 1975.)

The public sector's claim on Canada's resources has been financed by a combination of taxes, inflation, and government borrowing. Relative to most countries, however, Canada has relied more heavily on government borrowing. For example, when compared in relative terms with the United States, Canada's annual budget deficit is about 40% higher; its outstanding public debt is about 25% higher; and its interest payments on public debt are about 30% higher.

## Conservative expectations dashed

When Mr. Brian Mulroney's Progressive Conservatives swept the Liberals aside on September 4, 1984, hopes were high that the so-called Conservatives would reduce the government's spending appetite. At the time, Mr. Mulroney was talking tough, and with a commanding 211 of the 282 seats in the House of Commons, it appeared that he would be able to rid the country of excessive government spending. These expectations have been dashed in the intervening months.

The Prime Minister's strategy on government spending control has been one of co-opting the alleged political center by endorsing most of his predecessors spending programs and ignoring the remainder. Symbolic of Mr. Mulroney's commitment to dismantle big government is the fact that he has saddled himself with a bloated cabinet of no less than 40 ministers.

With the exception of a feeble attempt to reduce the indexation of pensions for the cost of living increases — a proposal that the government-backed away from — Mr. Mulroney has done little to attack Canada's public spending cancer. The Prime Minister's lack of resolve in dealing with this issue is reflected by the fact that he has failed to embrace a broad-scale privatization program that would transfer assets and activities from the public to the private sector. This is particularly noteworthy because privatization programs are sweeping the globe and have been adopted in more than 50 countries. Prime Minister Margaret Thatcher's government has taken the lead in this field. Since she adopted privatization, Britain has sold nearly C$40 billion of public sector assets — a rate of about C$7 billion per year — and has transferred almost one third of Britain's nationalized workforce into the private sector.

Privatization reduces the waste that accompanies public ownership. When nationalized industries — such as Canada's Crown Corporation — are privatized, there are a number of results: sales per employee increase; profits per employee increase; operating expenses per dollar of sales fall; sales per dollar of investment increase; profits per dollar of total assets increase; profits per dollar of sales increase; sales per employee grow at a more rapid rate; and the accounting

losses that typify nationalized industries disappear. In addition to reducing economic waste, privatizations have generated government savings through (1) sale receipts, (2) terminated subsidies, (3) new tax revenues, and (4) reduced government borrowing and debt services costs.

## Tax increases dull incentive

By not controlling government spending, the Mulroney government must employ some combination of increased taxes, inflation, or public borrowing to finance increased government spending. Since the Finance Minister, Mr. Wilson, believes that public borrowing is the country's primary economic problem and the government is not keen on reflation, the Prime Minister has been forced to adopt tax increases. His government has imposed a 5%-10% income tax surcharge on households with incomes of C$40,000 or more, a 5% surcharge on corporate income tax obligations, and a 1% annual levy on capital employed by commercial banks and trust companies. In consequence, economic incentives will be dulled in Canada because after-tax rates of return on both labor and capital will be lower than they would have been without the new taxes.

## Losing confidence

Aggravating the economic problems created by the government's unwillingness to cut public spending and its propensity to increase taxes is the basic lack of confidence in Canada's financial system. The Bank of Canada's appalling mismanagement of the liquidity problems of the Canadian Commercial Bank and the Northland Bank and the banks' ultimate collapse last year have seriously increased the anxiety about the financial system. After operating as a lender-of-last-resort for the troubled Canadian Commercial Bank, the Central Bank abruptly withdrew its support, whereupon, the beleaguered institution failed, followed shortly thereafter by the Northland Bank.

That the banks failed is cause enough for concern. However, the behavior of the Bank of Canada has compounded the financial system's problems because the Central Bank's role as a reliable lender-of-last-resort has been thrown into doubt. In consequence, the central bank's ability to deal with the commercial banks' almost certain liquidity problems in the future (Canadian commercial banks' non-performing loans are at least C$8.5 billion) will be virtually nil. The smaller commercial banks know that even the hint that they might request loans from the Bank of Canada would be enough to prompt depositors to withdraw their funds from troubled institutions, in favor of the larger chartered banks. This means that troubled banks will be more reluctant to seek loans from the central bank, which will push the troubled banks and the entire banking system into higher risk zones. Knowing this, smart money has already begun to shift from the smaller regional banks to the large chartered banks. This not only aggravates the problems of the smaller regional banks, but also accelerates the entire risk generating process. The lack of confidence in the Canadian banking system, of course, has increased the risk premiums associated with the evaluation of Canadian investment.

The prospects for continued increases in government spending, taxes, and financial system risks are already working their way through Canada. They have depressed the Canadian stock markets, reduced the flow of foreign direct investment into Canada, increased the flight of Canadian capital and pushed the Canadian dollar to record lows. Lets look at these items in turn.

## Canadian stock markets dismal

Stock markets operate like giant present valuing machines. The markets quickly and efficiently discount prospective after-tax returns to determine present values and share prices. Of late, the Canadian markets have turned in a truly dismal performance. When compared with the world's 15 largest exchanges, only one, Singapore, has performed more poorly over the past year than the Canadian exchanges. The reason for this revolves around two factors: First, investors anticipate higher taxes and consequently lower after-tax rates of returns; second, investors perceive higher risks. Consequently, the discount rates that they employ to determine present values and share prices have been adjusted upward. As a result of the lower net after-tax flows and higher discount rates, share prices are lower than they would have been without the prospects of higher taxes and increased risks.

Data for direct foreign investments into Canada complement the information revealed by share prices. Direct foreign investment began to weaken in the third quarter of 1984, turned decidely sour in the first quarter of 1985, and has remained so ever since.

For the past 15 years, there has been a steady flow of unaccounted-for capital moving out of Canada. Recently, this leak has turned into a torrent. An examination of the Canadian balance-of-payments statistics shows that the "errors and omissions" item is growing. This suggests an increased capital flight. It is clear that more Canadians prefer to put their assets beyond the strong arm of the Canadian tax authorities and into financial systems that are less shaky than their own.

The combination of expectations for reduced after-tax returns (increased taxes) and increased risks (a shakier financial system) have slowed the direct investment from abroad and accelerated the flight of Canadian capital. Add to these altered flows Canada's deteriorating current account, and we should not be surprised to observe considerable downward pressure on the Canadian dollar. (When the final data are recorded for 1985, the current account will probably register a deficit, which will remain in 1986, because of the weight of the interest payments on external debt and a growing invisible account deficit.) In short, these changed flows have reduced the demand for and increased the supply of Canadian dollars on foreign exchange markets. Hence, the value of the Canadian dollar has fallen.

# Some balance of payments considerations

**By Albert D. Friedberg**

It is a truism that in a freely floating exchange rate regime, there are no deficits, gaps or shortfalls. Looking at the Canadian balance of payments statistics, one will note that while debits and credits (or what is the same, inflows and outflows) are neatly summarized and *categorized* under attractive headings such as current account, capital account, and so on, the totals add up to zero, or, in other words, they balance. But, you may ask, if they balance, if supply and demand for US dollars equal, what is the use of the neat statistical arrangement, and even more puzzling, how does the Canadian dollar fluctuate? After all, supply and demand are in balance.

The answer, of course, is that at a given equilibrium price, supply and demand always equal. If the US dollar is too high, supply of US dollars will exceed demand for US dollars, and the price will have to drop. Economists refer to these two stages as ex ante and ex post: ex ante, supply exceeds demand; ex post, supply and demand come into balance. Conversely, if ex ante the US dollar is in great demand, the price will rise, the demand will be cut back, and the supply will be increased. Ex post, supply and demand are in balance. Note, in our latter case that if the monetary authorities do not allow the US dollar to rise, they must supply new dollars to meet or satisfy the strong demand. Ex ante, demand exceeds supply; ex post demand equals supply, not at a higher price but because supply was increased: The monetary authorities have run down their reserves. The item "net official monetary movements" in Canadian balance of payments statistics indicates the true movement of international reserves, after external borrowings, repayments, and asset disposals.

A freely floating exchange rate would never affect international reserves: All ex ante imbalances would be resolved via price adjustment. To the extent that monetary authorities maintain artificial exchange prices (i.e., intervention), reserves rise or fall to help achieve the ex post balance.

## Interest rate manipulation

There is one other type of Central Bank intervention that can help achieve a balance of supply and demand for US dollars that will not necessitate a full price adjustment or a movement in reserves. This intervention takes the form of an interest rate manipulation. Everything else being equal, by raising domestic interest rates, the monetary authorities increase the demand for Canadian dollars (i.e., increase the supply of US dollars), while a lowering of the interest rate differential causes a drop in the foreign demand for Canadian dollars (i.e., an increase in the demand for US dollars).

But, if ex post the supply and demand for US dollars balance, why should we care about the various categories or components of the balance of payments? While the statistics are necessarily imprecise, speculators and policy makers will find them useful in gauging the likely source and direction of ex ante exchange rate pressure.

## Short-term statistics useful

Some of these categories reflect medium- to long-term trends: That is the case with the current account (a function of international competitiveness and differential rates of economic growth), direct investments in Canada and abroad ("the investment climate"), and negative statistical discrepancies (if persistent, they could indicate lack of confidence, high taxes, smuggling through high tariffs, etc.) Other categories are much more subject to short term influences, notably the relationship between short-term capital flows and interest rates. In the *short term*, the current account, direct investments in Canada and abroad, and statistical discrepancies can be treated as givens, not subject to direct manipulation. If this is true, one should be able to observe and measure (as imperfect as the data are, of course) the degree of ex ante pressure on the Canadian dollar. Chart 1, column 3, adds these components for every year from 1964 through 1985. Until 1974 inclusive, the financing gap (the amount required to balance, ex post, the medium- to long-term factors) was either very small or nonexistant. Note the ex ante surplus of 1974, the upward impact on the Canadian dollar and the (practically) nonexistant spread in short-term rates (columns 4, 5, and 7). In 1975, the financing gap becomes larger, the exchange rate falls and interest rate differentials widen. In 1976, interest rate differentials skyrocket, and Canada is able to attract enough short-term funds to cover the financing gap and to force its dollar higher.

Our model explains remarkably well the relationship between the short-term financing gap, and exchange rate movement and interest rate differentials. The year 1981 marks the introduction of the infamous National Energy Program: Canadians repatriate a substantial amount of US oil and gas interest. This enormous outflow is financed by a substantial increase in US dollar net bank liabilities to nonresidents, attracted by the size and prestige of the operation. This "one time" inflow will not be repeated again, primarily because of institutional constraints.

Preliminary figures indicate that the short-term financing gap for 1985 is the largest on record (with the exception of the 1981 episode). The $13 billion ex ante excess demand for US dollars (column 2) is satisfied in three ways: net official monetary movements show a decline of almost $2 billion, the average interest rate differential widens to above the historic norm, and the exchange rate plummets 5.1%, the largest such drop since 1978. Once again, our simple model explains rather satisfactorily the pressures at work.

## 1986: All-time high is possible

What of 1986? Best guestimates put the deficit on current account at $10.2 billion, an all-time high, primarily because of the sharp deterioration that has taken place in the trade balance. The catastropic fall in oil prices augurs very poorly

for direct foreign investment in Canada and could cause some large outflows of undistributed oil and gas earnings. Put the guesstimate (highly tentative) at $5 billion (down from $6.4 billion for the first three quarters of 1985). Finally, the likelihood of a substantial increase in direct and indirect domestic taxes and the relatively better performance of the US securities market makes us guess at a large $8 billion outflow (under the heading of "statistical discrepancy"). In view of the recent US $2.4 billion increase in international reserves (primarily through a $1 billion Eurobond issue and a $1 billion drawdown under a revolving credit facility), we presume that the Bank of Canada will countenance an adverse movement in its net official balances of C$3.5 billion, thus reducing the short-term anticipated financing to approximately $20 billion. *This grotesque sum should put serious downward pressure on the exchange rate as well as upward pressure on the domestic structure of interest rates.* A taste of what is to come may have been experienced in the most recent six weeks, as the exchange rate collapsed to 69.2¢ and the interest rate differential widened to 450 basis points, basis three-months T-bills.

Canada's currency is in for a prolonged period of siege. In the short term, the government could resist an inordinately large devaluation by means of jacking up short-term rates. What remains to be seen is how high must the differential to US rates rise before it can be effective. The cost lies in a major increase in foreign indebtedness. In the long run, government policy will have to reverse the unfavorable long-term trends discussed above. But first and foremost, the government of Canada must seriously reduce *fiscal spending and taxation.*

**Chart 1**

| DATE | ( 1 ) CURRENT ACCOUNT + STATISTICAL DISCREPANCY | ( 2 ) COLUMN 1 + DIRECT INVESTMENT | ( 3 ) COLUMN 2 - NET OFFICIAL MONETARY MOVEMENT | ( 4 ) 3-MONTH TR. BILLS RATE CAN - US | ( 5 ) COMMERCIAL PAPER RATE CAN - US | ( 6 ) AVERAGE EXCHANGE RATE | ( 7 ) % CHANGE OF EXCHANGE RATE |
|---|---|---|---|---|---|---|---|
| | ( MILLIONS OF CANADIAN DOLLARS ) | | | | | | |
| 1964 | -311.00 | -136.00 | -500.00 | 0.20 | | 1.0780 | 0.05 |
| 1965 | -1369.00 | -959.00 | -1117.00 | 0.04 | | 1.0780 | 0.00 |
| 1966 | -1344.00 | -559.00 | -200.00 | 0.11 | | 1.0773 | 0.06 |
| 1967 | -1000.00 | -434.00 | -454.00 | 0.31 | | 1.0787 | -0.13 |
| 1968 | -881.00 | -516.00 | -865.00 | 0.92 | | 1.0775 | 0.11 |
| 1969 | -1136.00 | -786.00 | -851.00 | 0.50 | | 1.0768 | 0.07 |
| 1970 | 719.00 | 1309.00 | -354.00 | -0.45 | | 1.0442 | 3.12 |
| 1971 | -917.00 | -223.00 | -1118.00 | -0.78 | | 1.0098 | 3.41 |
| 1972 | -1841.00 | -1621.00 | -1957.00 | -0.51 | -0.50 | 0.9899 | 2.01 |
| 1973 | -542.00 | -482.00 | -15.00 | -1.56 | 0.65 | 1.0001 | -1.02 |
| 1974 | -2327.00 | -2292.00 | -2316.00 | -0.04 | 0.65 | 0.9780 | 2.26 |
| 1975 | -5960.00 | -6150.00 | -5745.00 | 1.58 | 3.56 | 1.0172 | -3.85 |
| 1976 | -7876.00 | -8766.00 | -9288.00 | 3.88 | 3.41 | 0.9860 | 3.16 |
| 1977 | -6595.00 | -6860.00 | -5439.00 | 2.06 | 0.38 | 1.0635 | -7.29 |
| 1978 | -8043.00 | -10233.00 | -6934.00 | 1.45 | -0.21 | 1.1407 | -6.77 |
| 1979 | -7470.00 | -9270.00 | -11178.00 | 1.64 | 0.23 | 1.1714 | -2.62 |
| 1980 | -2437.00 | -4787.00 | -3507.00 | 1.18 | 0.53 | 1.1692 | 0.19 |
| 1981 | -14740.00 | -26040.00 | -27465.00 | 3.64 | 2.45 | 1.1989 | -2.48 |
| 1982 | 1055.00 | -1020.00 | -325.00 | 2.92 | 1.41 | 1.2337 | -2.82 |
| 1983 | -3132.00 | -5907.00 | -6455.00 | 0.68 | -0.05 | 1.2324 | 0.11 |
| 1984 | -3843.00 | -5493.00 | -4404.00 | 1.49 | 1.67 | 1.2951 | -4.84 |
| 1985 | -6635.00 | -13010.00 | -11023.00 | 1.95 | 1.43 | 1.3655 | -5.16 |
| 1986(E) | -18200.00 | -23200.00 | -19700.00 | | | | |

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| DATE | (1) CURRENT ACCOUNT + STATISTICAL DISCREPANCY | (2) COLUMN 1 + DIRECT INVESTMENT | (3) COLUMN 2 - NET OFFICIAL FINANCING* | (4) 3-MONTH TR.BILLS RATE CAN-US | (5) AVERAGE EXCHANGE RATE | (6) % CHANGE OF EXCHANGE RATE |
|---|---|---|---|---|---|---|
| | ( MILLIONS OF CANADIAN DOLLARS) | | | | | |
| 1964 | -311 | -136 | -500 | 0.20 | 1.0780 | |
| 1965 | -1369 | -959 | -1117 | 0.04 | 1.0780 | 0.0000 |
| 1966 | -1344 | -559 | -200 | 0.11 | 1.0773 | 0.0650 |
| 1967 | -1000 | -434 | -454 | 0.31 | 1.0787 | -0.1298 |
| 1968 | -881 | -516 | -865 | 0.92 | 1.0775 | 0.1114 |
| 1969 | -1136 | -786 | -851 | 0.50 | 1.0768 | 0.0650 |
| 1970 | 719 | 1309 | -354 | -0.45 | 1.0442 | 3.1220 |
| 1971 | -917 | -222 | -1118 | -0.78 | 1.0098 | 3.4066 |
| 1972 | -1841 | -1621 | -1957 | -0.51 | 0.9899 | 2.0103 |
| 1973 | -542 | -482 | -15 | -1.56 | 1.0001 | -1.0199 |
| 1974 | -2327 | -2292 | -2316 | -0.04 | 0.9780 | 2.2597 |
| 1975 | -5960 | -6150 | -5745 | 1.58 | 1.0172 | -3.8537 |
| 1976 | -7876 | -8766 | -9288 | 3.88 | 0.9860 | 3.1643 |
| 1977 | -6595 | -6860 | -5439 | 2.06 | 1.0635 | -7.2873 |
| 1978 | -8043 | -10233 | -6934 | 1.45 | 1.1407 | -6.7678 |
| 1979 | -7470 | -9270 | -11178 | 1.64 | 1.1714 | -2.6208 |
| 1980 | -2306 | -4656 | -6152 | 1.24 | 1.1692 | 0.1882 |
| 1981 | -14588 | -25888 | -25026 | 3.73 | 1.1989 | -2.4773 |
| 1982 | 713 | -1187 | -2539 | 3.20 | 1.2337 | -2.8208 |
| 1983 | -2626 | -5726 | -4693 | 0.71 | 1.2324 | 0.1055 |
| 1984 | -3742 | -4991 | -6879 | 1.59 | 1.2948 | -4.8193 |
| 1985 | -8209 | -14909 | -18753 | 1.96 | 1.3652 | -5.1568 |
| 1986 | -13744 | -16819 | -17960 | 3.01 | 1.3894 | -1.7418 |
| 1987 | -12350 | -14900 | -9509 | 2.41 | 1.3260 | 4.7813 |
| 1988 | -12144 | -14963 | -3280 | 2.75 | 1.2309 | 7.7261 |
| 1989 | -22454 | -23516 | -20442 | 3.91 | 1.1842 | 3.9436 |