Bank of Canada

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

1980

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February 27th, 1981

The Hon. Allan J. MacEachen, P.C.,
Minister of Finance,
Ottawa.

Dear Mr. MacEachen,

In accordance with the provisions of the Bank of Canada Act I am transmitting herewith my report for the year 1980 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 - 1980

General Observations

The conduct of monetary policy has attracted a great deal of attention in the last year or so and the reason is clear, namely, the level and volatility of interest rates during the period. There has been much discussion of the reasons for these interest rate developments and the Bank has made an unusually large number of statements explaining its policies. Because these policies involved interest rates that seemed very high they could hardly be said to be popular, at least among borrowers, but I have been encouraged by the understanding and support that they have received. At the same time I am well aware that the Bank's policies have given rise to doubts in some circles and to opposition in others. I therefore want to begin this Report with some comments on the basic facts that have to be taken into account in the consideration of monetary policy.

The Framework for Monetary Policy

The responsibility of the Bank is to discharge its Parliamentary mandate "to regulate credit and currency in the best interests of the economic life of the nation". The practical question is – what does that mean when the rate of inflation is as high as it now is?

As recently as a decade ago it was not uncommon to hear people argue that central banks had an excessive fondness for stability in the value of money, and that more willingness on their parts to run risks on the side of inflation would have been in the best interests of the economic life of their countries. During the inflationary surge of the first half of the 1970s this argument ceased to be heard. Attention focussed on the corrosive nature of inflation both nationally and internationally – on its debilitating economic effects, its social unfairness and its political divisiveness. There emerged a virtually unanimous view that inflation had to be resisted.

The world's central banks took seriously the lesson of the first half of the 1970s, and for some years now they have been trying to contain the inflationary surge that had been released. It is, however, proving to be much harder to get the genie of inflation back into the bottle than it was to release it. In Canada and elsewhere the experience of rapidly accelerating inflation set loose a wide range of expectations and defensive reactions that have been ricochetting around the economic system and sustaining the inflationary process.

We have thus seen in Canada and in a number of other countries the pursuit of anti-inflationary policies without as yet much evidence of a reduction in the rate of inflation. This has led to the resurfacing of questions about whether the game is worth the candle, and whether it might not be better for countries to learn to live with inflation than to resist it.

It is not at all clear what people have in mind when they talk about "learning to live with inflation".

Is it possible that they think that society could develop some way of indexing all money payments so completely that changes in the purchasing power of money would be neutralized and could therefore be ignored in the formation of public policy? The fatal weakness of this idea is that the more vigorously a country applied it the more rapidly would any inflationary impetus cause prices to accelerate. That system would be much too unstable to be workable. As a practical matter proposals to find ways of ignoring the rate of inflation cannot be taken seriously. This seems to be well recognized since nearly all of those who press for policies that would be very inflationary add a caveat that the rate of inflation must be limited by one means or another. They are usually not very specific about how this should be done.

A more plausible version of the learning-to-live-with-inflation thesis is that our society should accept the present rate of inflation, high as it may be, and should stabilize it. This, it is argued, would avoid all the difficulties involved in rolling back the present rate. But the proposal also involves the idea that any acceleration of the present rate of inflation should be effectively resisted. The question then arises – how is this to be done? It can certainly not be done by relaxing anti-inflationary policies. Only a few years ago there seemed to be some disposition in the United States to accept an inflation rate of 6 to 7 per cent per annum, and the rate there is now over 10 per cent. In Canada anti-inflationary policy has not yet succeeded in preventing a high rate of inflation, but without that policy the inflation rate would now be much higher than it is. If efforts to reduce inflation are now relaxed it will increase. There is no escape from the problem of inflation by willingness to accept a stable inflation rate. It is in fact by no means clear that it would be easier to learn to live with the present rate of inflation than to learn to live without inflation. I think it would be harder. What credibility could there be in public policy that in principle accepted inflation? If public policy indicated a willingness to accept a 10 per cent inflation rate, who would be prepared to believe it would not under pressure accept 12 per cent, or later 14 per cent or more?

The essential point of the preceding paragraphs is that there is no escape in our society from the need to deal with inflation. The only choices we have are when and how to do it. Procrastination will only make matters worse.

This state of affairs has profound implications for the conduct of monetary policy. Inflation means a decline in the value of money, and the value of money, like that of virtually everything else, is much influenced by the supply of it. Monetary policy has to do with the supply of money, however defined. There is no way of preserving the value of money in an economy when the money supply is allowed to grow faster than the economy needs to function at price stability. Even very tough direct controls are unable to protect the value of money more than temporarily if there is too much monetary expansion. Control over the rate of monetary expansion is thus an absolutely essential element in effective anti-inflationary policy.

In a market-oriented economy there is a direct interaction between monetary expansion and interest rates. A reduction in the rate of monetary expansion will, other things being unchanged, push up short-term interest rates, and vice versa. In the longer term the relationship is different. A reduction in the rate of monetary expansion will over time lead to a lower rate of inflation than would otherwise have existed and interest rates will be lower than they would otherwise have been. But the first effect on interest rates is in the other direction. These relationships are part of the nature of Canada's economic system, so if the rate of monetary expansion is to be controlled, the interest rate consequences must be accepted.

One sometimes encounters skepticism about how an increase in interest rates arising from monetary constraint can contribute to reducing cost and price inflation. Is it not obvious, it is asked, that an increase in interest rates adds to costs and thereby puts upward pressure on the rate of inflation? This is one short-run effect but it is not the only one. The effect of an increase in interest rates on the foreign exchange rate has as immediate and pervasive an influence on Canadian costs but it is in the opposite direction. The longer run effects are also in the opposite direction. Over time higher interest rates reduce the demand for credit and the level of total spending in the economy, and this restrains the upward movement of costs and prices throughout the economy. The overall impact of rising interest rates is unquestionably anti-inflationary. Thus a policy of resisting inflation by trying to keep interest rates down through monetary expansion would have results exactly the opposite of those sought.

It is a common error to suppose that monetary policy is the sole determinant of the level of interest rates that exists at any particular time. Monetary policy involves primarily the control of the rate of monetary expansion, and a given rate of monetary expansion can be compatible with many different levels of interest rates depending on the other factors that affect interest rates. Critics of high interest rates should be clear about whether they believe that the rate of monetary expansion is too low – that is to say, that monetary policy is wrong – or whether what they really want is action outside the field of monetary policy to affect interest rates such as, for example, a change in fiscal policy, or some kind of credit rationing, or direct initiatives to reduce inflation by influencing the wage and price decisions of particular groups.

Although control over the rate of monetary expansion is an essential component of an effective anti-inflationary policy it should not be the only element. If it is left to carry the whole load it may, to be effective, have to involve such high interest rates as to be very disruptive to the functioning of the economy. Very high interest rates have an uneven impact on the economy, affecting particularly those areas of activity that typically involve the use of large amounts of credit, as for example, house building. The slowing of inflation will be accomplished with much less economic and social strain if policies elsewhere in the economy help the process.

The basic way that anti-inflationary financial policy works in a market-type society such as we have in Canada is by moderating the demand in the markets for goods and labour, making it more difficult for prices to be increased. Market discipline was the control that we relied on during past periods of cost and price stability, and it is this control that we must rely on to restore that stability.

The main instruments of public policy to influence the level of demand in the economy are fiscal policy and monetary policy. What level of demand is consistent with a decline in the rate of inflation depends on how flexible the economy is. If prices and costs respond sensitively to changes in market conditions the reduction in inflation will proceed with little adverse impact on output and employment. To the extent, however, that markets respond insensitively – to the extent that groups in markets have and use the power to continue to push up costs and prices rapidly in the face of weakening market conditions – the reduction of inflation will require a greater easing of total demand and thus a greater impact on output and employment.

It is sometimes said that the reduction of inflation in Canada through market processes is not practical in that markets are too unresponsive because of the degree to which power to control supply and prices lies in the hands of particular businesses or of trade unions or of marketing boards or of regulatory agencies. One cannot deny that there is some such unresponsiveness and that it intensifies the problem. But the Canadian economy has operated without significant inflation in the past, and the current problem may be more manageable than it looks. For one thing, we might be agreeably surprised at how well our markets would react if they were exposed to restrained demand over a considerable period of time and were convinced that the public authorities were serious and determined in their anti-inflation policy. For another thing there probably are initiatives that could be taken to improve the responses of particular markets if the possibilities were examined by those involved. It appears that inflationary practices in particular markets are sometimes facilitated by privileges given by governments to particular groups, and these arrangements should be reviewed in the light of the present economic situation. I believe that efforts to increase the responsiveness of the Canadian economy to changes in the economic environment would much improve the prospects for high levels of employment and output in the years ahead.

One way that is sometimes proposed to improve the response of the economy to anti-inflationary policy is to impose direct controls to force less inflationary practices. Experience has shown that there are difficult problems involved in using direct controls even on a temporary basis. The only point I want to make here is that, to be effective, direct controls need to be not only well designed and well managed but strongly underpinned by anti-inflationary financial policies so that market discipline reinforces the controls. If that support is lacking the direct controls will not achieve the transition to a lower rate of inflation that they seek. They are at best a supplement to, not a substitute for, firm anti-inflationary financial policy.

Because there is no easy and comfortable way of dealing with the problem of inflation, every possible course of action can be expected to attract criticism. When monetary and fiscal policies are directed towards lowering the pressure of total spending on prices and costs there is likely to be a period during which business earnings decline and unemployment and unused capacity rise, and one can expect to hear the familiar charge that "inflation is being fought on the backs of the unemployed". If, in an attempt to minimize the loss of potential output and employment that may be associated for a time with anti-inflationary monetary and fiscal policies, more direct intervention in the setting of prices and incomes is attempted by governments, it will be said that inflation is being fought by restricting basic freedoms to determine prices in the marketplace and wage settlements through free collective bargaining. There is no point in pretending that a painless solution is available, but the long-run interest of the Canadian economy requires that a choice in favour of anti-inflationary policies be made despite the difficulties associated with them.

That concludes my comments on the basic framework within which monetary policy must be considered. The country's economic interest requires that monetary policy be anti-inflationary, which means that control of the rate of monetary expansion must be firm and sustained and that the short-run consequences of such control on interest rates must be accepted. This is true whether or not monetary policy is supported by other anti-inflationary policies.

Monetary Policy in 1980

I shall now turn to deal more specifically with some aspects of monetary policy during 1980.

The Bank's operations during 1980 were directed towards the same broad objective as they have been for some years, namely the creation of monetary conditions that will encourage the economy to achieve growth within a framework of increasing stability in the value of money. This means that the rate of monetary expansion must over time decline to levels consistent with economic growth at reasonably stable prices. The Bank continued to be particularly interested in the movement over time of the narrow measure of the money supply (currency and demand deposits, or M1) as a guide to that end. Its target limits for M1 growth were between 5 and 9 per cent per year from the average level of M1 in the second quarter of 1979. Within that broad framework the Bank has tried to respond to short-term developments in financial markets in whatever way seemed most likely to smooth the anti-inflationary process.

In the financial area the outstanding feature of 1980 was the extraordinary volatility of interest rates in the United States. One indicator of these rates, the prime lending rate of U.S. commercial banks, moved from 15¼ per cent at the beginning of the year to a peak of 20 per cent in April, to a low of 11 per cent in August and then to a second peak of 21½ per cent in December. In late February of 1981 it was 19 per cent. Further details on movements of U.S. interest rates appear in a later section of this Report.

Movements of this magnitude in U.S. interest rates were bound to have substantial effects on interest rates in Canada or on the foreign exchange value of the Canadian dollar or on both. The distribution of the impact between interest rates and the exchange rate depended to a considerable extent on how the Bank of Canada reacted. Since the Bank followed a course of action lying between the extremes available to it, some of the impact fell on Canadian interest rates and some on the exchange rate. The swings in Canadian short-term interest rates, while considerable, were much smaller than in the United States and the value of the Canadian dollar in U.S. funds almost always moved inversely with U.S. interest rates. The December peak reached by short-term interest rates was about 3 percentage points lower in Canada than it was in the United States and the Canadian dollar fell to a low point of U.S.$0.8249.

For the Bank to be able to react in this way it was necessary that the interest rate at which the Bank lends money, the so-called Bank Rate, be flexible, and so on March 13, 1980 the Bank began setting the Bank Rate each week at ¼ percentage point above the average rate established in the weekly tender for 91-day treasury bills issued by the Government of Canada. Subsequent events demonstrated that this was a timely change, and the Bank has continued to follow this practice. It is in fact difficult to see how Canada can have a Bank Rate that remains fixed for any significant period as long as interest rates in the United States are volatile. I was concerned initially that our change to a floating Bank Rate would be regarded as an effort by the Bank to escape from such responsibility as can properly be attributed to it for movements in interest rates. We therefore followed the practice of making public statements whenever the Bank Rate moved substantially. The result has been that interested observers have been unusually well informed about the nature of the Bank's reactions as the situation developed.

It is quite easy to make arguments, according to one's preference, that the Bank permitted Canadian interest rates or the exchange rate to move too much or too little in response to the fluctuations of interest rates in the United States in 1980. These arguments turn mainly on how seriously one regards the threat of inflation in Canada and how vigorously one wants to resist it.

To have sought a lesser rise of interest rates in Canada than occurred and to have thereby invited more depreciation of the exchange rate would have added to the upward pressure on costs and prices in Canada. In the inflationary atmosphere that existed the impact of exchange rate depreciation would certainly not have been limited to the automatic first-round effects on prices of internationally traded goods but would have spread rather quickly. If the Canadian economy had not been competitive internationally at the prevailing exchange rate, as was the case in 1976, exchange rate depreciation is medicine that it would have been sensible to swallow. In 1980, however, the Canadian economy was strongly competitive internationally because of the exchange rate depreciation that occurred from late in 1976 through 1978. What has been needed since then is not more exchange rate depreciation but enough slack in domestic markets to preserve the country's restored competitiveness and to facilitate changes in the flow of trade. A later section of this Report records how these changes have proceeded quite dramatically in the last two years. To have courted significant further exchange rate depreciation in 1980 when the economy was already clearly competitive internationally, and when the real problem was to avoid intensifying upward pressures on Canadian costs of production that were already distressingly strong, would have compounded rather than eased Canada's economic problems.

The contrary argument is of course that, whatever the effect on inflation and hence on our longer term economic problems, production and employment in Canada would have benefitted in the short run from lower interest rates and more exchange rate depreciation. In my view even a short-term benefit was questionable. Expectations and confidence play an important role in the determination of exchange rates and, if financial markets and the public generally had been given the impression that the Canadian authorities were disposed to accept an inflationary solution to their problems by allowing the foreign exchange value of the Canadian dollar to decline freely, that value would probably have dropped sharply and unpredictably in a market dominated by speculation. In that event strong measures to restore order would have become imperative, and those measures would have been more prejudicial to production and employment in Canada than anything that happened in 1980.

Those are considerations that underlay the response of the Bank to the extraordinary developments during 1980 in U.S. financial markets. That response was, I believe, both moderate and consistent with the Bank's aim of keeping the way open for the Canadian economy to move gradually to lower rates of inflation and lower rates of interest in the years ahead. While it was a response that was not triggered by current movements of M1, it was compatible with the operating objectives of our M1 targets, namely, to moderate the rate of monetary expansion in Canada, and the trend of M1 remained within the target range during the year.

I might note in passing that many other countries experienced problems similar in kind as a result of the volatility of U.S. interest rates. For some countries the movements induced in their exchange rates with the U.S. dollar were larger than for Canada but on the other hand the proportion of their transactions denominated in U.S. dollars to the size of their economies is less than for Canada. In Canada's case that proportion is very high, mainly because of our geographic location.

The Last Five Years

I wish now to comment on the view of some people that the approach being followed in Canada to deal with inflation has not worked and will not work.

We in the Bank certainly hoped in 1975 that by 1980 the rate of inflation would be less than it turned out to be. The rate of inflation in 1980 was in fact not significantly less than in 1975. What is more disturbing, the rate of inflation in 1980 was higher than it had been in the years immediately preceding and was showing some tendency to rise further. The short-term prospects for food prices are not good, and further increases in energy prices lie ahead. Despite a general expectation of some easing in markets in 1981, expectations of continuing high inflation are strong. These expectations are contributing to and being reinforced by a rising trend in wage settlements. The problem of containing inflation in Canada has certainly not been resolved. Why is that?

Perhaps the first thing to say is that it was never realistic to suppose that the inflationary surge unleashed in Canada and elsewhere in the late 1960s and the first half of the 1970s would be contained either easily or quickly. Looking back at the economic history since World War II it is clear that it took a long time to erode public confidence in the future value of money. To restore it will require sustained efforts and much patience. In this matter five years is not a long time. This is particularly the case when, as in Canada, the approach to containing inflation has been gradualist in character. Gradualism in this matter has obvious advantages, but among its disadvantages are that adverse developments can check progress for long periods.

One development since 1975 that has been adverse from the point of view of reducing inflation is that the cost of foreign currencies in terms of Canadian dollars has risen on average by about 20 per cent. This decline in the foreign exchange value of the Canadian dollar was largely the delayed consequence of higher rates of cost and price inflation in Canada than in the United States over most of the decade which preceded it. The point that is relevant here is that the exchange rate decline caused appreciable further additions to Canadian costs and prices while it was occurring and afterwards. In view of the large size of the exchange rate change it is gratifying that these additions have not been greater than they have. That they have not seems to be due primarily to the fact that the initial impact was incurred while the 1975-78 anti-inflation program was still in force and cost and price pressures from other sources were less than they have since become.

Another development that has made a major contribution to the relatively poor performance of costs and prices in Canada in recent years is that the effective capacity of the economy to produce without overheating has grown at a much slower rate than it did earlier. One indicator of this is the recent disappearance of the growth of over-all productivity (real GNE per person employed) as measured by the National Accounts. This development was not foreseen by economic analysts nor was it peculiar to Canada. The reasons for it are not clear, though contrary to much popular opinion it does not appear in Canada to have been due to a decline in the over-all rate of gross business investment in plant and equipment. Whatever the reasons, the effect was that the pressure of demand on supply for the economy as a whole moderated much less than appeared on the basis of previous criteria, and the market restraint on cost and price increases was thus less than it was commonly considered to be. This was particularly the case in 1979. My Report of a year ago presented the evidence that during 1979 much of Canadian industry was operating at or close to its effective capacity. The situation has been somewhat easier since then, but for a number of industries that export or that compete with imports the level of demand relative to supply was also high in 1980. In short, the demand-supply balance in the economy in the last few years has by and large not been conducive to a moderation of inflation.

The increase in petroleum prices has been another impediment to the reduction of inflation in Canada in recent years. The Canadian economy has of course been much sheltered from this development, but even so it has added appreciably to Canadian costs. I do not regard increases in the price of one commodity relative to another as a valid reason for a general acceleration of the rate of inflation because in a less inflationary environment faster-than-average increases in some prices would tend to be offset by slower-than-average increases in others. But in the inflationary environment that we have had, there is a tendency for any cost or price increase to be accepted as an adequate reason for other cost or price increases. Individual price shocks thus accelerate the inflationary process more than they otherwise would. This is going to be a continuing problem in Canada as we catch up with the rise in world oil prices.

Throughout the last five years the Bank of Canada has been committed to bringing about a gradual reduction of the rate of monetary expansion in Canada as its contribution to the reduction of inflation. To assist it in this task the Bank has paid particular attention to M1. During the past two years M1 has grown at an average rate of about 7 per cent compared with peak rates of about 14 per cent during 1972 and 1973. Interest rates have risen quite a lot over the period, especially during the past three years. Whereas for much of the 1970s short-term interest rates were below the rate of inflation, in 1980 they were on average above it by a margin that was typical before 1970. It appears in retrospect that monetary policy would have been better if there had been a more rapid reduction of M1 growth rates during 1975 to 1977, but there is no doubt that it has been firmly anti-inflationary since then.

During the last half of the 1970s fiscal policy, as measured by the spending of the Government of Canada and the provinces, was much less expansionary than it was in the first half. The various governments have recognized that the economic situation has changed, and they have tried, and generally managed, to reduce the growth in their spending to that for the economy as a whole. The provincial governments taken together have also succeeded in reducing their fiscal deficits though there is a great disparity in their individual situations. The Government of Canada, however, has experienced a large and growing over-all deficit, and in the last few years its net borrowing requirements have been of the order of 4 per cent of Gross National Expenditure. From the point of view of dealing with inflation, this was an uncomfortably large deficit for the Government of Canada to have at a time when the level of economic activity relative to the economy's demonstrated capacity was as high as it then was. I am pleased that in the last budget the Government recognized the need to reduce its over-all deficit in the years ahead.

The above considerations seem to me to explain why Canada has made only limited progress since 1975 in containing inflation. The reason is not that the anti-inflationary financial policies followed were misconceived but that they were pursued with such gradualism that they did not succeed in dominating the influences that were working in the opposite direction. This view is further developed in the next section of this Report. If we in Canada are to have more success in dealing with inflation in the future we must make sure that public financial policy is sufficiently strongly anti-inflationary to cope with the economic circumstances that emerge.

The slow progress to date in dealing with inflation is unfortunate from many points of view. Perhaps the most serious penalty is that the continuation of high rates of inflation has further embedded them into people's practices and expectations, making them harder to deal with. Just as price stability had a tendency to be self-perpetuating when it existed because people regarded it as natural, so inflation develops a tendency to be self-perpetuating as people come to regard it as inevitable. This state of mind is difficult to change. It responds skeptically to statements of good intentions. It wants to be shown, not told. That is the problem we face.

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What does all this portend for the future? It means that the struggle with inflation will be "front stage, centre" for quite a while to come. One may not welcome that but it cannot be avoided.

As for the Bank of Canada, we find no reason to modify greatly the approach that we have evolved in the past several years. In mid-February, 1981, we announced a further revision to our targets for the growth of M1, from limits of 5 to 9 per cent per year based on the average level of M1 for the second quarter of 1979 to limits of 4 to 8 per cent based on the average for three months centred on September 1980. At that time the trend of M1 was well within the target band associated with the new target range. The Bank recognized that the new target range for M1 was low relative to the current growth of national expenditure but believed that a relatively low target range was necessary in the circumstances if monetary policy was to be able to provide effective resistance to inflation. The Bank will continue to be guided in its conduct of monetary policy not only by the trend of M1 but also by the other economic and financial developments that affect the outlook for inflation and economic activity in Canada. It remains the Bank's intention to ensure sufficient monetary expansion to accommodate as high a level of employment and output in Canada as proves to be consistent with a clearly moderating trend in the rate of inflation.

The influence of monetary policy will be felt throughout the economy but how the economy will respond will depend very much on the reactions of the various groups within it – governments, business and labour. Their reactions will determine how much economic stress and strain is involved in the reduction of inflation.

There are those in our society who are defeatist about reducing inflation in a market economy even at this early stage in the struggle. They offer various reasons for supposing that the effort cannot succeed. I think they are wrong. It has succeeded in other countries and it can succeed in Canada. Canadians will have to face up sooner or later to what is involved.

In these paragraphs I have concentrated on the need to reduce inflation and how that can be done. But price stability is not an end in itself; it is a means to an end. The goal is an economy that performs well. That means an economy that is flexible and dynamic, an economy with high rates of saving flowing into investment in productive plant and equipment, an economy that provides incentives for hard work and imaginative enterprise, an economy that can meet the challenge of world competition. That is the kind of economy that will generate not only high employment but varied and challenging jobs that develop human potentials. Canadians want that kind of economy, but we won't get it without restoring confidence in the value of money. The role of money is too important for that.

The Economy in Perspective

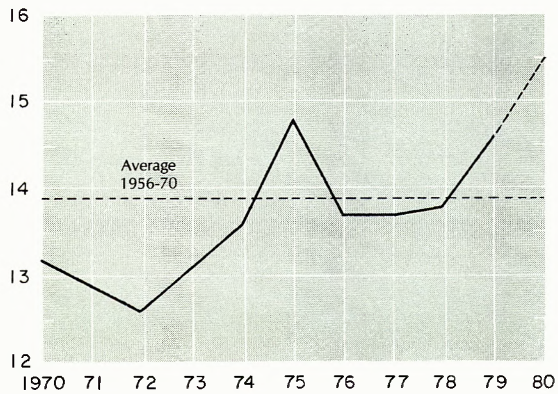
Economic developments in any single year are largely determined by economic forces and policies set in train over preceding years. Accordingly, after a brief account of economic developments in 1980, this section of the Report reviews the way in which some of the broad economic issues currently facing Canada emerged in the course of the 1970s.

Developments in 1980

The Canadian economy turned in a good performance in 1980 in some major areas, realizing strong gains in external trade, a very high rate of investment in plant and equipment, and an increase in employment that compared well with historical experience. At the same time, the economy was characterized by high inflation and the output of goods and services was little changed.

Total spending (Gross National Expenditure in current dollars) is estimated to have risen by about 11 per cent, somewhat less than in the previous year. However, the over-all rate of inflation remained about as high as in 1979 under the pressure of both foreign and domestic forces. World prices of industrial materials and precious metals rose sharply early in the year, reflecting the strong demand that built up in the United States through 1979 and into the early part of 1980, further steep increases in world oil prices, and reactions to political and military developments in the Middle East. This inflationary burst was given added impetus by an associated surge in inflation expectations in the United States that for a while made storable commodities appear cheap relative to paper assets. Later in 1980 poor harvests in a number of countries triggered a sharp rise in the prices of grains and some other foodstuffs. These developments, allied with an already high underlying rate of inflation among industrial countries not countered by strength in the Canadian dollar, resulted in substantial upward price pressures for the large part of the Canadian economy that is closely linked to international trade. Although the domestic capacity to supply came under less strain in 1980 than in the previous year, market conditions were sufficiently buoyant, particularly outside central Canada, to induce a strong increase in employment. The advance in money wages accelerated during the year, and the resulting

Trends in Business Fixed Investment
(Non-residential gross fixed capital formation as a per cent of GNE)



faster rise in production costs was reinforced by a further decline in output per worker. Food price increases were slightly less than in the previous year, but they were still high; as in other countries domestic energy prices increased faster, pushing up both consumer prices and producer costs.

The pattern of economic activity in 1980 was rather uneven. Production slackened in the first half of the year but in the final months the economy showed considerable buoyancy. An important element in the initial slowing was the weakening of U.S. and overseas markets as real incomes were squeezed by inflation and credit conditions were tightened sharply, particularly in the United States. Domestically, demand also slackened because of similar influences. In the second half of the year the U.S. economy picked up somewhat and Canadian activity received a strong boost through sharp gains in foreign trade. The substantial improvement in Canada's export and import performance in 1980, discussed in detail in the next section of the Report, was in large measure attributable to our continued very favourable international competitive position. This competitive strength has been a key factor in the recent vigorous domestic investment performance of many Canadian industries.

The Past Decade

In most important respects the experience of the 1970s as regards over-all economic performance falls rather naturally into two main periods. Over the initial years of the decade, partly through policies that were too expansionary and partly through bad fortune, most nations including Canada became caught up in increases in total spending and a surge of inflation virtually without historical parallel in its scope and intensity. In consequence, the more recent years of the 1970s have been dominated by efforts in most countries to contain the rise in aggregate spending, bring inflation under control and restore the basis for sustained economic expansion. Two of the major industrial nations, West Germany and Japan, began to combat inflation relatively early in the period, whereas in others the shift was either less clear-cut or more delayed. In Canada, policies giving increased priority to countering inflation have been pursued since 1975.

The First Half: The Inflationary Surge

In the latter part of the 1960s world inflation already showed a distinct if still rather gradual tendency to escalate. Demand pressures showed up first in the United States, largely associated with the Vietnam War, and later elsewhere. Fiscal and monetary policies were tightened in a number of countries between 1968 and 1969 and this produced a moderate economic slowdown. Soon, however, policies were switched back in an expansionary direction throughout virtually all the industrial world. A distinctive feature of the upswing was the way it was supported by a pronounced move to expansionary fiscal and monetary policies in all the major industrial countries, with scant recognition of the international repercussions. This unusual willingness of so many countries to resort simultaneously to easy financial policies, particularly easy monetary policy, appears to have been motivated to an important extent by the international payments imbalances which in the end led to the breakdown of the pegged exchange rate system. In these circumstances countries tended either to feel themselves freed from earlier balance of payments constraints on more stimulative domestic policies or to feel themselves under pressure to expand domestic liquidity in order to avoid the supposedly adverse effects of exchange rate appreciation.

The generalized shift to expansionary policies resulted in a reverberating boom as countries saw their domestic expansion strongly supported by vigorous demand for exports. At the same time the rate of inflation began to accelerate. Demand pressures showed up quickly in commodity markets. They were aggravated in part by such accidents as poor grain harvests in 1972, but the subsequent surge in the prices of industrial materials was entirely attributable to the boom in spending and mounting speculation in an inflationary environment where the cost of credit was held relatively low.

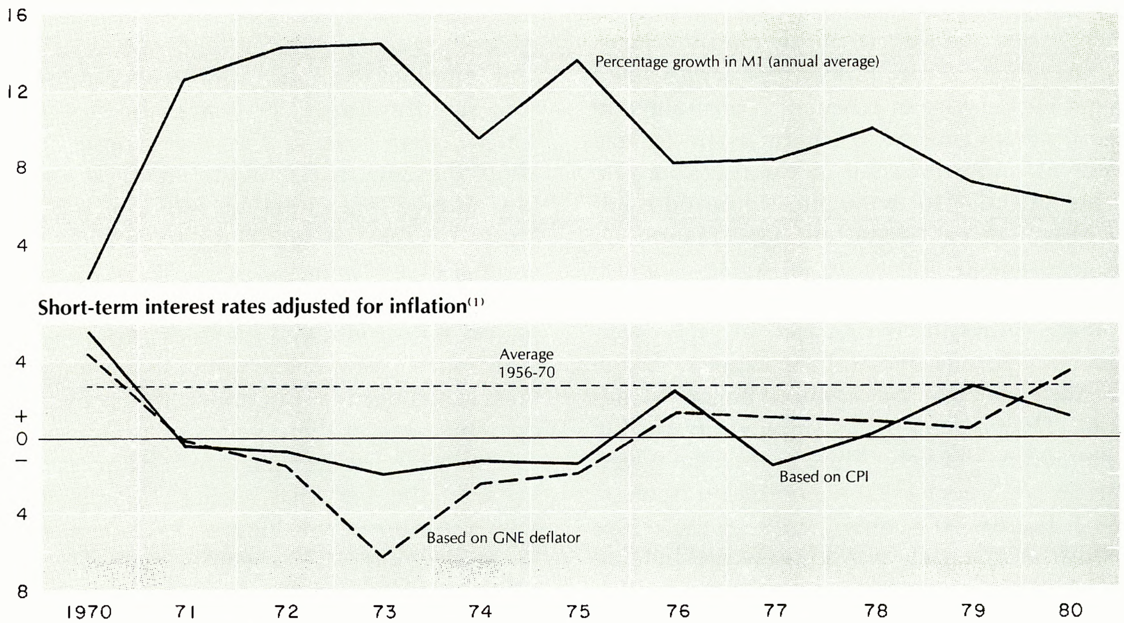
By 1973 the dangers of spiralling inflation began to outweigh other considerations and policies began to be tightened. This process had not gone very far, however, when the world economy was struck by a massive increase in energy prices arising from OPEC actions in late 1973 that resulted in a near quadrupling of the international price of oil. In these circumstances the middle years of the 1970s were marked by strong upward pressures on costs, downward pressures on real incomes and sluggish economic activity.

The demand policies pursued in Canada in the early 1970s fit quite closely the general picture of policy developments in industrial countries that has been sketched above. Fiscal policy was geared to expansion. Government spending, especially at the federal level, was boosted at a pace that came to outstrip by a wide margin the already steep advance in total spending in the economy. Revenues also rose rapidly, but largely on account of rapid inflation and a pace of economic activity that was unsustainably high. In 1973 monetary policy was turned in a restrictive direction but nevertheless accommodated a high rate of spending and inflation. Domestic short-term interest rates rose rapidly during 1973 and the first half of 1974. There was at the time some concern about these increases, but in fact they remained low relative to an inflation rate that was rising. Thus the rate of monetary expansion stayed comparatively high.

The looseness of Canadian policies in this period reflected some elements besides a lagging appreciation of the inflationary momentum that was building up under the pressures of demand. One of these was a continual concern to minimize upward pressure on the exchange value of the Canadian dollar. Canada had allowed its currency to float in exchange markets in the spring of 1970 – earlier than other countries – resulting in an initial appreciation. Reluctance to see a further major rise stemmed from a fear of short-run adverse consequences for activity in export and import-competing industries. Linked to this concern was another problem, namely, a failure to recognize the extent to which the economy in general and the labour market in particular were coming under strain. Although output and employment were rising vigorously over much of the period, the over-all unemployment rate stayed persistently high by the standards and expressed goals of the 1960s. Even at the low point of 5 per cent that was finally reached in mid-1974 the unemployment rate was regarded as rather high. In retrospect it is apparent that the meaning of the conventional measure of unemployment as an indicator of ease or tightness in the labour market had altered in a major way, reflecting the changed demographic composition of the labour force, the effect of more generous unemployment benefits introduced in 1971 and the strong expansion of multi-earner families.

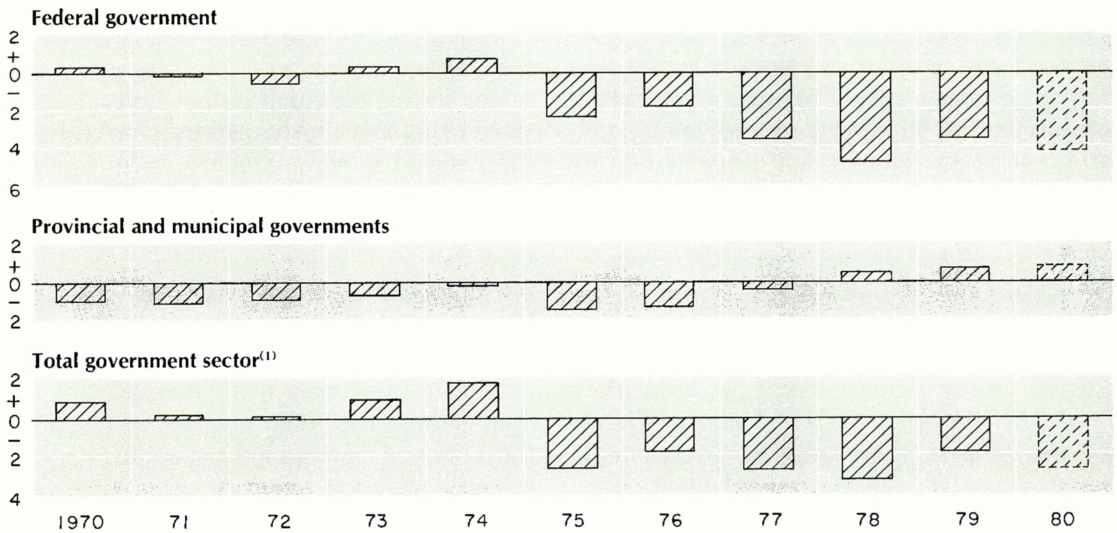
With costs and prices in Canada rising very

Monetary Expansion and Real Interest Rates



(1)Rate on 90-day commercial paper adjusted by the rate of change of the respective price index (annual average)

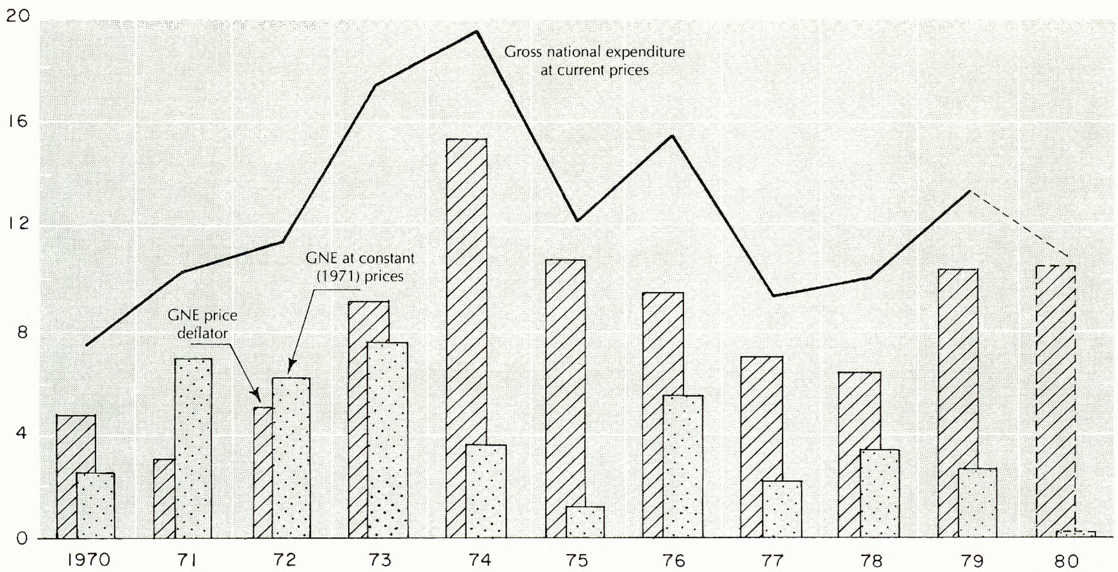
Fiscal Balances as a Percentage of Gross National Expenditure



(1)All levels of government plus hospitals and the Canada and Quebec Pension Plans

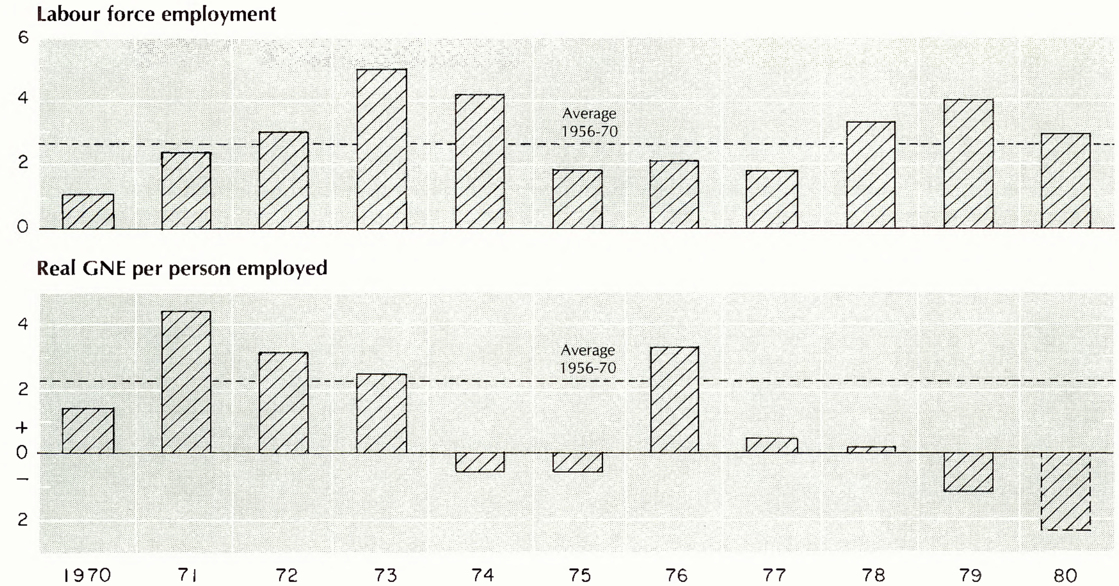
Spending, Inflation and Output

Annual percentage change

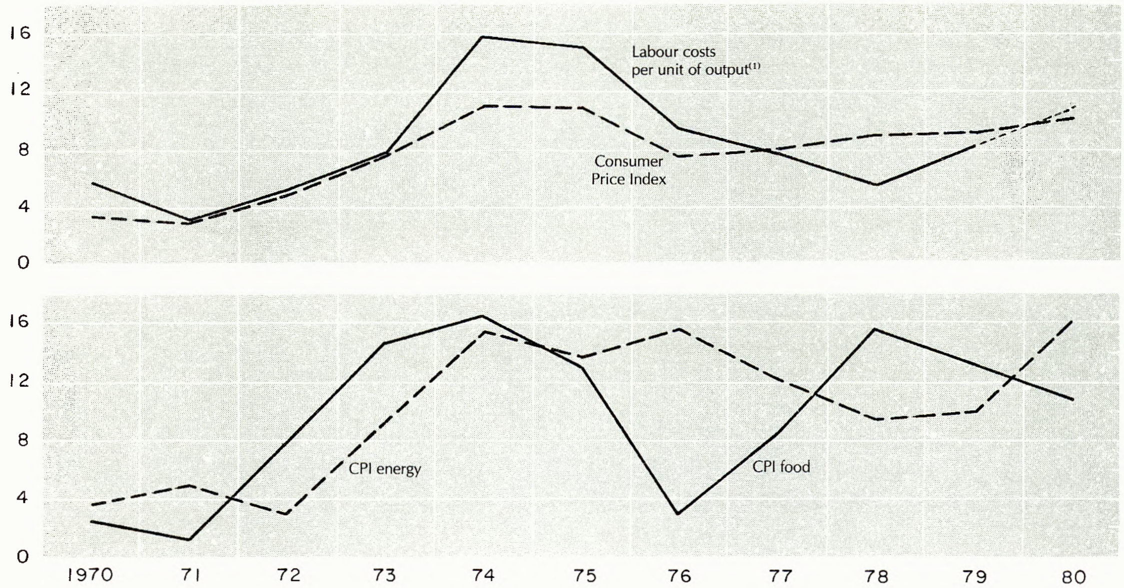


Employment and Labour Productivity

Annual percentage change

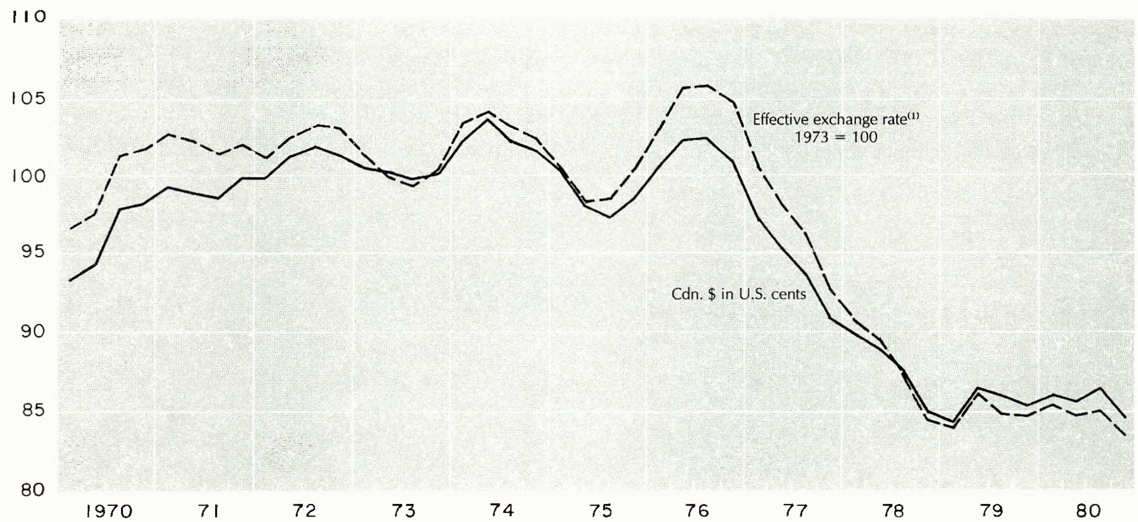


Prices and Costs
Annual percentage change



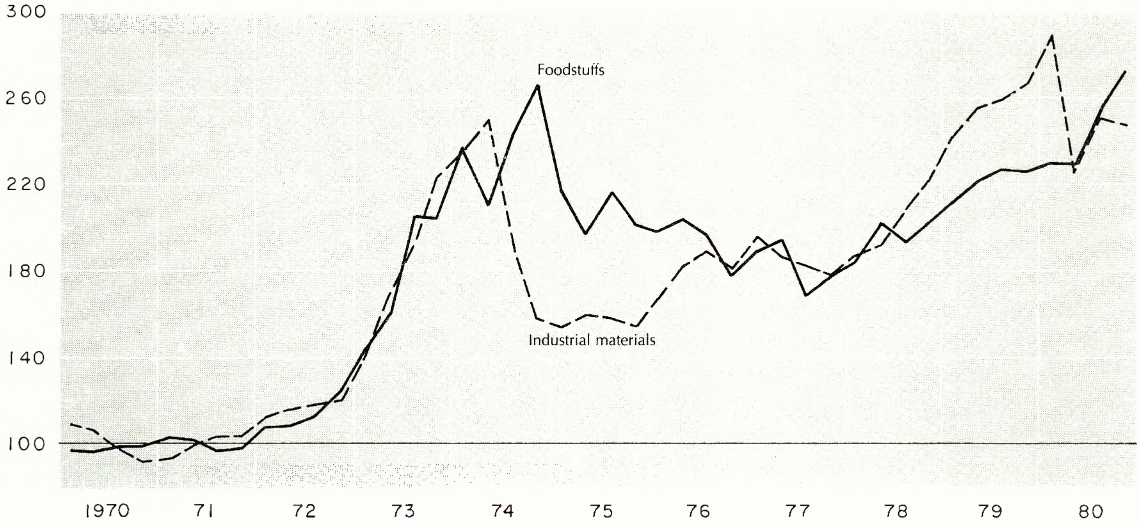
(1)Total labour income divided by real GNE

Exchange Rate
Quarterly average



(1)Canadian dollar in terms of currencies of ten major trading countries, weighted by their relative 1973 shares in Canada's foreign trade

World Prices of Sensitive Commodities
in U.S. dollars, 1971 = 100



sharply in 1974, in a climate where existing inflationary pressures were reinforced by policy efforts to sustain a strong expansion of economic activity, our inflation performance was turning out to be considerably worse than that of our main trading partners, especially the United States. Consequently the cost competitiveness of Canadian industry began to deteriorate. Also, after 1973 the U.S. economy slowed sharply and the market for Canadian exports contracted. With a sharp slide in the volume of exports, activity in Canada also weakened notwithstanding the efforts here to support demand. By 1975 the economy was suffering from a combination of intense domestic cost pressures, continued very high price inflation, and sluggish output.

The Second Half: Containing and Reducing Inflation

The combination of persisting inflationary pressures and the shift to generally more restrained fiscal and monetary policies resulted in an abrupt slowing in economic activity among the main industrial countries in 1974-75 as they attempted to cope with the income, inflation and balance of payments fall-out from earlier policies and the oil price shock. As economic slack increased, inflation pressures tended to ease, particularly in the United States, West Germany and Japan. By the latter part of 1975 activity was recovering quite smartly in these countries. However, all three economies were digesting price pressures and losses in real incomes due to the oil price shock, and consequently demand policies were much more cautious than a few years before. In the years that followed both West Germany and Japan pursued policies that continued to give priority to containing and reducing inflation. However, U.S. policies after 1976 were oriented towards an early speedup in economic activity under the belief that there was considerable unused capacity in the economy that could be taken up without reviving stronger inflationary pressures. This view turned out to be overoptimistic. By 1979 the United States was again in a situation of tight markets, worsening inflation and escalating inflation expectations. This was not a situation in which the economy could cope well with the price pressures from energy and food that also developed. In these circumstances U.S. monetary policy was set on a tighter path from the autumn of 1979.

Largely dominated by the situation in the United States, the international economic conditions facing Canada in the second half of the 1970s were initially ones of expanding markets but relatively moderate external price increases. More recently the international environment has been less favourable with growth in output slowing but with price pressures having gained in intensity. Regarding supply the initial developments were relatively favourable. Food prices in North America were held down from late 1975 through 1976 by better harvests and a cyclical oversupply of beef. Also, world oil prices remained relatively steady in U.S. dollars. However, in the latter part of the 1975-80 period events have been more adverse in this regard. Very sharp increases in OPEC oil prices took place in early 1979 and further major upward adjustments have been posted since; food prices in more recent years have also tended to rise faster than the prices of other consumer items, reflecting in part the cyclical downturn in North American livestock production and more recently poor grain harvests in a number of countries.

A special influence affecting both demand for Canadian output and domestic inflation directly has been the substantial depreciation of the Canadian dollar. This decline, which took place over the two years from late 1976 to late 1978 and reduced the average exchange value of the Canadian dollar against other major currencies by some 20 per cent, in large measure appears to have been a delayed market reaction to the earlier loss of international cost competitiveness. To that extent it meant that some of the upward pressure on Canadian costs that emerged in the first half of the 1970s only showed up in prices in more recent years. Viewed from another angle, by rapidly restoring Canada's competitive position this depreciation paved the way for the strength in export and import-competing industries that has emerged. However, the exchange rate adjustment would only bring about this improvement if a generalized domestic inflationary reaction could be avoided. During most of the period of exchange rate depreciation demand conditions and inflation expectations in Canada were sufficiently restrained to avoid such a reaction.

As was noted earlier, in 1975 Canadian policies shifted towards combatting inflation. In October the Government announced a program, of which the principal elements were: fiscal and monetary policies aimed at increasing total demand and production at a rate consistent with declining inflation; government expenditure policies aimed at limiting the growth of public expenditures and the rate of increase in public service employment; a consideration of possible structural policies to try to deal with the special problems of energy, food and housing, to ensure a more efficient and competitive economy and to improve labour-management relations; and a prices and incomes policy providing for mandatory guidelines. These guidelines were phased out during 1978.

The Bank of Canada embarked in 1975 on a policy designed to help gear down the pace at which total spending was increasing by gradually moderating the rate of monetary expansion. The Bank has implemented this policy by specifying a series of interim target ranges for money growth defined in terms of M1 – currency and chartered bank demand deposits. Over the past five years these targets have been gradually reduced from an initial range of 10-15 per cent annual growth to the present range of 4-8 per cent growth announced in February 1981. In line with these targets the expansion of M1 has gradually slowed, although the effect of the slowing was reduced by virtue of the fact that innovations in banking practices led to economies in the amounts of demand deposit balances required in relation to any given level of spending. However, even when developments of this kind are allowed for, monetary expansion has been reduced over these five years or so, and has been accompanied by short-term interest rates that are once again higher than the rate of inflation.

The adoption of more restrained fiscal policies, a shift apparent at the provincial and local as well as the federal level, resulted in an appreciable slowing in the expansion of government spending. In the five years through 1980 the rate of advance in outlays for all levels of government averaged about one third less than in the preceding five, and ran roughly at the same pace as total spending in the economy. At the same time, however, revenue growth also slowed considerably except in those areas where oil and gas revenues are important. This deceleration, besides reflecting the less rapid growth of the tax base and the reduction in inflation-induced increases in personal income taxes with the introduction of indexation from 1974, also was the result of tax cuts largely aimed at boosting private demand. In large measure as a result of the sharp advances in resource revenues, the deficit of the total government sector stayed at some 2-3 per cent of GNE, the proportion to which it had risen by 1975. However, within this total the federal Government's deficit expanded further as its revenues lagged; in the most recent years the deficit of the federal Government has averaged approximately 4 per cent of GNE.

In the first couple of years of this period an appreciable reduction in domestic inflation occurred. Markets were less buoyant than before, while other direct domestic and foreign influences on prices were generally relatively favourable. Food costs were held down by special supply conditions and the increase in money wages was slowed under the impact of the guidelines imposed under the anti-inflation program. Thus, even though the Canadian dollar began to fall sharply from late 1976, the feedback into domestic costs of production and again into prices was unusually restrained.

Early in 1978, however, domestic inflation began to accelerate. One reason was that the dismantling of the Anti-Inflation Board provided scope for some "catchup" in wage settlements. Another was the increased buoyancy of markets. The sharp depreciation of the Canadian dollar had increased the competitiveness of Canadian production to the point where bottlenecks and capacity constraints began in the autumn of 1978 to emerge over a wide range of industries. Labour markets generally also began to tighten up again around this time. The rise in labour costs has speeded up under the impact of larger increases in money wages and further declines in output per worker.

To these influences on inflation were added external pressures which turned markedly more adverse after 1977. By 1979, spurred by mounting inflationary demand in the United States, the prices of Canadian exports and imports were advancing at annual rates of 19 and 13 per cent respectively, even excluding the oil and gas components, and inflation measured by the deflator for GNE had again risen above 10 per cent. Recently the Consumer Price Index has been moving up at a higher rate.

Economic activity rebounded sharply after the recession of 1974-75 – production grew by almost 7 per cent in the four quarters ended in the middle of 1976 – but in more recent years the increase has averaged around 2 per cent annually. Given the relatively low average rate of growth of output during this period, it might be assumed that the economy was producing much below its potential. However, this is not at all the case. The sharp reduction in the growth of productivity since 1973 – notwithstanding substantial expansion in the capital stock and well sustained growth in employment – implies that the potential for output growth over the period was lower than was generally assumed to be the case. With any over-all slack in the economy not exceeding relatively modest proportions, and with weakness in some regions, industries, or segments of the labour market offset by considerable tightness in others, the conditions were not favourable to much slowing of inflation in Canada.

In summary, the recent over-all performance of the Canadian economy is very much the product of forces that have been in operation for some time. The slowing in the advance of total spending that has been realized in the last five years or so has indeed been rather gradual, so that the over-all adjustment towards a less inflationary economy has been correspondingly extended. Expectations of inflation have remained strong. Furthermore the economy in recent years, and perhaps more than in the earlier part of the 1970s, has been subjected to inflationary shocks whose effects have not yet been fully absorbed. Moreover, because the slower trend of real growth in the past several years reflected to an important degree a reduction in the growth rate of productivity and potential output for the economy, the pressure of demand on the economy has been greater, and the over-all capacity to supply has been less, than was earlier commonly supposed.

Canada's Balance of International Payments

The strong recovery in Canada's international competitive position flowing from the decline in the foreign exchange value of the Canadian dollar in 1977 and 1978 laid the foundation for a remarkable strengthening in our balance of international payments in 1980. A sharp rise in the surplus on merchandise trade resulted in a reduction of the current account deficit to its lowest level in six years. Moreover, the clear improvement in Canada's underlying balance of payments position contributed to a heightened interest by foreign investors in Canadian dollar long-term securities through much of 1980.

The upward trend of production costs in Canada has accelerated in the past two years but a similar deterioration has occurred in the United States, by far our largest trading partner. In these circumstances, the distinct improvement in the competitive position of Canadian suppliers relative to U.S. suppliers that had taken place after 1976 was only slightly eroded in 1980. Over the period as a whole, there has been a comparable improvement in Canada's competitiveness relative to Japan and an even larger gain relative to our major European trading partners.

The adjustments to Canada's trade flows in the wake of the recovery in our competitive position have taken time. New and expanded markets could only be developed as current and potential buyers, both at home and abroad, were induced to switch to Canadian goods and services. Moreover, increases in output could only be achieved quickly to the extent that there was spare productive capacity.

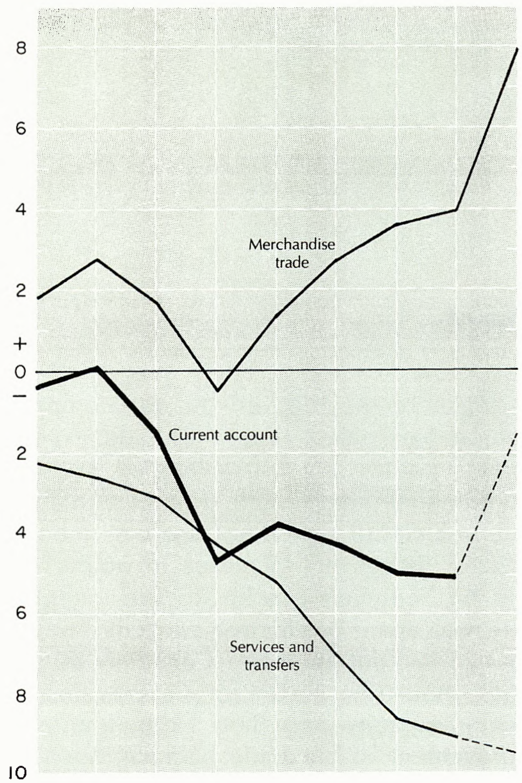
In fact, output in many Canadian tradeable goods industries began to press against productive capacity from late 1978, limiting the improvement in our trade balance. Such pressures also led firms to proceed with plans to expand their capacity. In the first instance, the relatively high import content of production equipment being put in place added considerably to the import bill. In 1980, as capacity constraints in the economy eased with the slowing in domestic demand and the coming on stream of new plant and equipment, the adjustment of trade flows to the stronger international competitive position became more apparent.

This adjustment occurred in the face of cyclical conditions abroad that were less favourable to an expansion of exports than had been the case in the previous few years. In the United States real GNP was virtually unchanged in 1980

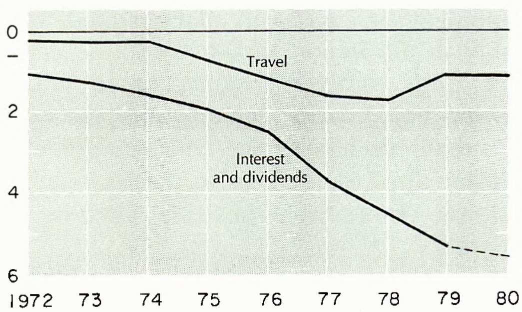
Current Account of the Balance of Payments

Balances

Main aggregates
Billions of dollars

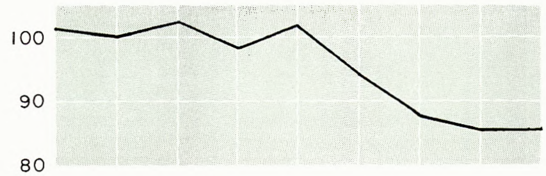


Services balances
Billions of dollars

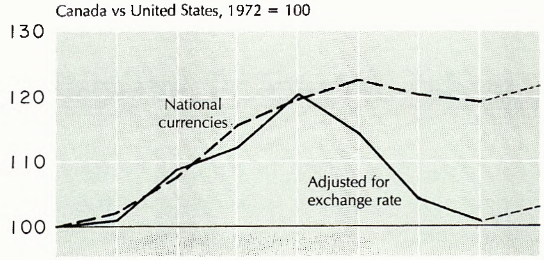


Major influences

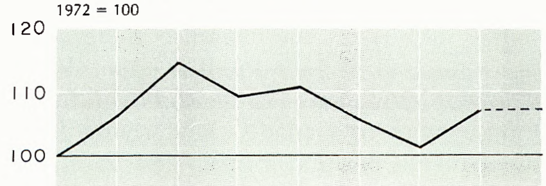
Exchange rate
Cdn. $ in U.S. funds (annual averages)



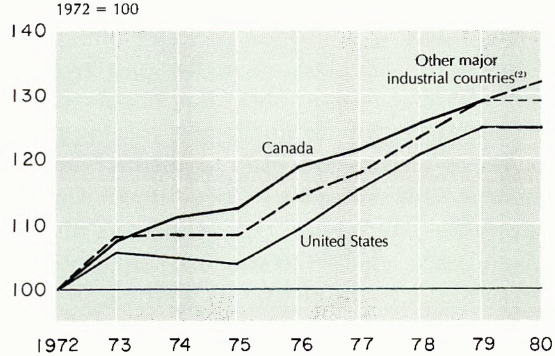
Relative unit labour costs[1]
Canada vs United States, 1972 = 100



Merchandise terms of trade
1972 = 100



Real GNP
1972 = 100



[1] Wages, salaries and supplementary labour income per unit of real GNP
[2] Real GNP/GDP in Japan, United Kingdom, Germany, France and Italy weighted by their shares of Canadian exports

and activity in some areas of that economy of particular importance to Canadian suppliers – new automobiles and housing – declined markedly. The rate of growth in the five largest overseas industrial economies also slowed, particularly for those in Europe, to around $2^{1}/_{2}$ per cent in 1980, not much more than half that recorded in the previous year.

Canadian trade in automotive products with the United States over the past two years has been affected by a marked shift in demand in the United States away from larger North American model cars in which Canadian production has been concentrated. This led to particularly sharp declines in Canada's automotive exports. Imports from the United States, however, did not drop until 1980 when sales of North American cars weakened here as well; imports of U.S. commercial vehicles also fell off from their high 1979 level. As a result, our deficit in automotive trade with the United States, which had widened from $0.5 billion in 1978 to $3 billion in 1979, narrowed in 1980 to $2.1 billion, with much of the improvement occurring in the second half of the year.

Two other important areas of our trade – wheat and energy – were also affected by rather special influences. The volume of wheat exports, which had been curtailed by transportation and handling difficulties in 1979, recovered sharply in 1980. At the same time, world wheat prices rose further so that the value of wheat exports nearly doubled to a record $4.1 billion. In contrast, Canada's net trade position in crude oil and natural gas swung from a surplus of $1 billion in 1979 to near balance in 1980; our deficit on crude oil doubled to $4 billion but this was partly offset by a further increase in the value of our natural gas exports.

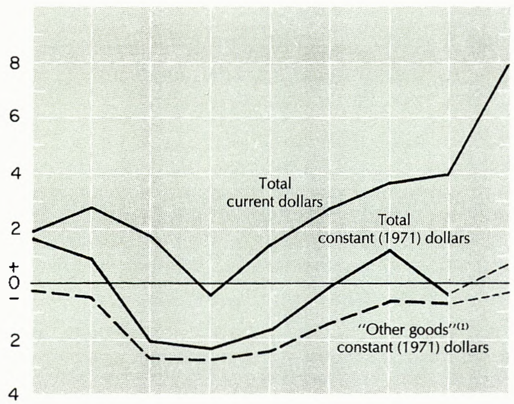
The net surplus in the above three rather special categories of trade combined rose by $1.6 billion in 1980 to $2 billion. More importantly, the surplus on Canadian trade in the broad range of other goods, which comprised over 70 per cent of total merchandise trade, rose even more strongly than in 1979, by $2.4 billion, to reach $6 billion. This gain occurred despite a further widening in our deficit on trade in manufactured end products. Over-all, Canada's trade surplus doubled in 1980 to a level of $8 billion.

Improved competitiveness and easing demand pressures in Canada in 1980 importantly affected the import side of our trade flows. In marked contrast to the growth of 11 per cent in volume terms in the previous year, imports of goods other than U.S. automotive products and oil are estimated to have risen by 3 per cent in 1980. Among the major components, the rate of growth of machinery and equipment imports decelerated from almost 20 per cent to 5 per cent, returning to a rate much in line with that of corresponding business investment. Fixed investment by both export-oriented and import-competing industries, undertaken to take advantage of improved sales prospects at home and abroad, appears to have been particularly buoyant in the past two years, increasing considerably faster than business investment as a whole. Among other major import categories, the inflow of industrial and construction materials decreased in 1980 in volume terms, partly reversing the increase of 15 per cent in 1979 when business inventory accumulation had been strong and constraints on productive capacity had diverted some purchases to foreign suppliers.

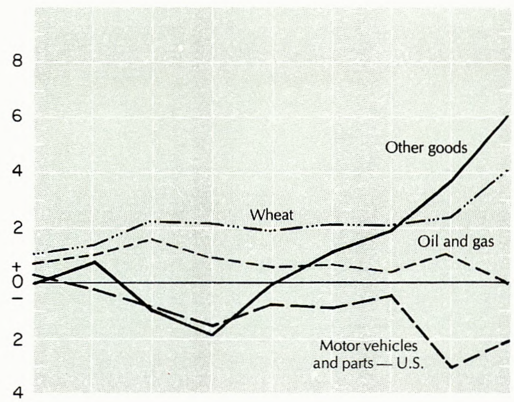
The volume of merchandise exports other than automotive products to the United States, wheat, oil and gas is estimated to have increased by 6 per cent in 1980, about one half the gain in each of the previous two years. This slower growth broadly reflected the weaker demand conditions among our major trading partners. Primary iron and steel exports, however, increased by more than in 1979 when they had been constrained by capacity limitations, while shipments of non-ferrous metals and minerals

Merchandise Trade

Major balances
Billions of dollars

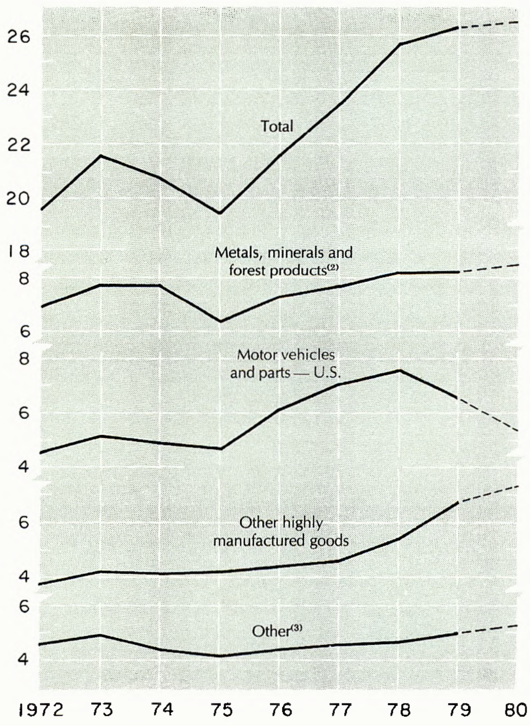


Balances on selected components
Billions of current dollars



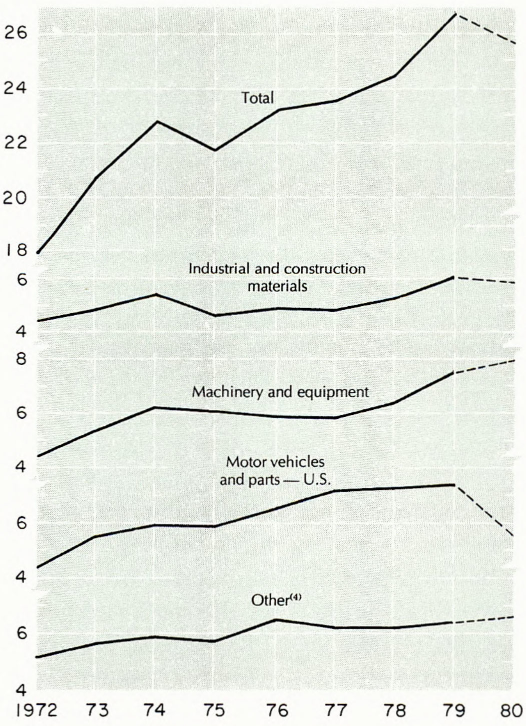
Volume of trade flows
Billions of constant (1971) dollars

Exports



[1]Total excluding motor vehicles and parts traded with the United States, oil, gas and wheat
[2]Excluding oil and gas
[3]Mainly farm and fish products, chemicals, fertilizers, oil and gas

Imports



[4]Mainly food, other consumer goods, fuels and lubricants

recovered from strike-affected levels. Highly manufactured goods, one of the components of exports that is more readily influenced by changes in relative prices, have been a dynamic component in the past three years, increasing in volume by roughly 20 per cent in 1978 and 1979 and by a further 8 per cent in 1980. As a result, their share in total exports excluding the special categories increased from about 30 per cent for the five years prior to 1978 to 37 per cent in 1980.

Trade in services too has been significantly affected by the shift in relative prices in Canada's favour. Our deficit on international travel improved substantially in 1979 to the lowest level since 1975 and was little changed in 1980. However, the deficit on the other components of the services account, such as net interest and dividend payments to non-residents, widened further. Over-all, the deficit on services and transfers is estimated to have increased by about $0.4 billion in 1980, much the same as in the previous year. As a result, the rise in the trade surplus led to an almost equivalent improvement in the current account deficit to about $1.5 billion from $5 billion in each of the previous two years. In relation to GNP, the current account deficit decreased to 0.5 per cent from the levels of 2 per cent or more that had prevailed in the previous five years.

In respect of capital flows, there was an appreciable increase in non-residents' demands for Canadian dollar long-term portfolio investments in 1980. Their purchases of outstanding Canadian stocks are estimated to have resulted in a net capital inflow of around $1 billion despite net sales in the final quarter of the year. This inflow was nearly three times as large as in 1979. Heightened non-resident interest in bonds denominated in Canadian dollars led to a net capital inflow estimated at over $1 billion during 1980, about twice that in the previous year. As a result of these non-resident acquisitions of Canadian securities, net long-term capital inflows other than those arising from federal Government borrowing abroad were somewhat larger in 1980 than in either of the previous two years. The federal Government had raised $2.5 billion in foreign long-term capital markets in 1978 and $1.6 billion in early 1979 in order to replenish official exchange reserves but was absent from those markets in 1980. Provincial and municipal borrowers also decreased their recourse to foreign bond markets and to syndicated loans in 1980, but this decline was largely offset by higher corporate borrowing abroad. A rise in the net outflow of capital resulting from direct investment transactions reflected increased acquisitions by Canadians of foreign-owned assets in Canada as well as higher direct investment abroad.

The combined total of the current and long-term capital accounts of the balance of payments, often referred to as the "basic balance", is estimated to have recorded a deficit of less than $1/4 billion in 1980, a marked contrast to the deficits of $2.3 billion and $1.7 billion in the previous two years that occurred despite the substantial federal Government long-term borrowing abroad. At the same time, however, short-term interest rates in Canada rose less from 1979 to 1980 on average than did those on U.S. dollar assets; indeed interest rates on some Canadian instruments were on average lower than those on competing U.S. dollar securities. The resulting decrease in the attractiveness of short-term investment in Canada seems to have counteracted the positive effect on the external value of the Canadian dollar of the other forces referred to above and the average level of the exchange rate changed little between 1979 and 1980. At the same time, there were substantial movements in the exchange rate during the year, importantly reflecting shifts in differentials between short-term interest rates in Canada and the United States. These developments are discussed in the next section of the Report.

Financial Developments and Bank of Canada Operations

This section of the Report contains a more detailed description of the movements of interest rates and the exchange rate during 1980 and the effects of these interest rate developments on various monetary aggregates and credit variables. It also reports on the operations undertaken by the Bank of Canada in respect of monetary policy and its operations as agent for the Government of Canada in respect of the public debt and the Exchange Fund Account.

Short-term Interest Rates, the Exchange Rate and Monetary Policy

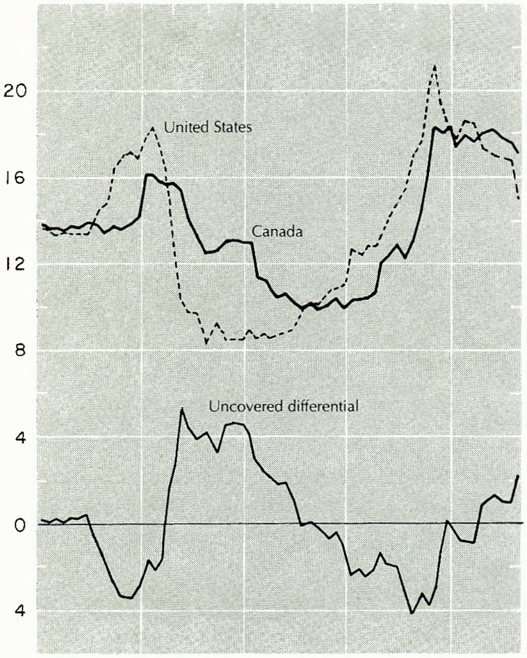
Financial markets in Canada were confronted during 1980 with generally unsettled international financial conditions, particularly the unprecedented fluctuations in interest rates in the United States. As explained in the first section of this Report, the course followed by the Bank of Canada was to moderate the amplitude of the swings in short-term interest rates in Canada relative to those in the United States with the result that the impact of the movement in U.S. interest rates fell partly on Canadian interest rates and partly on the foreign exchange value of the Canadian dollar. Quite apart from the problems posed by these movements in U.S. rates, the rapid pace of monetary expansion in Canada in the second half of the year called for a response in the form of a substantial rise in short-term rates here.

Three major swings in short-term interest rates during the year can be readily identified. The initial run-up in interest rates reached a peak in April. Rates declined sharply thereafter and the downward trend continued through the summer. Another upswing began in the early autumn and by the end of the year short-term interest rates had surpassed the peak levels reached in the spring. Differences in both the extent and timing of the movements in interest rates in Canada and the United States led to very wide swings in the differentials between rates in the two countries which had a marked influence on the course of the Canadian dollar exchange rate during the year.

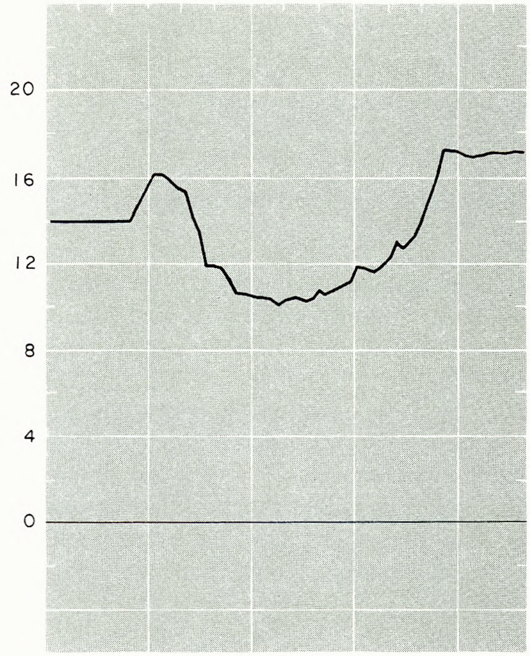
During the early months of 1980 there was an upward surge in U.S. short-term rates from the levels of about 13½ per cent that had prevailed since the beginning of the year to above 18 per cent by mid-April. Initially, the Bank resisted an upward adjustment in Canadian interest rates. The effect of the widening interest rate differential in favour of U.S. dollar investments on the external value of the Canadian dollar was for a time offset by strong international capital flows into Canada, mainly related to favourable views about the future profitability of companies in the energy sector of the Canadian economy, and in fact the exchange rate strengthened appreciably through the second half of February. However, as these inflows moderated, the short-term interest rate differ-

Interest Rates and the Exchange Rate

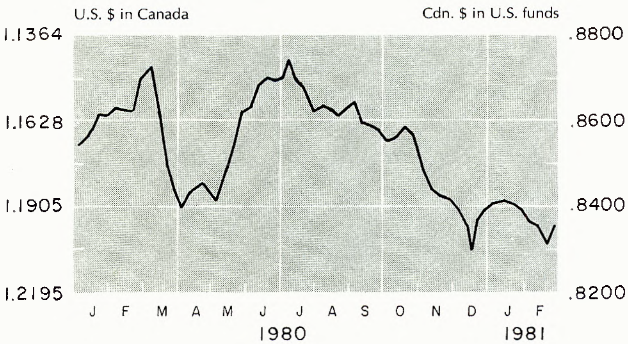
Rates on 30-day commercial paper



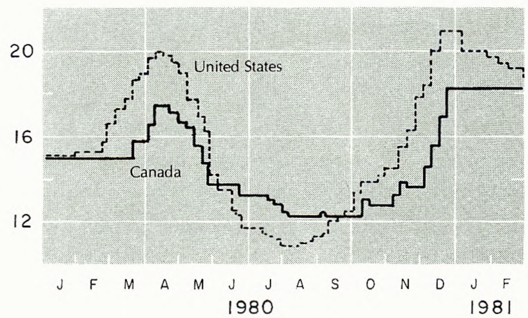
Bank Rate



Exchange rate
Average noon spot rate, weekly



Prime business lending rates at banks



ential between U.S. and Canadian rates of almost 4 percentage points weakened the Canadian dollar and it fell from U.S.$0.8757 at the beginning of March to U.S.$0.8334 a month later. The Bank of Canada responded to these circumstances by allowing short-term interest rates in Canada to rise. By mid-April these rates had risen from levels just below 14 per cent to more than 16 per cent and the prime lending rate of Canadian banks had been increased from 15 per cent to 17½ per cent. The consequent narrowing of the differential in favour of investments in the United States helped to bring the depreciation of the Canadian dollar to a halt. Nonetheless at the peak levels of short rates in the two countries, rates on market paper were still 2 percentage points lower in Canada and the prime bank lending rate was 2½ percentage points lower here.

From the peak in mid-April, there was an extremely sharp fall in U.S. short-term rates, of the order of 10 percentage points in six weeks, which led to a complete reversal of the situation that had prevailed in the latter half of February and March. A strong tendency for Canadian short-term interest rates to decline was resisted by the Bank, and the differential between U.S. and Canadian interest rates moved in favour of the latter towards the end of April and averaged about 4 percentage points throughout May and June. These differentials, together with evidence of Canada's strengthening trade performance and the reduction of some political uncertainties following the referendum in the province of Quebec, led to an appreciation of the Canadian dollar from a low point of U.S.$0.8334 at the beginning of April to a peak for the year of U.S.$0.8767 in early July.

Throughout the summer Canadian rates continued to fall while U.S. interest rates remained flat, with the result that differentials narrowed to more typical levels and the Canadian dollar gradually declined. In total the fall in Canadian short rates from the spring peak amounted to more than 6 percentage points. Rates eventually stabilized in the vicinity of 10 per cent for commercial paper and 12¼ per cent for the prime lending rate.

Late in the summer interest rates in the United States began to rise in response to an unexpectedly strong resurgence in both economic activity and inflation. The pace of the increase in short rates accelerated through the autumn with rates reaching a peak in December that was even higher than the levels recorded in the spring. The peak in commercial paper rates was above 21 per cent while the prime rate reached 21½ per cent at most large banks. As before, the Bank of Canada acted to moderate the resulting upward pressure on short-term rates in Canada and these rates initially rose much more slowly than comparable rates in the United States with the differential between them moving once again in favour of investment in U.S. dollar assets. The differential continued to widen until the end of November when both commercial paper and bank prime lending rates in the United States were about 4 percentage points above comparable Canadian rates. The exchange rate dropped below U.S.$0.84 at the end of November and reached a low for the year of U.S.$0.8249 on December 16.

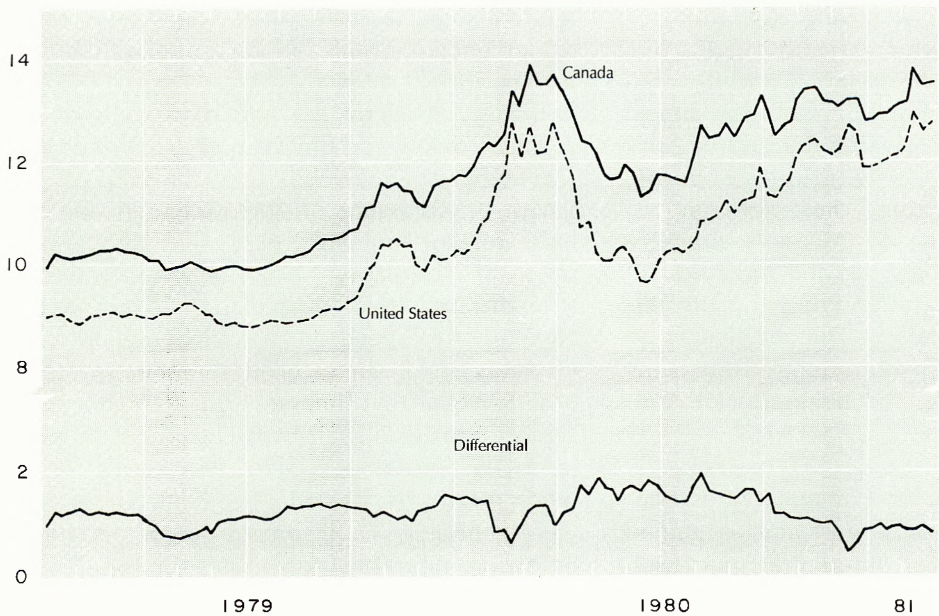
With this pressure on the exchange rate and indicators of monetary expansion and growth in total spending showing unanticipated strength, the Bank of Canada moved in late November to speed the rise in Canadian interest rates and reduce the differential in favour of U.S. dollar investments. Canadian short-term market rates rose sharply in December to levels in excess of 18 per cent. The banks' prime lending rate rose to 18¼ per cent. These rates were nonetheless still some 3 percentage points below comparable peak rates in the United States.

The differential between short-term rates in the two countries moved in favour of Canadian dollar investments late in December and in the early weeks of 1981 as U.S. rates came down somewhat while Canadian rates remained relatively stable. The Canadian dollar closed the year at U.S.$0.8377 but during February it declined once again to a low of U.S.$0.8269 and late in the month was around U.S.$0.8340.

As noted in the first section of this Report, the Bank of Canada found it desirable, in the face of these volatile interest rate movements, to implement a floating Bank Rate system in which the Bank Rate is set at 1/4 percentage point above the average rate on 91-day treasury bills at the weekly Thursday tender. The floating Bank Rate system provides the Bank of Canada with increased flexibility to respond to rapidly changing financial circumstances. The Bank continues to use the same techniques as it did before to influence the behaviour of short-term interest rates. The principal means used by the Bank to exercise this influence is the control of the amount of cash reserves available to the chartered banking system. To the extent that the Bank deals in treasury bills, either in the market or by participating in the weekly tender, it has a direct effect on treasury bill rates.

In order to influence the movements of short-term interest rates, the Bank sometimes acted in a particularly vigorous manner. There were unusually large variations in the quantity of cash reserves made available to the banking system and unprecedented amounts of treasury bills were purchased and sold by the Bank. Monthly changes in the Bank's portfolio of securities are shown in Appendix Table III.

Long-term Government Bond Yields[1]



[1]Theoretical yields on 20-year federal government bonds

	Bank Rate	Chartered bank prime lending rate	5-year conventional mortgage rate*	Non-chequable savings rate at banks	5-year personal term deposit rates at trust and mortgage loan companies*
End of 1979	14.00	15.00	13.25	12.00	11.25
Spring 1980 highs	16.20	17.50	17.50	13.25	14.25
Summer 1980 lows	10.18	12.25	13.00	9.25	11.00
December 1980 highs	17.36	18.25	15.75	13.00	13.25

* Typical rates

Other Financial Developments

There were particularly large and rapid movements in long-term bond yields in 1980. The most pronounced rise in these yields took place early in the year following the announcements of further increases in world oil prices, the political and military developments in Iran and Afghanistan and the unexpected persistence of very high levels of spending in the U.S. economy. Long-term Government of Canada bond yields rose from 11¾ per cent to almost 14 per cent in this period.

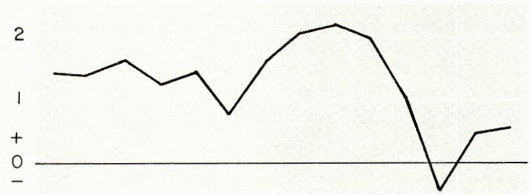
The sharp fall-off in economic activity in North America in the second quarter and the expectation of an imminent decline in short-term interest rates led to a strong demand for bonds by investors during the spring, and yields fell as far and as rapidly as they had risen earlier. Throughout the remainder of the year bond yields trended upwards but with a great deal of short-term volatility.

Financial institutions which had in the past funded a portion of their fixed-term loans and securities with notice and short-term deposits were confronted with a narrowing in the margin between their interest costs and receipts at those times when short-term interest rates rose sharply, and there was a tendency for interest rate spreads on new business to widen as an offset.

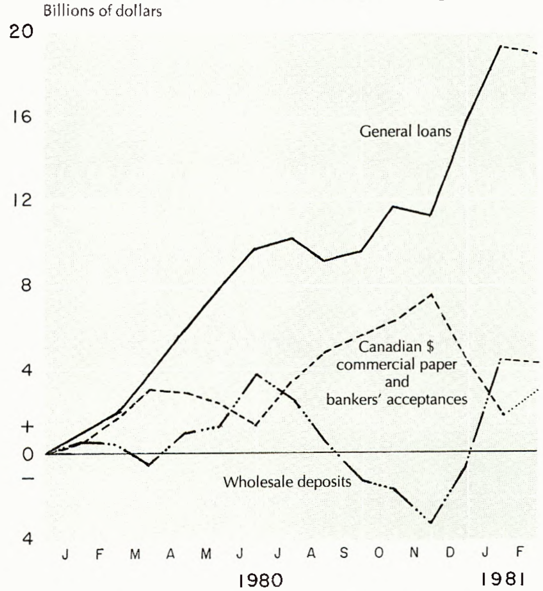
The variations in the Bank Rate and certain lending and deposit rates at banks and other financial institutions are summarized in the above table.

The pattern of domestic credit flows during 1980 was also influenced by the fluctuations in interest rates. The volatile state of financial markets in the year led to the disruption from

Differential on short-term credit rates in Canada
Prime business loans minus 30-day commercial paper



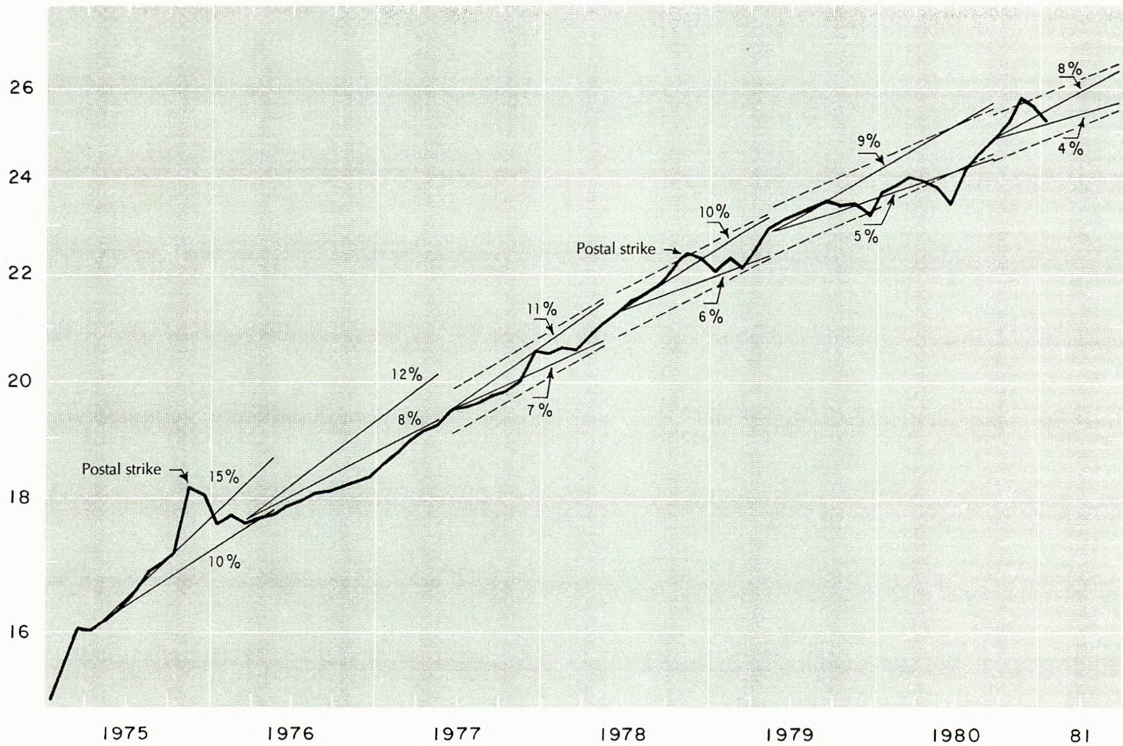
Cumulative financial flows from end of 1979
Billions of dollars



time to time of a number of traditional relationships between various interest rates in Canadian financial markets, providing incentives for borrowers to shift from one source of credit to another. Except for the flurry of new bond issues following the decline in long-term bond yields in the second quarter, there was an increased reliance by borrowers on short-term credit during the year. There were however some rather dramatic offsetting fluctuations in the use of different sources of short-term credit. Unusually wide variations in the differential between the banks' prime lending rates and the market rates on commercial paper and bankers' acceptances (as shown in the preceding chart) led to a very rapid growth in bank loans in the second quarter and again in December and through into the early weeks of 1981. At these times market-paper rates were relatively high compared to the banks' prime rates and large corporate borrowers allowed substantial proportions of their commercial paper and bankers' acceptance issues to run off and refinanced them by drawing on their bank lines of credit. The reverse situation took place during the late summer and autumn when

Money Supply and Target Growth Ranges
Seasonally adjusted

Currency and demand deposits (M1)
Billions of dollars, monthly - Ratio scale



the interest rate incentives for corporate borrowers to issue bankers' acceptances and commercial paper were at record levels.

These large shifts of corporate borrowers in and out of the banking system required equally large movements in the deposit liabilities of the banks, and the banks accommodated this mainly by varying their bids for wholesale term deposits. The fluctuations in these deposits are reflected in the broadly defined monetary aggregates. Thus movements of both the broad monetary aggregates and bank loans were much affected in 1980 by shifts of the flow of credit between channels. The narrow monetary aggregate, composed of currency and demand deposit balances (M1), which the Bank of Canada uses for setting targets for monetary expansion, is not affected by these changes in the channels of financing.

Despite the volatility of short-term interest rates, their average level through 1980 turned out to be broadly consistent with the Bank's target growth range of 5 to 9 per cent for M1 which prevailed during the year. However, the cycles in short-term interest rates during the year did lead to some fluctuations of M1 within the target band and to a brief deviation below the lower limit of the band in the summer.

The new target for M1 announced in February 1981 of a range of growth between 4 and 8 per cent is measured from the average level of M1 during the three months centred on September 1980. This base period for the new target was chosen to take account of the fact that there have recently been some changes in banking practices which encourage increased economies in the use of demand deposits at chartered banks. The main change has been the introduction of daily interest savings accounts in late 1979. A small part of the growth in these accounts has been at the expense of balances previously held in personal chequing accounts, which are part of the demand deposit component of M1. The new base period is somewhat below the centre of the previous range to reflect the downward adjustment in the level of M1 because of these institutional changes.

For practical purposes the Bank views this target as a band two per cent above and two per cent below the centre of the range. The average level of M1 in the final quarter of 1980 was near the top of the new target band and exceeded it in November but, with the restraining effect of the rise in interest rates late in 1980, M1 moved to just below the centre of the target band in January 1981.

Debt Management

During 1980 there was an increase of $12.7 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. Given the net domestic debt financing of $11.4 billion and the total Canadian dollar financing requirements of $9.7 billion, Government cash balances increased by $1.7 billion. At year-end the Canadian dollar cash balances of the Government amounted to $4.2 billion.

Additions to the outstanding amount of treasury bills totalled $5.5 billion in 1980, of which $4.1 billion came from augmenting the weekly auctions of 3-month and 6-month bill tenders. The remaining $1.4 billion took the form of additions to the one-year treasury bill tenders which occurred every four weeks. In addition the proceeds of a $300 million 14-day bill issue were used to supplement the Government's cash balances in early November when outflows related to redemptions of Canada Savings Bonds temporarily exceeded the inflows related to sales of Canada Savings Bonds. The holdings of treasury bills outside the banking system rose by $3.6 billion to $7.8 billion, accounting for about two thirds of the increase in the total amount of bills outstanding.

The amount outstanding of Government of Canada direct and guaranteed marketable bonds payable in Canadian dollars rose by $7.2 billion on a par value basis during 1980. As shown in Appendix Table IV, there were nine public offerings of such bonds over the year, five of which involved substantial refundings of maturing issues. Eight of the nine offerings included short-, medium- and long-term bonds with an extendible option offered on four of those occasions. The ninth offering consisted of an extendible bond only. Of the total of new marketable bonds issued in 1980, 16 per cent were short-term (due in three years or less), 51 per cent were medium-term (due in more than three years but less than ten years) and the remaining 33 per cent were long-term. The average term to maturity of outstanding unmatured marketable direct and guaranteed bonds payable in Canadian dollars increased in 1980 by six months to ten years eleven months.

The terms of the 1980/81 series of Canada Savings Bonds which were first announced on September 12 provided a yield of 10½ per cent for each of the seven years to maturity in 1987. However, higher interest rates on competing savings instruments after the original announcement necessitated an adjustment in the yield offered. On November 3 the rate for the first year was raised to 11½ per cent; the rate for the subsequent six years was not adjusted, remaining at 10½ per cent. The new rates also applied to the ten 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 increasing the cash bonuses payable on the maturity of the bonds. The campaign produced a gross sale of $3.3 billion in the fourth quarter of the year and, after allowing for redemptions, the outstanding amount of Canada Savings Bonds increased by $1.2 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 total Government of Canada securities outstanding held in this form declined from 27 per cent to 22 per cent.

The accompanying table summarizes the changes during 1980 in the distribution of the outstanding debt of the Government of Canada. The general public added very substantially to its holdings of treasury bills and marketable bonds while reducing its holdings of Canada Savings Bonds.

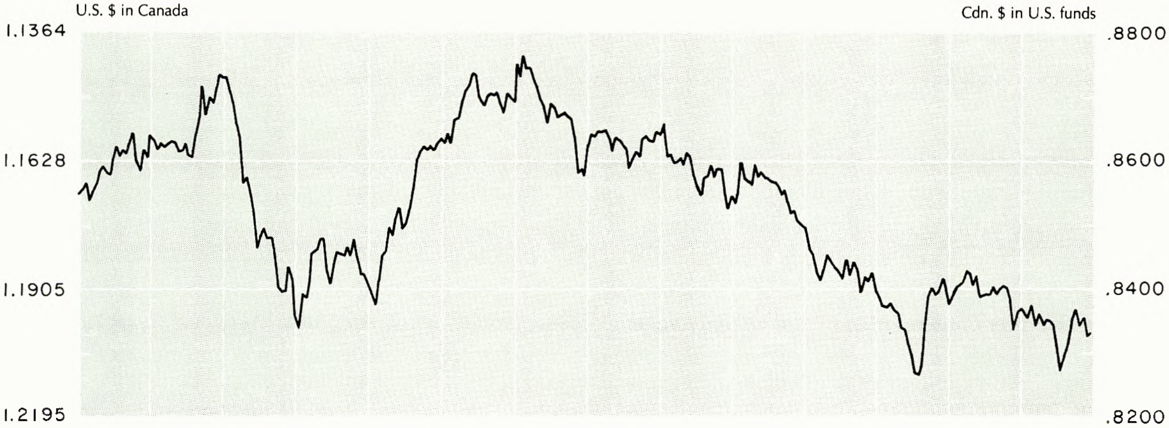
Summary of Changes in Government of Canada Securities Outstanding During 1980
Billions of dollars (par value)

Treasury bills	+ 5.5
Canada Savings Bonds	− 1.3
Marketable bonds	+ 7.2
	+11.4
Held by:	
Bank of Canada	
Treasury bills	+ 1.1
Marketable bonds	+ 1.2
	+ 2.3
Chartered Banks	
Treasury bills	+ 0.8
Marketable bonds	− 0.9
	− 0.1
Government Accounts	
Treasury bills	+ 0.0
Marketable bonds	+ 0.1
	+ 0.1
General Public	
Canada Savings Bonds	− 1.3
Treasury bills	+ 3.6
Marketable bonds	+ 6.8
(of which long-term)	(+ 2.2)
	+ 9.1

Foreign Exchange Operations

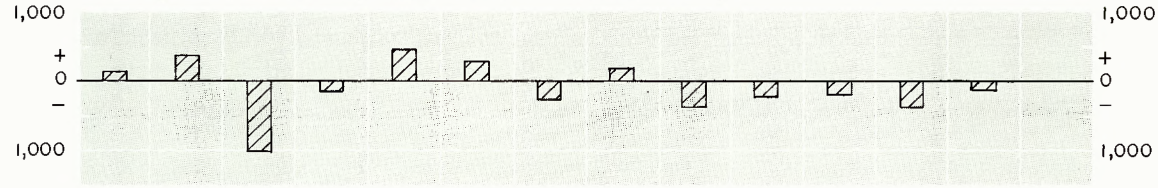
Exchange market operations by the Bank of Canada as agent for the Exchange Fund Account of the Minister of Finance continued to be directed towards dampening fluctuations in the exchange rate. During the periods of considerable pressure on the rate that occurred in both directions from time to time during the

Exchange Rate
Spot closing rates, daily



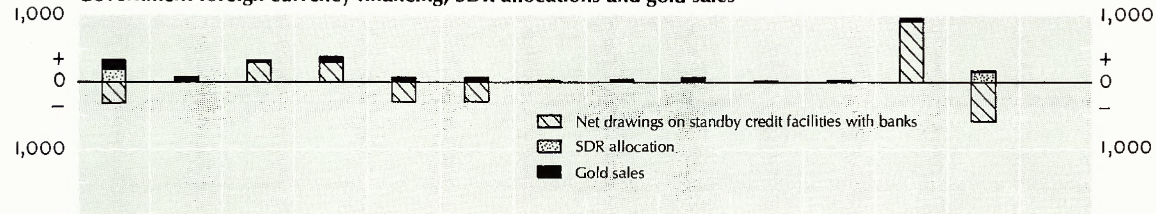
Changes in Official Reserves
Millions of U.S. dollars, monthly

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

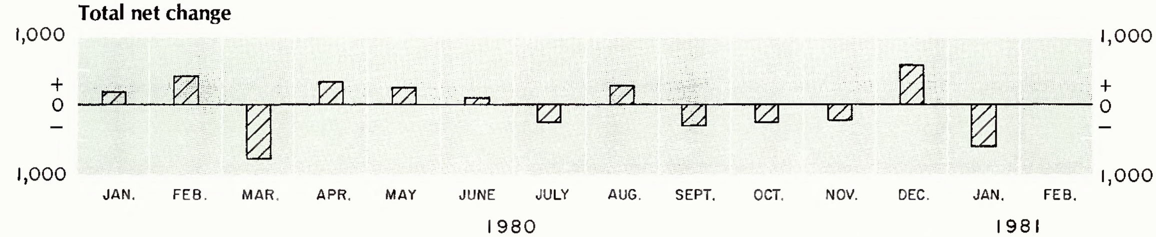


[1] The U.S. dollar value of SDR-denominated assets (gold, the IMF position and SDRs) rises when the exchange rate of the U.S. dollar declines in terms of SDRs, and decreases when the opposite occurs.

Government foreign currency financing, SDR allocations and gold sales



Total net change



Last date plotted: exchange rate February 26, 1981
official reserves January, 1981

year, these operations involved sizeable official purchases and sales of foreign exchange and therefore large changes in Canada's official holdings of foreign exchange.

Official reserve holdings were also importantly influenced by the use made of the Government's U.S.$2.5 billion revolving standby credit facility with Canadian banks and a similar U.S.$3.0 billion facility with foreign banks. In January the remaining U.S.$300 million outstanding, which had been drawn in 1979, under the facility with Canadian banks was repaid. As the exchange rate came under downward pressure, drawings of U.S.$300 million under this facility in each of March and April were added to official reserves. These were repaid in May and June. In December U.S.$600 million was drawn under the facility with Canadian banks and the facility with foreign banks was reactivated with a drawing of U.S.$300 million. The U.S.$600 million drawing was repaid in January 1981, leaving U.S.$300 million outstanding under the facility with foreign banks and a total of U.S.$5.2 billion available for future drawings in case of need.

In December 1979 the Minister of Finance announced that the Government would sell up to 1 million ounces of gold from official reserves to the market and the Royal Canadian Mint; further sales of up to 1 million ounces were authorized in August. During 1980 the Bank of Canada sold 1.2 million fine ounces of gold as the agent for this program, reducing Canada's official holdings of gold to 21.0 million fine ounces. As a result of the gold sales in 1980 official holdings of gold in reserves, which are carried at a book value of SDR35 per fine ounce (equivalent to U.S.$44.64 as at December 31, 1980), declined by U.S.$54.6 million during the year. The U.S. dollar proceeds of gold sales in 1980 amounted to U.S.$740.1 million and were added to official holdings of foreign exchange in the course of the year.

In January 1980 Canada also added to reserves 141.1 million of Special Drawing Rights (equivalent to U.S.$186.5 million) received from the International Monetary Fund as its share of the second of three annual allocations of SDRs to its members under a program agreed upon in December 1978. The third allocation was made in January 1981 and Canada's share was SDR 138.4 million (equivalent to U.S.$176.6 million). In addition, the increase in IMF quotas resulting from the Seventh General Review of Quotas agreed to by members in December 1978 came into effect in December 1980. As a result, Canada's quota in the IMF was increased by SDR678.5 million to SDR2,035.5 million. Under the Fund's Articles of Agreement Canada paid 25 per cent of the increase in its quota in SDRs. The SDR169.6 million required for this payment reduced the Exchange Fund Account's holdings of SDRs but increased Canada's reserve position in the Fund, thus leaving the level of Canada's total international reserves unchanged. The balance of Canada's quota was paid in the form of non-interest bearing Government of Canada notes denominated in Canadian dollars which were issued to the IMF. The enlargement of Canada's quota in the IMF increases both the amount that Canada could borrow from the IMF in case of need and the amount that Canada could in certain circumstances be called upon to lend to the IMF to meet the balance of payments needs of other members.

Canada's official international reserve holdings were U.S.$3,886.9 million at the end of 1979, U.S.$4,029.6 million at the end of 1980 and U.S.$3,436.0 million at the end of January 1981.

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	Government of Canada	Other
1980								
January	− 431	− 516	− 42	+ 73	− 931	+ 47	− 12	−20
February	− 82	− 205	-	−137	− 93	−330	+ 1	− 2
March	+1,262	− 110	-	+374	+ 37	+525	+964	-
April	−1,283	+1,015	− 46	−587	+ 160	−184	−964	+87
May	+ 35	+ 138	-	+616	+ 245	+564	+ 11	−31
June	+1,076	− 539	-	−620	+ 212	−243	− 12	−40
July	+ 663	− 548	− 39	− 85	+ 124	−151	− 2	+20
August	+ 489	− 55	-	−176	+ 29	+ 81	+160	−12
September	− 333	+ 45	-	+287	+ 29	+127	−159	+ 2
October	− 182	+ 287	− 47	− 53	− 13	− 33	+ 32	+19
November	+ 56	+ 437	-	+ 53	+ 84	+495	− 8	−25
December	+ 971	− 539	-	+311	+ 910	−171	+ 24	−20
	+2,241	− 590	−174	+ 56	+ 793	+727	+ 35	−22
1981								
January	− 920	− 221	− 39	+180	−1,077	+ 17	+ 65	− 5

APPENDIX TABLE II

Chartered Bank Cash Reserves

Millions of dollars unless otherwise indicated

		Total minimum cash requirements	Average holdings of Bank of Canada notes[1]	Required minimum Bank of Canada deposits	Average holdings of Bank of Canada deposits	Number of juridical days in period
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
	16-29				4,564	10
March	1-15	6,090	1,423	4,667	4,724	10
	16-31				4,718	11
April	1-15	6,196	1,388	4,808	4,854	10
	16-30				4,841	11
May	1-15	6,224	1,402	4,822	4,830	11
	16-31				4,851	10
June	1-15	6,446	1,407	5,039	5,085	10
	16-30				5,090	11
July	1-15	6,426	1,511	4,915	4,981	10
	16-31				4,943	12
August	1-15	6,562	1,512	5,050	5,100	11
	16-31				5,113	10
September	1-15	6,575	1,534	5,041	5,102	10
	16-30				5,106	11
October	1-15	6,614	1,545	5,069	5,123	10
	16-31				5,186	12
November	1-15	6,839	1,550	5,290	5,339	9
	16-30				5,326	10
December	1-15	6,869	1,572	5,297	5,338	11
	16-31				5,383	10
1981						
January*	1-15	7,041	1,555	5,486	5,519	10
	16-31				5,540	11
February*	1-15	7,092	1,819	5,273	5,357	10

* Preliminary.
(1) The figure for February 1981 also includes average holdings of coins as permitted under the 1980 Bank Act revision.
(2) 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[2]	
		Advances	PRA	Advances	PRA
435	.037	2	8	17.8	106.8
409	.029	1	11	0.4	147.4
600	.046	1	9	0.4	98.7
552	.047	–	2	–	2.5
567	.048	1	3	6.4	27.8
567	.044	1	5	6.4	79.1
459	.038	1	5	7.0	34.9
367	.028	1	10	0.8	173.8
89	.007	2	8	48.1	175.3
292	.025	4	9	47.8	202.5
460	.037	2	10	21.2	276.1
559	.041	1	11	1.7	189.2
657	.052	3	8	6.7	225.0
329	.022	1	10	0.8	258.4
544	.039	–	5	–	59.1
626	.049	–	6	–	48.7
603	.048	–	4	–	51.9
711	.051	1	3	1.4	22.0
533	.042	2	3	2.4	12.6
1,400	.092	–	8	–	142.7
441	.038	1	1	4.6	4.3
364	.028	1	4	5.0	56.2
452	.032	6	8	23.1	70.8
865	.067	7	10	61.0	172.5
329	.025	2	9	31.1	154.7
602	.042	2	10	13.6	192.5
843	.061	–	6	–	97.7

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
1980								
January	+ 53.0	–	–	–	–	–	+ 53.0	+ 30.0
February	+ 408.7	+32.9	–	–	–	–	+ 441.6	− 30.0
March	− 324.1	–	–	–	–	–	− 324.1	+214.9
April	−1,253.4	−82.9	–	–	–	–	−1,336.3	− 36.3
May	− 97.9	−22.0	−276.0	–	–	–	− 395.9	− 92.9
June	+ 612.7	–	–	–	–	–	+ 612.7	− 55.7
July	+ 337.0	–	–	–	–	–	+ 337.0	+286.6
August	+ 51.0	–	–	–	–	–	+ 51.0	−316.6
September	− 82.0	–	–	–	–	–	− 82.0	–
October	− 988.4	–	–	–	–	–	− 988.4	–
November	− 624.0	–	–	–	–	–	− 624.0	–
December	+ 120.5	–	–	–	–	–	+ 120.5	+120.5
Total	−1,786.9	−72.0	−276.0	–	–	–	−2,134.9	+120.5
1981								
January	−1,049.0	–	–	–	–	–	−1,049.0	− 92.9

(1) Classified by years to maturity at time of transactions.

(2) Includes maturing bankers' acceptances.

Net transactions with Government and other client accounts							
Purchases (+) of new issues less matured holdings		Net purchases from (+) or net sales to (−) Government and client accounts		Net change in holdings of Government of Canada securities and bankers' acceptances			
Bills	Bonds	Bills	Bonds	Bills	Bonds	Bankers' acceptances	Total
− 443.3	-	− 44.3	− 35.9	− 404.6	− 35.9	-	− 440.5
− 298.0	+ 70.6	− 209.5	− 12.3	− 128.8	+ 91.2	-	− 37.6
+1,086.9	+ 450.0	− 108.1	− 2.1	+ 817.9	+ 486.4	+13.2	+1,317.5
+ 468.7	− 237.0	− 178.4	− 10.2	− 980.4	− 353.4	+ 4.3	−1,329.5
+ 447.1	+ 300.0	− 208.6	− 12.8	+ 69.0	− 20.1	−12.0	+ 36.9
+ 183.8	+ 382.6	− 31.3	+ 14.7	+ 720.9	+ 391.4	− 5.5	+1,106.8
− 12.7	+ 200.0	− 126.2	− 15.0	+ 431.2	+ 220.9	+17.6	+ 669.7
+ 638.8	+ 258.5	− 136.5	− 3.4	+ 290.2	+ 219.2	−17.6	+ 491.8
− 169.9	-	− 93.7	− 7.8	− 345.6	− 7.8	-	− 353.4
+ 854.5	+ 177.6	− 213.0	− 5.1	− 346.9	+ 172.5	-	− 174.4
+ 885.7	-	− 172.5	− 12.4	+ 89.2	− 12.4	-	+ 76.8
+ 822.6	+ 121.7	− 182.0	− 29.1	+ 875.6	+ 98.6	-	+ 974.2
+4,464.2	+1,724.0	−1,704.1	−131.4	+1,087.7	+1,250.6	-	+2,338.3
+ 367.6	-	− 171.6	− .5	− 939.9	− 6.5	-	− 946.4

APPENDIX TABLE IV

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

Date in 1980		Issues offered/ retired	Term to maturity	Yield to maturity	Millions of dollars par value Amount delivered	Amount retired
Issues payable in Canadian dollars – direct and guaranteed						
Feb.	1	9% Feb. 1, 1980				344[1]
		7½% Feb. 1, 1980				600[2]
		11¾% Dec. 15, 1982	2 yrs. 10½ mos.	12.27	600[3]	
		11½% Dec. 15, 1984	4 yrs. 10½ mos.	11.91	350[4]	
		11¼% Dec. 15, 1989	9 yrs. 10½ mos.	11.86	50[5]	
		11¾% Feb. 1, 2003	23 years	12.07	600	
					1,600	
Mar.	31	13¾% Mar. 15, 1983	2 yrs. 11½ mos.	13.96	150	
		13¾% Mar. 15, 1985	4 yrs. 11½ mos.	13.75	850[6]	
		13¾% Mar. 15, 2000	19 yrs. 11½ mos.	13.86	250	
					1,250	
Apr.	1	6¼% Apr. 1, 1980				450[7]
						199[8]
May	1	13¾% Mar. 15, 1983	2 yrs. 10½ mos.	13.75	150[9]	
		13% May 1, 1985	5 yrs.	13.14	500[10]	
		13% May 1, 2001	21 yrs.	13.14	450	
					1,100	
June	1	7½% June 1, 1980				475[11]
		11¼% Mar. 15, 1983	2 yrs. 9½ mos.	11.49	400	
		11¼% July 1, 1985	5 yrs. 1 mo.	11.51	450	
		11¼% Dec. 15, 1989	9 yrs. 6½ mos.	11.69	150[12]	
		11¾% Feb. 1, 2003	22 yrs. 8 mos.	12.00	650[13]	
					1,650	
June	26					41[14]
July	1	10% June 1, 1984	3 yrs. 11 mos.	10.19	275[15]	
		10½% Oct. 1, 1989	9 yrs. 3 mos.	10.80	150[16]	
		11¼% Dec. 15, 2002	22 yrs. 5½ mos.	11.31	475[17]	
					900	
Aug.	1	5½% Aug. 1, 1980				267[18]
		10½% Feb. 1, 1983	2 yrs. 6 mos.	10.50	250	
		10¾% Oct. 1, 1985	5 yrs. 2 mos.	10.87	325	
		11¼% Dec. 15, 1989	9 yrs. 4½ mos.	11.29	125[19]	
		11¾% Feb. 1, 2003	22 yrs. 6 mos.	11.81	450[20]	
					1,150	

(Continued)

Date in 1980		Issues offered/ retired	Term to maturity	Yield to maturity	Millions of dollars par value	
					Amount delivered	Amount retired
Oct.	1	9% Oct. 1, 1980				449[21]
		12¼% Oct. 15, 1982	2 yrs. ½ mo.	12.76	150	
		12½% Oct. 1, 1984	4 yrs.	12.99	775[22]	
		13% May 1, 2001	20 yrs. 7 mos.	13.28	375[23]	
					1,300	
Dec.	1	7½% Dec. 1, 1980				800[24]
		13¼% Dec. 15, 1983	3 yrs. ½ mo.	13.45	200	
		13% May 1, 1985	4 yrs. 5 mos.	13.07	800[25][26]	
		13½% Dec. 1, 1999	19 yrs.	13.65	400	
					1,400	
Dec.	22	13% May 1, 1985	4 yrs. 4½ mos.	12.91	500[27][28]	
Dec.	31					6[29]
		Total bonds			10,850	3,631
		Total treasury bills*			53,520	48,045
Issues payable in foreign currencies – direct						
Apr.	15					1[30]
Oct.	15					1[30]
		Total bonds				2

* Includes three-month, six-month and one-year treasury bills.
(1) Maturity of 9% bonds issued October 1, 1975.
(2) Maturity of 7½% bonds issued February 1, 1977, April 1, 1977 and May 15, 1977.
(3) In addition to $275 million 11¾% December 15, 1982 already outstanding.
(4) In addition to $350 million 11½% December 15, 1984 already outstanding.
(5) In addition to $125 million 11¼% December 15, 1989 already outstanding.
(6) Exchangeable at the option of the holder, on or before December 14, 1984, into an equal par value of 13¾% bonds due March 15, 1990 yielding about 13.75% from March 31, 1980 to maturity in 1990.
(7) Maturity of 6¼% bonds issued April 1, 1971 and April 1, 1975.
(8) Cancellation of $9.0 million 5½% August 1, 1980 bonds, $36.6 million 9½% June 15, 1994 bonds, $19.1 million 10% October 1, 1995 bonds, $30.0 million 9¼% May 15, 1997 bonds, $18.1 million 9% October 15, 1999 bonds, $15.6 million 9¾% December 15, 2000 bonds, $40.6 million 9½% October 1, 2001 bonds, $7.5 million 8¾% February 1, 2002 bonds and $22.5 million 9½% October 1, 2003 bonds.
(9) In addition to $150 million 13¾% March 15, 1983 already outstanding.
(10) Exchangeable at the option of the holder, on or before February 1, 1985, into an equal par value of 13% bonds due May 1,1990 yielding about 13.09% from May 1, 1980 to maturity in 1990.
(11) Maturity of 7½% bonds issued July 1, 1977, September 1, 1977, October 15, 1977, December 15, 1977 and February 1, 1978.

(Continued)

(12) In addition to $175 million 11¼% December 15, 1989 already outstanding.
(13) In addition to $600 million 11¾% February 1, 2003 already outstanding.
(14) Cancellation of $7.3 million 9½% June 15, 1994 bonds, $6.4 million 10% October 1, 1995 bonds, $6.0 million 9¼% May 15, 1997 bonds, $3.6 million 9% October 15, 1999 bonds, $3.1 million 9¾% December 15, 2000 bonds, $8.1 million 9½% October 1, 2001 bonds, $1.5 million 8¾% February 1, 2002 bonds and $4.5 million 9½% October 1, 2003 bonds.
(15) In addition to $800 million 10% June 1, 1984 already outstanding.
(16) In addition to $200 million 10½% October 1, 1989 already outstanding.
(17) In addition to $750 million 11¼% December 15, 2002 already outstanding.
(18) Maturity of 5½% bonds issued August 1, 1962, February 1, 1966, May 1, 1966 and February 1, 1967.
(19) In addition to $325 million 11¼% December 15, 1989 already outstanding.
(20) In addition to $1,250 million 11¾% February 1, 2003 already outstanding.
(21) Maturity of 9% bonds issued October 1, 1975 and April 1, 1976.
(22) Exchangeable at the option of the holder, on or before June 29, 1984, into an equal par value of 12½% bonds due October 1, 1990 yielding about 12.77% from October 1, 1980 to maturity in 1990.
(23) In addition to $450 million 13% May 1, 2001 already outstanding.
(24) Maturity of 7½% bonds issued December 1, 1973 and February 1, 1974.
(25) In addition to $500 million 13% May 1, 1985 already outstanding.
(26) Exchangeable at the option of the holder, on or before February 1, 1985, into an equal par value of 13% bonds due May 1, 1990 yielding about 13.04% from December 1, 1980 to maturity in 1990.
(27) In addition to $1,300 million 13% May 1, 1985 already outstanding.
(28) Exchangeable at the option of the holder, on or before February 1, 1985, into an equal par value of 13% bonds due May 1, 1990 yielding about 12.95% from December 22, 1980 to maturity in 1990.
(29) Cancellation of guaranteed debt by Purchase Fund.
(30) 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, 1980 (with comparative figures for 1979)

	1980	1979
	(thousands of dollars)	
INCOME		
Revenue from investments and other income After deducting interest of $5,849 ($2,975 in 1979) paid on deposits	$1,541,892	$1,161,133
EXPENSE		
Salaries[1]	$ 31,733	$ 28,397
Contributions to pension and insurance funds[1]	4,954	4,647
Other staff expenses[2]	1,298	1,621
Directors' fees	49	47
Auditors' fees and expenses	231	200
Taxes – municipal and business	4,932	4,232
Bank note costs	19,611	18,685
Data processing and computer costs	3,491	3,013
Maintenance of premises and equipment – net[3]	6,542	6,471
Printing of publications	453	470
Other printing and stationery	1,275	1,400
Postage and express	866	826
Telecommunications	983	913
Travel and staff transfers	1,080	977
Other expenses	768	597
	78,266	72,496
Depreciation on buildings and equipment	4,824	4,704
	83,090	77,200
NET INCOME PAID TO RECEIVER GENERAL FOR CANADA	1,458,802	1,083,933
	$1,541,892	$1,161,133

(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 1,9S6 in 1980 and 1,883 in 1979.
(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 1979 have been reclassified in order to conform with the presentation adopted for 1980.

BANK OF CANADA Statement of Assets and Liabilities

as at December 31, 1980
(with comparative figures for 1979)

ASSETS	1980	1979
	(thousands of dollars)	
Deposits payable in foreign currencies:		
U.S.A. dollars	$ 278,625	$ 225,398
Other currencies	5,672	5,580
	284,297	230,978
Advances to chartered and savings banks	16,000	116,900
Investments — at amortized values:		
Treasury bills of Canada	5,252,434	4,239,985
Other securities issued or guaranteed by Canada maturing within three years	3,892,522	3,768,421
Other securities issued or guaranteed by Canada not maturing within three years	6,648,736	5,542,889
Bonds and debentures issued by the Industrial Development Bank	170,612	344,283
Other investments	225,340	827,356
	16,189,644	14,722,934
Bank premises:		
Land, buildings and equipment, at cost less accumulated depreciation	76,655	76,567
Cheques drawn on other banks	488,552	384,591
Accrued interest on investments	253,205	206,782
Other assets	4,870	6,994
	$17,313,223	$15,745,746

LIABILITIES	1980	1979
	(thousands of dollars)	
Capital paid up	$ 5,000	$ 5,000
Rest fund	25,000	25,000
Notes in circulation	11,108,020	10,314,754
Deposits:		
Government of Canada	58,701	24,799
Chartered banks	5,466,282	4,738,420
Other deposits	85,935	107,452
	5,610,918	4,870,671
Liabilities payable in foreign currencies:		
Government of Canada	177,647	136,285
Other	239	233
	177,886	136,518
Bank of Canada cheques outstanding	281,423	297,429
Collections and payments in process of settlement:		
Government of Canada (net)	99,496	38,814
Other	1,491	54,655
	100,987	93,469
Other liabilities	3,989	2,905
	$17,313,223	$15,745,746

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, 1980 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, 1980 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.

ROBERT E. L'ABBÉ, C.A.
du cabinet Raymond, Chabot, Martin, Paré & Associés

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

Ottawa, Canada, January 16, 1981

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. The figures for the prior year have been reclassified to comply with the 1980 revisions to the 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%

Board of Directors

G. K. Bouey	OTTAWA Governor *Member of the Executive Committee*
R. W. Lawson	OTTAWA Senior Deputy Governor *Member of the Executive Committee*
R. W. Campbell	CALGARY, ALTA.
W. Dodge	OTTAWA, ONT.
S. Kanee	WINNIPEG, MAN. *Member of the Executive Committee*
S. G. Lake	RAMEA, NFLD.
A. A. LeBouthillier	CARAQUET, N.B.
J. R. Longstaffe	VANCOUVER, B.C.
J. W. E. Mingo, Q.C.	HALIFAX, N.S. *Member of the Executive Committee*
J. H. Potts, Q.C.	TORONTO, ONT. *Member of the Executive Committee*
Mme Y. Lefebvre-Richard	MONTREAL, QUE.
D. A. Smith	CHARLOTTETOWN, P.E.I.
J. A. Stack	SASKATOON, SASK.
J. Taschereau	QUEBEC, QUE. *Member of the Executive Committee*

Ex-officio

I. A. Stewart	OTTAWA Deputy Minister of Finance *Member of the Executive Committee*

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R. W. Lawson, *Senior Deputy Governor*

G. E. Freeman, *Deputy Governor*
*B. J. Drabble, *Deputy Governor*
J. N. R. Wilson, *Adviser*
W. A. McKay, *Adviser*
G. G. Thiessen, *Adviser*
D. G. M. Bennett, *Associate Adviser*
W. Cheveldayoff, *Associate Adviser*

Alain Jubinville, *Deputy Governor*
D. J. R. Humphreys, *Deputy Governor*
Jacques Bussières, *Adviser*
J. W. Crow, *Adviser*
Serge Vachon, *Adviser*
J. S. Roberts, *Associate Adviser*
T. E. Noël, *Secretary*

*On leave of absence as an Executive Director of the International Monetary Fund

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V. O'Regan, *Deputy Chief*
I. D. Clunie, *Securities Adviser*

Research Department
W. R. White, *Chief*

Department of Monetary and Financial Analysis
C. Freedman, *Chief*
W. E. Alexander, *Deputy Chief*

International Department
J. E. H. Conder, *Chief*
R. F. S. Jarrett, *Chief, Foreign Exchange Operations*

Department of Banking Operations
R. E. A. Robertson, *Chief*
S. V. Suggett, *Adviser, Currency Research*

Public Debt Department
J. M. Andrews, *Chief*
J. M. McCormack, *Deputy Chief*

Secretary's Department
T. E. Noël, *Secretary*
S. L. Harris, *Deputy Secretary*

Computer Services Department
G. M. Pike, *Chief*

Department of Personnel Administration
R. L. Flett, *Chief*
H. A. D. Scott, *Personnel Adviser*

Department of Administrative Services
R. H. Osborne, *Chief*
K. W. Kaine, *Deputy Chief*

Comptroller's Department
A. C. Lamb, *Comptroller and Chief Accountant*

Audit Department
J. M. E. Morin, *Auditor*
M. Muzyka, *Deputy Auditor*

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TORONTO	D. R. CAMERON, *Chief, Toronto Division*
MONTREAL	J. CLÉMENT, *Chief, Montreal Division*
VANCOUVER	P. E. DEMERSE, *Representative*
EDMONTON	A. G. KEITH, *Representative*

International Department

TORONTO	D. R. STEPHENSON, *Foreign Exchange Adviser*
MONTREAL	G. HOOJA, *Foreign Exchange Officer*

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	R. DUPONT, *Assistant Agent*
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