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Opening Statement by
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Governor of the Bank of Canada
before the
House of Commons Standing Committee
on Finance, Trade and Economic Affairs

I would like to say first of all that I am very pleased to appear again before this Committee and I will gladly be of whatever assistance I can in furthering your consideration of the very substantial bill that you have before you, and especially of that small part of it which involves changes in the Bank of Canada Act.

I do not propose to comment in detail on the contents of the bill at this stage, but it might nevertheless be useful to indicate in general terms how I view its provisions in relation to the role and operations of the Bank of Canada. In my judgment the proposals would not materially affect the Bank of Canada's ability to discharge its responsibilities in the field of monetary policy. While several areas of the Bank of Canada's operations would be affected in some degree by certain of the bill's provisions, the essential nature of these operations would remain substantially unchanged.

Perhaps it would be helpful in explaining why I take this view if I were to outline very briefly the basic mechanics of monetary control, and then to comment on those provisions of the legislation that would

appear to be most relevant in that context. I shall then touch briefly on some of the other proposals, especially those entailing amendments to the Bank of Canada Act.

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The main way in which the Bank of Canada's operations exert their influence on interest rate levels and on the growth of the money supply is by affecting the behaviour of the chartered banking system. The basic fulcrum for these operations is the need of the chartered banks to hold cash reserves, mainly in the form of deposit balances at the Bank of Canada, equal on average to some fraction of their deposit liabilities to their customers. The banks have to maintain these deposit balances at the Bank of Canada partly for business reasons and partly for legal reasons. A bank must be able to provide cash settlement to other banks for honouring its customers' cheques, and it must also be in a position to meet cash withdrawals by its depositors. Thus even in the absence of a legal requirement the banks would have to maintain a reserve of ready cash sufficient for these purposes. In fact, of course, a minimum level of cash reserves that each bank is required to maintain is stipulated in the Bank Act. Since this required minimum is at least as high as the banks would want to hold voluntarily in any case, and since these cash reserves do not earn any interest, the banks generally try to avoid holding deposit balances at the Bank of Canada much in excess of the statutory minimum. The result is that the banking system's combined demand for deposit balances at the Bank of Canada is a relatively predictable quantity.

The fact that the Bank of Canada is able to control the total quantity of its deposit liabilities available to meet this demand for cash reserves gives it the leverage it needs over the behaviour of the chartered banking system. It is the amount of cash supplied by the central bank in excess of the banking system's minimum requirements that is at the heart of the control mechanism. If the central bank is relatively generous in providing excess cash reserves, this will induce the chartered banks to invest more actively in money market instruments, compete less aggressively for deposit inflows, and in due course lend more freely. These responses of the chartered banks will tend to put downward pressure on the whole structure of Canadian interest rates radiating out from the short-term money market. Conversely, if the central bank makes excess cash relatively scarce, the banks will have to scramble for the cash they need by liquidating investments and bidding aggressively for deposits, thereby exerting upward pressure directly on short-term interest rates and indirectly on longer-term rates. The central bank also of course uses Bank Rate changes from time to time in tandem with its cash reserve management in order to encourage the interest rate responses that it is seeking.

In short, monetary policy operates mainly by changing the amount of excess cash available to the banking system beyond its minimum requirements. Thus the proposed changes in the absolute level of cash reserve requirements do not have significant implications for monetary management, since the Bank of Canada will still be able to determine the margin of cash available in excess of the new required minimum levels.

Another issue which has attracted considerable attention in the discussions leading up to this legislation is whether the effective implementation of monetary policy does, or does not, require including the so-called near-banks -- the trust and mortgage loan companies, credit unions and caisses populaires -- within the reserve requirement system. However, as I have already indicated, the response of the chartered banks is only the first stage of the process by which monetary policy affects the economy, and competitive forces soon spread the effects of central bank operations throughout financial markets. The near-banks have little option but to adjust the interest rates that they pay on their deposits and earn on their loans and investments to keep them in line with interest rate changes occurring in the banking system and short-term money market if they are to maintain their share of deposits and/or their profitability. Otherwise customers would move en masse from one area of the credit market to another in pursuit of the highest rates offered on savings and the lowest rates charged on loans. Thus, so long as chartered bank interest rates respond sensitively to excesses and deficiencies in their cash reserve positions and so long as the banks play a major role as financial intermediaries, the operations of the central bank will have prompt and pervasive effects on all financial institutions and markets, including the near-banks. One need only look at the immediate responses of the financial system to the changes in the Bank Rate this year for confirmation of this statement.

This is not to say that the institutional arrangements required to meet the minimum needs of monetary policy are necessarily entirely satisfactory from other points of view. Reserve requirements do have implications for profitability and for the competitive balance between those deposit-taking institutions to which they apply and those to which they do not apply. Important issues of equity and economic efficiency would therefore seem to be involved. However, in this country the system of reserve requirements is only one of many provisions in the complex framework of federal and provincial laws governing our deposit-taking institutions that raise similar issues. It is therefore inevitable that difficult value judgments must be made in attempting to reach a balanced view about the equity or lack of equity arising from this and other dissimilarities of treatment among institutions that are engaged in increasingly similar activities.

I would like now to turn from the discussion of reserve requirements to comment briefly on the proposals with respect to the operation of foreign banks in Canada. I have no hesitation in saying that I welcome these proposals. Foreign banks already have a very significant presence in Canada, albeit on a basis that is outside existing banking legislation. The thrust of the proposals is to regularize this situation and to regulate its future evolution. I believe that foreign banks do have a useful role to play in Canada and I regard it as desirable that all banks operating here should be part of the same system operating under the same basic rules

and regulations. At the same time I feel that the principle of applying some limits to the growth of foreign banks in Canada is not unreasonable and is indeed desirable in view of the risks and uncertainties we would invite by opening the door too widely.

The proposals with respect to foreign banks do not in my view have significant implications for the implementation of monetary policy. Because these institutions are likely to raise most of the funds they will be lending in this country from financial markets in Canada, they too will have to compete for funds within the prevailing structure of our domestic interest rates. I have seen the suggestion, however, that foreign-controlled institutions will be less likely than Canadian institutions to respond to moral suasion. As you are no doubt aware, moral suasion consists in requesting the banks, and possibly other financial institutions and market participants, to allocate credit, set interest rates, or otherwise conduct their operations in conformity with particular, specified monetary policy objectives rather than solely in the light of their own assessments of current market conditions. Without necessarily accepting the proposition that the behaviour of foreign controlled banks will be different from that of Canadian-owned banks in this respect, I would like to say that so far as I am concerned the Bank of Canada does not now, and probably will not in the future, rely to any great extent on moral suasion. Except in very special circumstances the Bank of Canada prefers to rely on market forces to transmit the effects of monetary policy. In my view, moral suasion is only useful for a short

period of time, and in unusual circumstances in which the need for some special type of action is evident to the affected parties and is ultimately in their own best interest. In such a situation I would expect to receive the co-operation of both Canadian and foreign controlled banks, and indeed, if the circumstances were to require it, that of other financial institutions and market participants as well.

I would like to turn now to comment briefly on the proposed amendments to the Bank of Canada Act, which, as mentioned earlier, are relatively limited in scope. These amendments fall into two basic categories -- those that are consequential to the proposed establishment of the Canadian Payments Association and those that up-date certain provisions of the Act or add marginally to the Bank's existing technical powers for other reasons.

The thrust of the first group of amendments is to allow non-bank members of the CPA to effect their settlements with other members through the Bank of Canada in much the same way as central bank facilities are now used for this purpose by the chartered banks -- that is by making transfers between deposit accounts held at the Bank of Canada. The essential difference is that such deposit accounts held by the chartered banks, while available for making clearing settlements, are an integral part of the system of minimum cash reserve requirements, whereas in the case of non-bank members of the CPA these deposit accounts would be maintained for the purpose of clearing settlements only. It seems probable that a choice of clearing arrangements (depending on the volume of a member's chequing business) will be considered desirable, so that only the larger non-bank

members may in the end wish to maintain a deposit account with the Bank of Canada. In any case, to put all members on an equal legal footing in this respect, it is proposed that the power of the Bank of Canada to accept deposits from banks be extended to include the acceptance of deposits from other members of the CPA. Likewise, any non-bank member which chooses to keep its clearing balance with the central bank will also need contingency borrowing facilities to enable it to make settlements that in unforeseen circumstances might be larger than its deposit. Thus, it is proposed that the Bank of Canada's power to make temporary loans and advances to banks be extended to permit similar credit facilities for non-banks. Since these changes would broaden the group of institutions with which the Bank could have direct dealings, it would accordingly seem desirable to adjust certain other provisions of the Act such as that relating to the eligibility of Directors.

The remaining amendments include a number of relatively minor changes affecting the management of the Bank and a new provision designed to clarify the status of Bank of Canada notes in the light of a recent Supreme Court decision, but they mainly serve to clarify or broaden somewhat the Bank's technical powers with respect to its foreign exchange operations and the range of financial assets it can deal in or take as collateral. For instance, the Bank would be empowered to maintain deposit accounts with banks either in Canada or abroad to facilitate its foreign exchange operations, to buy and sell Special Drawing Rights issued by the International Monetary Fund, and to deal in a slightly broader range of instruments issued or endorsed by chartered banks than those presently specified in the Act.

These proposed amendments are of a limited and technical character and do not entail any significant change in the basic powers embodied in the present Act. The absence of proposals for more fundamental changes in the Bank of Canada Act reflects our view that the basic powers currently at the disposal of the central bank are adequate for the effective conduct of monetary policy and for the proper discharge of the Bank's other responsibilities.