frequently referred to as the source and use of funds respectively. The system reveals the important role of financial institutions in providing the link between borrowers and lenders by accepting deposits, for example, which may be highly liquid and yield low interest rates to the depositor. These funds deposited with a financial institution are in turn re-loaned in the form of loans with quite different liquidity and yield characteristics.

Financial activity in Canada in 1972 continued to expand to meet the strong demand for funds generated by the second full year of economic recovery. In particular, credit markets were able to satisfy the needs created by the continuing, very strong, growth of residential construction and the sharp surge on consumer spending which rose more rapidly than in any year since 1955. Demand for business financing was somewhat lower as increased cash flow resulting from an impressive rise in profits permitted business to satisfy more of its needs from internal sources. There was a considerable shift in the pattern of borrowing, however, as more attractive interest rates on bank loans drew business away from more traditional sources of funds. Plant and equipment expenditures and inventory accumulation by business were only moderately higher in 1972. Expenditures on machinery and equipment increased sharply but non-residential construction was little changed. Similarly, according to preliminary estimates, a strong growth in inventories in the first quarter was not maintained during the rest of the year.

The main thrust of the expansionary monetary and fiscal policy in 1972 was again directed toward the reduction of the considerable slack remaining in the economy. Unemployment persisted at unacceptably high levels throughout the year as the largest employment gains since 1969 were virtually offset by almost equally large increases in the labour force.

International currency markets continued to be plagued by considerable instability despite the major realignment of currencies resulting from the Smithsonian Agreement of December 1971. Conditions in Canada, however, were relatively stable although higher short-term interest rates in Canada attracted large short-term capital inflows in early summer, as residents converted substantial amounts of their foreign currency holdings. The threatened appreciation of the Canadian dollar was obviously incompatible with the principal objectives of monetary and fiscal policy. However, short-term rates declined sharply following the so-called Winnipeg Agreement in June when the chartered banks, with the concurrence of the Minister of Finance, agreed to limit interest rates on large deposits to 5½%. Keen competition between the banks to attract deposits to accommodate the demand for business loans had been largely responsible for the escalation of short-term interest rates during the first half of the year. By the end of the year short-term interest rates were only moderately higher than those at the end of 1971.

Long-term interest rates followed a similar course in 1972 although mid-year increases were by no means as pronounced as for short-term rates. Lower interest rates abroad, especially for German mark and Swiss franc issues, encouraged provincial and municipal governments to resume their long-term borrowing abroad on a fairly substantial scale.

The liquidity of the chartered banks fell to a new low in 1972 in line with the policy of close control adopted by the Bank of Canada in the summer of 1971. Despite further substantial inflows of deposits in 1972, the banks were obliged to reduce their holdings of more liquid assets, particularly of federal bonds, in order to meet the very strong demand for loan and mortgage funds.

Broadly defined money supply (currency and privately held Canadian dollar deposits) grew by 16% over the year, or at about the same rate as in 1971. During the first half of the year a rate of increase of 25% was recorded. However, following the restructuring of interest rates between banks and non-banks in late June there was a run down of non-personal term and notice deposits and the rate of increase slowed to 8%. Money supply, narrowly defined, in contrast, expanded sharply (at an annual rate of 19%) after averaging an annual growth rate of 7% in the first half of the year. Much of the increase in the latter part of the year occurred with the unusually large upswing in demand deposits in August.

The volume of credit market borrowing rose by a further 9% to $17,274 million compared with the already high $15,883 million of 1971. For both years this was equivalent to 17% of gross national product, indicating a continuing high rate of financial activity. Very strong increases were recorded in borrowing through bank loans, consumer credit and mortgages over the already high levels registered for 1971. Net sales of other bond issues, stocks and commercial paper, however, were sharply down.