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Notes for Remarks by Mr. G.F. Towers to
Recently-appointed Foreign Service Officers of
External Affairs, April 27th, 1954

I understand that you would like me to talk to you in very general terms about the Bank of Canada. Now this is something that I am invited to do from time to time and so I have, perforce, had a bit of practice at it but I am always bothered by the same initial difficulty, namely, that I never know quite how to start. I confess that I do not know how to start today but perhaps it will do if I begin by saying a little about the organization of the Bank of Canada and this will, I hope, bring me around to saying something about what the various groups that we have in the Bank do and what it is that they are trying to achieve.

At the end of 1953 we had a total staff of just under seven hundred and fifty people. Of these something like one hundred and fifty were located in our nine agencies throughout the country and the other six hundred were in our head office here in Ottawa. The largest single group in Ottawa is our Public Debt Division; it numbers nearly three hundred people. The Public Debt Division discharges one of the normal functions of a central bank, a function usually described as "managing the public debt". The public debt, in our case, means the debt of the Government of Canada, a debt which is something like fifteen billion dollars and "managing the public debt" means, principally, keeping the records of the debt, issuing and redeeming bonds, paying coupons and so forth. While managing the public debt is a fairly routine operation, it is an operation of some size; as an indication of this I mention that in 1953 the Public Debt Division had to handle about eighteen million coupons, about four million bonds (separate pieces that is, not dollar amount) and nearly one million separate cheques. We do this work as fiscal agent of the Government.

The next largest Division in the Bank is the one handling currency. This Division is responsible for supplying the commercial banks with new notes as they require them and for taking in used notes for destruction. About three hundred million notes were handled in 1953 and it took something approaching one hundred people to do the job. The life of one and two dollar notes is about ten months, while the twenty dollar note stays in circulation about three years before it gets too dirty for use. Even when total note circulation is not increasing, a very substantial number of notes is always coming in and going out so that the circulation in the hands of the public can be kept in a reasonably clean condition. In addition to its duties in the currency field, this Division is also responsible for the custody of Canada's gold reserve and gold which central banks in other countries may wish to keep with us in Ottawa. The war brought a tremendous amount of other countries' gold to our vaults, and in that respect, as in so many others, the effects of the war have not disappeared. Since 1939 our Currency Division has handled many billion dollars worth of gold for foreign central banks and governments.

The remaining two hundred or so of our Ottawa staff are engaged in a variety of tasks. There is the Secretary's Department which supervises our general operations at head office and agencies. There is a Staff Department - from many points of view the most important Department in any organization. The Chief Accountant and his people maintain our books and records. The Audit group check our accounts both at head office and agencies and keep a watchful eye on the methods we employ to guard against the disappearance of cash and securities.

I come now to three Departments of the Bank which are peculiarly associated with central banking activities; these Departments are the Securities Department, the Foreign Exchange Department and the Research Department. Let me first say something about the Securities Department.

The Securities Department is engaged principally in buying and selling securities of the Government of Canada. The focus of this activity is the Securities Department in Ottawa but the actual transactions almost all take place with banks and dealers in Montreal and Toronto and Securities Department personnel operate in both of these cities. Having the central direction of our securities activities located in Ottawa and having to conduct the actual operations in other cities is not the most convenient thing in the world, but direct telephone lines to Montreal and Toronto help to lessen the inconvenience by giving us constant contact with our traders.

The security trading done by the Securities Department is the thing that is usually referred to in textbooks on central banking as open market operations and I should like to stop here for a moment to say a bit about why it is that open market operations are always considered to be a very important part of a central bank's business. Let us turn for a moment to look at the banking system. We have in Canada eleven commercial banks - usually referred to as chartered banks, presumably because they operate under a charter granted by the Federal government - and these are the banks which do the ordinary banking business of the country. In particular, these are the banks that, through their loans, finance an important part of the industrial, agricultural and commercial activity of the nation. Now it is the custom of these banks - a custom reinforced by law - to carry deposit accounts with the central bank; these balances with us they regard as their main cash reserves in much the same way as individuals and businesses regard their balances with the commercial banks as their main cash reserves. Because the commercial banks regard their balances with us as their main cash reserves, the changes in these balances play a vital part in the activities of the commercial banks. If these reserves are relatively high in relation to the liabilities of the banks to their depositors, the banks will tend to be in an expansive frame of mind, keen to make new loans or to add to their holdings of securities. Their activities along these lines tend to permeate through the country's whole financial structure. It becomes easier to borrow from the banks and also easier to sell new issues of securities in the capital market. Interest rates decline. Businesses and governments are encouraged to go ahead with projects which need to be financed with borrowed money. Conversely, if the banks feel that their cash reserves are relatively low they ill pull in their horns, borrowing will become more difficult and more expensive and this will be an obstacle in the way of those who are contemplating the borrowing and spending of money. As you are aware, the policy of expansion is suited to a time when human and material resources of a country are under-employed; the more restrictive policy fits an occasion of over-full employment when people are trying to spend more money than there are goods and services available to spend it on.

Now the key fact about a central bank is that it is able to determine the level of the commercial banks' cash reserves. It is able to increase or decrease these reserves through its open market operations, that is through its purchases and sales of securities. The way in which open market operations affect the level of the cash reserves of the commercial banks can be explained quite simply. When we buy X dollars worth of Government securities in the market, we pay the seller with a cheque on the Bank of Canada. In due course the seller deposits this cheque with his commercial bank and that bank's cash reserves are increased by X dollars when it presents the cheque to us for payment. In the same way, when we sell X dollars worth of Government securities in the market the cash reserve of some commercial bank is decreased by X dollars.

Thus we have the picture of the Securities Department buying and selling Government securities in the market in order to increase or decrease the cash reserves of the commercial banks which, in turn, may be expected to have some effect on the activities of the commercial banks and, through them, on the level of business activity generally. Before I leave this picture, however, I want to emphasize that there are all kinds of qualifications which should be attached to the ability of the central bank to affect the level of business activity through its open market operations. That useful phrase "other things being equal" could fit in nicely at almost every point. The actual level of business activity is, of course, affected by many factors other than our monetary operations. I have in mind such factors as crop conditions, resource discoveries, booms or recessions abroad, hot or cold wars, and the degree of optimism or pessimism among our business men and consumers, to give only a few examples. When so many variables are at work, obviously no exact measurement of the results of central bank action is ever possible. All this uncertainty makes central banking quite an interesting trade, and one which can inspire endless arguments.

Those of you who recall that the Bank of Canada commenced its operations only in 1935 may quite reasonably wonder how these matters were dealt with before that time. Until the First World War, the cash reserves of the commercial banks had been rigidly tied to the country's gold reserves. At the beginning of World War I, it was recognized that the exigencies of war financing would require more flexibility in the credit base. Parliament passed the Finance Act in 1914, which made it possible for the Government in effect to lend cash reserves to the commercial banks.

The Finance Act was continued after the war, and its facilities were used on a large scale in the late twenties. It left the initiative with the banks, who were naturally not happy to be heavily indebted to the Government, and when the depression began after 1929 the weaknesses of the Finance Act machinery became very obvious. The struggle of the banks to repay their debt to the Government added fuel to the flames of deflation, and there was nothing the Government could do about this problem except by rather unsatisfactory ad hoc measures or by attempting some form of persuasion. While the public probably did not have an understanding of the technicalities, they certainly knew that something had hit them and were inclined to lay a very liberal share of the blame -- too much indeed - on the banking system. The Government of the day decided that it would be wise to create a central bank, and appointed a Royal Commission which in due course reported that such a bank should be brought into existence. Parliament passed the Bank of Canada Act in 1934, and in March, 1935, we opened our doors.

Let me return now to the organization of the Bank of Canada and say a brief word about the Foreign Exchange Department. The set-up of our foreign exchange operations resembles closely that of our securities operations. The chief of the Department is located in Ottawa and his traders operate in the foreign exchange markets in Montreal and Toronto. We also conduct substantial business in foreign exchange with the central banks of a number of countries. Our dealings in foreign exchange are almost entirely on behalf of the Minister of Finance, for whom we operate something called the Exchange Fund Account in which is held the country's gold and foreign exchange reserves.

Last but not least there is our Research Department. A central bank without a good Research Department is too horrible a thing to contemplate. Our Department provides the information and background which help to determine policy. The field of its activities is wide. Indeed, there are almost no limits to the things in which a central bank's Research Department might interest itself. Our constant objective is to cover the essential fields and yet avoid getting spread out too thin.

The reason why our interests must range so widely can be readily understood from a reading of the directive which Parliament gave when it framed the Bank of CanadaAct in 1934. The preamble to the Act reads as follows:-

> "Whereas 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."

This is, of course, a very dangerous preamble for any institution to have in its act of incorporation, because it may seem to direct the Bank to produce some form of Utopia. However, you will note that there were certain safeguards. 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.

In any case, Parliament clearly expected the central bank to have an extensive knowledge of the financial and economic factors which make Canada tick. This brings me to one aspect of our activities which the Act does not mention specifically but which it does imply, viz: - advising the Government on matters of policy which may lie outside the monetary field but which importantly affect the financial and economic life of the country. This relationship with the Government is not one which can be precisely defined. If people don't want advice it is difficult to force it on them. In certain circumstances, an advisor who has not received a pressing invitation may arrive too late for the party. And it has to be remembered that if advice does not turn out to be good distinctly more often that it is bad, the mat with "Welcome" on it is likely to be pulled out from under the advisor's feet. But, one way or another, the closest and most friendly contact between a central bank and its government on matters of financial and economic policy is essential to the public interest. I feel that the relationships between Bank of Canada and the Canadian Government have been close and friendly since we commenced operations.

The Bank of Canada has engaged in a number of other activities which are not directly related to central banking. We supplied the personnel for the administration of foreign exchange control during the period of its existence, from 1939 to December last. We were very closely connected with the National War Finance organization which conducted the Victory Loan campaigns during the war, and continue to be responsible for the annual Canada Savings Bond campaigns. Last but not least, we have since 1944 had a wholly-owned subsidiary, the Industrial Development Bank, which is designed to make loans to industrial enterprises which cannot secure funds from other sources on reasonable terms and conditions. Since its inception, the Industrial Develpment Bank has financed about 1,100 Canadian enterprises and has, I think, done a very useful job. But I must not take the time which would be required to cover that field.

Thus I come to the end of my review of the organization and operation of the Bank of Canada. In order to round out this review I think that I would normally feel obliged to say something about the policies which we have tried to carry out in the years since the war. I have, however, very recently made a statement of this kind before the Standing Committee on Banking and Commerce of the House of Commons and I sent along some copies of this statement to you. Perhaps some of you have had a look at that statement and if you have any questions to ask about it, I shall be pleased to try to answer them.