CANADA'S CENTRAL BANK

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Address by MR. GRAHAM TOWERS, Governor
of the Bank of Canada to
The Institute of Chartered Accountants of Ontario
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EXTRA

I have often been asked to give a brief and simple explanation of why we have a central bank such as the Bank of Canada and to describe its activities. This is a difficult - perhaps an impossible - task because a discussion of banking in general and central banking in particular is bound to contain a certain amount of technical material which is not readily understood unless one has some familiarity with the subject. For this reason I have shied away from making speeches about the Bank of Canada except for some very elementary remarks shortly after the Bank was established. The invitation for me to speak to you this evening was accompanied by a suggestion that the subject matter of my remarks might be the Bank of Canada and possibly also the Industrial Development Bank. I accepted both the invitation and the suggestion, feeling that if I could not make the activities of these two institutions live and comprehensible topics for an audience such as this, then something was rotten in the State of Denmark. If you find that the choice of subject was a poor one, I ask you to place part of the blame on Mr. Grant Glassco. Let me remind you that he was one of our auditors last year and that at the time when he talked to me about this meeting, our certificate for 1948 had not been signed.

The first point that comes to my mind about the Bank of Canada is the situation which ultimately led to its establishment. Canada is not a country which moves with undue haste in matters of thid kind and one has to go back to 1914 to understand why the Bank of Canada Act was passed in 1934. Until the First World War, the Dominion Government note issue has to be backed 100 percent by gold except for a comparatively small fiduciary issue. Any increase in the issue of legal tender, therefore, required an addition to our gold reserves. At the beginning of the First World War it was recognized that an increase in legal tender was both essential and inevitable if war activities were to be financed. Dominion Notes would be required both for public circulation and to meet the need for larger cash reserves of the chartered banks as their business expanded. However, with a war on and the United Kingdom off the gold standard, it was most unlikely that Canada would obtain the additional gold backing for any considerable increase in the Dominion Note issue. In these circumstances, Parliament passed the Finance Act in 1914. This measure authorized the Government to lend Dominion Notes to the banks against the deposit of appropriate security. The Finance Act of 1914 was in fact a recognition that at least some of the facilities of a central bank were needed in Canada.

Shortly after the end of the First World War some Canadian bankers, notably the late Mr. E. L. Pease, felt that while the Finance Act had rendered invaluable assistance during the War, it left something to be desired as a permanent piece of financial machinery. They proposed that the Finance Act should be replaced by a central bank. However, they found few supporters and many opponents. In 1923 the Finance Act was reconstituted on a peace time basis and in the years following up to 1929 its facilities were used on a large scale and at the peak of the 'boom' in 1929 borrowings by banks under the Finance Act reached the amount of $111 millions. Then came the crash and the deficiencies of the Finance Act became obvious. The events that followed made the banks most anxious to reduce their borrowings under the Finance Act and in the process their cash reserves were brought down to an uncomfortably low level. This decline in their liquidity put pressure on the banks to reduce their loans and investments. Efforts by banks and others to sell caused market yields on high grade securities to rise considerably, tending to discourage new capital investment at a time when the opposite result was desirable. To some extent also, banks' own impaired liquidity made it impossible for them to look after their customers' normal credit requirements.

Since the period of depression following 1929 was an almost world-wide catastrophe, it is inconceivable that any domestic policy - monetary or other - could have shielded us completely. But it became apparent that in addition to the unfavourable non-monetary factors at work, the banking situation to which I have just referred, was contributing a further and undesirable deflationary pressure. After the pros and cons of the matter had been aired before a Royal Commission in 1933, the Commission reported in favour of a central bank and Parliament passed the Bank of Canada Act in 1934. In March 1935 we opened our doors.

Fourteen years have passed since that time and I believe it would be difficult to find another period of like length in our history, when Canadians had to cope with as important and varied national problems as those which we have faced since 1935. Within this relatively brief space of time we emerged from the worst economic depression the world has ever seen, survived five years of all-out warfare and then went on to a post-war period of full employment in which the market for our products, generally speaking, has been greater than our ability to supply.

Before describing the Bank of Canada's operations during this period I think it would be desirable for me to refer briefly to the broad objectives which the Bank of Canada was expected to seek, and which were outlined in the Preamble of the Act of Incorporation, reading as follows: 'It is desirable to establish a central bank in Canada to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion.'

You will notice that throughout the Preamble it was emphasized that the objectives of the Bank were to be 'general' or 'national' in their scope. This emphasis reflected the fact that monetary action by the central bank would not be appropriate for dealing with localized problems. The Bank was to concern itself with providing the broad financial background which would encourage a high and sound <u>overall</u> level of economic activity.

It is also important to note that the Preamble limited the objectives of the Bank to the extent that they might 'be possible within the scope of monetary action.' This recognized that variations in the general level of 'production, trade, prices and employment' were importantly influenced by factors other than monetary action by the central bank and that there might be circumstances in which the best monetary policy would not be sufficient to counteract other influences. While the Bank's primary responsibilities are in the monetary field it is, of course, necessary for us to be in touch with every phase of Canadian affairs which has a bearing on economic activity.

The story of the Bank of Canada's operations since 1935 can conveniently be divided into three periods - pre-war - war - and post-war.

Pre-War Period

The pre-war period of our operations began after recovery from the worst effects of the depression had started, but unemployment was still very evident and in the circumstances an 'easy money' policy was appropriate. For that reason the Bank of Canada carried on 'open market' purchases of Government securities which increased the cash reserves of the chartered banks and maintained their liquidity somewhat above the normal level so that they would have an incentive to expand credit in the form of loans or security purchases, as opportunities were presented. The overall result of monetary action in these years was quite substantial as is indicated by the fact that total Canadian bank deposits and note circulation in August 1939 were about 14 per cent higher than in the former peak year of 1929.

One of the more apparent results of easier monetary conditions was the decline which took place in the yields on high-grade securities. For example, the rate on long-term Government bonds declined from an average of more than 5 percent in 1932 to approximately 3 percent in the years 1936-39. Many borrowers - both public and private - took advantage of the lower level of interest rates to refund obligations incurred at higher rates and so reduce their fixed charges.

Ideally, it would have been desirable for the reduced level of interest rates to have stimulated a substantial further increase in the rate of new capital investment which in 1939 was still only about one-half the 1929 level. In that event our favourable balance of payments on current account in those years would have been used to finance larger imports of capital goods. However, depression psychology had taken such a firm hold that even easy money conditions and lower interest rates failed to stimulate an adequate volume of new investment. Under the circumstances, our favourable trade balance was largely used for the repatriation of debt previously held abroad.

However, a very considerable improvement in economic conditions did take place in the period 1935-1939. The gross value of production which fell from $6 billions in 1929 to only $3½ billions in 1933 because of the decline in both physical production and prices, had recovered to $5.6 billions by 1939. But for the continued low level of prices for farm products because of conditions in foreign markets, our gross value of production in 1939 would considerably have exceeded the 1929 level.

Although the rise in economic activity to which I have referred was large enough to restore the 1929 physical volume of production by 1939 it was not enough to produce full employment due to the increase in the number and productivity of our population of working age and therefore we entered the war period still with a considerable amount of unemployment.

<u>The War Period</u>

The outbreak of war made it evident that there would be more than sufficient demands to absorb all our resources and it was only in the early stage when some additional monetary expansion was deliberately undertaken.

During the remainder of the war period the Government endeavoured to meet as much as possible of its expenditures by taxation. However, as the scale of war expenditure increased, taxation - even when pushed to what seemed to be the practical limits - provided only about half the total amount of funds required.

There was no alternative but to finance the remaining part of the Government's fiscal needs by borrowing - which meant an increase in the general public's holdings of liquid assets. When borrowing took the form of purchases of Government securities by banks, the increase in liquid assets of the public was in the form of currency and bank deposits. When the borrowing was by means of selling Government securities to the public, the increase in public holdings of such securities represented an increase in their liquid assets. An effort was made to persuade the public to invest as much as possible of its liquid assets in Government securities rather than currency or bank deposits, largely because it was more likely that the public would associate the increase in its holdings of Government securities and the great need for saving during the war period.

Government borrowing from the public during the war years was at rates of interest which, broadly speaking, were approximately the same as the pre-war interest rate structure of the years 1936-39.

Neither Canada nor any other major country felt that the effectiveness of the intensive war-time savings programme would be increased by higher interest rates on Government bonds. Indeed, an upward trend in interest rates might well have seriously impaired the voluntary savings programme because the public would have been unwilling to buy bonds if it was likely that bond prices were going to drop.

In the wartime circumstances which I have just described the best we could do was to try and see that credit expansion did not exceed, in any material way, the amount required for the essential purpose of winning the war. The Bank of Canada tried to keep the banks' cash reserve position as near as possible to what was regarded as 'normal' so that they would not be encouraged to make any unnecessary credit expansion because of 'excess' cash reserves. The fact that the average ratio of cash reserves to Canadian deposits rose from about 10½ percent before the war to 11½ percent in the latter war years was not so much indicative of excess cash reserves, as of the fact that under war conditions banks' ideas about their normal cash ratio had increased somewhat.

Two other considerations were also very important in restraining unnecessary credit expansion during the war years. Direct Government controls of one kind and another prevented the public from undertaking non-essential activities of most kinds, so that there was much less pressure to borrow funds from banks for such purposes than would otherwise have been the case. Finally, I believe that the banks themselves had a clear understanding of the kinds of transactions which were not in the general interest under wartime conditions and that they exercised a good deal of common sense in avoiding undesirable or speculative lending. The fact that there was no appreciable overall increase in banks' loans and non-Government investments during the war period, in spite of the large increase in economic activity and prices, is I believe fairly good evidence that non-essential credit expansion was, in practice, kept to a minimum.

Post-War Period

Following the last Victory Loan in the fall of 1945 a strong market for Government bonds developed and the interest yield on the longest-dated issue declined from 3 percent to about 2.6 percent per annum. This trend was not due to central bank action but rather to support from non-banking investors. United States Government bond prices also rose during this period, the long-term issues yield declining from about $2\frac{1}{2}$ percent to just over 2 percent per annum.

After this flurry of strength the bond market returned to the position where the general public was on balance an appreciable net seller of bonds. There was nothing unexpected about this situation in view of the large increase in public bond holdings during the war and the extent of deferred expenditures and investments of various kinds. In addition the rate of such public bond selling showed a definite downward trend and there was no particular evidence that it was encouraged because the public felt that interest rates were too low.

In the final quarter of 1946 and during 1947 the monetary situation was improved because the Government had an overall cash surplus of substantial proportions available to reduce the total liquid assets held by the public. In part, this surplus resulted from the reduced scale of war and demobilization expenditure; in part, it was due to the loss of foreign exchange reserves. The Government applied the major portion of this cash surplus to redeem bank-held Government securities. As a result of the Government surplus, total liquid assets of the general public declined somewhat in 1947 even though there was a large increase in chartered bank loans and non-Government securities.

Towards the end of 1947 the picture changed. The United States bond market entered a period of weakness with certain psychological reactions on Canadian investors, and the rate of Canadian net public bond selling which had almost vanished by mid-1947 turned sharply upwards. At the same time it became evident that the rate of new capital investment was going to be materially increased - even though with full employment of labour and materials this could only result in driving up dollar costs rather than physical quantities of such investment.

Market forces were permitted to bring about an increase in the rate of interest on Government bonds in January and February 1948. The yield on the longest-dated issues rose from about 2.6 percent to just under 3 percent per annum - representing a decline in price of about $4\frac{1}{2}$ points. At that time the Bank made a public statement to the effect that this increase in interest rates did not appear inappropriate at a time of very large capital investment, but that the Bank was not in favour of a drastic increase in interest rates which might prevent essential forms of capital investment which Canada needed.

Also in February 1948 Bank of Canada suggested to chartered banks that it was, in general, inappropriate to finance business capital expenditures by means of bank credit at a time when the expressed intentions of business to increase materially the rate of such spending could only serve to drive up dollar costs still farther. An exception was made in the case of small concerns which would not be able to do public financing. In February of this year the Bank announced that it had withdrawn this suggestion to the banks because the abnormal pressures which had given rise to it had abated somewhat.

During 1948 the Government's over-all cash surplus available to reduce the total liquid assets held by the public, was small as compared with 1947. The main factor in the change in the Government's cash position between 1947 and 1948 was the development of a substantial export balance in Canada's international transactions during 1948 which was used to rebuild the exchange reserve and made it necessary for the Government to advance to the Foreign Exchange Control Board the Canadian dollars needed to finance this increase in reserves.

The increase in chartered bank loans and non-Government investments during 1948, though much less than in 1947, was still considerable and somewhat larger in amount than the Government's over-all cash surplus. The net result, therefore, was that in 1948 there was an increase in the general public's aggregate holdings of liquid assets, which came very close to offsetting the reduction which had taken place during 1947.

As I have already mentioned, much of the war-time increase in the general public's holding of liquid assets was the result of fiscal necessity and not necessary on economic grounds. Probably therefore some decrease in the aggregate of such liquid assets after the war period, if feasible, would not have been inappropriate. However, this could have taken place in only two ways. First, Government might have maintained larger overall cash surpluses than have in fact been received. I do not know whether more strenuous efforts in this field would have met with general public support. Secondly, there would have had to be less increase in chartered bank loans and non-Government investments in the post-war period. On this point I think it was inevitable that there should have been a substantial increase in bank loans in the circumstances of 1947 and 1948. There was an increase in the physical volume of business in those two years and a strong upward influence from other countries on our price level; both these factors involved an increase in the current financing requirements of business, which at the same time was making large expenditures for capital replacement and expansion.

When a country is waging an all-out war, in practice monetary action cannot be wholly conceived in terms of its effect on 'production, trade, prices and employment' (to quote from the Preamble to the Bank of Canada Act) but in effect monetary expansion becomes the residual instrument of fiscal policy. After several years of all-out war when monetary expansion of necessity has exceeded economic requirements and when the general public (and governments as well) have accumulated urgent backlogs for consumption and capital goods, it is not likely to be feasible to reduce the public's total liquid asset holdings, to a major extent. To a large degree the remedy for the monetary situation inherited at the end of such a war period, must be to encourage as large as possible an increase in the physical volume of production and trade. In that event upward pressure on the general price level is minimized.

It is not yet certain that the world is ready to settle down to normal, peacetime existence which would avoid the extremes of economic behaviour that tend to limit the effective scope for monetary action. But in view of the importance and variety of the national problems we have faced in the first fourteen years of the Bank of Canada's existence, I believe that properly-timed action by the central bank can continue to make an appreciable contribution towards the economic welfare of Canada.

Industrial Development Bank

In one important respect the scope of the Bank of Canada's activities has been increased beyond the type of monetary action envisaged at the time of its establishment. I refer, of course, to the setting up of the Industrial Development Bank in 1944 as a wholly-owned subsidiary of the Bank of Canada. I am sure that many of you have come in contact directly or indirectly with IDB operations during the course of the past four and a half years.

Chartered accountants have a better opportunity than most people to appreciate the financial problems faced by small and medium-sized industrial concerns seeking to become established or to expand the scale of their activities. It is usually possible for such firms to obtain reasonable working capital assistance through chartered bank loans but very difficult for them to obtain longer-term money to finance plant and equipment because they are too small to go to the market for new public security issues. It is this type of situation which the

Industrial Development Bank was designed to meet.

When IDB was first established some doubts were expressed as to whether the 'gap' in our financial machinery to which I have referred was significant enough to warrant a new lending institution. In its first four years of operations IDB dealt with 1,640 applications for credit, of which 535 were withdrawn by the applicants because their requirements had been found elsewhere or for other reasons; 519 refused by the Bank and 586 authorized for a total amount of $39,027,624. The 586 credits which the Industrial Development Bank authorized during its first four years of operations, have been widely distributed. A classification of the Bank's loans shows that almost every type of industrial enterprise is represented and we have extended credit in every province of Canada.

We have found it necessary to include a considerable number of specialists on the staff of Industrial Development Bank. In addition to officers with banking experience, there are engineers, chartered accountants, lawyers, and men with a background in insurance matters. I am sure you realize that the smaller business concerns are usually not equipped to provide these services. For example, we have very often found it necessary to give advice to clients regarding the maintenance of proper books and audits in order that they themselves as well as IDB will know whether the business is actually making progress or not.

For reasons of this sort, the expense of carrying on the type of lending in which IDB is engaged, tend to be rather heavy and doubts were expressed in 1944 as to whether IDB could be financially successful in this type of financing. On other occasions I have said that it takes at least ten years' operating experience under varying economic conditions to get a fair picture of the financial results of an institution such as IDB. In the four year period actual losses have amounted to only $34,340.12 and reserves amounting to $1,083,612.09 have been accumulated. There are undoubtedly accounts on the Bank's books on which additional losses will be suffered, but there is nothing discouraging about our experience to date.

I might mention one other problem which we have experienced in connection with IDB. That is the matter of making our facilities known to potential borrowers without engaging in the kind of advertising or promotion which would be out of place for a residual lending institution of this kind. There have been occasions when chartered accountants have suggested to their clients that IDB might offer a solution to their financial problems. I think it would be helpful to all concerned if industrial firms requiring medium - or long-term financing were at least made aware of the existence of IDB.

Earlier in my remarks I suggested that the Bank of Canada had lived its life during a period distinguished by unprecedented problems. It has also been a period of great development. Between the years 1939 and 1944 the volume of production - and I underline the word 'volume' - increased about forty per cent although the increase in the employed civilian labour force was only about fifteen per cent. Effective organization, continuity of production and last but not least, heavy investment in new plant and machinery all contributed to this remarkable result during such a short period of time. It is this ability to increase our productive capacity which, taken in conjunction with other measures, has proved such an effective barrier to the more extreme type of inflation with which so many other countries have been plagued. We were able to supply our overseas partners in the war with $11,000 millions worth of goods and services, and after the war, in the years 1946-1948, to extend credit and relief to other countries to the tune of $1,600 millions. Over and above these activities, we have since 1945 been engaged upon the greatest peace-time programme of capital development which has ever taken place in Canada. However, all this had not taken place at the cost of lowering the standard of living of our people. On the contrary, the increase in our total volume of production has supplied a larger amount of goods and services for domestic consumption with the result that our average standard of living has shown an appreciable increase not only during the past decade but also as compared with the last period of peace-time prosperity and high employment in the years 1928-1929.

These are some of the good features of Canadian economic history in recent times. I think we do well to remind ourselves of such a remarkable record of performance, so that we do not become discouraged by the problems which undoubtedly lie ahead. One cannot forget that our export trade normally accounts for about 20/25 per cent of our total production, nor that the war has greatly changed for the worse the situation of some of our major and traditional customers abroad. So far, as the record shows, this has not interfered with our having a high level of prosperity in Canada. To a large extent, this has been because the countries concerned have received large credits, and, more recently, ERP aid, which has enabled them to maintain their dollar imports at a high level. But they have been urged to make plans which will greatly reduce, if not eliminate, their dollar deficits by 1952. If such a balance in their dollar trade is chiefly attained by an increase in their exports to dollar countries, well and good. But if they rely in large measure on reducing their imports from dollar areas, or on bilateral trade deals among themselves, the outlook for Canadian export trade would not be favourable. Already there have been instances of developments along these lines having an adverse effect on certain Canadian exports.

It is not for me to predict - indeed it would be impossible for anyone to predict - just what the outcome of this situation will be. A forecaster in 1945 might well have felt entitled to take a gloomy view of Canadian prospects in the years immediately following the war, having in mind the vast destruction and dislocation which had taken place over a large part of the world. Events would have falsified any such prophecies. It might be equally wrong today to forecast a period of effortless and untroubled prosperity. With so much of the world in trouble, North America can hardly expect to avoid some toil and sweat, and perhaps a few tears. But I do feel, so far as Canada is concerned, that the high quality of our population, and the character of our natural resources - so much needed by the rest of the world, including our neighbours to the south - provide a sound basis for an optimistic estimate of Canada's prospects over the years, unless one subscribes to the view, which I most certainly do not, that common sense has vanished from the international scene.