Bank of Canada

Annual report of the Governor
to the Minister of Finance
and statement of accounts for the year

1979

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February 29th, 1980

The Hon. John C. Crosbie, P. C.,
Minister of Finance,
Ottawa.

Dear Mr. Crosbie,

In accordance with the provisions of the Bank of Canada Act I am transmitting herewith my report for the year 1979 and a statement of the Bank's accounts for this period, signed and certified in the manner prescribed in the by-laws of the Bank.

Yours sincerely,

Governor

Bank of Canada

Report of the Governor – 1979

General Observations

The level of economic activity in Canada rose further in 1979, the fourth year in a row of expanding employment and output. The number of Canadians with jobs rose by a full 4 per cent and the quantity of goods and services produced by about 3 per cent. Although the current account balance in our international payments remained in substantial deficit there were encouraging signs that the marked improvement in Canada's international competitive position in recent years was strengthening our external payments position. At the same time strong inflationary pressures re-emerged on the Canadian economic scene, and there was an upturn in Canada's previously declining inflation rate.

In part the increased upward pressure on prices and costs in Canada reflected external developments, notably the fresh upsurge of inflation in the United States where the current cyclical expansion was nearing its peak. In the circumstances little insulation from these external price pressures was provided by the movement of the exchange rate, and there was indeed a serious risk that the spillover of inflation into Canada from abroad would be magnified by a further decline in the external value of the Canadian dollar. At the same time there was evidence that demand pressures within the domestic economy were also giving substantial impetus to inflation in Canada. Many of our goods producing industries were producing about as much as they could with their existing plant, equipment and skilled manpower, and they could have sold considerably larger quantities of goods had they been able to supply them. Both the trend of our prices and costs and our foreign trade performance in 1979 were symptomatic of an economy nearing full stretch.

Monetary Policy

Canadian monetary policy faced a challenging task in 1979 in seeking to contain this resurgence of inflationary pressures. That policy continued to be directed towards restraining the growth of the money supply in accordance with the Bank's monetary targets and, within that framework, seeking interest rate relationships between Canada and the United States that did not contribute to an acceleration of inflation in Canada through a further substantial decline in the external value of the Canadian dollar.

In recent years the Bank has been giving particular emphasis to bringing about a gradual slowing in the trend rate of domestic monetary growth with the primary focus on the money supply defined in terms of currency and chartered bank demand deposits, or M1. The Bank's experience to date in pursuing M1 targets is reviewed in a later section of this Report. The gradual slowing of the growth of the money supply is of course a means to an end rather than an end in itself. The basic goal is to bring about a decline in the rate of inflation and thereby to establish the basis for a stable and prosperous Canadian economy.

Within this general policy framework the Bank continues to have regard in its operations to any near-term developments on the economic and financial scene that may pose a direct threat to Canada's cost and price performance. The Bank sees no inherent conflict between doing this and pursuing at the same time a trend rate of growth of M1 consistent with gradually receding inflation. The experience of the past year shows how the Bank can blend its attention to the underlying trend of M1 with regard for other considerations.

After a pause early in the year the growth of M1 was strong throughout most of 1979 in spite of continuing increases in interest rates. This suggested that total money expenditure in the economy was rising strongly. It was accompanied by sharp increases in the public's demand for credit both from banks and from other sources, and by unusually steep rates of expansion of those monetary aggregates with a broader coverage than M1.

This strength in the demand for money and credit was accompanied by other signs that the Bank took account of in its conduct of monetary policy during 1979. Among these was evidence that in many areas the Canadian economy had come to operate rather close to the limits of its available resources. This evidence is presented in the next section of the Report. The Canadian economy appeared in fact to have reached virtually full capacity over a broad range of industries despite the fact that its rate of growth in recent years has been below what used to be widely regarded as the sustainable rate of economic growth in Canada. That situation within the domestic economy was generating direct upward pressures on costs and prices.

There was also reason to believe that inflationary psychology – that is, expectations of more rapid inflation in the future – was again on the rise in Canada. What was happening to the rate of inflation in other countries, particularly in the United States, was disturbing. As the year progressed it became increasingly apparent that speculative pressures were building up in world commodity markets, reflecting a widespread erosion of confidence in the future value of money.

In those areas of our international trade where a reasonably prompt reaction was possible sizeable gains were being made (as described in the third section of this Report) in the wake of the great improvement in our international competitive position brought about by the depreciation of the exchange rate and the more moderate trend of domestic cost increases after 1976. But it also appeared that in many areas the gains were being limited by the existing capacity to produce those goods in demand at home and abroad. For the time being, therefore, further substantial improvement in our international trade balance depended to an important extent upon Canadian suppliers adding needed capacity.

This is the background to the specific actions that the Bank of Canada took in the late summer and autumn of 1979 to raise the level of short-term interest rates in Canada. The Bank Rate had been increased very early in 1979, and during the first half of 1979 interest rates in Canada tended to fluctuate around the levels then established. From the middle of the year U.S. interest rates began to move up sharply under the impact of mounting inflationary pressures in that country and a shift of monetary policy towards greater restraint. In view of the economic and financial conditions that existed in Canada the Bank concluded that further increases in interest rates in this country were needed. Given the forces at work in our balance of payments there appeared to be little to be gained by allowing monetary conditions to develop which would cause a further sizeable depreciation of the Canadian dollar. With inflation already showing clear signs of intensifying, further direct upward pressure on Canadian prices and costs through exchange depreciation would exacerbate rather than ease Canada's economic problems. The resulting upward adjustment of short-term interest rates in Canada was not, however, as great as the corresponding increase in the United States. Whereas short-term interest rates in Canada are typically somewhat higher than in the United States, they have for many months not been significantly higher and have on occasion been lower.

Interest rates have nevertheless risen very sharply in Canada. Such an abrupt movement is undesirable if it can responsibly be avoided for it is painfully disruptive to borrowers. It is also true that Canadian interest rates are at historically high levels, but these interest rates are in nominal terms. To arrive at the real cost of credit and the real return to savers these nominal interest rates must be adjusted to take account of the rate of decline in the value of money as the price level rises. It is nominal interest rates, not real interest rates, that are high by historical standards, and they are high because inflation is high. Nominal interest rates in the last decade have frequently been below the rate of inflation and thus have not provided a real return to savers. This has given a windfall gain to borrowers at the expense of those who provide the savings to be borrowed. Interest rates that provide a real return, as they now do, are historically normal and are necessary to achieve and sustain stability in the value of money.

Prospects for Controlling Inflation

I have referred to the resurgence of inflation and inflationary expectations in Canada in 1979. These developments are disappointing and naturally raise questions about Canada's prospects in the fight against inflation.

An important point to make in this connection is that despite the setbacks of 1979 some progress can be seen to have been made if the situation is viewed in perspective. The rate of inflation of Canadian costs and prices in 1979 was appreciably less than at the previous cyclical peak in economic activity in 1974. This progress was, moreover, achieved in the face of adverse influences over which Canadians had limited control. There was a large downward adjustment of the exchange value of the Canadian dollar beginning late in 1976 which was a belated adjustment for a higher rate of inflation in Canada than in the United States in earlier years. This added appreciably to prices and costs in Canada. The economy also had to absorb strains originating in shifts in the prices of food and energy relative to other prices together with the impact of sharply rising prices abroad for the goods we import and export. Nor should one lose sight of the fact that over most of the period from 1975 to 1979 the Canadian economy was operating without a large margin to spare against an increase in domestic inflationary pressures. More recently the degree of slack that would give some assurance that cost and price pressure in goods and labour markets would diminish has virtually disappeared.

While the progress made to date in reducing inflation in Canada has been less than we in the Bank had hoped for, I do not consider this as indicating that the gradualist policy was wrong. The monetary policy followed was intentionally moderate because the Bank wanted to minimize the strains involved in adjusting to a less inflationary economy. A gradual approach does leave open the possibility that unforeseen events may for a time give rise to short-term movements away from rather than towards lower inflation. The fact that the supply capability of the economy grew as slowly as it did was a development of this kind. The important point is, however, that even in an economy that was operating not much below its capacity and that was faced with severe and unusual price disturbances a basic improvement did take place. Recent experience thus provides reasonable grounds for confidence that moderate policies aimed at curbing inflation can succeed. The policy of lowering the rate of monetary expansion gradually has been, and will continue to be, followed with persistence.

One reason sometimes offered for pessimism about the prospects for reducing inflation in today's world is that countries are increasingly subject to "price shocks". The one most commonly referred to is the price of oil. Developments of this kind are clearly disturbing but their accommodation calls for shifts in relative prices rather than a continuing increase in the over-all price level. Shifts in relative prices can and should be accommodated without any lasting impact on the over-all rate of inflation; what is required is that the prices of goods and services that are not in short supply rise more slowly than the prices of those that are. Such changes in relative prices change the distribution of income and of purchasing power within an economy or internationally but they cannot be avoided by tolerating a general increase in the rate of inflation. The more an economy is exposed to price shocks the more it has need of effective defences against generalized inflation.

Another ground offered for pessimism about the ability of our society and others like it to achieve any sustained reduction in the rate of inflation is that the economic costs involved would prove unacceptably high. This argument implies that good rates of growth of output and employment and a sound external payments position are readily attainable if our societies are tolerant of inflation – a proposition that virtually nobody will now argue openly because it is so discredited by the events of the 1970s. During the last ten years much the best record of over-all economic performance was realized by those countries that showed the greatest determination in resisting inflation.

It is interesting to note in this connection that some countries have been able to do much better in controlling inflation than the countries with which they trade; this illustrates that a country's progress in resisting inflation is not dependent on that of its trading partners. Differing rates of inflation have been accommodated by movements in exchange rates, with the lower rates of increase in costs of production in those countries that have resisted inflation most successfully being accompanied by appreciations of the foreign exchange values of their currencies. Because of the lesser increases in their costs of production the countries whose currencies have appreciated in foreign exchange markets have remained competitive in their external trade.

That the case for pursuing good economic performance by resisting inflation is not more widely accepted and supported is probably due mainly to the awkward economic fact that in the short run anti-inflationary policies tend to restrain output more than prices. This is what has been observed, it is what short-term economic forecasts tend to show, and it is widely known. The fact that over a longer time horizon the economy will perform much better in a non-inflationary climate is much more important but much less widely appreciated.

These are some of the reasons why expectations of high future inflation are as firmly rooted as they are in our society. These expectations of high inflation now constitute the central element of the inflation problem. The stronger they are the more difficult the reduction of inflation becomes because people resist more strongly any moderation of wage and price increases from which they feel they would benefit. If strong expectations of inflation persist in an economic environment otherwise conducive to a better price performance they cause output and employment to be restrained more than would otherwise be the case. Thus the transition to a declining rate of inflation is much easier if the economic participants have confidence that the policies being followed will succeed. How can they be given that confidence?

The firm commitment of the Bank of Canada to persist with a gradual reduction over time in the rate of monetary expansion is intended both to encourage and to justify confidence in declining inflation in the years ahead. The latest stage in this process was a reduction of the Bank's targets for M1 growth to the range of 5 to 9 per cent measured from the second quarter of 1979. It is an orientation of monetary policy that should not be taken lightly; if Canadians effectively resist a gradual reduction in the size of price and income increases they will force a reduction in the growth of employment and output.

There is no doubt that persistence in a monetary policy designed to bring about a progressive reduction in the rate of monetary expansion can in time achieve stability in the value of money, but such a policy cannot of itself assure good performance of the economy in other respects. How prosperous and dynamic the economy will be will depend upon how the resources that it has are used.

Most Canadians want the economy to generate high employment with rising real incomes, and to have that kind of economy it is necessary that there be a sustained and fairly rapid growth in the stock of physical capital, that is, in plant, machinery and equipment. In our society most of that investment is made at private initiative, and it will not be made unless the economic environment encourages it.

An element of public financial policy that has very great influence over time on the willingness and ability of the community to invest in productive plant and equipment is fiscal policy. The scale of such investment is much affected both by tax policy and by the borrowing requirements of governments. The former is obvious but the latter is not. Large fiscal deficits undertaken to transfer income to individuals, and thereby to increase consumption, at times when the economy would otherwise be substantially under-employed will encourage investment in business plant and equipment. But if large fiscal deficits are continued when the economy has little more effective capacity to increase output they will discourage such investment. The restraint on investment is felt through various channels. One of them is that the fiscal deficits absorb savings that could otherwise be channelled by financial markets into financing the expansion of plant and equipment. This can militate against the increases in productivity and income that capital formation makes possible.

There is also an international aspect to the matter. A country's international balance of payments is two-sided; the balance on current account must be matched by an equal and opposite balance on capital account. If we in Canada want to reduce our international deficit on current account and thus our use of foreign savings we shall have to pay careful attention to the rate at which domestic savings are being absorbed by the fiscal deficits of our governments.

Canada's human and physical resources are very great. They provide us with the means of achieving sustained prosperity but they do not guarantee it. It is, I am pleased to note, being increasingly recognized that the best way to realize our potential is to restore confidence in the value of our money and to provide the room and the incentive for high investment out of domestic saving. The benefits of this approach will not be immediately dramatic but they will mount up steadily over time. It is the best way to ensure a strong economy in the years ahead.

* * *

While this Report was being completed interest rates in the United States again rose sharply. Expectations about the prospects for bringing inflation under early control in that country have been adversely affected by a number of events, including the sharp rise in oil prices, the high rate of other price increases and international political developments. A large increase in bond yields has occurred in U.S. financial markets and has spilled over into Canada, giving rise to nearly as large an increase in bond yields here. Money market interest rates have moved sharply up in the United States to levels higher than those in Canada, where rates have remained relatively stable in recent months. The prime lending rates of banks have risen to as high as 16¾ per cent in the United States while in Canada they have remained at 15 per cent, the level attained last October. The Canadian dollar was relatively strong in the exchange market in February because of inflows of funds that appear to be related in considerable part to Canada's energy prospects.

Recent international events show how vulnerable the world economy is to an increase in inflationary pressures and underline the need for resolution in resisting inflation here in Canada.

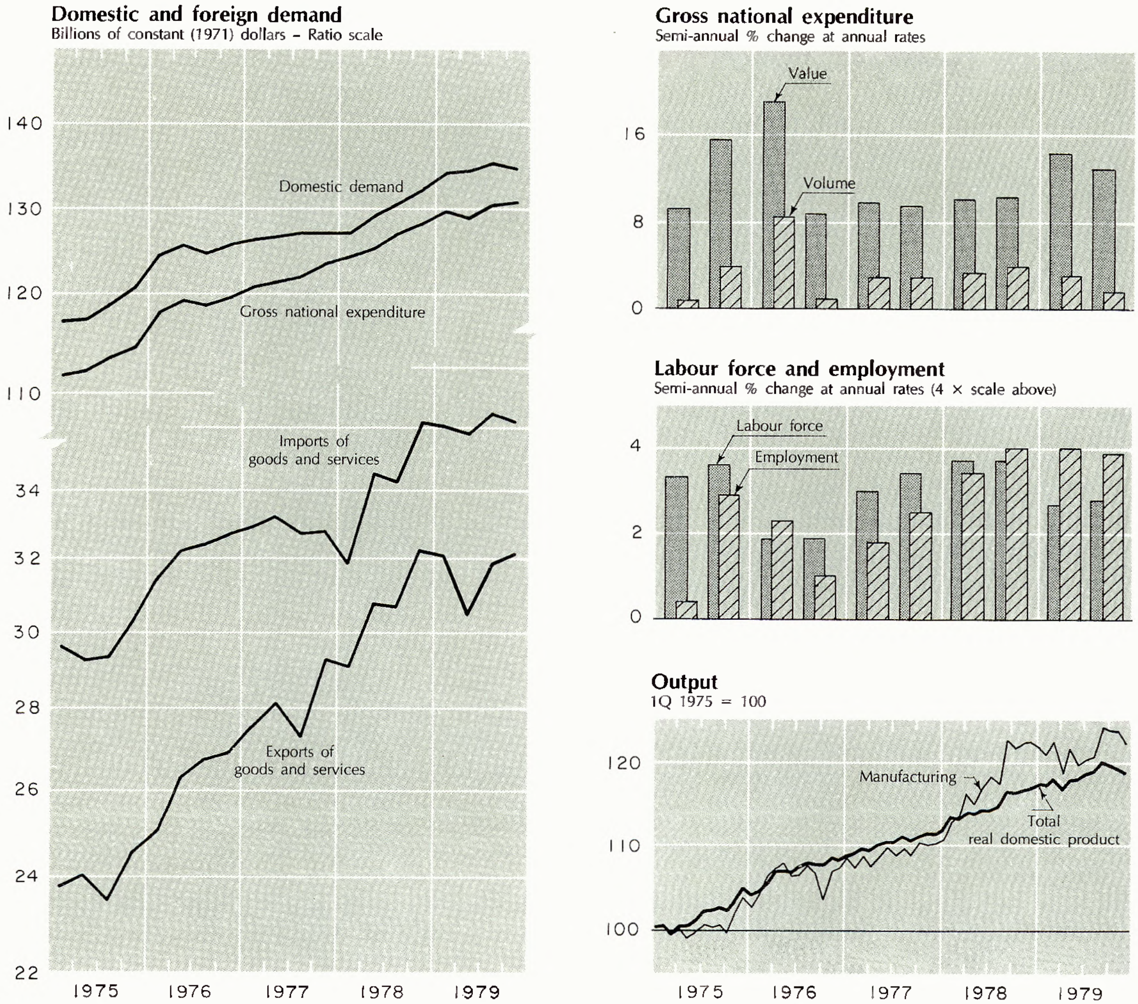
Output, Capacity and Inflation

Since the trough of the recession in early 1975 total nominal spending in the Canadian economy has grown at a substantial pace. The rate at which the physical volume of output has expanded, however, has been lower on average than has been typical of previous cyclical upswings. Constraints relating to supply conditions, which now seem to be limiting our scope for matching average postwar rates of increase in output, have played a greater role in this outcome than is commonly supposed. Important sectors of the Canadian economy, particularly those whose competitiveness improved as a result of the depreciation of the Canadian dollar in 1977 and 1978, have been operating recently at virtually full stretch. This situation contributed to some reversal of the substantial progress made between 1975 and early 1978 in reducing the inflation of Canadian costs and prices.

Growth of Output

The pick-up in economic activity following the 1974-75 recession was initially rather uneven. Between mid-1975 and mid-1976 Gross National Expenditure (GNE) in volume terms grew very rapidly indeed, at a rate in excess of $6^1/_2$ per cent, with most of the stimulus arising from domestic sources. Under the influence of government programs, housing starts rose to historically high rates while the volume of consumer expenditures, many of them related to housing, also went up rapidly. During the four quarters from mid-1976 to mid-1977 the economy's advance slowed and GNE in volume terms grew by $1^1/_2$ per cent as housing starts fell and consumption expenditures levelled off. It was only after mid-1977 that more substantial growth resumed, but with the primary impetus arising from external rather than domestic sources. The growing strength in the U.S. economy had earlier begun to have an influence on the volume of Canadian exports, and to this was added the impact on exports and imports of the substantial recovery in Canada's international competitive position that occurred in 1977 and 1978. The stimulative effect of these developments on demand was particularly marked in the manufacturing sector. Between mid-1977 and the end of 1978 the volume of manufacturing output grew at an annual rate of about 8 per cent whereas GNE in volume terms grew at less than half this rate. Demand pressures on many of the Canadian industries whose production is exported or which compete with imports continued to be

Demand, Output and Employment
Seasonally adjusted



in strong evidence in 1979 as well. Under the influence of improved profits and significant capacity constraints, business investment picked up sharply in the second half of 1978 and grew at about a 10 per cent rate in 1979 as a whole, or considerably more rapidly than total output; in volume terms GNE in 1979 was 3 per cent higher than in 1978.

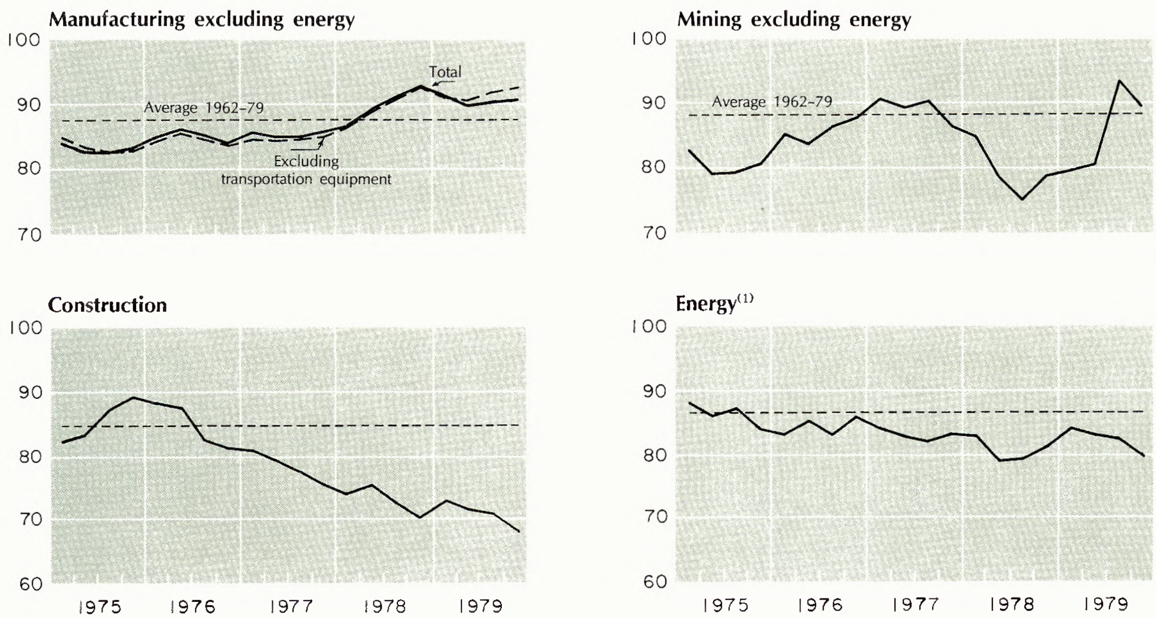
Capacity Constraints

Although the growth of output from the most recent cyclical trough in 1975 through to 1979 was not high by historical standards, important parts of the economy were by 1979 being substantially constrained in their capacity to meet demand efficiently. That this is not more widely recognized is due in part to the fact that some widely used summary measures of operating limits for the total economy can easily be misinterpreted, particularly when important shifts in demand are taking place. A more detailed analysis is required to obtain a clear picture of what the situation was.

Tightened conditions in manufacturing have been apparent for well over a year, with the level of capacity utilization recorded since the middle of 1978 remaining well above the average of the last eighteen years. Moreover, high operating rates were widespread among the different manufacturing sectors. For example, the industries producing food and beverages, knitted products, textiles, paper and allied products, and fabricated metals all recorded utilization rates at or close to peak levels in 1979. More direct investigation confirms that these industries and many others were commonly producing at levels which were stretching the practical limits of their available plant and equipment.

There were a number of manufacturing industries where capacity utilization measures pointed to some slack in 1979. In most cases, however, it is apparent that special factors reduced the usefulness of these indicators. The recorded capacity utilization rate for the chemical industry was biased downward by recent major additions to the capital stock that were not fully on-line. In the fish and meat processing industries, conversely, capital was available but could not be used fully because of shortages of raw materials for processing. As for the primary metals industry, there were supply problems with respect to steel; some

Capacity Utilization Rates for Major Goods Producing Industries
Seasonally adjusted



[1] Includes petroleum and natural gas mining, electric power and gas utilities, petroleum and coal products, and pipelines

domestic customers were put on allocation as early as the second quarter of 1978. Finally, and most importantly, the weakening of output relative to capacity in the transportation equipment sector reflects abrupt changes in the pattern of automobile demand. In the face of OPEC price increases and growing insecurity of oil supply, the U.S. demand for new cars declined and shifted markedly towards smaller vehicles. The Canadian automobile industry, whose facilities have mainly been oriented to producing larger cars, was particularly affected by these developments. Subject to what was an effective if not a measured capacity constraint, output fell sharply. For manufacturing other than the production of transportation equipment the rate of capacity utilization was both much higher than average and rising in 1979.

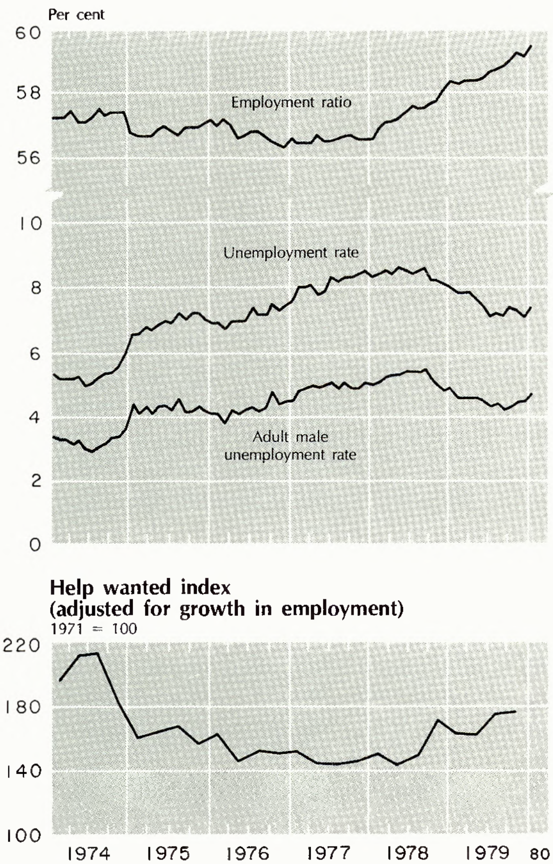
Among the other main goods producing sectors of the Canadian economy, only construction has in fact been operating well below capacity. While the energy sector may also seem to have been characterized by similarly low operating rates in recent years, as a practical matter this impression is misleading. As in the case of chemicals, recent investment in energy producing activities has been dominated by a number of large projects which in many cases have not yet become fully productive. The fact that such investments are nevertheless included in the available estimates of the physical capital stock exerts at the present time a substantial downward bias to measured capacity utilization figures in the energy sector. As for mining, while strikes in both 1978 and 1979 artificially depressed output, by the second half of 1979 the underlying strength in this sector was becoming increasingly obvious.

What a review by industry reveals is that in 1979 a great many Canadian goods producing industries were operating without much effective capacity to spare. Demand was generally high, particularly in those areas oriented to exports or which competed with imports. In some industries output was held back by bottlenecks related to a lack of materials. In other areas where there was considerable unused capacity to produce, such as in construction and in the manufacture of large cars, resources could not be shifted quickly to supply the kinds of goods that were in demand at home and abroad.

Statistics on labour markets pose similar problems of interpretation. It has been apparent for some time that the level of the over-all unemployment rate is also an unreliable guide to the extent of unused capacity in Canada and the possibility for further output growth. There are major differences in the degree of labour market tightness across regions, but there is considerable evidence that the over-all unemployment rate for Canada has since the early 1970s been subject to both demographic and policy influences which have raised its measured level relative to any realistic perception of ease or tightness in the economy as a whole. Various studies have underlined the importance of the recent very rapid rise in the proportion of the total workforce made up of adult women and young people, whose relative lack of experience often contributes to higher job turnover and longer periods of unemployment. As for the influence of policy, revisions to unemployment insurance legislation in 1971 reduced the effective costs of being unemployed, resulting in longer average periods for job search, increased participation in the workforce, and a greater reluctance on the part of employers to retaining on a permanent basis employees whose work was highly seasonal. Accordingly, the range of measured unemployment which the economy cannot avoid without intensifying inflationary pressures is now substantially higher than it was in the 1950s and 1960s. To achieve lower measured rates of unemployment on a sustainable basis calls for policies that address these structural developments or imbalances directly.

Other labour market indicators reveal a picture that differs importantly from that portrayed

Labour Market
Seasonally adjusted



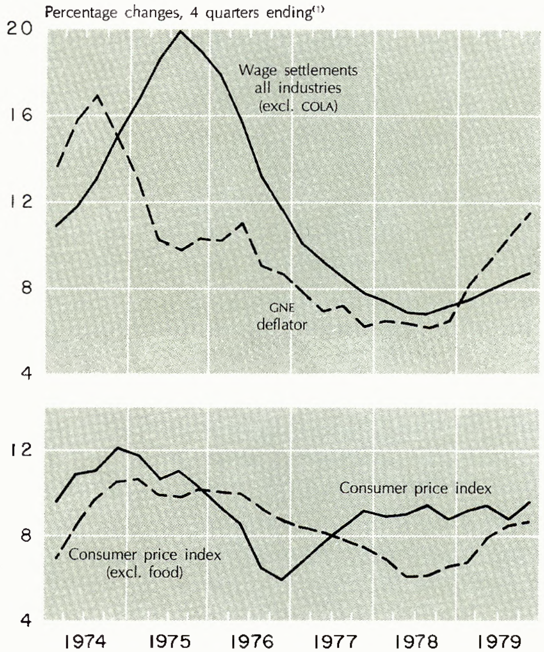
by the over-all unemployment rate as conventionally measured. The unemployment rate for adult males did rise as high as 5.4 per cent in mid-1978 but, unlike the over-all rate, remained appreciably below its postwar peak, even though it too was likely pushed up by the policy influence discussed above. During 1979, moreover, this rate has registered a substantial decline. A similar impression of growing tightness in labour markets is given by the employment ratio, which measures the proportion of the working age population having jobs. This proportion declined moderately between mid-1975 and early 1978, but over the more recent period it has risen dramatically as employers have greatly expanded their workforces. Recent increases in the level of the help wanted index, along with numerous reports of shortages of skilled workers, give further indication that the labour market was under increased pressure.

An important aspect of the economy's reduced ability to increase output has been the recent performance of productivity. Productivity growth seems to have been slowing in the 1970s, particularly in the latter part of the decade. The causes of the productivity slowdown, which is not limited to Canada but has also been apparent in most other major industrial nations, are not easy to isolate. Reductions in the quantities of readily available natural resources, a relative weakness in investment other than in energy, an accelerated obsolescence of plant and equipment caused by rapid rises in energy prices since 1973, and the change in the composition of the workforce, have all been suggested by investigators in Canada as possible contributing elements. In any event, the persistent nature of the slowdown indicates that it is more than a cyclical phenomenon.

Costs and Prices

From 1974 into 1978 there was an appreciable diminution of inflation. The deflator for Gross National Expenditure, which had reached an annual rate of growth of well over 15 per cent, increased by less than 7 per cent in the second half of 1977. The Consumer Price Index also demonstrated a substantial though more moderate deceleration over the same period, while increases under new wage settlements slowed steadily. Whereas in 1975 newly negotiated wage settlements without cost of living adjustment (COLA) clauses commonly gave average annual percentage increases of over 20 per cent per annum, by late 1977 they had declined to the 7-8 per cent range. While there can be little doubt that this improvement in Canada's

Selected Measures of Inflation



(1) Except wage settlements, which are a 4 quarter moving average plotted on the final quarter

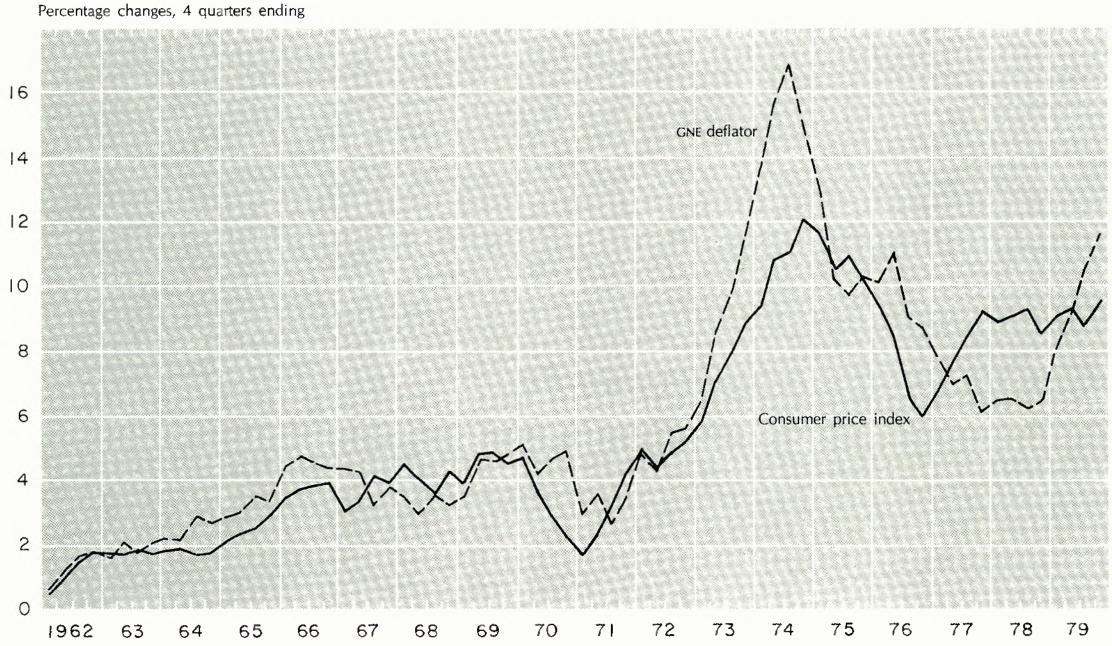
inflationary performance was helped by the influence of the Anti-Inflation Board, the evidence in Canada and in other countries indicates that it is unlikely that any such success would have been achieved had there not been an appropriately competitive climate existing in the Canadian economy at that time. It is noteworthy that the reduction in inflation observed during 1977 occurred despite a large depreciation of the Canadian dollar during the year, the effects of which were to raise directly and significantly the Canadian dollar price of many imported and exported goods.

Since the middle of 1978 there has been accumulating evidence of a resurgence of inflationary pressures. From about 6½ per cent annually in the first half of 1978, the rise in the GNE deflator went up to about 10 per cent in the second half of 1979. Inflation measured by the Consumer Price Index failed to slow from the high rate associated with the earlier rapid acceleration of food prices. Indeed, consumer prices other than food rose considerably faster through 1979 despite a relatively slower upward adjustment of domestic energy prices, while wage settlements (without COLA clauses) in the commercial sector of the economy also moved up into the 10 per cent range in the second half of last year. For the non-commercial sector the pick-up in wage increases was less pronounced.

These recent developments reflect in part the impact of external inflationary forces which were transmitted to Canada in the absence of offsetting strength in the external value of the Canadian dollar. The prices of both Canadian exports and imports rose extremely rapidly in both 1978 and 1979. Although these developments in 1978 were heavily influenced by the 7 per cent decline in the value of the Canadian dollar over the year, in 1979 the primary impetus came from the very rapid rate of growth of prices in the United States and overseas. These external developments had a substantial effect on measured inflation in Canada. Their impact has been exacerbated by the recent behaviour of food prices in North America. With beef supplies at a cyclically low point and severe weather conditions influencing many crops, food prices in Canada rose in both 1978 and 1979 at rates substantially in excess of other domestic prices. Domestic energy prices on the other hand rose at about the same rate as the Consumer Price Index.

The recent resurgence of inflationary pressures in Canada has also, however, been fuelled by domestic influences. As described above, the Canadian economy has over the last year or so been producing at a rate which for important sectors of the economy has meant operating very close to full capacity. This environment has provided little incentive for workers, con-

Inflation: A Historical Perspective



cerned about living standards in the face of external price shocks, to moderate their wage demands, and rising wage settlements in turn have begun to have an impact on business costs and on prices. This effect has been compounded by the poor productivity performance. At the same time, given the high level of demand for its products, the business sector has in general been able to improve its profit margins. In sum, the substantial degree of tightness in many sectors of the Canadian economy in 1979 contributed directly to inflationary pressures and supplemented the effect of external influences.

The deterioration in our cost and price performance during the cyclical expansion of the last few quarters is disappointing but only partially erases the progress made in combatting inflation over the longer period measured from the peak in the last economic upturn. Whereas the GNE deflator reached a maximum rate of growth of over 15 per cent per annum in 1974, the comparable figure in 1979 was approximately 10 per cent. Furthermore, the rise in consumer prices is running appreciably below the rate reached in 1974. In each of the three previous periods of economic upswing inflation reached a successively higher peak, and by this standard the degree of deceleration achieved is the more significant.

Canada's Balance of International Payments

One of the most important questions in recent years about Canada's balance of international payments has been how the balance on current account would respond to the substantial improvement that has taken place since 1976 in the competitive position of Canadian suppliers of goods and services in relation to foreign suppliers both in Canadian markets and abroad.

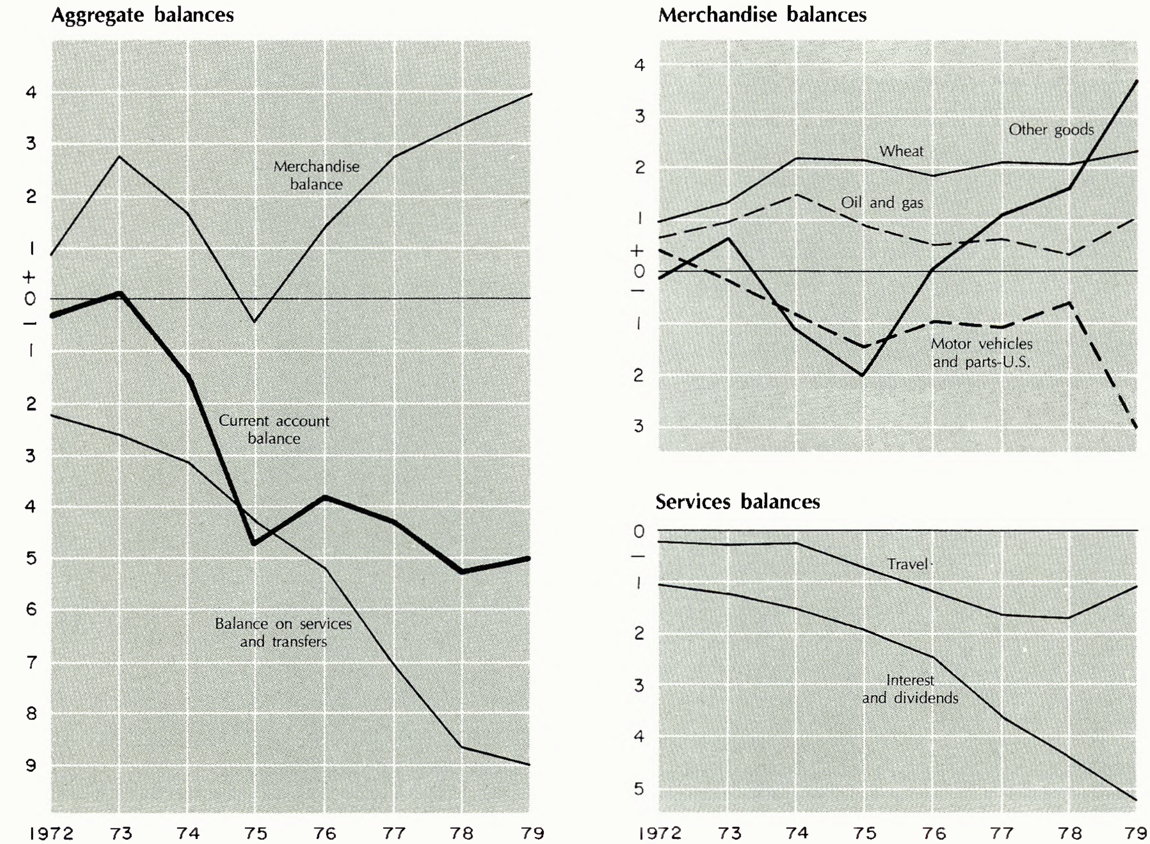
Since 1976 there does not appear to have been much difference in the trends of costs of production in Canada and the United States as measured in their own currencies, and therefore the substantial depreciation of the Canadian dollar in terms of the U.S. dollar has greatly improved the position of Canadian suppliers relative to U.S. suppliers. The Canadian competitive position has improved even more relative to suppliers from a number of important trading nations overseas since there was also a substantial depreciation of the U.S. dollar against their currencies.

There is considerable evidence that Canada's improved competitive position as an international supplier is, in fact, having a substantial effect on a wide part of our international trade. The impact on the total balance on current account has, however, so far been largely offset by other influences, some of them transitory, and our underlying payments position is stronger than appears on the surface. This view is reinforced by the present prospects for Canada's international trade in oil and gas.

The improvement in 1979 in the balance on merchandise trade would have been considerably larger but for some developments of a rather special nature. Canada's net deficit on trade in automotive products with the United States grew from 1978 to 1979 by $2.5 billion to a level of $3 billion. This was due to a combination of a much weaker market for North American models in the United States than in Canada and a concentration of Canadian automobile production in larger models for which demand in the United States was particularly weak. Also, the physical volume of wheat exports was severely constrained by transportation and handling difficulties although the effect on the value of wheat exports was more than offset by an increase in the price of wheat. In another area of our trade where the outturn is determined by special considerations, namely that of crude oil and natural gas, the value of Canada's net exports increased from $0.3 billion in 1978 to $1 billion in 1979. The balance of Canada's international trade in other goods improved substantially in 1979, continuing a trend evident since 1975. For this trade, which comprised over two thirds of Canada's total trade in goods, there was an increase in the net surplus from 1978 to 1979 of over $2 billion to a level of $3.7 billion.

The physical volume of exports of goods other than automobiles and parts to the United States, wheat and oil and gas rose by 10 per cent in the year, nearly the same gain as in 1978 and twice that of 1977. The expansion was paced by shipments of highly manufactured goods, one of the more price-sensitive components of exports, which rose by over 20 per cent in each of the last two years. This was achieved

Current Account of the Balance of Payments
Billions of current dollars

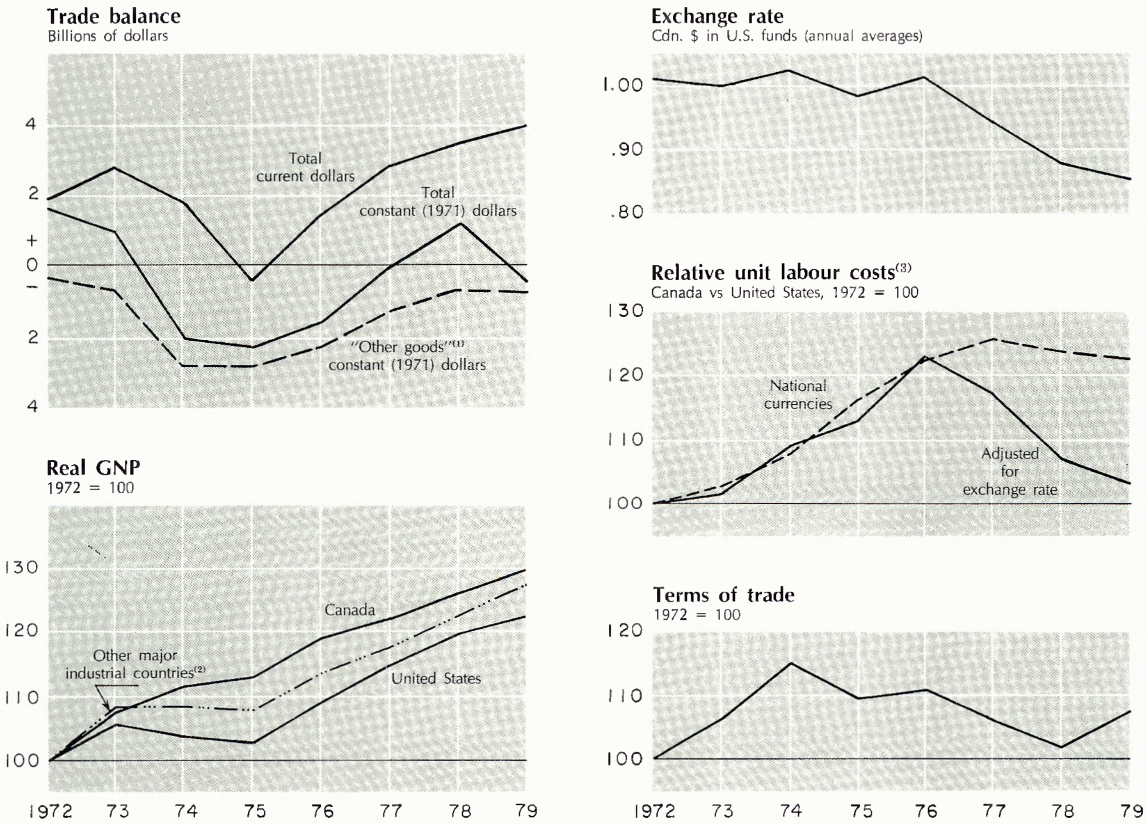


in the face of some slowing in the pace of real growth in the United States, by far our largest market.

The competitive position of Canadian industry in many areas of trade would have allowed our real trade balance to be stronger than it was in 1979 if the output of many suppliers had not been constrained by productive capacity. Indeed, the emergence of high levels of capacity utilization in Canada during the past year or so was in part a manifestation of the response of Canadian industry to its enhanced international competitiveness. Limitations on production capacity and improved profits spurred a marked pick-up in business investment which will increase the scope for the rechannelling of trade flows in favour of Canada in the longer run. However, increased outlays on machinery and equipment worsened the trade balance in 1978 and 1979 because such outlays have a high import content. At the same time imports of industrial materials rose by more than might have been expected in the light of general economic conditions. In both these areas high levels of capacity utilization in various domestic industries, notably machinery and primary iron and steel, forced an increasing reliance on imports. The volume of imports of machinery, equipment and industrial materials rose more than by 15 per cent in 1979 while imports of other goods, comprising over half the total, increased by just 2 per cent.

The surge in imports of investment and industrial goods held the real balance of trade in 1979 in goods other than automotive products with the United States, wheat and oil and gas to much the same level as in 1978. The sharp rise in the value of the net surplus on this trade was mainly the result of a greater increase in the prices of Canada's exports than in the prices of its imports. This improvement in our merchandise terms of trade largely reflected upward pressures in world commodity markets. Since Canada is a net exporter of raw materials and a net importer of manufactured

Major Influences on Merchandise Trade



(1) Total excluding motor vehicles and parts traded with the United States, oil, gas and wheat

(2) Real GNP/GDP in Japan, United Kingdom, Germany, France and Italy weighted by their shares of Canadian exports

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

goods, an increase in world prices for primary commodities relative to manufactured goods strengthens our trade balance.

Trade in services has also responded to the gain in competitiveness. The deficit on the travel account decreased markedly in 1979. Canadian expenditures on travel abroad declined, in sharp contrast to the rapid growth of the previous several years, and receipts increased strongly for the second year in a row, particularly from visitors from countries other than the United States. The effect of the improvement in the travel account on the over-all balance on services and transfers was, however, more than offset by an increase in the deficit on interest and dividends. The continued widening of the latter deficit was due mainly to the growth of Canada's foreign-held debt, the counterpart of the large current account deficits of recent years. Since most of this debt is denominated in foreign currencies, the depreciation of the Canadian dollar has contributed to the increase in interest payments expressed in Canadian dollars.

Although the net inflow of long-term capital into Canada in 1979 was of much the same order of magnitude as in the previous year there were significant changes in its composition. The net outflow resulting from direct investment transactions moderated substantially from its unprecedented level in 1978, but the inflow from borrowing by the Government of Canada in foreign capital markets decreased appreciably. Gross provincial, municipal and corporate financing in bond markets abroad, which had fallen off dramatically from a very high level in 1976, was little changed in 1979.

Short-term capital movements in the year resulted in the first substantial net inflow since 1975. The margin of Canadian shorter term interest rates over yields on corresponding U.S. dollar instruments was at no time very large in 1979, and in the latter part of the year it was on occasion negative, but there was an improvement in attitudes of investors towards Canadian dollar assets. While assessments continued to be tempered by concerns about Canada's large current account deficit and domestic cost and price increases, the depreciation of the Canadian dollar that had taken place was widely viewed in the exchange market as having restored the international competitiveness of domestic industry. Attention also focussed on Canada's favourable energy position compared with most industrial countries in a world of rapidly rising oil prices and uncertain supplies. In the event, the exchange value of the Canadian dollar in terms of the U.S. dollar was relatively steady most of the time in 1979 and was a little higher at the end of the year than it was at the beginning.

Recent Experience with Monetary Targets

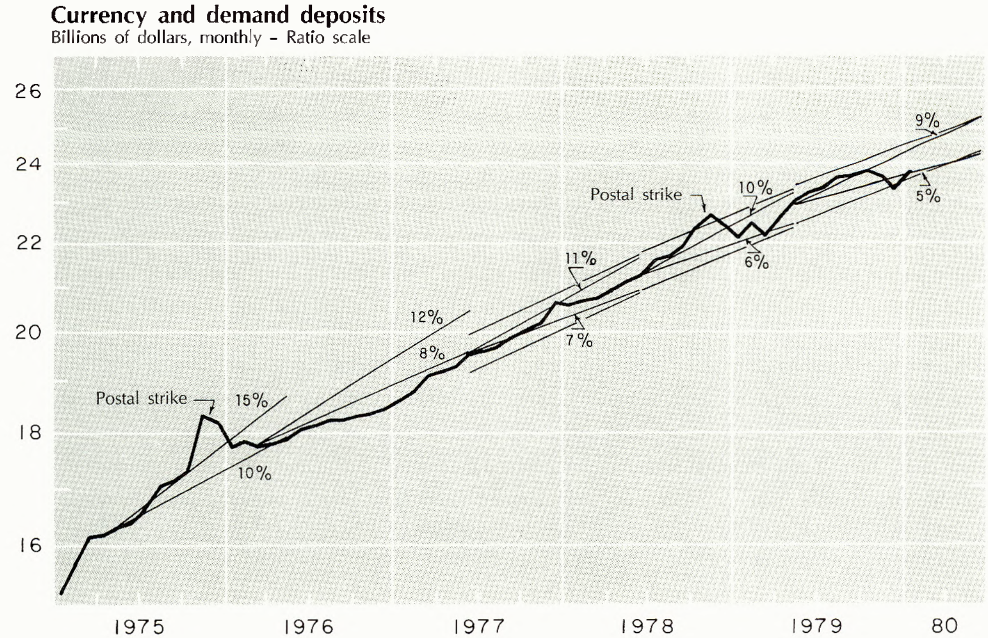
In the course of 1975 the Bank of Canada began to give a good deal of weight in the conduct of monetary policy to the trend rate of growth of a particular measure of the money supply, namely, currency plus demand deposits at chartered banks, a measure known as M1. In the latter part of that year it announced a target range for M1 growth of not less than 10 per cent a year but well below 15 per cent. Since then the target range has been lowered on four occasions to its present level announced in December 1979 of between 5 and 9 per cent a year.

For practical purposes the Bank has come to regard these target ranges as establishing a target band of 2 per cent on either side of the centre of the target ranges. The target ranges, the related target bands, and the actual movement of M1 are shown in the accompanying chart.

The reason that the Bank decided to give close attention to the trend of M1 was that it reached the conclusion from its analysis of past experience that monetary policy would be improved by so doing. M1 was therefore given an important place among the wide variety of financial and economic indicators of the performance of the economy that the Bank examines in the course of the conduct of its affairs.

That there is a broad and important association between upswings and downswings in the pace of monetary expansion and in the growth

Money Supply and Target Growth Ranges
Seasonally adjusted



rate of total spending in the economy has of course long been recognized. The idea of using some notional limits for the growth rate of the money supply as a guide in conducting monetary policy is thus not a new one. But as a practical matter the possibility of realizing the potential advantages of pursuing monetary targets had to wait on the progress of analytic work that would give a more precise understanding of the relationship between the movements of particular monetary aggregates and those of national expenditure. The Bank's conclusion that it would be constructive to pay a good deal of attention to the trend of M1 followed on such work.

The Bank has now done this for over four years. Looking back on the period it is the Bank's judgement that the change in approach in 1975 has been justified by experience, and that monetary policy has been improved through the use of M1 targets. But it should be added immediately that as a guide for monetary policy the behaviour of M1 presents some problems in practice. The Bank has come to know more about these problems than it did four years ago and experience has confirmed that movements of M1 need to be interpreted with a good deal of care.

The value of M1 – or any other monetary aggregate – as a guide for the conduct of monetary policy depends very heavily on the confidence that one can have in the stability over time of its relationship to the growth rate of total money expenditure in the economy. While M1 growth has proven by and large to bear a fairly systematic relationship to the growth of spending in the economy if account is taken of changes in interest rates, that relationship is not always as close as one could wish. The observed looseness seems to be of two kinds.

Some of the looseness is random in the sense that deviations occur for which no explanations are found even after the event. M1 growth is indeed subject continually to random short-term fluctuations but these have rarely been either so large or so long lasting as to present a problem for policy. Occasionally, however, unexplained movements of this kind take longer to reverse themselves, causing M1 to diverge from its underlying trend for some months. That is one reason why targets for M1 continue to be expressed as a range between two growth rates rather than as a single target growth rate. The Bank has learned not to attach great significance to M1 movements over the course of a few weeks or even a few months. It is the trend of M1 over considerably longer periods that is of primary importance.

The other kind of looseness arises from innovations in banking practices. The nature of the various measures of the money supply in any society is shaped by the practices of its financial institutions, and changes in these practices affect the way the measures move. As long as the changes are relatively minor and do not result in sharp adjustments in the average size of the money balances demanded by the public they give rise to no particular problem in interpreting the money supply series. But major changes in banking practices can cause a problem because it is rarely possible to get a direct measure of their effects on the money supply statistics, and so it is difficult to know with any precision what allowance should be made for these effects in interpreting the behaviour of M1 and adjusting the target range from time to time.

One relatively recent innovation in Canadian banking practices has been of consequence in this regard. In the course of 1976 and 1977 there was a considerable acceleration for a while in the rate at which the banks' larger customers took advantage of new facilities provided by the banks to enable these customers to manage their affairs satisfactorily with lesser current account balances relative to their transactions than they had previously needed. This development appears to have contributed significantly to the relatively low rate of growth of M1 during that period, a rate that understates the effective growth of M1 at that time.

More recently the widespread offering by banks of personal savings accounts on which interest is calculated on a daily basis is providing an inducement to individuals to minimize the balances that they hold in chequing accounts. It is still too early to be able to judge the extent to which the growth of daily interest savings accounts may be affecting the growth of demand deposit accounts and thus of M1, but so far the indications are that the effect is not large.

Actual and potential shifts of this kind reduce the confidence that one can have in the stability of the relationship between M1, national expenditure and interest rates, and mean that one cannot put uncritical reliance on this measure of the money supply as a guide to monetary policy. But, provided M1 movements are interpreted with care in the context of banking practices, it seems likely that they will continue to be useful as a guide for monetary policy.

While continuing analysis of the behaviour of monetary aggregates underlines the need for care in using M1 it has not indicated that monetary policy would be better if the Bank of Canada framed its monetary targets in terms of some broader aggregate. There are more difficult problems in drawing information useful for the conduct of monetary policy from the broader aggregates. This is because there is more room in the Canadian financial system for the movement of the broader aggregates to be appreciably affected by factors other than the growth of national expenditure and changes in interest rates than there is in the case of M1. Shifts in the shares of business flowing through banks, other financial institutions and securities markets are constantly occurring and they sometimes give rise to major movements of the broader aggregates that are without significance for monetary policy. If one of the broad aggregates were used to set targets for monetary growth, it would be extremely difficult to adjust the targets in a way that would make adequate allowance for these recurring extraneous movements.

Bank of Canada Operations

The Bank of Canada's operations include those which it carries out as principal in the conduct of monetary policy and those which it carries out as fiscal agent for the Government of Canada. It is as agent for the Government that the Bank manages the public debt and operates in the foreign exchange market.

Interest Rates and Cash Reserve Management

In 1979 the Bank's operations in pursuit of its interest rate and money supply objectives were carried out in an unusually vigorous manner at times, and for a period they involved intervention in the long-term bond market on a large scale. Details of these operations by months appear in tables at the end of this section.

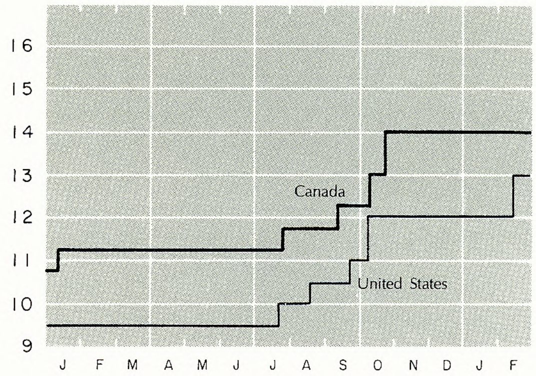
The Bank Rate was raised from $10^3/_4$ per cent to $11^1/_4$ per cent effective January 4, 1979. During the first half of the year the Bank's daily operations were designed to keep short-term interest rates within a range that was consistent with that Bank Rate. Expectations of an impending recession in the United States led on occasion to a strong tendency for long-term interest rates to decline, and the Bank resisted this tendency by selling in the market long-term Government of Canada bonds from its own portfolio. By early April it had sold about \$1.1 billion of such bonds, and had replenished its own holdings by purchasing long-term bonds at the time of new Government of Canada issues and by a purchase of a special \$300 million issue directly from the Government. The debt management operations of this period featured very large tranches of long-term Government of Canada bonds which were sold to the public at the time of new issues. Including these new issues, the market absorbed a total of \$2.7 billion long-term bonds in the first six months of 1979.

The relative stability of interest rates in the first half of 1979 gave way to a sharp upward movement of rates in the United States and Canada in the second half of the year. Short-term rates rose in Canada from mid-summer to mid-autumn by about 3 per cent while long-term rates rose by about $1^1/_2$ per cent. The Bank Rate was increased from $11^1/_4$ per cent to $11^3/_4$ per cent effective July 23, to $12^1/_4$ per cent effective September 10, to 13 per cent effective October 9 and to 14 per cent effective October 25. After each increase the day-to-day operations of the Bank were mainly directed towards encouraging stability of interest rates at the new level.

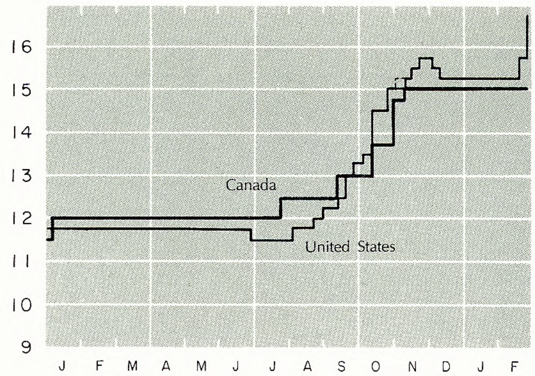
The increase in interest rates during the latter part of this period produced complications for the annual Canada Savings Bond campaign and for other aspects of Government finance. Because of rising interest rates during the Canada Savings Bond campaign two upward adjustments were made in the yields on the new and outstanding series of Canada Savings Bonds. These changes proved sufficient to prevent a net redemption of Canada Savings Bonds for the campaign period as a whole. However, during the first two weeks of November there was a temporary net run-down of more than \$$1^1/_4$ billion in outstanding Savings Bonds due to the difference in timing between redemptions and sales of bonds. During this interval the chartered banks, trust companies and other financial intermediaries experienced large increases in private sector deposits while the cash balances of the Government declined to a very low level. In response to this developing situation the increment of treasury bills offered at the weekly tender was increased and the Bank of Canada engaged in sales of treasury bills in the open market; the Bank also acted to absorb part of the increase in the liquidity of the financial system by selling short- and mid-term

Interest Rates

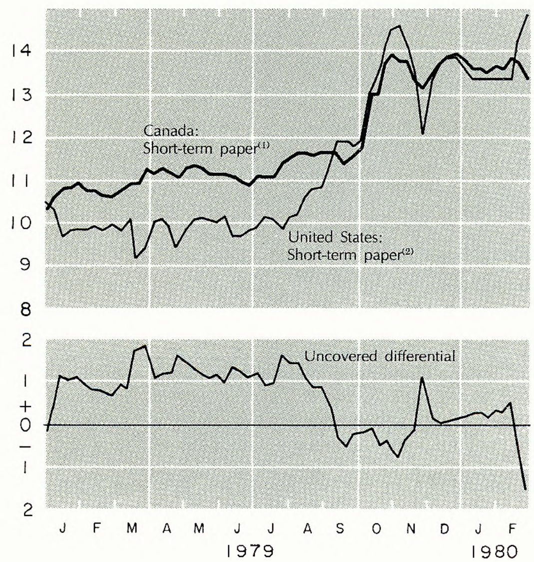
Bank Rate and U.S. discount rate



Prime lending rates

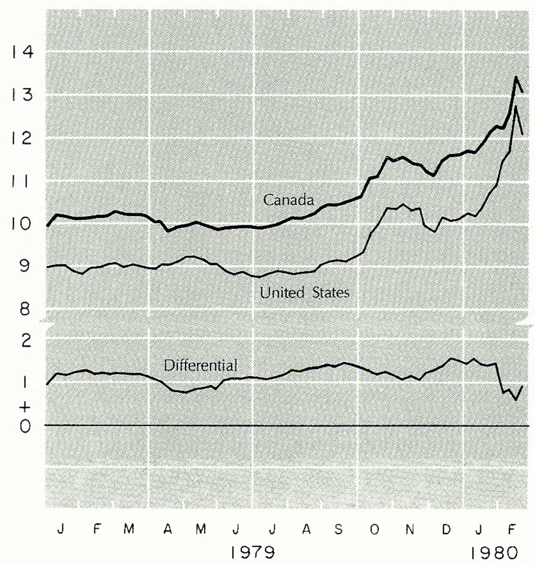


Short-term (1 month) market rates



(1) Finance company paper
(2) Dealer-placed commercial paper

Long-term federal government bond yields(3)



(3) Theoretical yield on 20-year federal government bonds

Government bonds. These bond sales occurred in relatively small amounts initially but they accelerated in late November when a brief reversal in the general upward movement in world interest rates led to a significant increase in the demand for Government of Canada bonds. In total such bond sales amounted to about $825 million by month-end.

Towards the end of 1979 and in early 1980 many financial markets in the world were characterized by extreme nervousness and volatility. Among the unsettling factors were the announcements by OPEC members of further increases in crude oil prices, the prolonged hostage incident in Iran, and the USSR's military intervention in Afghanistan. In the United States indications of the long-awaited recession were still few and inconclusive and inflationary expectations seemed to intensify. In these circumstances the confidence of investors suffered a marked decline and an extremely sharp downward adjustment in U.S. bond prices took place; this development had a major impact on bond prices in Canada as well.

Debt Management

During 1979 there was an increase of $8.9 billion in the par value of outstanding marketable Government bonds and treasury bills payable in Canadian dollars and a decrease of $1.3 billion in the outstanding amount of Canada Savings Bonds. Part of the $11.6 billion total Canadian dollar financing requirement of the Government was met by a decline of $4.0 billion in cash balances. At year-end the Canadian dollar cash balances of the Government amounted to $2.5 billion.

Additions to the outstanding amount of treasury bills totalled $2.1 billion in 1979, of which $1.5 billion came from augmenting the weekly auctions of 3-month and 6-month bills. The remaining $625 million took the form of additions to the one-year treasury bill tenders which occur every four weeks. The holdings of treasury bills outside the banking system increased by $174 million in 1979 to $4.2 billion.

The amount outstanding of Government of Canada direct and guaranteed marketable bonds payable in Canadian dollars rose by $6.7 billion on a par value basis during 1979. As shown in Appendix Table IV, there were eight public offerings of such bonds over the year, four of which involved substantial refundings of maturing issues. All but one offering included tranches of short-, medium- and long-term bonds, while on two occasions a ten-year tranche was added. Of the total new marketable bonds issued, 7 per cent were short-term (due in three years or less), 27 per cent were medium-term (due in more than three years but less than ten years) and the remaining 66 per cent were long-term. As a result the average term to maturity of direct and guaranteed bonds payable in Canadian dollars lengthened further in 1979 by twenty-two months to ten years five months. In addition to the public offerings of bonds, on March 21 a long-term issue of $300 million was placed directly with the Bank of Canada in order to facilitate the continuation of the Bank's sales of bonds in the open market.

The terms of the 1979/80 series of Canada Savings Bonds were first announced on September 12 and provided a yield of $10^1/_4$ per cent for each of the seven years to maturity. As was described above, interest rates in the United States and Canada moved rapidly upwards, and the yield offered on the new series was adjusted on two occasions. On October 18 the rate for the first year was raised to 11 per cent with the rate for each subsequent year set at $10^1/_2$ per cent. On November 5 the rate for the first year was raised again, to 12 per cent; the rate for the subsequent six years however was not adjusted, remaining at $10^1/_2$ per cent. The new rates were also to apply to the eleven previous issues still outstanding. In the case of those series dated before November 1, 1977, the increase in the rate of return was achieved by means of cash bonuses payable on the maturity of the bonds. The campaign produced a gross sale of $4.9 billion in the fourth quarter of the year, and after allowing for redemptions the outstanding amount of Canada Savings Bonds increased by $0.5 billion over the same three months. For the year as a whole, however, the outstanding amount declined by $1.3 billion, and the proportion of the total of Government of Canada securities outstanding held in this form declined from 33 per cent to 27 per cent.

In addition to its involvement in domestic financing operations during 1979 the Bank of Canada assisted the Government in two operations in foreign capital markets which raised net in foreign currency the equivalent of U.S.$605 million from issues of marketable securities and U.S.$759 million from fixed rate bank loans. These financings were completed in the first quarter of the year. The first involved a total of 100 billion Japanese yen, of which 30 billion yen took the form of a public offering of five-year bonds bearing a coupon of 6.4 per cent, 35 billion yen took the form of a ten-year syndicated loan bearing an interest rate of 7.1 per cent, and 35 billion yen took the form of a twenty-year syndicated loan bearing an interest rate of 7.5 per cent. The second borrowing, in the Swiss capital market, involved a total of 1,500 million Swiss francs, of which 700 million Swiss francs took the form of a three-year fixed rate bank loan bearing an interest rate of $2\frac{7}{8}$ per cent, 500 million Swiss francs took the form of a private placement of six-year non-callable notes bearing a coupon of 3 per cent, and 300 million Swiss francs involved a public offering of ten-year marketable bonds bearing a coupon of $3\frac{5}{8}$ per cent.

Changes during 1979 in the distribution of the outstanding debt of the Government of Canada are summarized in the accompanying table. Although the general public reduced its holdings of Canada Savings Bonds, it added very substantially to its holdings of marketable bonds, especially long-term bonds.

Summary of Changes in Government of Canada Securities Outstanding During 1979

Billions of dollars (par value)

Treasury bills	+2.1
Canada Savings Bonds	−1.3
Marketable bonds*	+7.5
	+8.3
Held by:	
Bank of Canada	
Treasury bills	+0.8
Marketable bonds	+0.9
	+1.7
Chartered Banks	
Treasury bills	+1.2
Marketable bonds	−0.9
	+0.3
Government Accounts	
Treasury bills	−0.2
Marketable bonds	−0.1
	−0.3
General Public	
Canada Savings Bonds	−1.3
Treasury bills	+0.3
Marketable bonds	+7.6
(of which long-term)	(+4.3)
	+6.6

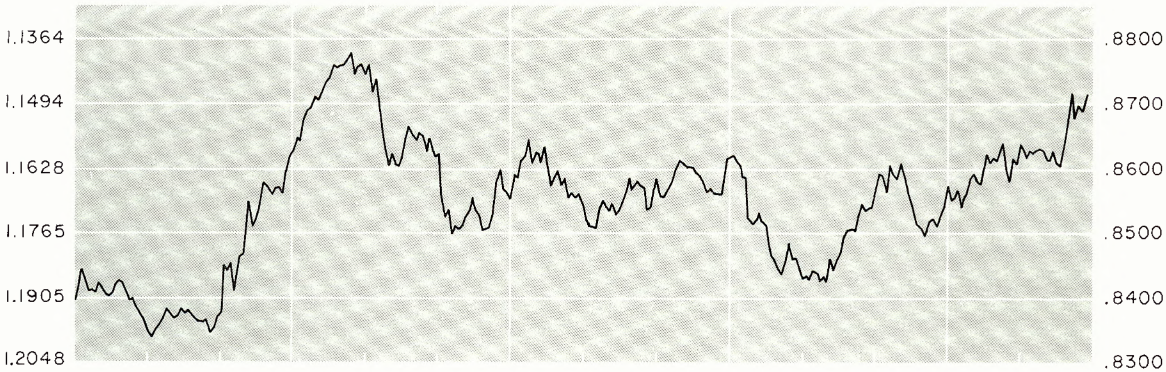
* Includes an increase of $0.7 billion in securities payable in foreign currencies.

Foreign Exchange Operations

Through much of 1979 the exchange rate was a good deal steadier than in recent years. Moreover, following more than two years of decline against the U.S. dollar, the Canadian dollar strengthened modestly over the period. From its low of U.S.$0.8320 early in 1979 the Canadian dollar rebounded strongly in March and April to a high of U.S.$0.8778 and then settled back into a trading range of about U.S.$0.85-0.86 for the summer months. It fell through October to a low of about U.S.$0.84 but recovered to stand at U.S.$0.8572 at year-end. As of February 27, 1980, the Canadian dollar stood at U.S.$0.8714.

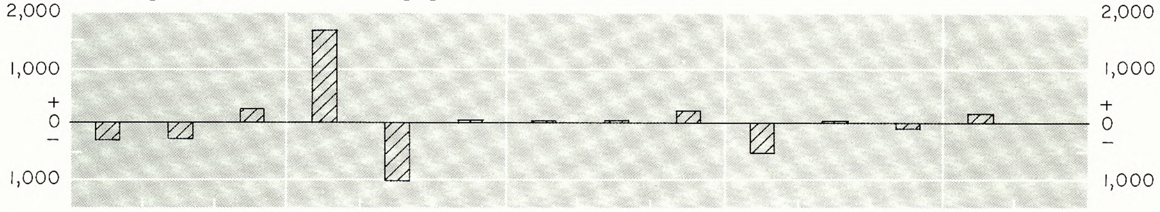
Official exchange market operations by the Bank of Canada as agent for the Exchange Fund Account of the Minister of Finance continued to be directed towards moderating the pace of movements in the exchange rate in either direction. This at times involved sizeable purchases and sales of foreign exchange and consequent changes in Canada's official holdings of foreign currency.

Exchange Rate
Spot closing rates, daily



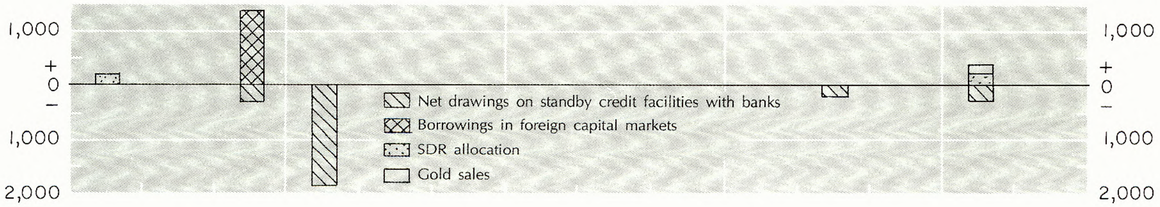
Changes in Official Reserves
Millions of U.S. dollars, monthly

Excluding official external financing, gold sales and revaluation effects[1]

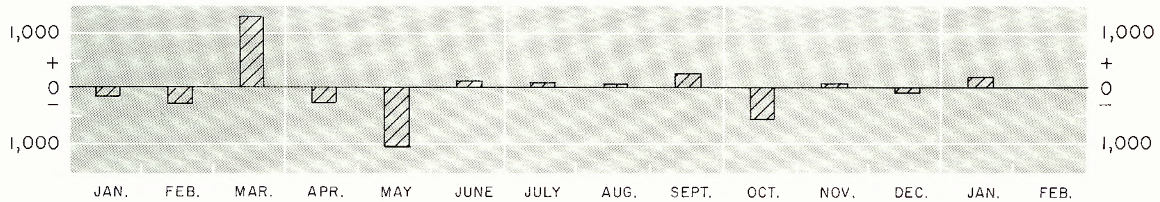


[1] The U.S. dollar value of SDR-denominated assets (gold, the IMF position and SDRs) rises when the exchange rate of the U.S. dollar declines in terms of SDRs, and decreases when the opposite occurs.

Government foreign currency financing, SDR allocations and gold sales



Total net change



Last date plotted: exchange rate February 27, 1980
official reserves January, 1980

Transactions relating to the Government's borrowings and repayments of foreign currency debt were at times also an important factor in the changes in Canada's official reserves. In March 1979 the net proceeds of medium- and long-term borrowings in the Swiss and Japanese capital markets, amounting to U.S.$880 million and U.S.$484 million respectively, were added to reserves. In March and April U.S.$2.2 billion of outstanding drawings under the two revolving standby credit facilities with banks were repaid. As a result, by the end of April 1979 the drawings from foreign banks had been fully repaid and U.S.$500 million remained outstanding with Canadian banks. In November a further U.S.$200 million was repaid to Canadian banks, and the remaining U.S.$300 million was repaid in January 1980.

The gold component of Canada's official reserves did not change much in 1979. Sales of gold to the Royal Canadian Mint in connection with the production of Canadian commemorative coins and the Gold Maple Leaf program were slightly more than offset by purchases of gold from the International Monetary Fund as part of the Fund's gold restitution program. At the end of 1979 official reserves included 22.2 million fine ounces of gold valued at 35 Special Drawing Rights per fine ounce (or U.S.$46.11 at that date), giving a value of U.S.$1,022.6 million. In January 1980, 252 thousand fine ounces of gold were sold from the official reserves for U.S.$174.0 million.

Canada's official international reserve holdings (with gold valued at 35 SDR per ounce) were U.S.$4,566.2 million at the end of 1978, U.S.$3,886.9 million at the end of 1979 and U.S.$4,065.9 million at the end of January 1980.

Appendix Tables

APPENDIX TABLE I

Bank of Canada Assets and Liabilities

Monthly changes, millions of dollars

	Government of Canada securities at book value	Net foreign currency assets	Investment in Industrial Development Bank	All other assets (net)	Note circulation	Canadian dollar deposit liabilities: Chartered banks	Canadian dollar deposit liabilities: Government of Canada	Canadian dollar deposit liabilities: Other
1979								
January	+ 53	− 414	− 41	−187	−809	+256	− 23	−13
February	− 553	+ 377	-	+ 6	− 22	−156	+ 6	+ 2
March	+1,207	−1,024	-	+ 61	− 71	+177	+ 99	+39
April	− 603	+1,061	− 38	−159	+227	+169	−103	−32
May	+ 290	− 262	-	+ 32	+242	−182	+ 4	− 4
June	− 281	+ 144	-	+498	+319	+ 16	+ 7	+19
July	+1,378	− 615	− 42	−522	+123	+101	− 7	−18
August	+ 76	− 331	-	+ 99	− 64	−149	+ 62	− 5
September	− 467	+ 369	-	+254	− 86	+265	− 47	+24
October	+ 510	− 91	− 50	−432	+153	−175	− 14	−27
November	−1,379	+ 776	-	+937	−103	+423	+ 7	+ 7
December	+1,397	− 217	-	−585	+866	−299	+ 5	+23
	+1,628	− 227	−171	+ 2	+775	+446	− 4	+15
1980								
January	− 431	− 516	− 42	+ 73	−931	+ 47	− 12	−20

APPENDIX TABLE II

Chartered Bank Cash Reserves

Millions of dollars unless otherwise indicated

		Total minimum cash requirements	Average holdings of Bank of Canada notes	Required minimum Bank of Canada deposits	Average holdings of Bank of Canada deposits	Number of juridical days in period
1979						
January	**1-15**	5,817	1,305	4,513	4,575	10
	16-31				4,563	12
February	**1-15**	5,792	1,503	4,289	4,317	11
	16-28				4,321	9
March	**1-15**	5,735	1,269	4,466	4,479	11
	16-31				4,503	11
April	**1-15**	5,844	1,266	4,578	4,630	9
	16-30				4,630	11
May	**1-15**	5,777	1,259	4,518	4,579	11
	16-31				4,555	11
June	**1-15**	5,793	1,325	4,468	4,497	11
	16-30				4,495	10
July	**1-15**	5,837	1,341	4,496	4,527	9
	16-31				4,552	12
August	**1-15**	5,937	1,408	4,530	4,584	11
	16-31				4,603	12
September	**1-15**	5,956	1,396	4,560	4,624	9
	16-30				4,601	10
October	**1-15**	5,991	1,403	4,588	4,659	10
	16-31				4,697	12
November	**1-15**	5,999	1,426	4,573	4,643	10
	16-30				4,606	11
December*	**1-15**	6,003	1,427	4,576	4,621	10
	16-31				4,670	9
1980						
January*	**1-15**	6,127	1,451	4,676	4,720	10
	16-31				4,710	12
February*	**1-15**	6,198	1,689	4,509	4,563	11

* Preliminary.
(1) Advances to banks and Purchase and Resale Agreements with money market dealers summed and divided by number of juridical days.

Excess cash reserves		Advances to chartered banks and PRA outstanding			
Cumulative excess reserves at end of period	Average excess reserve ratios	Number of days outstanding		Average outstanding[1]	
		Advances	PRA	Advances	PRA
624	.062	2	7	1.0	83.1
610	.050	1	11	3.3	121.3
309	.028	1	8	3.6	102.8
293	.032	1	7	9.1	154.8
146	.013	2	10	21.5	188.7
409	.037	1	10	12.4	130.9
466	.050	2	6	23.2	91.1
566	.050	3	8	9.6	143.3
681	.059	1	9	1.2	133.2
409	.036	2	7	1.7	78.1
326	.028	2	8	1.5	153.7
282	.026	2	8	3.8	212.3
285	.029	1	7	5.2	202.4
672	.052	2	11	3.6	225.9
594	.049	–	7	–	85.0
879	.067	–	4	–	20.4
575	.057	1	2	0.0	1.6
402	.036	2	3	12.5	30.0
707	.063	2	7	8.6	85.8
1,302	.097	–	6	–	31.2
703	.062	–	4	–	22.7
368	.030	1	6	14.5	107.3
451	.039	2	8	10.3	181.8
845	.082	1	5	13.0	106.4
438	.037	2	8	17.8	106.8
412	.029	1	11	0.4	147.4
603	.046	1	9	0.4	98.7

APPENDIX TABLE III

Bank of Canada Net Transactions in Government of Canada Securities and Bankers' Acceptances

Delivered basis, par value in millions of dollars

Net purchases from (+) or net sales to (–) investment dealers and banks

	Treasury bills	Bonds[1] 3 years and under	Bonds[1] 3–5 years	Bonds[1] 5–10 years	Bonds[1] Over 10 years	Bankers' acceptances[2]	Sub-total of bills and bonds and bankers' acceptances	Securities under PRA
1979								
January	+ 403.4	–	–	–	– 166.4	–21.7	+ 215.3	+ 52.3
February	– 325.6	–	–	–	– 122.0	–	– 447.6	+252.0
March	+1,320.6	–	–	–	– 366.8	–	+ 953.8	–304.3
April	+ 209.5	–	–	–	– 441.5	–	– 232.0	+221.2
May	+ 592.1	–	–	–	–	–	+ 592.1	–217.2
June	+ 545.4	–	–	–	– 1.1	–	+ 544.3	– 4.0
July	+1,139.6	–	–	–	–	–	+1,139.6	+236.6
August	+ 659.7	–	–	–	–	–	+ 659.7	–236.6
September	+ 98.2	–	–	–	–	–	+ 98.2	–
October	– 109.3	–	–	–	–	–	– 109.3	–
November	+ 111.0	–292.9	–526.9	–3.0	–	–	– 711.8	–
December	+ 684.0	–	–	–0.5	–	–	+ 683.5	–
Total	+5,328.6	–292.9	–526.9	–3.5	–1,097.8	–21.7	+3,385.8	–
1980								
January	+ 53.0	–	–	–	–	–	+ 53.0	+ 30.0

(1) Classified by years to maturity at time of transactions.
(2) Includes maturing bankers' acceptances.

Net transactions with Government and other client accounts				Net change in holdings of Government of Canada securities and bankers' acceptances			
Purchases (+) of new issues less matured holdings		Net purchases from (+) or net sales to (−) Government and client accounts					
Bills	Bonds	Bills	Bonds	Bills	Bonds	Bankers' acceptances	Total
− 55.0	-	− 204.0	+ 21.8	+191.7	−143.6	−17.7	+ 30.4
− 273.6	+ 129.8	− 220.5	+ 17.4	−600.8	+ 46.4	+11.9	− 542.5
+ 140.8	+ 750.0	− 329.0	+ 23.1	+866.2	+384.1	−15.9	+1,234.4
− 329.9	− 223.0	− 20.0	+ 21.7	+ 18.7	−618.5	+37.8	− 562.0
− 501.9	+ 400.0	− 57.7	+ 33.0	−126.6	+408.7	−33.8	+ 248.3
− 555.1	+ 132.1	− 366.2	− 33.8	−375.9	+ 97.2	− 4.0	− 282.7
− 353.8	+ 400.0	− 32.8	+ 14.0	+955.3	+430.2	+18.1	+1,403.6
− 473.4	+ 350.0	− 247.9	+ 25.1	−263.9	+358.9	−18.1	+ 76.9
− 372.6	-	− 243.0	+ 34.9	−517.4	+ 34.9	-	− 482.5
+ 494.2	+ 184.7	− 69.0	+ 38.3	+315.9	+223.0	-	+ 538.9
− 536.2	-	− 161.3	+ 27.3	−586.5	−795.5	-	−1,382.0
+ 293.5	+ 519.4	− 75.3	− 15.4	+902.2	+503.5	-	+1,405.7
−2,523.0	+2,643.0	−2,026.7	+207.4	+778.9	+929.3	−21.7	+1,686.5
− 443.3	-	− 44.3	− 35.9	−404.6	− 35.9	-	− 440.5

APPENDIX TABLE IV

Government of Canada Direct and Guaranteed Marketable Securities*: New Issues and Retirements

Date in 1979	Issues offered/ retired	Term to maturity	Yield to maturity	Millions of dollars par value: Amount delivered	Millions of dollars par value: Amount retired
Issues payable in Canadian dollars – direct and guaranteed					
Feb. 1	8¼% Feb. 1, 1979				100[1]
	9¾% Feb. 1, 1982	3 yrs.	10.20	75[2]	
	10% June 1, 1984	5 yrs. 4 mos.	10.18	225	
	10¼% Feb.1, 2004	25 yrs.	10.31	500	
				800	
Mar. 15	9¾% Feb. 1, 1982	2 yrs. 10½ mos.	9.99	75[3]	
	10% June 1, 1984	5 yrs. 2½ mos.	10.06	375[4]	
	10 ¼% Feb. 1, 2004	24 yrs. 10½ mos.	10.30	800[5]	
				1,250	
Mar. 21	10¼% Feb. 1, 2004	24 yrs. 10½ mos.	10.26	300[6]	
Apr. 1	7% Apr. 1, 1979				325[7]
May 1	10% May 1, 2002	23 yrs.	10.11	850	
June 1	6½% June 1, 1979				585[8]
	9¾% Feb. 1, 1982	2 yrs. 8 mos.	9.80	100[9]	
	9¾% Feb. 1, 1984	4 yrs. 8 mos.	9.88	350[10]	
	10% May 1, 2002	22 yrs. 11 mos.	10.08	500[11]	
				950	
July 15	9¾% Feb. 1, 1982	2 yrs. 6½ mos.	9.81	100[12]	
	9¾% Feb. 1, 1984	4 yrs. 6½ mos.	9.89	400[13]	
	10% May 1, 2002	22 yrs. 9½ mos.	10.05	500[14]	
				1,000	
Aug. 15	10% June 1, 1984	4 yrs. 9½ mos.	10.13	200[15]	
	10% Oct. 1, 1989	10 yrs. 1½ mos.	10.16	200	
	10¼% Feb. 1, 2004	24 yrs. 5½ mos.	10.28	600[16]	
				1,000	
Oct. 1	3¼% Oct. 1, 1979				343[17]
	7½% Oct. 1, 1979				624[18]
	10¾% Oct. 15, 1982	3 yrs. ½ mo.	10.85	200	
	10½% Oct. 1, 1984	5 yrs.	10.63	300	
	10½% Oct. 1, 1989	10 yrs.	10.54	200	
	10½% Oct. 1, 2004	25 yrs.	10.50	600	
				1,300	
Dec. 15	5 ¾% Dec. 15, 1979				225[19]
	11¾% Dec. 15, 1982	3 yrs.	12.16	275	
	11½% Dec. 15, 1984	5 yrs.	11.77	350	
	11¼% Dec. 15, 1989	10 yrs.	11.46	125	
	11¼% Dec. 15, 2002	23 yrs.	11.44	750	
				1,500	

(Continued)

Date in 1979		Issues offered/ retired	Term to maturity	Yield to maturity	Millions of dollars par value Amount delivered	Amount retired
Dec.	29					5[20]
		Total bonds			8,950	2,207
		Total treasury bills*			41,705	39,580
Issues payable in foreign currencies - direct						
Mar.	14	S.F. 500 million 3% notes due Mar. 14, 1985[21]	6 yrs.	3.00	351	
Mar.	20	S.F. 300 million 3⅝% bonds due Mar. 20, 1989[21]	10 yrs.	3.72	208	
Mar.	27	Yen 30 billion 6.4% bonds due Mar. 27, 1984[22]	5 yrs.	6.49	169	
Apr.	15					1[23]
Oct.	15					1[23]
		Total bonds			728	2

* Includes three-month, six-month and one-year treasury bills.
(1) Maturity of 8¼% bonds issued December 1, 1976.
(2) In addition to $125 million 9¾% February 1, 1982 already outstanding.
(3) In addition to $200 million 9¾% February 1, 1982 already outstanding.
(4) In addition to $225 million 10% June 1, 1984 already outstanding.
(5) In addition to $500 million 10¼% February 1, 2004 already outstanding.
(6) $300 million placed directly with the Bank of Canada on March 21, 1979.
In addition to $1,300 million 10¼% February 1, 2004 already outstanding.
(7) Maturity of 7% bonds issued April 1, 1974.
(8) Maturity of 6½% bonds issued June 1, 1971, December 15, 1972 and February 1, 1973.
(9) In addition to $275 million 9¾% February 1, 1982 already outstanding.
(10) In addition to $250 million 9¾% February 1, 1984 already outstanding.
(11) In addition to $850 million 10% May 1, 2002 already outstanding.
(12) In addition to $375 million 9¾% February 1, 1982 already outstanding.
(13) In addition to $600 million 9¾% February 1, 1984 already outstanding.
(14) In addition to $1,350 million 10% May 1, 2002 already outstanding.
(15) In addition to $600 million 10% June 1, 1984 already outstanding.
(16) In addition to $1,600 million 10¼% February 1, 2004 already outstanding.
(17) Maturity of 3¼% bonds issued October 1, 1954.
(18) Maturity of 7½% bonds issued July 1, 1975 and August 15, 1975.
(19) Maturity of 5¾% bonds issued December 15, 1971.
(20) Cancellation of guaranteed debt by Purchase Fund.
(21) Does not include the S.F. 700 million 3-year 2⅞% loan delivered March 8, 1979 that raised $493 million.
(22) Does not include the Japanese yen 35 billion 10-year 7.1% fixed rate syndicated loan arranged on February 19, 1979 that raised $199 million.
Does not include the Japanese yen 35 billion 20-year 7.5% fixed rate syndicated loan arranged on February 19, 1979 that raised $199 million.
(23) Partial redemption at par of U.S. pay 5% October 15, 1987 for Sinking Fund.

BANK OF CANADA Statement of Income and Expense

Year Ended December 31, 1979
(with comparative figures for 1978)

	1979	1978
	(thousands of dollars)	
INCOME		
Revenue from investments and other income After deducting interest of $2,975 ($3,965 in 1978) paid on deposits	$1,161,133	$989,493
EXPENSE		
Salaries[1]	$ 28,390	$ 24,823
Contributions to pension and insurance funds[1]	4,647	3,090
Other staff expenses[2]	1,606	1,261
Directors' fees	47	43
Auditors' fees and expenses	200	173
Taxes – municipal and business	4,472	4,093
Bank note costs	18,685	15,243
Data processing and computer costs	3,013	2,619
Maintenance of premises and equipment – net[3]	6,231	4,910
Printing of publications	470	568
Other printing and stationery	1,400	1,099
Postage and express	826	666
Telecommunications	938	883
Travel and staff transfers	977	860
Other expenses	594	561
	72,496	60,892
Depreciation on buildings and equipment	4,704	3,570
	77,200	64,462
NET INCOME PAID TO RECEIVER GENERAL FOR CANADA	1,083,933	925,031
	$1,161,133	$989,493

(1) Salaries, including overtime, and related contributions to pension and insurance funds for bank staff other than those engaged in building maintenance. The number of employee years worked by such staff (including temporary, part-time, and overtime work) was 1,883 in 1979 and 1,782 in 1978.

(2) Includes cafeteria expenses, retirement allowances, educational training costs and medical expenses.

(3) Includes all building maintenance costs (including staff costs) but net of rental income.

Certain of the expenses for 1978 have been reclassified in order to conform with the presentation adopted for 1979.

BANK OF CANADA Statement of Assets and Liabilities

as at December 31, 1979
(with comparative figures for 1978)

ASSETS	1979	1978
	(thousands of dollars)	
Deposits payable in foreign currencies:		
Pounds sterling and U.S.A. dollars	$ 229,273	$ 213,124
Other currencies	1,705	1,236
	230,978	214,360
Advances to chartered and savings banks	116,900	
Bills bought in open market, not including treasury bills, at amortized values		21,606
Investments — at amortized values:		
Treasury bills of Canada	4,239,985	3,489,436
Other securities issued or guaranteed by Canada maturing within three years	3,768,421	3,362,414
Other securities issued or guaranteed by Canada not maturing within three years	5,542,889	5,071,828
Debentures issued by Industrial Development Bank	344,283	515,660
Securities issued by the United Kingdom and the United States of America	824,723	1,053,000
Other securities	2,633	2,633
	14,722,934	13,494,971
Bank premises:		
Land, buildings and equipment, at cost less accumulated depreciation	76,567	75,395
Cheques drawn on other banks	384,591	903,908
Accrued interest on investments	206,782	193,546
Net balance of Government of Canada collections and payments in process of settlement		197,946
Other assets	6,994	3,910
	$15,745,746	$15,105,642

LIABILITIES	1979	1978
	(thousands of dollars)	
Capital paid up	$ 5,000	$ 5,000
Rest fund	25,000	25,000
Notes in circulation	10,314,754	9,539,707
Deposits:		
Government of Canada	24,799	29,248
Chartered banks	4,738,420	4,291,793
Other deposits	107,452	92,494
	4,870,671	4,413,535
Liabilities payable in foreign currencies:		
Government of Canada	136,285	121,571
Other	233	153
	136,518	121,724
Bank of Canada cheques outstanding	297,429	987,356
Collections and payments in process of settlement:		
Government of Canada (net)	38,814	
Other	54,655	
	93,469	
Other liabilities	2,905	13,320
	$15,745,746	$15,105,642

Governor, **G. K. BOUEY**

Chief Accountant, **A. C. LAMB**

Auditors' Report We have examined the statement of assets and liabilities of the Bank of Canada as at December 31, 1979 and the statement of income and expense for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these financial statements present fairly the financial position of the Bank as at December 31, 1979 and the results of its operations for the year then ended in accordance with the accompanying summary of significant accounting policies, applied on a basis consistent with that of the preceding year.

GÉRALD PRÉFONTAINE, C.A.
du cabinet Normandin, Séguin & Associés

M. A. MACKENZIE, F.C.A.
of the firm Clarkson, Gordon & Co.

Ottawa, Canada, January 17, 1980

Summary of Significant Accounting Policies

The financial statements have been prepared within the framework of the accounting policies summarized below.

a. Form of Presentation

The form of the statement of assets and liabilities meets the requirements of the Bank of Canada Act.

b. Revenues and Expenses

Revenues and expenses have been accounted for on the accrual basis.

c. Investments and Bills

In accordance with the requirements of the Bank of Canada Act, these assets have been recorded at their cost adjusted for amortization of purchase discounts and premiums. The amortization as well as gains and losses on disposition have been included in income.

d. Translation of Foreign Currencies

Assets and liabilities in foreign currencies have been translated to Canadian dollars at the rates of exchange prevailing at the year-end.

e. Depreciation

Depreciation has been recorded at the following annual rates applied on the declining balance method:

Buildings	5%
Equipment	20%

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M. MUZYKA, *Deputy Auditor*

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