Radio Address

Subject - "Bank of Canada"

By

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In the first of these two talks on the subject of the Bank of Canada, I said that I would try to answer the questions: What is the job of a central bank, and how does it do it? I mentioned that the primary duty of a central bank was to see that at any given moment in the development of its country's economy there was the right amount of money in existence, neither too much nor too little, and explained that by money I meant not only notes and coin, but also deposits in the banks. I went on to give the reasons why someone must be responsible for performing this duty, and explained some of the effects of variations in the quantity of money. To-night, I wish to describe how the central bank, in fact, controls the supply of money. The Bank does so through the medium of the other banks, and is, therefore, often spoken of as "the bankers' bank". Either by custom or by law, the commercial banks have to keep their cash reserves in the form of balances with the central bank, or in the form of the central bank's notes. In this way their reserves are all legal tender, or can at once be turned into legal tender. In Canada, the banks collectively keep about 10 per cent of their deposits in these two forms, and by law must keep 5 per cent. Under existing conditions, the central bank has control of the amount of these reserves. The next bit of what I am going to say is a little difficult, so I will speak slowly. By buying securities, or adding to its assets in any way whatever, the central bank increases the reserves of the other banks, because the cheques which it issues in payment for such securities, etc., are deposited in banks, and swell the deposits of the receiving banks at the Bank of Canada when the cheques are presented to the Bank of Canada for payment. In the same way, any sale or reduction of its assets by the central bank diminishes the commercial banks' reserve balances with it. This is the main way in which the central bank controls the amount of the other banks' reserves.

Now, if the commercial banks collectively wish to keep an amount equal to 10 per cent of their deposits in the form of cash reserves, and they receive some more cash reserves as a result of central bank action, the proportion of cash reserves to deposits will rise; and since 10 per cent is collectively the figure found sufficient - though some banks will be working to a higher and some to a lower ratio - they will collectively proceed to reduce their proportion again to 10 per cent, not by reducing their cash reserves, for this they cannot do, but by taking such action as will lead to an increase in their deposits by about ten times as much as the amount of extra cash they have received. The action they will take to bring this about is to make new loans or buy additional securities, for by so doing they will increase the deposits of their customers, as well as their own earning assets. The process works in the opposite direction if the central bank contracts cash reserves.

What I said a moment ago is related to that much discussed subject, the "creation of deposits". A few comments on that subject might therefore be appropriate.

I have always believed, though I have no means of proving it, that the people who discuss the "creation of deposits" as if it were a highly valuable privilege of the banks, think of bank deposits as an asset; and they therefore believe that the banks can create assets for themselves. That would indeed be a valuable privilege. In fact, however, while a bank deposit is an asset for the individual owner, it is a liability so far as the bank is concerned. It might save confusion then if we talked of banks creating liabilities - a thing any one of us can do if we have a reputation good enough to persuade someone to sell us goods on credit.

It is well to remember also that the procedure which I mentioned a few moments ago will not operate unless two conditions are satisfied:-

(1) The banks must be able to acquire securities which are safe and suitable from a banking point of view, or they must find credit-worthy borrowers who are interested in negotiating loans, and

(2) The people into whose hands the resultant deposits come must be willing to leave these deposits with the banks.

What should a central bank's general aim be? A central bank should endeavour to reduce as much as possible fluctuations in business. It should try to stimulate business at a time when confidence is weakening, and act as a restraining factor when there is danger of the development of boom conditions. As business comes out of a depression, first there may be a moderate and diffused prosperity, but later on a lack of equilibrium may show itself. Prices rise, but the prices of some goods may rise much faster than those of others, owing to a temporary scarcity or to speculation. Production of such goods may then be accelerated in the expectation that the higher prices will continue or go still higher. But the moment demand is satisfied, producers and merchants may find themselves with stocks of goods which they cannot sell at prices which will cover their costs, which will also have risen. If business is over-extended or misdirected on any important scale, and conditions of disequilibrium become accentuated, expectations which can never be fulfilled are aroused in important sections of the community. It is then only a question of time before a crash comes, prices fall all round, confidence is destroyed, and business becomes stagnant. It is the difficult task of a central bank to endeavour to foresee and guard against such a course of events so far as it can, while not checking the sort of revival which leads to a well-balanced prosperity. It must act firmly, not too early, but above all not too late. In the last resort a central bank can be fairly sure of being able to stop a boom, if it acts at the right moment. To help business out of a depression, however, may take a long time, and is much less certain of achievement. In keeping things on an even keel, the central bank needs the co-operation of the other banks, who should endeavour to make their loans in such a way that unsound positions will not be built up, and that the whole economy will move in a well-balanced way. The responsibility here is primarily with the commercial banks, but if the central bank has an established and deserved reputation, it can assist indirectly. Thus the banking system as a whole can exercise a wise and restraining or a stimulating influence; but it can never quite ensure, of course, that the industries and people of the country will use their incomes and their capital to the best advantage. Too much, therefore, must not be expected of the commercial banks and the central bank. Both, however, are indispensable pieces of machinery in our complex economic life.

Perhaps it is hardly necessary to say that if the Bank is to perform its duties properly, it must take a very close interest in all departments of the Canadian economy. Its closest connection is likely to be with the financial activities of its market - with the operation of the stock and bond markets as well as with the business of the commercial banks. It is deeply interested in the machinery by which the savings of the people are mobilized and invested. But the Bank's interests go beyond the scope of matters purely financial. It cannot fail to be concerned with the progress and development of particular industries. If the Bank has reason to believe that unsound developments are taking place, or unsatisfactory practices being followed in any important department of the Canadian economy, it must try to take steps or make suggestions which will bring about an improvement. I do not suggest for a moment that the central bank has superhuman intelligence. Activities of the type which I have just mentioned should be undertaken with prudence and restraint; and they depend for their success on the experience and prestige of the central institution.

In conclusion, let me remind you that the two main points I have tried to make in the course of my remarks on November 17th and this evening are these: Firstly, that the central bank is the primary agency responsible for seeing that at any given moment in the development of the country's economy there is the right amount of money in existence; and secondly, that in discharging its duties the central bank must operate with complete impartiality. Speaking of the first duty, may I repeat what I said two weeks ago, namely, that money is not wealth; it is only the go-between which enables persons who have wealth - that is, goods or services which people want - to exchange them for other goods or services which they want. Money is a medium of exchange. In some ways it may be compared to a lubricant. Just as an automobile requires lubricating, so do exchanges of goods and services need money. But it is possible to have too much money, just as it is possible to have too much oil or grease in a car for its efficient working. And the quality of the lubricant is also important.

The duty of acting impartially is not so difficult to perform. A central bank is not operated in order to make profits, and even if it were its fortunes are bound up with that of the whole country, and not with those of any section or sections of it. In many countries, of which Canada is one, central banks' profits are paid to the Government, that is, to the tax payer.

A central bank then, as you see, is a public institution created to serve the public interest. The fulfilment of that trust is the paramount concern - indeed it is the sole concern - of your Bank of Canada.