CENTRAL BANKING IN CANADA

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(Portions enclosed in brackets eliminated from speech in order to bring it within the usual time limit.)

In approaching the subject of central banking, one can hardly forget that the question of whether there should or should not be a central bank in Canada was most actively debated in 1933 and 1934. While the controversies which took place at that time probably resulted in a better understanding of central banks, I am bound to say they also promoted a number of misconceptions. On the one hand, there were those who expected that the central bank would do many things that no bank could or should do. On the other hand, prophets of evil were not lacking. It would be foolish to attempt to rehash all the arguments. I believe, however, that it is worth while to refer to one or two. If we can clear away some of the accumulated débris, it will be all the easier to proceed to the discussion of facts.

When the Bank Act was revised in 1934, it was provided that the chartered banks' authority to issue notes should be reduced to an amount not exceeding 25 per cent of paid up capital, instead of 100 per cent of paid up capital. This change will have the effect of taking away certain earning power from the chartered banks. Without in any way minimizing the unpleasantness of any reduction of earning power, I think that two comments can be usefully made:

1. That the change takes place gradually over a period of ten years.
2. That the benefit arising from the transfer of this earning power to the Bank of Canada is passed on to the Dominion Government, directly in the form of profits and indirectly through

accumulation of surplus in which the Government - not the shareholders - has the beneficial interest.

The transaction by which we became owners of the gold previously held by the Government and the chartered banks was another matter that caused misunderstanding. We paid $20.67 an ounce for that gold. To-day, we value the gold at market price, approximately $35 per ounce. Where has the profit gone? Not to the Bank of Canada. A portion went to the chartered banks by virtue of an Order-in-Council, the terms of which are a matter of public knowledge. The balance was paid to the Dominion Government. Moreover, all future profits or losses on the gold held by us are for Government account as provided in the Exchange Fund Act.

You may have heard it said, or you may have realized from reading our weekly statements, that the banks keep on deposit with us large sums of money on which they receive no interest. No banker, of course, refers to the non-payment of interest in a serious spirit, but those who are not bankers may be inclined to think that the new situation involves, in this respect too, a loss of profits to the chartered banks. Actually, there is no major change. The new law provided that banks must maintain a minimum reserve of 5 per cent against deposit liabilities in Canada. But prior to the passage of the law the average reserve of the banks was substantially in excess of 5 per cent - was, in fact, approximately double that percentage as it still is. Before we came into being the money now on deposit with us was kept in the chartered banks' vaults in the form of Dominion notes or gold on which, I need hardly say, no interest was paid.

Finally, and this is somewhat more important, it was said that this was no time to indulge in a costly experiment and that the expense of setting up and operating a central bank would be large. I do not think that definite figures were ever mentioned, but one gained the impression that they might reach an amount of a million or two per annum. At the time of our annual meeting on February 25th, there will be available an estimate of the new costs arising from the organization and operation of the Bank of Canada in 1934-35. In the meantime, I can say that the net cost of the new regime is comparatively small, and as time goes on I hope and expect that it will be reduced, not increased.

I have not taken up these points in a controversial spirit, but to stress the fact that they are side issues. The question of the desirability or undesirability, of the effectiveness or ineffectiveness, of a central bank must be argued on other and more important grounds. Let me try to give you now a description of what the Bank of Canada is, what it is meant to do, and its methods of procedure.

The Act to incorporate the Bank of Canada contains a preamble which recites the things that we should do. The list is a formidable one. I read it in full to your associated Club in Toronto about a month ago, rather in the spirit of one who says, "Who's afraid of the big, bad wolf?" I shall not repeat that preamble to-day. It is sufficient to say that regulation of credit and currency in the best interests of the economic life of the nation is the main duty imposed on us. Regulation of credit is an indirect matter - an influence we exert. Regulation of currency is direct and definite, and is therefore the subject which I propose to discuss.

First of all, I should define what I mean when I say "currency". I do not want economists to accuse me of forcing a new definition of currency on the world, but I think I can safely take the liberty of devising a formula for the purpose of my remarks to-day. The definition can usefully be divided into two sections, namely, what was meant before the creation of the Bank of Canada and what is meant now. A year ago Dominion notes were the only legal tender in the country other than gold. Dominion notes were the country's currency. You will recall that this currency constituted the main cash reserves on which our banking institutions stood. It was, in essence, the financial lifeblood of our whole system. Realizing this, a natural query would be, "Who was responsible for the determination of how much currency there should be to meet the varying requirements of our business life? What machinery existed to enable someone to undertake the task of regulation?" The answer quite simply is that no one admitted any such responsibility, and even if they had done so would have found no suitable regulatory machinery at their disposal. Our currency laws provided for certain free issues of Dominion notes and for another limited issue against which 25 per cent gold reserve had to be maintained. Additional issues could not be made without 100 per cent gold backing. Not a bad arrangement, in certain circumstances, if we were on a gold standard, but certainly unsatisfactory when the standard had been abandoned. Elasticity in a currency issue is essential, but our currency laws were such that no elasticity remained after the gold standard ceased to operate. Under such conditions, if we had reached the limit provided by the law, there we stayed, no matter what was transpiring in the business world. It is true that borrowing by the chartered banks under the Finance Act had the effect of increasing the currency outstanding, and repayment of the loans decreased it. This Act provided facilities to cover seasonal fluctuations, but, except for this purpose, could not be regarded as the solution, since no bank would want to, or should want to, borrow except for temporary periods. It is hardly necessary to deal here with the amendment to the Dominion Notes Act which was put into effect about the middle of 1934, though I would not minimize the importance of this change. It provided much needed elasticity pending the formation of the Bank of Canada, but it did not pretend to effect any fundamental change in our currency arrangements.

So much for the previous regime. To-day, we find notes of the Bank of Canada and deposits with the Bank of Canada in the category which was formerly occupied by Dominion notes alone. These notes and deposits combined can be described as the country's cash. The mistake is sometimes made of regarding the note issue as the most important item. Actually the contrary is true. Deposits with the Bank of Canada are equally important in effect and, at the moment, twice as important in amount.

From time to time you may examine the weekly statement which we publish. A recent one shows that the banks keep on deposit with us some $178 million. They also hold about $37 million of our notes. The notes are legal tender, but deposits with us are in effect the same thing as they can be converted into notes at any time. These two assets of the chartered banks, totalling some

$215 million, are their cash reserves against their deposit liabilities in Canada, and they bear a ratio to deposits of a little more than 10 per cent. Banks have certain views in regard to the amount of cash they should hold in relation to deposits. If the ratio goes too low, they must pull in their horns - collect loans or sell securities. If the ratio seems high, they may expand by buying securities or making new loans if good borrowers are available. By doing so, in both cases they restore their cash proportion to normal. Subject to changes in the amount of Bank of Canada notes in general circulation in the hands of the public, the only way in which the total amount of bank reserves can be changed - increased or decreased - is through action on the part of the Bank of Canada. If we increase our assets by buying gold or securities or making advances - up go chartered bank reserves. If our advances are repaid, or we sell gold or securities - down go the chartered bank reserves. Day by day and month by month we must make up our minds as to whether the cash should be increased or decreased or allowed to remain stationary.

There, as briefly as I can describe them, are the mechanical features of the control of currency. Not a complicated operation physically. But let me assure you it can carry momentous consequences. If I may illustrate by an exaggerated example, let us suppose that, while we were still off the gold standard, bank cash was reduced 50 per cent and banks forced to reduce their assets and liabilities by approximately the same percentage, which means ten times the amount of the cash reduction. You can imagine that the repercussions from such a development would be very serious indeed. Or suppose that with inflationary motives we doubled the cash. In such a case, the effect is not necessarily immediate. The banks, I assume, would have the good sense not to expand their assets in proportion to the new cash. But I recall no case in history where an unnecessary and large expansion of cash was not followed by some inflation, if the cash is left lying around long enough. I can imagine the process taking years: I cannot imagine it failing to materialize eventually.

Naturally, these wide swings are examples so exaggerated that we must not think of them as practical possibilities. Even the minor movements, however, are of real importance in view of the delicacy of the machinery of credit. In charting our course of action the fullest possible information on business and financial conditions in Canada and other countries is essential. If a speculative boom appeared to be developing, it would be our duty to try to exercise a restraining influence. In a period of deflation, quite a different policy is required. Let me make it plain that I do not pretend for a moment that central banks are a cure-all for booms and depressions. So far as I am aware, no central bank has ever made such a claim. One must recognize the great importance of influences unconnected with money, and the many ways in which the business of one country is affected by developments in other countries. But these qualifications of the ability of central banks to ensure stability are not an argument against central banks, so long as half a much-needed loaf is better than no bread. Simply because perfection cannot be attained, it does not follow that no effort should be made to achieve an improvement. Any reduction of the extremes of instability would be of great value to us all.

In the time at my disposal, it would be difficult to deal adequately with the possible lending and rediscounting activities of the Bank of Canada. One point might be brought out, namely, that the monetary effect of a loan made by the central bank is quite different from the effect of a loan by a commercial bank. The latter, in making a loan, provides credit. A central bank in making a loan increases the amount of cash in the country. And if we consider 10 per cent as a normal ratio of commercial banks' cash reserves to their liabilities, the increase in cash resulting from a central bank advance of, say, $1,000,000, provides scope for an increase of $10,000,000 in the advances or investments and also in the deposits of the commercial banks. To put it another way, our lending activities may have an effect on credit equal to ten times the amount of our loans. Obviously, in giving consideration to loans, we must think not only of the factors of safety and security, but also the ultimate effect on the credit position of the country. A central bank must be what is known as the lender of last resort, which implies that in times of real need its rediscounting and lending facilities will be freely accorded.

There is a school of thought, with which I need hardly say I disagree, which regards a central bank as an institution which is unlikely to do much good. But all schools will unite in agreeing that a central bank which did very foolish things would be dynamite indeed - that it could affect the real wages and savings of the Canadian people in ways which would constitute a grievous injustice. I should be glad to see a greater general understanding of these facts. It is desirable that there should be a sounder knowledge of central bank operations - not of the details necessarily, but of the main factors. Enlightened public opinion is the greatest safeguard that a central bank can have.

I am not going to inflict on you an extensive catalogue of our activities, but, in view of the fact that our institution is a new thing in this country, I would like to say something about its physical characteristics. A little over a year ago, we had no staff, no premises, no equipment. We had the advantage that we were destined to take over the Currency Division of the Department of Finance and the various offices of the Assistant Receivers General across Canada. We had to organize a head office in Ottawa and an office in Montreal, and we had to adapt the governmental offices to fit into the new system. One section of our work has to do with the supply of Bank of Canada notes. The $90 million of notes now outstanding have a life which varies from nine months to a year, depending on the denomination. The smaller denominations need to be renewed more frequently than the larger, but the entire circulation is redeemed and reissued in the course of a year. It may convey more if I say that since we opened for business some ten months ago we have issued over 49 million separate notes and redeemed over 38 million notes. A large reserve stock has to be carried, not only to meet all possible requirements but also for the reason that notes should be matured before issue.

We are the Financial Advisors of the Dominion Government, and as such must supply them with the best and most impartial advice which we are capable of giving in financial matters. We act as Issuing Agents when Dominion loans are floated or Treasury Bills sold. In connection with these activities, and also for the purpose of dealing with our own large portfolio of securities, it was necessary to organize a Securities Department, with representatives in Montreal and Toronto as well as in Ottawa. Obviously we must maintain close touch with the securities markets in Canada and abroad.

The Dominion Government, as you can understand, has very large dealings in foreign exchange. Shipment abroad of the gold bought from Canadian mines - over $115 million a year - provides a supply of foreign exchange. We act as Agents in shipping the gold. The Government's need for exchange arises from interest payments on or redemption of foreign debt, and various other remittances which it must make. As bankers for the Dominion Government it was our duty to set up a Department to handle this foreign exchange business. The Department operates in Montreal and Toronto, and maintains close connection with the principal exchange centres outside of Canada.

Last, but by no means least, we have initiated a Research and Statistical Department. We carefully abstained from setting up an over-elaborate organization. We determined to do our utmost to avoid duplication of material available elsewhere, and to avoid also the compilation of statistics which did not serve a definite and useful purpose to the Bank. These principles might seem to lead us along an extremely straight and narrow path, but in fact we have found there is a broad field for accumulation of financial and public debt statistics not presently available elsewhere.

That ends the abridged catalogue of our activities. I have described them in an attempt to give some idea of our organization and methods of procedure. When we first opened for business, there was throughout the country a very evident and wide-spread interest in the new central bank. Public interest and sympathy are the greatest assets that any institution can have. Yet for a central bank to achieve, and once having achieved, to retain these assets, is no easy task. Its direct contacts with the public are infrequent; its activities, even of the most important kind, are not easily understood, and its Governor would indeed be lacking in common sense if he thought that this situation could be remedied by constant speech-making. In the final analysis, a central bank must attend to its own business, say little, and expect that over a period of years the results will speak for themselves.

While I have deprecated any claims to perfection on the part of central banks, I think that it is permissible to say that in any central bank worthy of the name you have an organization which has no axe to grind, no personal or selfish motives for its actions. Its interest is the public interest, and that is the interest which we shall try to serve to the maximum of our capacity.