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Luncheon Address by

Gerald K. Bouey

Governor of the Bank of Canada

to

The Canadian Club

Toronto, Ontario

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When I received the invitation of your President last winter to speak to the Canadian Club this autumn I thought it most likely that my remarks would be devoted entirely to questions related to monetary policy. A speech at this time would give me the useful opportunity of presenting an account of the way economic conditions have developed and how we have conducted monetary policy over the half year from the time my Annual Report was published in March. Since I did not expect that we would be confronted with the kind of banking problems that had not arisen in this country for over sixty years, I thought that there was a good chance that we were at last in for a reasonably quiet period. I sent my letter to Jim Pitblado accepting the invitation on March 14th. Little did I know that the effort to deal with the problems of the Canadian Commercial Bank was about to begin.

Therefore, besides the Bank of Canada's continuing responsibilities in regard to monetary policy, our main preoccupation since that time has been with the attempt to save two small western banks -- small in the sense that they account for only one per cent of the total assets of the Canadian banking system. As you know, and as I greatly regret, the outcome has not been a happy one. I want later in my remarks today to say something about that episode because I know it has been on many people's minds. My references will focus on the role of the Bank of Canada, a role which it seems to me from what I read and hear is not always well understood. First, however, let me talk about matters related to our major responsibility, monetary policy.

In my Annual Report last spring I described the continued recovery of the Canadian economy from the recession of 1982. The fact that we were still some distance from full prosperity was evident in the difficulties still being encountered in some regions and industries and in the persistence of a high unemployment rate. Nevertheless I concluded that our economy was in better shape than it had been for some time, and I expressed some confidence in our prospects for the future. I am pleased to say that events during the last six months have served to reinforce that view.

During the first two years of this recovery, a major source of stimulus was the rapid economic expansion in the United States. The value of our exports to the United States increased by more than 45 per cent from 1982 to 1984. While the contribution to our economic recovery from the strong expansion of spending in the United States has been very welcome indeed, there have been concerns that our recovery has been too narrowly-based. The fear seemed to be that when the rise in economic activity began to slow in the United States, as it was bound to eventually, Canada would slide back into recession. Such views were far too pessimistic about our underlying economic situation but the concern was nonetheless understandable. The heavy indebtedness accumulated by both households and businesses in Canada during the period of high inflation had left them vulnerable and, with the fear of a return of high interest rates never far from people's minds, confidence in the Canadian economy was at a low ebb. Through 1983 and 1984 many individuals and businesses gave priority to reducing their indebtedness, and we saw only moderate advances in spending by consumers and no increase in investment.

By the beginning of 1985 the financial health of both businesses and individuals had become much improved. Also, the progress in bringing down inflation both in Canada and overseas, and the record in keeping it down, provided a much firmer basis for economic expansion than had existed for some time. It is true that there were discouraging increases in interest rates in the first half of 1984 and again in early 1985. Still, a sustained improvement in inflation performance in the industrial world was bound eventually to be reflected in lower interest rates. I am pleased that not only have the increases in interest rates that occurred early this year been reversed but that many rates have declined further.

The improvement in consumer and business confidence has produced increased spending on consumer goods, housing, and business investment this year. We can also welcome some signs of improvement in those regions of the country where the recovery has up to now been rather weak. Even so, the pace of activity still remains strongest in central Canada.

The sustained advance in economic activity has led to substantial increases in employment and has at the same time attracted many workers, particularly women, into the labour force. The unemployment rate has continued to decline but, at 10.3 per cent in August, still remains far too high.

The earlier improvement in our inflation performance has been maintained although some indicators point to a slight quickening in the pace of price increases so far this year. However both the wage bargaining process and adjustments in salaries seem to have been realistic in recognizing the improved outlook for inflation in Canada. And the price pressures that have occurred as the Canadian dollar weakened from early 1984 to early 1985 have in our present economic circumstances largely been absorbed.

With a 4 per cent rate of inflation currently, there is clearly still room for improvement but I see no signs of any reversal of the basic trend towards better price performance. Indeed I am more hopeful about the longer run prospects for inflation than I have been for some time. What is particularly important is that the objective of stable prices appears to be increasingly accepted in public attitudes. There is very little support these days for taking risks with inflation. Unfortunately people had to learn from bitter experience that inflation brings with it no lasting gains but only substantial costs. Monetary policy has a special responsibility for ensuring that the bitter experience does not get repeated.

For some time, in line with our improving inflation performance, the objective of the Bank of Canada has been to encourage lower interest rates in this country. However, the road to lower interest rates has had some detours. That is why I devoted so much space in my last Annual Report to explaining the different influences, both domestic and external, at work in shaping the particular path taken by Canadian interest rates. The key element in our experience in 1984 and early 1985 was the demonstration that if confidence in the international value of the Canadian dollar becomes undermined, it is impossible to "buy" lower Canadian interest rates by permitting a further depreciation of the dollar.

Early this year, as the U.S. dollar strengthened sharply and the Canadian dollar reached a new low point in terms of U.S. currency, our financial situation was in fact distinctly uncomfortable. Following this bout of exchange rate pressure, we found ourselves with interest rates higher than before and with a wider margin above U.S. interest rates. The appreciation of the U.S. dollar against most other currencies aggravated still further the distortion of international exchange rates. The relationship of the Canadian dollar to other major currencies was pushed further out of line. Canadians found themselves even more competitive in U.S. markets, sometimes to the point of generating protectionist responses from the United States. But at the same time the position of those companies and industries engaged in selling to overseas countries became even more difficult. That situation has been described to me as something like having your head in the oven and your feet in the fridge. Your average body temperature may still be normal but the overall feeling will certainly be uncomfortable.

I am pleased to report that the situation in our financial markets has become more comfortable in recent months. U.S. interest rates have come down as economic growth has slowed in that country. This decline in interest rates is welcome although I would much rather that the decline was the result of action to reduce the U.S. fiscal deficit. As well, the U.S. dollar has depreciated and exchange rates around the world are somewhat less distorted than before. The Canadian dollar has depreciated correspondingly against most major overseas currencies, and that should be helping to ease some of the strains on companies with traditional markets in overseas countries.

At the same time our exchange rate with the U.S. dollar has been reasonably stable, after recovering from the low point reached last March. With the benefit of this more stable environment there appears to be some recovery of confidence in the Canadian dollar. As a result it has been possible to narrow the margin of our interest rates above those in the United States. The combination of the decline in external interest rates plus the narrowing of these margins has brought interest rates in Canada down significantly since last March, and some rates are at the lowest levels seen since 1979. I would still like to see lower interest rates in Canada but we may soon be approaching a point where more progress will be needed both with respect to inflation and in reducing fiscal deficits here and elsewhere if we are going to have further sustained reductions in interest rates.

In this report on economic and monetary policy developments I have been emphasizing our improved domestic performance; however I should also point out that the international situation is surrounded by considerable uncertainty. In particular there is the U.S. budgetary deficit and its effect on interest rates both in the United States and the rest of the world. The high U.S. interest rates have been a major cause of the distortions in the international value of the U.S. dollar and hence in the structure of the U.S. balance of payments. An ever larger trade deficit is now fanning protectionist sentiment in that country. No one can be sure where that can lead. The position of heavily indebted developing countries also remains rather worrisome. Nonetheless, our own improved economic performance still provides grounds for a positive view of the future. External events can and will affect us, but our domestic situation is now much more resilient than it was before, and we are much better placed to withstand external complications while continuing to get our own house in better order.

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As I mentioned at the beginning, I would also like to make some comments on the Bank of Canada's involvement in the developments surrounding the Canadian Commercial Bank and the Northland Bank. There will be an occasion to review these developments with a parliamentary committee and I will limit myself here to making a few basic points about the Bank of Canada's role.

Perhaps I should start by stating what our role in regard to banks experiencing difficulties is not. The Bank of Canada is not involved in monitoring the financial soundness of individual banks and supervising their behaviour. Parliament has not given us that responsibility or the powers that would enable us to fulfil that function. The Bank of Canada has no bank auditors, no bank examiners, no power to require details of individual loans, deposits or any other kind of private transaction. This situation seemed to come as a surprise to some people. The misunderstanding probably stemmed from the fact that supervisory arrangements are quite different in some other countries. In many, including Britain, the central bank is solely responsible for the supervision of banks. In the United States the responsibility at the federal level is shared among the Federal Reserve System, the Comptroller of the Currency and the Federal Deposit Insurance Corporation. In this country the system of bank supervision, based on an information network of external bank auditors, internal bank inspection systems and bank managements, was designed by Parliament to operate separately from the Bank of Canada, and the Bank must rely on the judgements that emerge from it.

Thus, although the Bank of Canada was thoroughly involved in the discussions last March that led to the establishment of a support package for the Canadian Commercial Bank, it was not in a position to provide information to that part of the discussions bearing on the condition of the bank and therefore on how large the support package needed to be. The judgement about the size of the support package required to make the bank solvent and viable was based on the best information available at the time the decision had to be made. And I regarded that judgement as reasonable in the circumstances. The Bank of Canada therefore wholeheartedly supported the effort to save the bank. That is why I stated publicly at the time, and repeated subsequently, that since the bank was judged to be solvent and viable the Bank of Canada would provide whatever liquidity support was required.

And after the support arrangements had been agreed upon, the Bank of Canada performed in accordance with its responsibility to supply liquidity to chartered banks. It continued to make advances right up until the time -- September 1st -- when it received notification from the Inspector General of Banks that in his opinion the Canadian Commercial Bank could no longer be considered a viable operation. By then our advances outstanding, secured by assets of that bank, amounted to $1,316 million.

Although a great many depositors left the Canadian Commercial Bank, in the end it did not fail because of lack of funding. While the Canadian Commercial Bank was still judged viable, the Bank of Canada provided all the liquidity that the bank required. It failed because of problems with its loan portfolio.

That the effort to save the Canadian Commercial Bank was not successful does not mean that none should have been attempted. I believe the blow to confidence in our financial system both in Canada and abroad would have been very severe indeed if the first bank failure in over sixty years had been allowed to occur suddenly without a serious attempt to prevent it.

The Bank of Canada also made substantial, fully secured advances to the Northland Bank on the understanding that it was solvent and viable, and we continued to do so until we received a similar notification of non-viability. At the end of August the outstanding advances amounted to $510 million.

The Bank of Canada can expect to recover all the funds it has advanced to these two banks on a secured basis but of course it is a matter of very great regret that their problems have not been solved through this liquidity support.

I think this account underlines quite clearly the role the Bank of Canada plays in helping to preserve the stability of our financial system. That role is one of providing liquidity support to solvent banks that are encountering withdrawals of funds they cannot readily meet out of their own resources. It would be foolish to force a bank to call its loans and sell off its assets at fire-sale prices because of a temporary withdrawal of funds. The duty of the Bank of Canada is to advance funds to banks needing help on these occasions in order to prevent a loss of confidence from spreading and to give a sound institution time to demonstrate that a loss of confidence by its depositors was unjustified.

Let me emphasize this last point. The fact that our massive liquidity support for the Canadian Commercial Bank did not in the end prove to be a sufficient remedy does not in any way call into question the need for the Bank of Canada to provide such support should any other bank ever require it. The Bank stands ready to carry out that responsibility.

In concluding, let me remind you that these problems occurred in institutions that constitute only one per cent of the assets of the Canadian banking system. A good banking system is absolutely essential for a well-functioning economy. We Canadians have for many years been justifiably proud of our banking system, and the Bank of Canada will play its part in ensuring that the system remains strong in the future.