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WOULD CANADIAN MONETARY POLICY BE MORE EFFECTIVE IF OTHER DEPOSIT-TAKING FINANCIAL INSTITUTIONS WERE SUBJECT TO THE DIRECT EFFECTS OF BANK OF CANADA OPERATIONS IN THE SAME WAY AS THE CHARTERED BANKS?

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Would Canadian monetary policy be more effective if other deposit-taking financial institutions were subject to the direct effects of Bank of Canada operations in the same way as the chartered banks?

Governor Mitchell and I have been asked to respond to an important question about the powers that a central bank needs in order to do its job effectively. Do the operations of the central bank impinge directly on a large enough proportion of the country's deposit-taking institutions for effective monetary control? Discussion of this question is timely. In the United States it is under active consideration, and I have no doubt that in Canada "bank, near-bank" questions will have to be considered as we prepare for the next decennial review of banking legislation.

The powers and the technical arrangements that a central bank needs to do its job depend on how the job is viewed. The immediate targets of central bank action and the manner in which they are pursued vary to some extent from one country to another, and even within particular countries they have evolved over time in the light of accumulating experience and changing circumstances.

Some central banks rely almost entirely on the indirect influence of cash reserve management to regulate the pace of monetary and credit expansion in terms of broad aggregates, leaving it mainly to the workings of private financial institutions and markets to sort out the specific impacts on the cost and availability of credit to particular classes of borrower and lender. The outcome may well be modified by government action such as direct lending programs or other forms of intervention, but these activities are not viewed as part of the central banking job as such. The application of specified minimum cash reserve requirements to banking institutions is the main technical arrangement usually associated with this general approach to monetary policy. Since this is the basic approach followed in Canada, the central question for today's discussion is whether the Bank of Canada could achieve its main policy objectives more effectively if deposit-taking institutions other than chartered banks were subject to the same kind of cash reserve requirements as banks.

The role of monetary policy may, however, be taken to go beyond a general influence of this kind and to encompass as well measures directly influencing the allocation of credit to particular classes of borrowers or the relationship among particular rates of interest. Many central banks employ supplementary techniques designed for these purposes and some rely heavily on them. In some cases governments themselves, rather than central banks, intervene in this way. If cash reserve management is to be supplemented by formal or informal measures that intervene more

directly in market processes, the question is whether they should be imposed on the banks alone or should extend beyond them.

The laws and regulations that apply to deposit-taking institutions in Canada have evolved over many years. They do not reflect a single grand design, but are rather something of a patchwork made up of pragmatic responses to particular problems that from time to time seemed to call for solution. These responses have come from provincial governments as well as from the Government of Canada, and this has contributed to a situation in which differing rules are in many cases applied to essentially the same kind of business. The result has not been an entirely haphazard set of laws, but it is certainly not the result one would have arrived at if it had been possible to sit down with a blank piece of paper to draft a coherent framework of legislation.

If one were able to start from scratch in establishing the legal framework for the conduct of monetary policy, one would presumably begin by deciding what technical powers the central bank needs to exert its general influence over the financial environment and, secondly, what additional powers, if any, it should have to intervene directly in market processes. With this job description in mind one would then, presumably, so write the law that any obligations to be imposed on financial institutions for the sake of an effective monetary policy would apply equally to all institutions doing the relevant kinds of financial business.

Thus cash reserve requirements applied to institutional deposits, which are the fulcrum of monetary policy as we conduct it in Canada, would

be imposed equally on deposits having the same characteristics, at whatever financial institution they might be held. This obvious approach would seem to be logical, equitable and efficient. Why would one do otherwise? Similarly, any authority given the central bank to bring about a particular allocation of credit or a particular structure of interest rates would apply equally to all relevant areas of the financial system. Equal treatment in equal circumstances is an important principle of law, and in economic affairs it contributes to an efficient allocation of resources. Departures from this approach may be desirable in the interests of particular social or economic objectives, but the starting point for regulation and control of the financial system would surely be a uniform, comprehensive framework of laws and regulations.

As we all know the situation in Canada is some distance from that ideal of logic, equity and efficiency. Similar kinds of business done by financial institutions are subject to different limitations and requirements depending on the particular statute under which the institution is organized. The requirements that are of particular interest to the central bank -- minimum cash reserves held solely in the form of claims on the Bank of Canada, and a variable minimum level of secondary reserves -- apply only to the chartered banks. Even here they do not apply in a fully uniform way to all deposits. While the Bank Act does require banks to "maintain adequate and appropriate assets against liabilities payable in foreign currencies", there are no specific minimum reserve requirements

on foreign currency deposits, even those covered by a Canadian dollar forward exchange contract and which are, therefore, the same in all essentials as Canadian dollar term deposits. But the main feature of the system is that minimum cash reserve requirements are imposed on banks and not on other institutions.

And who are the Banks? They are defined in law not by the nature of the business that they do but by the fact that they are incorporated under a particular Act. Although The British North America Act assigns jurisdiction over banking and the incorporation of banks to the federal Parliament, our laws do not provide a clear-cut definition of banking. Provincial governments as well as the federal Government have for many years incorporated and regulated institutions that do many of the same kinds of business as banks, but which are subject to substantially different limitations.

For example, although trust and loan companies, caisses populaires, credit unions and the depository institutions owned by certain provinces can offer deposit accounts that are in all essentials the same as those at banks, they are not subject to the same reserve requirements. The banks have to hold cash reserves at the central bank, earning no interest, equal to 12 per cent of Canadian dollar demand deposits and 4 per cent of Canadian dollar time deposits. The various pieces of legislation that regulate the other deposit-taking institutions in most cases require them to keep specified

minimum liquid reserves, but these may usually include securities of various kinds and term deposits which bear interest as well as demand deposits. The cash reserves of these institutions are not held at the Bank of Canada; by the same token these institutions do not have the same access to central bank credit as do the chartered banks.

There are, of course, many other provisions of law that affect depository institutions, some of them obviously concerned with the same problems of liquidity that must be of concern to the central bank in its role as lender of last resort. Arrangements for inspection and requirements for publication of condition statements differ among categories of institution, and other rules affecting the conduct of their business also differ substantially. There is no need to spell out the whole catalogue of minimum and maximum asset ratios, permitted investments and prohibited investments, basket clauses, laws that in some cases specify minimum capital requirements and in other cases are silent on the subject, differing tax treatment and so forth. I do not wish to suggest that these various federal and provincial laws taken by themselves are inadequate, but it is fair to say that consistency and uniformity are not their obvious hallmarks.

A particularly anomalous aspect of the matter has recently been brought to prominence by the rush of foreign banks to extend their business into Canada. The Bank Act contains general limitations on the ownership of Canadian banks that prevent foreign banks from operating offices in their own

name in Canada, or from owning any substantial part of a Canadian bank. Moreover federal law as well as some provincial legislation covering trust and loan companies contain similar restrictions. However other federal and provincial laws provide avenues of incorporation whereby foreign banks are able to extend their business into Canada, and they have done so in various ways including the establishment of wholly-owned subsidiaries using general purpose names with a financial ring.

Many of those who are engaged in setting up such affiliate institutions in Canada come to see us, and I may say that whatever the form of incorporation or corporate name they may have chosen, we have been in no doubt that we were talking to bankers. Although these Canadian affiliates cannot use the name of the parent bank, they can usually do most of the kinds of business that are permitted to Canadian banks. Their short-term liabilities are in all essentials the same as bank deposits: they are indeed normally backed by the guarantee of the parent banking institution although not in practice subject to any regulation by Canadian authorities. Moreover these companies are able to do some kinds of business, notably leasing, that Canadian banks may not enter directly.

I might digress for a moment to report that the Bank of Canada is now collecting regular returns from these new Canadian financial institutions that are owned entirely or in substantial part by foreign banks, and will soon begin to publish a combined monthly balance sheet for the

group. The reporting companies had total assets of almost $1 billion at the end of June compared to just over $600 million at the end of 1973. In June the assets included $121 million of leasing business, $100 million of real estate loans, and $584 million of other loans to businesses: of this latter amount, $388 million was in loans with a term of less than a year. More than one-half of the total assets were financed by the issue of short-term paper, and the remaining sources of funds included $116 million of loans from Canadian banks. Although the figures are still relatively small -- less than two per cent of the Canadian dollar assets of the chartered banks -- these new arrivals on the Canadian financial scene have grown rapidly during the start-up period of their operations.

To return to the legislative framework for banks and near-banks, an admission that the present arrangements are anomalous in certain respects does not mean that they fail to work reasonably well in practice so far as monetary policy is concerned. The technical powers given to the Bank of Canada have in fact proven broadly adequate for the Bank's purposes. Largely through its control over the supply of cash reserves to the chartered banking system, the Bank of Canada has unquestionably been able to exert sufficient influence over the process of monetary expansion to have a major impact on the degree of ease or tightness in financial markets. So much is evident from the record. It is clear that the effects of Bank of Canada operations on the growth of money and credit and on the level of interest rates have not been confined to the chartered banks but

have been felt pervasively throughout the financial system.

As I need hardly tell this group, the Bank of Canada can, by varying the supply of chartered bank cash reserves, influence the operations not only of the banks but of near-bank financial institutions aswell. Changes in the supply of cash reserves relative to the banking system's demand for them have the immediate consequence of putting downward pressure on short-term money market and institutional interest rates when reserves are run at relatively high levels, and upward pressure on these rates when the central bank is less generous in providing cash reserves.

If the central bank is a reluctant provider of cash to the banking system so that heightened competition for money balances is pushing short-term interest rates upward, the near-banks must meet these rates or else suffer pressure on their own cash positions. These pressures would result from a tendency for funds to slip away as depositors sought the higher returns available elsewhere and as borrowers tried to take advantage of relatively cheap near-bank sources of credit.

The basic character of these responses is not altered by the fact that the near-banks are not required to maintain a stipulated minimum level of cash reserves nor indeed to hold part of their cash in accounts with the central bank, as the chartered banks must do. The function of the banking system's cash reserve requirements is simply to increase the short-run

precision and predictability of their response to changes in the supply of central bank money. So long as the banks are required to hold somewhat larger non-earning cash reserves than they would by choice, they will respond rather sensitively to excesses as well as to deficiencies in their cash reserve positions. And so long as the institutions that are subject to these legal requirements bulk large in the financial system -- and in particular in the business of issuing chequable deposit liabilities -- their response to changes in their reserve positions will have prompt and substantial effects on other financial institutions and markets.

These conditions for the reasonably effective implementation of monetary policy are met in Canada as things stand at present. The chartered banks are dominant enough in the relevant areas of deposit-taking and short-term credit extension to give the Bank of Canada, through its management of their cash reserves, an adequate degree of leverage and precision for monetary control purposes. So far as its needs for statistical information are concerned, it is true that the Bank of Canada's statutory power to collect statistics applies only to the chartered banks. In practice, however, our experience has been that we have obtained excellent co-operation from other institutions, who meet our statistical requests on a voluntary basis.

Although other deposit-taking institutions have been expanding their business rapidly, deposits at chartered banks still comprise about two-thirds of all deposits held by Canadians with financial institutions in Canada.

The chartered banks' share of chequable deposit accounts is even higher. At the end of 1973, 78 per cent of such deposits were held with chartered banks and only 22 per cent -- consisting mainly of chequable household savings accounts -- were held with other depository institutions. While the chartered bank share of deposits has declined in recent years it remains the case that an overwhelmingly high proportion of payments in Canada is made by means of cheques drawn on bank accounts.

Up to the present, then, I am afraid that I cannot blame any shortcomings in monetary policy on deficiencies in the technical arrangements that link the Bank of Canada to the rest of the financial system. The absence of cash reserve requirements applicable to depository institutions other than the chartered banks has never, to my knowledge, frustrated the efforts of the Bank of Canada to bring about as sharp a curtailment of the pace of monetary expansion and as large an associated rise in short-term interest rates as we were prepared to contemplate in the circumstances of the time.

Whether this would continue to be the case in future years if a growing proportion of the country's banking business were taken on by institutions other than the chartered banks is another question. In thinking about the adequacy of our present cash reserve arrangements for purposes of monetary control, one does have to consider the implications of a possible further decline in the chartered banks' share of chequable deposit business. A progressive loosening of the relationship between the amount of cash reserves supplied by the central bank and the probable responses of the institutions which provide the public with most of the money it uses for

transactions purposes would undoubtedly make the effects of central bank operations less predictable.

One must also give some weight to another aspect of the matter. The minimum cash reserves that the chartered banks are required to hold earn no interest and are somewhat higher than the banks would hold by choice. The secondary reserve requirement, which also applies to chartered banks but not to their competitors, can sometimes have a comparable effect of reducing total earnings below what they might otherwise be. Taken by themselves these arrangements work to the competitive disadvantage of the chartered banks, if only to a modest degree. It is true that the banks also have offsetting competitive advantages owing to the very broad borrowing and lending powers available to them, to the peculiar magic of the word "bank" which is reserved to them, and in some cases to sheer size. Nevertheless, it is possible to question the appropriateness of discriminatory arrangements of this kind on grounds not just of efficiency but also of equity, at least with respect to small chartered banks and potential applicants for new bank charters.

It is true that in Canada our concerns on this score do not include one that is relevant in the United States, where fully-fledged banks can be established outside the Federal Reserve System and where member banks can leave the System without forfeiting the advantages of incorporation as banks. Nonetheless it does concern me that in recent years the number of new entrants into the chartered banking system on which

the central bank operates directly has continued to be small by comparison with the number of new institutions that have been set up to do closely similar business under other legislation.

I have discussed the relationship of the Bank of Canada with deposit-taking institutions mainly in terms of the cash reserve requirements because the Bank of Canada Act leaves no doubt that cash reserve management is the major technique of monetary control that the Bank is expected to use. Except for the secondary reserve requirement which applies to the chartered banks, the Bank of Canada has no statutory power to influence the allocation of credit or the interest rates at which private institutions deal. Nevertheless, the Bank has supported agreements that have been entered into at times within the banking system, with the approval of the Minister of Finance, to limit the rates of interest paid on certain types of deposit. The Bank has also on occasion asked the banks to follow particular policies in the conduct of various aspects of their business, such as the composition of their lending. These requests have normally been made in cooperation with the Minister of Finance rather than as completely independent actions by the Bank of Canada.

Since we have resorted to such measures only to a limited extent, their application to the chartered banks alone has not seemed to me to raise serious problems. If much greater reliance were to be placed on the use of such requests, there would be a strong case for extending them beyond the banking system. In certain circumstances

this might be the appropriate course of action. The fact that this general approach has been used to such a limited extent in Canada is in my opinion not so much due to the framework of the financial system as to the many practical problems involved in devising major interventions of this kind in a way that offers the reasonable prospect that they will in fact be effective in the pursuit of their ultimate objective.

I have touched on a number of topics that go beyond the particular matter of the powers needed by a central bank. I would like to conclude by coming back to the question posed in the title of my remarks. It is my view that an extension of the Bank of Canada's powers to cover a broader range of financial institutions has not so far been necessary in order to achieve the central bank's objectives with reasonable efficiency. But this judgment is related to the structure of the Canadian financial system as it has developed to date. Some of the structural trends currently in evidence are not altogether reassuring from this point of view and their continuation could in time make it more difficult for the central bank to do its job effectively.