Speech by G. F. Towers,
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The subject I am speaking on tonight is not one which I would call tremendously difficult or technical. Yet it is not an easy subject to deal with in the course of a half hour's remarks. I think I shall be doing what you want me to do if I stick as closely as possible to the broad general outlines of central banking in general, and Bank of Canada in particular, and try to explain:-

(1) Why the machinery of a central bank is needed.

(2) How the machinery is operated, and with what objects.

Turning first to the question of why the machinery of a central bank is needed, I think it is obvious that at any given time a country requires a certain amount of cash for the conduct of its business operations. Cash, as I use the word here, means not only the circulating medium - the money which people carry in their pockets - but includes also the legal tender, or claims on legal tender, which constitute the cash reserves of commercial banks.

Now so far as Canada is concerned, cash in the first sense - that is, in the sense of a circulating medium - includes the notes issued by the chartered banks as well as the notes of the Bank of Canada. At the end of last December, for example, chartered bank notes in the hands of the public amounted to $96 millions, while Bank of Canada notes were held by the public to the extent of about $111 millions.

If we lived in a static economy where the volume of business, the velocity of circulation and the level of prices never varied from one month to another, or from one year to another, I suppose it would be possible to operate quite satisfactorily with an unchanging amount of money in the hands of the public. But no one does live in such an economy. In Canada, the amount of notes required by the public, i.e., the active circulation, varies with the seasons. For example, between June and December in an ordinary year the increase in active circulation is about $15 millions. The western grain crop, lumbering operations, Christmas trade and other factors are responsible for this change in the circulation every autumn. Over a longer term the minimum amount of notes outstanding will depend on the number of our population, the volume of business, the price level, and people's habits in regard to the means they use to effect payments. As you can understand, therefore, the amount of notes in the hands of the public is the result of certain factors, not the cause of them. And there is no sound reason why a change in the public's needs for circulating media should be allowed to influence monetary conditions. In other words, the note issue should be flexible, so that an increase in demand will not necessarily curtail the cash reserves of the chartered banks, nor a decrease in demand necessarily increase the cash reserves. A little later on when speaking of the operations of the Bank of Canada I shall indicate how this object can be achieved by a central bank.

Let me turn now to a much more important subject, namely, cash in the second sense in which I used the word, that is, the cash reserves of the chartered banks. These cash reserves, in so far as Canadian business is concerned, consist of notes of the Bank of Canada and deposits with the Bank of Canada. The banks are accustomed to operate with a reserve equal to about 10 per cent of their deposit liabilities in Canada. If their cash holdings increase, the banks tend to add to their loans and investments, if they can do so on a safe basis. At the same time as they increase their assets in this way, they also increase their deposit liabilities. Under such circumstances it is said that money is "easy", to use a current financial phrase. If the cash ratio of the banks gets unduly low, they curtail loans and investments, reducing deposits in the process, and money is described as being "tight".

No one could regard it as desirable that the volume of bank credit outstanding should always remain the same. Over a period of time changes must surely occur which would make an increase or decrease in bank credit appropriate. To look at the optimistic side of the picture, if the volume of business in the country is increasing, bank resources should be keeping pace with this development. Perhaps I should make the qualification that increasing rapidity of turnover of deposits may enable a larger volume of business to be financed without an increase in the amount of bank deposits. But it remains true that under appropriate circumstances the cash reserves of the banks must be augmented; otherwise, business may be greatly impeded. And at other times curtailment is in order if boom conditions are in view.

As soon as you can see that variations in the amount of cash are vital, it becomes apparent that some machinery must be set up to deal with this situation. And it becomes apparent, also, that the matter is of such great national importance that it cannot be dealt with by a number of unco-ordinated agencies. Some one body must be assigned the duty of exercising control, and have no other interests which would clash with its responsibility for the regulation of currency and credit. This is the reason why there are central banks in operation in most countries. Instead of having central bank functions performed by a department of government, the governments have preferred to intrust these functions to specialized institutions. The laws under which they operate vary. But the banks all have one thing in common: their monetary policy must conform to the policy of their respective governments. No other conception of the situation is possible in this day and age, nor would any other state of affairs be desirable in view of the vital effect which monetary policy can have on the affairs of a country.

Strangely enough, the supreme control of government in matters of monetary policy does not lessen by one iota the responsibility of central bank executives and directors. If things go wrong, in a monetary sense, while they are in charge of the affairs of a central bank, they are in no position to pass the responsibility on to the government. For it must be assumed that the policies which have been followed are in substance policies which they endorsed and recommended. If they did not agree, they should have said so. And in those circumstances they would, no doubt, have been replaced by others who did not share their objections.

I would like to turn now to a description of how central banking machinery is operated, and with what objects. I mentioned earlier in my remarks that the commercial banks' cash reserves consisted of notes of the Bank of Canada and deposits with the Bank of Canada. As at December 31st last, the banks held $54 millions of their reserves in the form of notes, and $196 millions in the form of deposits. The banks find it convenient to carry the bulk of their reserves on deposit with us, and to restrict their holdings of our notes more or less to the amount they may require from day to day. They know that the deposits can be exchanged for our notes at any time.

This being the form in which the chartered banks' cash reserves are maintained, let me explain how the central bank can expand or contract these cash reserves at will. We must assume, in the first place, that the central bank can buy securities or other suitable assets when it wants to, and can sell them when it wants to. The buying and selling of securities for this purpose are commonly known as the open market operations of a central bank. Suppose, for example, that the central bank buys $2 millions worth of securities; then, no matter who it buys these securities from, the reserves of the combined chartered banks will rise by that amount; if it buys from a bank or banks, their accounts at the central bank will be credited, and those accounts are part of their reserves; if it buys from someone not a bank, then the seller deposits in his account with some bank the cheque which he has received from the central bank. And the commercial banks' balances with the central bank are increased when the cheque is presented to and paid by the central bank. Exactly the opposite processes take place if the central bank sells securities.

Operations of this kind can be undertaken either to change the size of the chartered banks' cash reserves or to offset changes in the amount of Bank of Canada notes in the hands of the public - the amount of what we call our active circulation. Between the end of June and the end of December last year, the amount of our notes in active circulation increased by about $22 millions. Had no offsetting action been taken by the central bank, the cash reserves of the chartered banks would have decreased by an equal amount as our notes are paid out by the chartered banks to customers who require them. In fact, however, if you examine our month-end statements for June and December, you will see that during this period we added to our investments by the amount of $42 millions. This had the effect, amongst other things, of fully offsetting the increase in our active circulation, and adding nearly $17 millions to the chartered banks' cash reserves. I will not burden you with any more figures, but I may say that the return flow of circulation in January and February has been matched by a reduction in our investments.

While I have spoken at some length on the subject of fluctuations in active circulation, I should re-emphasize the fact that this matter can only be regarded as important in a negative sense. The country would be handicapped if we had no machinery to provide flexibility, and fluctuations in the active note issue provide me with a handy illustration of how that flexibility is achieved. The amount of the chartered banks' cash reserves is the factor of positive importance; and that leads me to the question of what guides a central bank in determining whether these reserves should be increased or decreased or allowed to remain stationary.

I wish I could say that there was a simple rule of thumb which could be used in dealing with this problem, but there is no such rule. The Bank must watch all the indications of business activity available to it, such as the volume of production, the level of prices both at home and abroad, the state of trade internal and external, the borrowing needs of the community, capital movements, seasonal requirements and so forth. It must also be concerned with changes in the relationship between wholesale prices, retail prices and the cost of living, and changes in the relationship between prices of consumers' and producers' goods, manufactured goods and primary commodities, as well as changes in the relationship between import and export prices. Disequilibrium between these separate sets of prices is liable to upset the balance of payments and national income. Generally speaking, the main objective must be the avoidance of disequilibrium. For if such a state of affairs develops to any major extent, there is likely to be trouble - a boom or a depression, or both.

When there is a state of stagnation - in other words, a depression - it is usually a good thing that the amount of money should be increased, perhaps very considerably, so as to try and create the conditions under which profitable spending may be resumed. There will have been a rapid decline in velocity, so this should be met by an increase in the volume of money, which is in such circumstances not inflationary, and may be a longish time in having its effect. It must be remembered that while an "easy money" policy on the part of a central bank will probably lead to an increase in chartered banks' assets and in the deposits of their customers, the central bank cannot impel the spending of these deposits. Nor, if the money is spent, can it determine the way in which the spending takes place. Its power, therefore, while most important, is by no means all-embracing.

Just as a central bank should try to stimulate business at a time when confidence is weakened, so should it act as a restraining factor when there is danger of the development of boom conditions. If a boom gets well under way, expectations which can never be fulfilled are aroused in large sections of the community, and it is then only a question of time before a crash comes, prices fall all round, confidence is disappointed, 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, 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 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 conditions will not be built up, and that the whole economy shall move in equilibrium. 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 influence; but it can never 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.

The central bank may perform a number of other functions subsidiary to its main responsibility for the regulation of currency and credit, but nevertheless of an important character. It acts as fiscal agent to and financial advisor of the Dominion Government, and may, by agreement, act in a similar capacity for provincial governments. The Bank, acting on behalf of the Minister of Finance, now brings out all Dominion Government direct and guaranteed issues in Canada. It must be prepared to give the Government advice in regard to the timing, the character and the price of such issues. It acts as the Government's banker in connection with purchases and sales of foreign exchange. The volume of these transactions is extremely large. Again, the Bank may be called upon - and, in fact, has been called upon - by governments to investigate and report on their financial position.

As an expert and impartial organization a central bank can be of service to the community in a great many ways. With that in mind, the Bank should do everything possible to develop its knowledge of financial affairs in particular, and the state of business in general, so that it will qualify as an expert advisor. Its impartiality should not be open to question unless it is a very poorly run organization indeed. This question of impartiality and independence of thought is, of course, a vitally important one. And a central bank which possesses these qualifications, linked with adequate experience and prestige, can sometimes accomplish things which others can not, not by virtue of superior knowledge but by virtue of its position in the community.

To say that a central bank has a great task and a great responsibility is almost an understatement. The Bank needs the interest and support of the community ad a whole, but it does not advertise, and its officers cannot indulge in speech making except to a very limited extent. It must rely on the general impression which it conveys to the public, and the more informed opinion of those with whom it is more directly in contact. But if organizations such as yours devote some time to the study of financial matters of general interest, including the study of central banking, and thus bring to some of your members a knowledge of the subject and the ability to criticize, I believe that you will be performing a public service.