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EXPECTATIONS AND EVENTS

Address by MR. GRAHAM TOWERS,
Governor of the Bank of Canada,
to a joint luncheon meeting of the Empire Club of Canada and
the Canadian Club of Toronto in the Royal York Hotel, Toronto.
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Mr. Chairman, I think those present today will agree that whatever one's opinion may be of events in Canada since the war, no one could say the period has been a dull one in the fields of business and finance. The year 1950 has been no exception to that rule.

However, the remarks I intend to make are not directed to documenting this case, but to making, I hope, another point. This is that many of the looming anxieties of our time have not in fact materialized ... and that even some of our most hopeful guesses have been surpassed by realization.

I do not intend by this to suggest a Pollyanna view of our affairs and situation, for that would be manifestly foolish. I hope rather to emphasize the risks that beset the prophet in such fast-moving times ... and to suggest that if the immediate past is any guide, then the prophet with a built-in bias towards pessimism can often be wrong.

But before going on with this, I want to digress a little at the outset. Foreign exchange problems and changes in policy have recently attracted a good deal of attention and a word about them would appear to be topical.

When 1950 began, the markets of the world were still adapting themselves to the wide-spread devaluation of currencies which had taken place in September, 1949. An important step of this sort naturally has far-reaching repercussions, some favourable but some unfavourable. In the event, the adverse repercussions from these substantial changes in the United States dollar value of many currencies were not as marked as some people had feared. Under certain circumstances, devaluation on this scale might have induced a sharp fall in the United States dollar prices of many important commodities. In fact, however, the improvement in business which was taking place in the United States stimulated the demand for raw materials and various imported foodstuffs at a time when inventories had probably been allowed to run down in anticipation of devaluation, and as a result the United States dollar prices of many primary commodities were higher at the end of 1949 than before devaluation.

This strength in the United States business situation was naturally of vital importance to Canada. We had to expect that the more restrictive import policy adopted by many of our overseas customers in the summer of 1949, combined with the great increase in local currency costs of imports from Canada, would result in a very substantial curtailment of our exports to the sterling area and many other soft currency countries. If we had not been able to look forward to a considerable increase in our exports to the United States, the picture would not have been a very happy one. The hope was that such a shift in our exports would take place, and, in fact, it has done so.

At no time during the year was there an expectation that Canada would have a substantial surplus in her current account transactions with the rest of the world. It was thought possible that we might have a modest surplus, sufficient perhaps to permit some relaxation of import restrictions.

So far as capital movements were concerned, predictions were even more difficult than in the case of current account transactions - in fact predictions were impossible. But one could say that if the inward movement was limited to the probable amounts required for direct investment in branch plants, oil development and so on, it would not exceed the gross amount of capital outflow of various types which could be expected to take place, and would not therefore result in any addition to our exchange reserves.

In fact, however, as the year went on widespread anticipation of a rise in the value of the Canadian dollar developed among United States investors, and as in 1945 and 1946, they began to buy Canadian securities on a considerable scale. The Minister of Finance described the course of events in his statement of September 30th last. During June, our official reserves of gold and United States dollars increased $73 millions. July produced a somewhat similar result. In August, the inward movement was accelerated, and reserves rose by $184 millions. Finally, in September, the movement reached flood proportions and the total inflow rose to figures in excess of $335 millions. Not all of these dollars came from purchases of Canadian securities by non-residents, but such transactions accounted for a substantial portion of the increase in reserves.

While I have not delved into statistics, I doubt whether any other country has ever experienced a capital inflow of proportionate size in such a short space of time. A comparable situation for the United States would be one in which the Government was called upon to buy more than 10 billion dollars worth of gold in four months.

For Canada, this movement posed some formidable problems. It is not always realized that additions to exchange reserves require to be financed. When the Government buys United States funds from an American investor who wishes to purchase a domestic security, it must find the Canadian dollars to pay him with. During June and July the Canadian dollars required to pay for the increased gold and United States dollar holdings of the Foreign Exchange Control Board were provided from the cash resources of the Government. In August and September, as the capital inflow continued and then increased in volume, the Government found it necessary to borrow from the chartered banks, by issuance of $200 millions of Deposit Certificates, and from the Bank of Canada to the extent of nearly $300 millions by selling us exchange on a temporary basis. This financing with the Bank of Canada would have had inflationary implications if it had resulted in a large increase in the cash reserves of the chartered banks. However, we set out to prevent this happening by selling in the market part of our holdings of Government of Canada securities. Our net sales in August and September totalled more than $200 millions. Taken in conjunction with certain other changes in our position, these sales of securities prevented an increase in chartered bank reserves over the period, despite the substantial central bank financing of the Foreign Exchange Control Board to which I have referred. I need hardly add that the pressure of our selling brought short term security prices down and interest yields up. We had never before had occasion to conduct open market operations on this scale within such a short period of time.

The experience of recent months serves to remind us that from certain points of view Canada's situation is unique. If one sets aside the war debts of certain countries, it is true to say that Canada has a larger foreign debt than any other country in the world. This debt has been incurred over a long period of years, and for productive purposes - hence our ability to service it without undue strain. But the existence of the debt, a large part of which is composed of marketable securities, does mean that we are exposed to swings in foreign opinion. If non-residents, particularly residents of the United States, take a dark view of the Canadian picture, they can give effect to that view by selling some of their tremendous holdings of Canadian market issues, and withdrawing their capital from Canada unless exchange control imposes a barrier. If they are optimistic, they can increase their holdings of Canadian securities. The movement in either direction can be extremely large, in terms of Canadian magnitudes. Because of the difference in size of the countries, a disturbance which causes little more than a ripple in the United States can have the effect of a tidal wave in Canada.

In 1945-46, the frame of mind of American investors was optimistic, and a lot of capital came in. In 1947, when our exchange reserves were low, I noticed no enthusiasm for Canadian obligations in New York. Not long afterwards, as our position improved, a more optimistic attitude returned and this has strengthened ever since. These swings in opinion to which I have referred are not a recent development. My memory goes back to other waves of optimism and pessimism on the part of United States investors in the period between the First and Second World Wars. On balance, there has been in the United States a continued faith in the long-term future of Canada, particularly on the part of their investors in our natural resources and branch plants. But we have to recognize that there can be very sharp fluctuations in those investments which are purely financial in character.

Now . . . at this point I should like to call a halt to my discussion of details of Canada's special foreign exchange situation . . . and pass on to recent events in the broader international field. I ask your indulgence for going over some things which, though not "ancient" . . . are none the less "history" to all of us. But since Canada's business situation is affected by developments in the affairs of her principal customers, I think it is appropriate to review briefly the financial and foreign exchange problems which they have encountered during the post-war period.

It is true, of course, that sufficient time has not elapsed to set the major economic and financial events of these years in proper perspective. There have been so many crises in the headlines that it now requires some thought to recall them all. But I would contend that the record of progress has been extraordinarily good, all crises to the contrary notwithstanding.

You will recall that even before the end of the war plans were made which resulted in the creation of the United Nations Relief and Rehabilitation Organization, the International Bank for Reconstruction and Development, and the International Monetary Fund, each one of which was designed to play its appropriate part in the extraordinarily difficult task of post-war reconstruction and development. A further contribution of great importance was made by the large loans authorized by the United States and Canada in 1946. Then came the discovery in 1947 that the magnitude and difficulty of the task had been underestimated, partly because it had not been possible earlier on to anticipate the full effects of the Cold War in all its many aspects. The United Kingdom effort to establish convertibility of sterling had to be ended after five weeks. The threatened crisis of 1947-48 was met with the bold, imaginative project of the Marshall Plan. While its operations were of inestimable help to the recipients, it did not directly assist a number of countries in the Middle East and Asia, whose economies had been disrupted by the war and who relied on sterling to cover their urgent post-war needs. Filling these needs threw an extra burden on the United Kingdom. Through a combination of factors, of which the one just mentioned was not the least, the sterling area price level drifted from its moorings, a new foreign exchange crisis developed, and a 30 percent devaluation of sterling took place in September 1949. The most recent additions to the list of major events are, of course, the outbreak of hostilities in Korea and the commencement of a tremendous rearmament programme.

Through all these major disturbances and threats of trouble, North American business has never faltered (except briefly in the United States in 1949) and capital development has proceeded on a scale never before attained.

There have, of course, been plenty of forebodings expressed during these years. For example, there has been a rather general assumption on the part of a number of countries that they would experience a serious shortage of United States dollars for a long period of time. The dollar shortage as it manifested itself after the war arose in the main from the fact that war-shattered countries badly needed unusually large quantities of United States raw materials, foodstuffs and machinery to help in their work of reconstruction, and there was no prospect of their being able to supply tangible things in return for all they desired to obtain. The gap was filled by United States loans and gifts. In consequence, there developed a tremendous excess of exports from the United States. This was the reality of assistance which must take the form of physical things rather than money. In the peak year 1947 the United States surplus in merchandise trade was nearly $10 billions, and that persuaded people in many countries to take the view that the elimination of this great surplus, as United States loans and gifts dwindled and disappeared, was going to be an exceptionally painful process, that it would require the maintenance and intensification of import restrictions, and that such restrictions, discriminating against the dollar area, were likely to be a necessary part of long term policy and a form of protection against the overwhelming competitive capacity of the United States.

I do not want to suggest that the dollar problem has disappeared entirely or for good. No one should risk prophecies in this difficult and uncertain field. But the fact is that the United States surplus with the rest of the world has dropped very sharply to the point where her current account transactions must now be close to a balance. It is true that overseas countries still have severe import restrictions against dollar goods. Indeed these restrictions were intensified in the summer of 1949 and there has been no appreciable relaxation as yet. But there is no doubt that devaluation, by raising the cost of dollar imports, took some of the pressure off these controls, and lessened the need for them. In any case, with or without controls, the overseas world is now approximately in balance with the United States. That is a result which, twelve months ago, few would have dreamed was possible so soon, and this great change has taken place without serious economic disturbance to the rest of the world. That is Outstanding Fact No. 1.

For Outstanding Fact No. 2 I turn to Canada. It was a normal experience for us to have a deficit in our transactions with the United States, and a surplus in our dealings with the sterling area and Western Europe. In the early post-war period, this so-called normal distribution of our trade was exaggerated in degree by the circumstances and financial arrangements of the time. In 1947 the peak was reached with a deficit of $1,135 millions with the United States and a surplus of $1,155 millions with the sterling area and a group of Western European countries. This year it seems likely that our current account deficit with the United States will be about $200 millions, and that our surplus with the sterling area and Western Europe will not more than offset this deficit

There are, of course, a number of Canadian commodities whose traditional markets are still to be found in the sterling area and Western Europe. I hope that as the years go on the countries concerned will be able to earn enough Canadian dollars to remain good customers, and become even better customers, of Canada. This year, for example, the sterling area will probably earn $600 millions in their trade with Canada. That is no small sum, and represents an increase of $250 millions since 1947. While it would be rash to assume that the future is all plain sailing, or that we shall never be plagued by United States dollar shortages on the one hand, and embarrassing curtailment of our overseas exports on the other, it can be said that the extreme fears which were so commonly expressed a year or so ago have not yet been justified. For this, we have to thank in large measure the high level of United States business, and the energy and initiative of our people.

I have a reason for speaking about these things. They illustrate what great changes can take place in world trade and finance without causing painful disruptions so long as a high level of activity is maintained, particularly in that vast country to the south of us. I am sure that European thinking has been influenced by a fear that, sooner or later, the United States would experience a severe depression and high unemployment. Certainly the Russians have not failed to encourage fear by hammering away at the thesis that the capitalistic economy of the United States is one of boom or bust.

Now no one, least of all the United States, can give binding and effective guarantees in regard to the course of United States business through the years. One can readily understand, too, why fear of wide fluctuations in United States activity should have developed during the thirties and left its legacy in the forties and fifties. But I think it is time now to re-examine thoughts and emotions on this subject. Policies based even in part on fear of deep depression are not justified by the facts of the post-war world, nor do I think they are really consistent with certain other policies such as those for mutual defence and economic cooperation as exemplified in the Atlantic Pact.

There is, of course, another factor in the situation, and that is the feeling in many countries that they lack the capital resources, and in some cases the "know how", to compete on even terms with the highly organized United States.

Some may feel that trade restrictions must be continued until the countries concerned can catch up with the United States. It may well be the case, however, that wide-spread trade restrictions are a barrier to efficiency and to the type of development which would assist in the catching up process.

It is clearly not possible to dismiss these various fears with a wave of the hand, nor to suggest that all forms of trade restriction and discrimination can be eliminated over-night. But it does seem to me that the first steps in that direction might now be taken, and that it is time to have a fresh look at policies which have been based on the assumption that an extreme and stubbornly enduring dollar shortage was an unavoidable feature of the post-war world. I make no apologies for dwelling on these matters before a Canadian audience. Canadians have a deep, practical interest in this subject, as well as a philosophical one; and through the post-war years Canada has consistently supported various international organizations whose objective has been the eventual restoration of world trade to a multilateral and non-discriminatory form.

Earlier in my remarks I expressed rather cheerful views about Canada's progress in recent years. One of the major factors easing the problems of this post-war period has been the great scale of capital development going on, both here and in the United States. But quite apart from this effect, I think we have cause to be very thankful that North America has added so much to its capital equipment in the last five years. Not all of the things which have been done were essential from the point of view of strengthening the fundamental position of the economy, but a very great deal has been done of a character which will help us in the testing times which lie ahead.

The post-war period had its unsatisfactory aspects, not least of which has been the world-wide decline in the purchasing power of money, resulting from a combination of wartime developments and the distortions produced by the subsequent Cold War. The destruction of real wealth overseas, the accumulation everywhere of long deferred capital needs and postponed desires of consumers for goods, and the huge volume of liquid assets accumulated by consumers and businesses as a result of the large scale deficit financing of the war years, gave rise at the war's end to an unprecedentedly large demand for everything that could be produced, and urgent demands that could not be filled elsewhere had to be met out of North America's supply. If the present Cold War had not followed so closely on the heels of World War II, recovery abroad would have been quicker and less dependent on North America; individuals and businesses who wished to use their accumulated liquid assets to make deferred expenditures would have experienced less competition in bidding for the resources they wanted. However, there is no way of telling now what the price level would have been if real peace had been achieved. Post-war fiscal and monetary policy have, of course, been directed towards lessening the impact of the liquid assets created during the war and in Canada budgetary surpluses contributed to this objective.

By the end of 1949 it seemed that the western world at least had worked its way through to a fair measure of recovery and stability. To-day the need for a large re-armament programme, made evident by events in Korea but far transcending the particular requirements of the Korean War, seems to threaten to upset the degree of stability which had been achieved. In every country, the problem of maintaining the purchasing power of currencies is again causing concern as re-armament expenditures on a large scale are being undertaken or discussed. I saw evidences of that concern on the part of many countries at the recent meeting of the International Bank and Monetary Fund in Paris. No one is fortunate enough to possess a blueprint of the course of events, but I think that the very lively recognition of the dangers of the situation which exists all round the world is a good thing, provided it leads to appropriate action and provided that the fear element is not overstressed.

It has to be assumed - or so I should suppose - that the re-armament and defence problem is going to form part of the life of the free countries of the world for a long time to come. In the economic field, that calls for policies whose effect is likely to endure, rather than for stop-gap methods. Above all, it calls for pay as you go financing, and for maximum productivity. The task is by no means impossible, if the requisite understanding and determination are forthcoming.

It is sometimes too readily assumed that large scale defence spending, by its mere existence, automatically means inflation, but if an increase in defence spending is matched by a decrease in other spending - private as well as governmental, and spending for consumption as well as business spending - there need be no fundamental domestic reason for an upward pressure on prices generally. It would still be possible for consumers and businesses, under the mistaken impression that the experience of the last war was going to be repeated, to rush out and try to spend a larger than normal proportion of their incomes. Specific credit controls and a strong monetary policy are appropriate and necessary weapons of self-defence for the community against such actions. But the fundamental policy clearly must be the fiscal one of reducing spendable incomes, by increased taxes, to the extent that the available supply of goods is being reduced by the demands of the defence programme. And so long as re-armament expenditures go on increasing, I believe that Government revenues should anticipate the future level of requirements rather than merely try to keep pace with current requirements. Anticipations of future developments might induce larger current spending by various groups, if not offset by larger current discouragement of such spending.

And so may I close by emphasizing once more that the task before us, though unpleasant, is a manageable one. That is not to say that the problems involved can be met in any easy way, or by the exercise of any financial sleight of hand. The situation calls for a number of dull things - things which we may have got tired of hearing about time and again during the last war, but which are none the less essential if we and our partners in the free world are to win through.

The North American partners - one large, one relatively small - possess between them great resources and productive capacity. Their performance in the last war, and the record of growth and abounding vitality in the post-war years, support that statement. If to all these advantages there can be added an understanding of the price to be paid, and a determination to pay it now for the sake of the future, these countries should certainly be able to handle the job of defence production and finance in a workmanlike manner, and by so doing contribute greatly to world stability and peace.