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Address by MR. GRAHAM TOWERS, Governor
of the Bank of Canada, to the Board of Trade,
St. John's, Newfoundland
Monday, June 19th, 1950.

I would like to take this opportunity of my first visit to Newfoundland to tell you something about the purposes and activities of the Bank of Canada. I report to you as proprietors of the Bank, inasmuch as its share capital is wholly owned by the Government of Canada and all profits earned form part of the Government's revenues. Although they may not all be conscious of it, every Canadian is affected by the operations of the Bank of Canada, and in a sense is a shareholder.

Before dealing directly with the Bank of Canada's activities, I think I should say something about the nature and functions of a central bank. Central banks have come to be a recognized feature of the modern state...sort of 'standard equipment' one might say...called into being as a result of the complex and interwoven strands of domestic and international finance. And as one would expect, central banks have many characteristics in common. One such characteristic is, I fear, that the functions of central banks are not widely understood. This is only natural, because the banking business of the citizen is normally conducted with the commerical banks - the banks that we in Canada call chartered banks. The typical central bank, on the other hand, does business mainly with the Government and the commercial banks of its own country, and with the central banks of other countries.

The central bank's most important function is that of being the depositary for the commercial banks' cash reserves. Just as persons and companies keep a part of their financial resources in the commercial banks, so the commercial bankers keep their cash reserves on deposit in the central bank, or hold them in legal tender in the form of the central bank's notes. The financial commitments and volume of business that an individual or company can undertake depend to some extent on resources in the form of cash in the bank. In much the same way, the commitments and obligations of a commercial bank are limited by the cash reserve which, by custom or by law, it feels obliged to hold in the central bank. The central bank has ways of increasing or decreasing this cash reserve, and these changes in turn cause the commercial bank to expand or contract its obligations through lending or putting into investments more money or less money. It is by this indirect control over the quantity of money, and by other similar measures, that the central bank attempts to promote the economic and financial welfare of the nation. The typical central bank has a number of other activities, but its primary responsibility is in the field of currency and credit.

Having in mind that for a great many years most countries of any importance have felt it necessary to have a central bank, it may seem surprising that Canada should have established one only fifteen years ago. Perhaps the explanation can be found in the caution which so often characterizes our attitude towards change. I am speaking, of course, of a time prior to March 31st, 1949, when new blood was injected into our veins. It required the events of the depression years of the early thirties to stimulate a strong and practical interest in the creation of a central bank. Parliament passed the Bank of Canada Act in 1934, and in March, 1935, we opened our doors.

The broad objectives which the Bank of Canada was expected to seek were outlined in the preamble of the Bank of Canada Act 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 strictly local affairs. The Bank was to concern itself with providing the broad financial background which would encourage a high and sound overall 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 fifteen years since the creation of the Bank of Canada have been eventful ones, quite different from what the creators of the institution expected - and quite different, I can assure you, from what the officials of the Bank expected. The first four and a half years of relative stability enabled us to organize and find our feet, but from 1939 onwards we have operated in conditions for which orthodox central banking theory provided no guidance, adapting ourselves and the organization first to the rigours of wartime economic policy and then to the problems created by the unprecedented post-war investment boom. It is with this experience in the background, and continually changing economic problems and institutions in the foreground, that it is not easy to describe exactly the role of a central bank in a changing world.

Our principal contribution to the Canadian economy in the years before the war was commonly called an <u>easy money</u> policy designed to remove deflationary influences and to encourage the moderate recovery that had taken place from the low point of the depression.

Our objective was to create a situation in which credit-worthy borrowers desiring to obtain funds for capital development or other purposes would readily be able to do so at interest rates which would tend to encourage their activities, rather than the reverse. Whether or not business or other potential borrowers responded to this encouragement obviously depended on a number of things other than money rates. In fact, a fair degree of improvement in general business and capital development took place during the years 1935 to 1939. The improvement was sufficient to reduce, but not to overcome, the unemployment problem of those days.

The outbreak of war made it evident that before long the appropriate economic policy would change from one which sought by monetary expansion to add to consumer demand for labour and productive resources to one whose objective was to curtail non-war demand. It was recognized that unless the Government's vast war expenditures could be financed by taxes or bond issues which were purchased from current savings, an inflation of prices would inevitably take place. It was therefore the war-time duty of Government to go as far as practicable in raising taxes and encouraging savings. I think it is the general view that Canada did a relatively good job in both these fields during the war years. Even so, the scale of the war effort was such that a substantial increase in bank deposits and currency took place.

In the early years of the post-war period, inflationary influences were overpoweringly strong. War-time controls, which had held prices down by force or by subsidies, were gradually removed, as indeed they had to be, sooner or later. Price increases in other countries inevitably spread to Canada through the all-important influence exercised on our import and export price levels. Moreover, there were important legacies from the war in the form of widespread holdings of war bonds and large holdings of cash by businesses and individuals. The liquid asset holdings of corporations were in many cases used directly to finance post-war capital expenditure, and the holdings of individuals facilitated large public issues of securities. There was bound to be a fairly substantial rise in bank loans as business returned to wholly civilian activities, and turnover and stocks increased. So far as Government was concerned, the most significant contribution which could be made to an abatement of inflationary pressures lay in the maintenance of substantial surpluses of cash receipts over disbursements, and this was the policy which was adopted. It was the opinion of Bank of Canada that drastic action in the monetary field designed to raise interest rates and curtail credit would have done more harm than good. But there was reason to exercise care in the extension of credit, to avoid accumulation of excessive business inventories; and there was a time when it was particularly desirable that new capital development should not be financed by bank advances. On various occasions, we expressed views along these lines. I believe that the chartered banks shared these views, and determined their policies accordingly.

It appears that, commencing last year, we have passed on to a new stage. The level of capital investment remains high, but the period of substantial annual increases on this account is apparently over for the present. As a result of increases in production, the inflationary pressures of the early post-war days have largely disappeared. Such a situation, when observed in its entirety, has a deceptive appearance of balance and normality, the product of various degrees of abnormality offsetting one another. What new developments may be expected during the next few years I certainly shall not attempt to predict, as a harsh fate awaits central bankers who claim the faculty of being able to see around corners. But it can be said that Canadian business has shown a remarkable ability to adapt itself to changing conditions during the last ten years, and that we should be able to give a good account of ourselves in the future.

I have given you a very abbreviated and simplified description of Bank of Canada activities since 1935, not to register claims of perfection on behalf of the Bank but rather to illustrate the duties and preoccupations of a central bank under varying circumstances. I have spoken hitherto of our more obvious functions imposed on us by statute. It is also the duty of a central bank to act as financial advisor to its Government. In order to retain the ear and respect of Government, the Bank must manage to give more good advice than bad. There is always the risk that the bad advice may unwittingly be accepted, and the good rejected. So it is most desirable that the percentage of good advice should be decidedly high.

The war and its aftermath brought to us a number of new activities, as well as a great enlargement of our normal business. The Bank participated in planning and providing the staff for the operation of foreign exchange control. It played its part in the National War Finance Committee which organized the great Victory Loan campaigns. Its staff made some material contributions to the task of organizing the International Monetary Fund and the International Bank for Reconstruction and Development, and to the subsequent work of the Boards of Directors of these organizations. Since 1944 we have been responsible for the activities of the Industrial Development Bank about which I shall say more in a moment. Before doing so, however, I would like to mention certain of the functions which bring Bank of Canada into its closest contact with that mythical person known as the Man in the Street. These functions are the issuance of currency and the management of the public debt. I imagine it is safe to say that thousands of Canadians know that there is such an institution as the Bank of Canada only because the folding money they carry in their pockets bears its magic name. Bank of Canada is responsible for the distribution of new bank notes and the destruction of those that become too worn for further use. As an example of the volume of currency we handle in a year, you might be interested to know that in 1949 we shipped from Ottawa to Agencies of the Bank of Canada and to the chartered banks some 125 million new bank notes. The same year we received from the chartered banks about 120 million notes which had become unfit for circulation and had to be destroyed.

The story of the redemption of destroyed bank notes would provide material for a twenty minute talk all by itself. It is amazing how many people choose, for instance, such an unlikely place as a kitchen stove to cache the family savings. I hardly need to tell you what happens all too often. Someone gets up on a cold morning and lights a fire in the kitchen stove. Someone else remembers the hidden treasure and the fire is put out amid great excitement. A soggy bundle of charred bank notes is finally retrieved from the ashes. Often they are so badly burned they are completely unrecognizable as currency. But chemistry and human skill can work minor miracles with material like this, and many a bundle of charred, mildewed or water-logged paper has been accepted at the Bank of Canada, the individual bank notes identified and full replacement made.

Another function of the Bank of Canada is the management of the Government's funded debt. This involves, amongst other things, the delivery of new bonds in the proper denominations to agency points whenever an issue is placed on the market. It involves, also, the maintenance of records regarding the holders of registered securities, the issuance of interest cheques to holders of registered bonds, the payment of coupons on bearer bonds after they have been cashed by the commercial banks, and the redemption of matured issues of all forms of Government debt, including War Savings Certificates and Savings Bonds. Once again, perhaps I can mention a few statistics to give you some indication of the volume of detail represented in this work. Last year, we received for transfer and exchange three million bonds with a value of more than six billion dollars. We handled and checked 23 1/2 million interest coupons, issued more than a million interest cheques to holders of Government registered bonds, and nine million cheques covering the redemption of War Savings Certificates. In addition to handling this heavy traffic, the Public Debt Division staff has to deal with thousands of anxious enquiries every year. Enquiries about bonds which have been lost or destroyed; about redemptions and maturities; about the settlement of estates which involve Government bonds; all these reflections of individual problems and needs keep the job from settling down into mere routine for long.

The Bank of Canada is a comparatively young institution but the Industrial Development Bank is still younger. Dating from the end of 1944, it was created by Parliament not to compete with existing lending institutions but to supplement their activities. It is intended to provide financing for companies engaged in manufacturing or processing, and certain other activities - mainly small or medium-sized concerns which are not otherwise able to obtain loans on reasonable terms and conditions. Such companies may not be large enough or sufficiently well known to make a public issue of bonds or stocks. They may need financing repayable over a term, or on a type of security which makes it unlikely that a commercial bank would wish to undertake the business. The Government felt that there ought to be some institution in Canada which could provide credit in such cases, and in 1944 Parliament passed the Act which set up the Industrial Development Bank as a subsidiary of the Bank of Canada. While the figures of credits authorized by the Bank since its inception are not extremely large judged by post-war standards, the thing which seems to me impressive is that the Bank has assisted over seven hundred small and medium-sized companies as well as a few larger enterprises. The communities in which these seven hundred concerns operate have benefited directly from increased employment and increased business activity; and this in turn has benefited the national economy.

The typical loan is one where a new enterprise, or one contemplating expansion, needs to make an investment in plant and machinery. It may be able to find the funds to cover part of the cost but not the whole thing. If the Industrial Development Bank believes that the project has a reasonable chance of success, and that the investment of owners provides a fair degree of protection for the loan requested, the Bank will authorize a credit. Repayment terms are tailored as far as possible to fit the special circumstances of the business concerned. Some loans are repayable in a comparatively short period of years; others run for ten years or more.

In framing the Act, and in the discussions which took place in Committee, Parliament made it clear that the Bank was not intended to subsidize inefficiency nor to act in any sense as a Santa Claus. It was expected to take risks and, on occasion, to experience losses. We have done both, but, as trustees of public funds, it is our duty to encounter as few losses as possible, and to offset them with profits from successful accounts.

The lending business in which the Industrial Development Bank is engaged is a very specialized affair, and for this reason the Bank finds it necessary to employ a high percentage of specialists. Of our present staff of 99, 10 are industrial engineers, 8 are lawyers, 9 are accountants, and 7 insurance experts. When these men have completed their survey of a prospective client's business, they are able to provide a pretty complete picture to aid us in reaching a decision. Our loans cover a broad list of enterprises, ranging from the construction of boats to the fabrication of many forms of textiles. Bakeries are on our list; so is the refining of oil, the manufacture of lumber, refrigeration and many other things. Many war-time plants owe their rebirth in a peace-time role to Industrial Development Bank financing, and many skills and crafts developed in various communities have been kept alive in the same manner. From our point of view, nothing would be more welcome than to see business men in less thoroughly developed parts of the country come forward with plans which would qualify for financial assistance. Wherever a business man who has a practical project and a reasonable amount of capital presents himself, he can be sure of receiving full consideration from the Industrial Development Bank, and financial assistance whenever warranted.

I have spoken at some length to-day on the subject of Bank of Canada and Industrial Development Bank because I wanted to take this first opportunity to tell you about the purposes and activities of these two institutions of which you and other Canadians are in a sense the owners. Before concluding my remarks, I would like to say a few words about the general business situation and the main problems of our time. For Canada as a whole, the post-war years have been prosperous ones. The level of production and the average standard of living have been far higher than they were before the war. This prosperity has been fostered and sustained by a great volume of exports, and great activity in the form of new capital investment. In the four years 1946 to 1949 the dollar value of Canadian exports reached a total of \$ 11.3 billions and the annual physical volume must have averaged about 70 per cent higher than in 1938. During these same years, gross capital expenditure of all kinds amounted to nearly \$ 13 billions - equal in magnitude to the increase in the national debt during the war. These expenditures went into new housing, new or modernized plant and machinery, public utilities, the financing of inventories and a host of other things. Exports and new capital investment are the two great dynamic factors in our economic situation - two great providers of employment. In these circumstances, the problems facing us in certain export markets have been a cause for worry. I refer, of course, to the difficulties experienced by a number of countries in earning sufficient U.S. or Canadian dollars to enable them to buy all the things they want to get from Canada. For certain countries, these inadequate earnings of dollars have been supplemented by loans from the United States and Canada, and more recently by large sums of U.S. dollars granted to them under the provisions of the Marshall plan. Even so, they have had to economize on imports from dollar sources. This dollar shortage problem is one with which you are familiar because it has affected the markets for various Newfoundland products both in Europe and Latin America. You may well imagine that I am not here to-day to offer any easy solution. The problem has to be attacked from many angles. First and foremost, the countries concerned have to try to sell more in dollar markets on a competitive basis. That calls for reasonable production costs, good merchandising and lots of initiative. Since the devaluation of currencies which took place last September, a number of countries are showing signs of doing better on the export side, although the very substantial improvement which has taken place in the foreign exchange reserves of our most important customers is so far due in the main to a reduction in the amount of their dollar payments.

Another important factor is the willingness of North America to take more imports from overseas. So far as Canada is concerned, that involves, in part at least, a shift in our sources of supply. Developments of this kind have been encouraged in various ways, and some progress is being made. Lastly - and I am again referring to Canada - the solution must come in part from an increase in our sales to the U.S.A. Fortunately for us, that is the field in which the greatest progress has been made during the last two years - aided by a very high level of prosperity south of the border line.

I do not for a moment underestimate the importance to Canada, and to each and every province of Canada, of our overseas markets. I hope that their efforts, buttressed by co-operation from this side of the Atlantic, will result in a very substantial volume of trade being done. It remains true, I believe, that the dollar difficulties of many of our customers are not going to disappear completely in the foreseeable future. If that is the case, our interests will be served best by increasing production of those things which are most likely to be saleable in the United States. There is a market which has increased in numbers by 20 millions or 15 per cent since 1939, and is growing at the rate of 2 1/2 million people a year. It is, practically speaking, the only market in the world where imports are not restricted for foreign exchange reasons.

Before I sit down, I want to speak about the Bank of Canada's interest in Newfoundland. We have not as yet an Agency of our own here, but I believe that the arrangements which have been made for the issuance and retirement of currency, and for the servicing of Government of Canada bond issues, are such that facilities in Newfoundland are as good as in any other part of Canada. Nevertheless, there are reasons which make it desirable for Bank of Canada to have an Agency in every province. The question of premises is a problem at the moment, but we shall come to St. John's as soon as it is practical for us to do so.

Earlier in my remarks I mentioned that a central bank's main concern is with problems which are general and national in their scope. But do not take that to imply that we have anything but the keenest interest in the situation in every part of Canada. I hope that our contacts with Newfoundland, and our knowledge of what goes on here, will help us to make the best contribution that a central bank can make to the maintenance of a stable and prosperous Canada.