Statement by Mr. Towers before Prices Committee, May 28, 1948
File copy 1145

At this stage I had proposed to confine myself to a rather brief general statement referring to the increase which has taken place in the supply of money and the reason why this monetary expansion took place.

The increase in Money Supply which has taken place since 1939 is accounted for by the increase due to Government war expenditure. War expenditure was financed in part by taxation and in part by borrowing from the public. But these two sources of funds did not cover the total financial requirements of the Government. Assuming that the level of Government expenditure was dictated by the necessity of winning the war, the residual financing required had to be obtained through the banking system even although this involved a substantial increase in Money Supply.

The question can be raised of course as to whether taxation was sufficiently high during the war years and whether the efforts made to encourage the public to save and loan its savings to the Government, were sufficiently intensive and comprehensive. I believe that quite a number of people both in Canada and other countries, ~~hold the view that Canada and other countries~~, hold the view that Canada's performance in the fields of taxation and public borrowing during the war was as good as could reasonably be expected. However, this is a matter on which the Committee will have its own views.

The expansion in Money Supply due to the war-time situation which I have described did not come to an end immediately with the cessation of hostilities. For some months following the end of the war, Government war expenditures (including under this heading demobilization expenses, gratuities, etc.,) remained at a high level and therefore the Money Supply continued to increase in that period. However, the peak was reached in October 1946 and there has been no further addition to Money Supply since that date.

As I mentioned in the Annual Report of the Bank of Canada for last year, during 1947 Government was in a position to make a substantial retirement of outstanding debt. This resulted in a very considerable decline in banks' holdings of Government securities and would, in itself, have been accompanied by a reduction in bank deposits of a corresponding amount. However, the increase which took place in banks' loans and securities other than those of the Government, approximately offset the reduction in banks' holdings of Government securities. The figure of Money Supply, therefore, declined only very slightly during 1947.

The increase in Canada's Money Supply as compared with the pre-war situation, has been somewhat less than the increase in a similar figure for almost any other country. For example, to take two of the countries with whose statistics it is customary to compare Canadian figures, between December 1939 and December 1947 Canadian Money Supply rose 168%, United Kingdom 202% and United States 214%.

No doubt the Committee will expect me to express some opinion as to the effect which monetary expansion in Canada may have had on the level of prices. That is not something which one can do with any claim to accuracy. The level of prices is the result of many factors and it simply is not possible to isolate their separate importance. In his evidence before this Committee some time ago Mr. Taylor, Chairman of the Prices Board, mentioned various non-monetary influences which have had a considerable bearing in the determination of Canadian prices. This is particularly true in the case of consumer goods which are so heavily influenced as a group, by import and export prices. In the case of capital goods, it is probable as indicated in the Bank of Canada Annual Report for last year, that the tremendous rate of capital development did have an upward influence on costs and prices in that field. The war-time developments to which I have already referred had left ample financial resources available to finance this capital programme. The problem has been to gauge when plans under contemplation were tending to outrun manpower and material resources and then to judge the limits within which action in the field of money and credit could be taken which would help to moderate the pressure without being so drastic as to cause unemployment.

As long as Government war financing needs were large enough to require assistance from the banking system it was not feasible to take restrictive monetary action. The first improvement in this situation became possible after Government came into possession of a considerable cash balance following the Ninth Victory Loan campaign in November 1945. While war expenditure (including demobilization expense, gratuities etc.,) ran at a high level for several months more, there was no more general public borrowing or bank financing required.

Discussions with the chartered banks were started in January 1946, which ended in what is commonly called the Savings Agreement. This agreement limited the banks holdings of Government market securities (as distinct from special banking issues such as treasury bills and deposit certificates) to not more than 90 percent of their personal savings deposits. Since the largest banks Government bond holdings were at or about the 90 percent figure at that time, the result was to guard fairly effectively against any major further addition to Money Supply due to banks continuing to buy Government bonds in the market. Another feature of the Savings Agreement was an undertaking on the part of the banks not to exceed an agreed rate of earnings on their investment portfolio of Government bonds. One result of this arrangement was that if banks wished to sell Government bonds in order to expand their loans and non-Government securities, they had to sell on the average a fairly long term bond giving a remunerative yield; if the banks sold short term low yield bonds exclusively, the yield on the remainder of their investment portfolio would go over the agreed limit. The increase in earnings which banks might stand to obtain by having loans instead of Government bonds was thus somewhat reduced.

Later, Government's budget position improved to the point where there was an overall cash surplus and debt retirement became possible. This had the effect of reducing the amount of money in public hands. At the same time the transfer of such funds to Bank of Canada made it possible to effect some reduction in the cash reserve ratio of the chartered banks. During the latter war years and through 1946 the cash reserve ratio of the banks averaged about $11\frac{1}{2}$ percent. By mid-1947 the cash reserve ratio was down to about $10\frac{1}{2}$ percent and the chartered banks on balance had become net sellers of Government bonds in the market in contrast to the substantial purchases made in previous years.

In January and February of this year as the Minister of Finance mentioned in his Budget Speech market forces were permitted to bring about an increase in the rate of interest on Government bonds. In the case of the longest dated issues the increase in yield was from about 2.6% to just under 3% per annum. This increase in yield represented a decline in price of about $4\frac{1}{2}$ points. While it was not anticipated that this change in interest rates would have any major effect on the rate of new capital investment it was felt it was a step in the right direction under existing circumstances.

In his Budget Speech the Minister of Finance also referred to the unlikelihood of the general public becoming a net buyer of Government bonds under existing conditions, at any reasonable level of interest rates. If the general public is not a net buyer of Government bonds -- and I agree with the view expressed by the Minister in that regard -- it is not feasible for the Bank of Canada to carry what is usually called "open market" policy beyond the stage which I have already described. Further reduction in the cash reserve position of the chartered banks would involve the central bank selling Government bonds. If the chartered banks were in a tight cash position they would not be buyers so that the only potential buyers would be the general public who - as has already been mentioned - are most unlikely to be net buyers in practice under present conditions.