CENTRAL BANKING AND INVESTMENT BANKING

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During the past two years there have been developments of considerable interest in the fields of both central banking and investment banking, and in the relationship between the two. These developments have continued a process which began 21 years ago with the establishment of a central bank in Canada, and which has been going forward ever since, both in peace and in war. Certainly the investment banking business has acquired increased importance in Canada over this period, has come to fulfil an increasingly important function in the financial structure of our economy. That structure as a whole is in consequence stronger, better integrated, more flexible and of more value to the nation through the assistance it provides to economic growth and development, to the increasing maturity and diversity of our economic life.

By way of background to some further comments on investment banking in Canada today, I should like to refer to changes in the monetary situation over the past year, and to the way in which the monetary operations of the central bank and the credit-granting operations of the chartered banks interact with the operations of investment dealers in the distribution and re-distribution of securities and other investments.

It is sometimes said, inaccurately and with misplaced dramatic emphasis, that monetary policy is now restrictive, where a year or more ago it was expansive, and that credit has been or is being restricted. These phrases imply that there is less money available, less credit available, today than at some time in the recent past. This idea is sometimes coupled with the statement, also inaccurate, that the raising of the Bank Rate by the central bank was intended to bring about monetary restriction and did so.

The facts are that the total money supply (currency and bank deposits) has not been reduced, but has continued to grow, and that credit has not been restricted but has continued to expand. Savings are continuing to rise, both in bank deposits and in other forms, long-term investors have more money available for new investment this year than ever before; economic growth this year will be the biggest in our history. Bank loans have increased every month so far during the period of so-called restriction, although it seems probable that the rise in total bank loans will slow down before very long; some categories of loans may decline while others go on increasing.

It is always possible, indeed it is normal, for bankers and investors to take different views from time to time of various kinds of loans and investments. In particular, at a time when the demand for money, the desire to borrow money, exceeds the supply that may prudently be made available, it is inevitable that some potential borrowers will be disappointed, some financing will have to be postponed, some loans will fail to meet the higher standards of credit-worthiness adopted by lenders in such circumstances.

This is what has been happening in the credit field, both long term and short term, in recent months. On the supply side there has been no overall reduction but rather continued growth. But demand has grown even more, and the projects for which funds are required have given every indication of being more, in total, than the physical potential of the economy. This has been true both of Canada itself, and of North America as a whole, and indeed of the greater part of the world. To permit the supply of money to become excessive, to expand to the full extent of the demand at the pre-existing level of interest rates, would in such circumstances be clearly inflationary; it is the duty of central banks not to give way to the demand for such an excessive financial expansion. I am speaking of overall totals; monetary policy as such does not deal with the allocation of financial resources to particular persons or enterprises or regions.

Limiting the rate of financial expansion under such circumstances does not limit or attempt to limit the total amount of physical expansion, whatever amount may be physically possible, but simply seeks to ensure that financial expansion does not exceed or encourage futile efforts to exceed what is possible in the physical sense. Too much money chasing the available production of goods and services will not help to achieve the maximum sustainable rate of physical growth of the economy, but may hamper such growth, in addition to bringing all the other evils of inflation in its train.

Except at a time of marked underemployment of the economy as a whole, any strong demand for money, any rapid increase in the total demand, will cause a rise in interest rates. This rise is caused by the interaction of supply and demand, not by the action of the central bank, except in the sense that the central bank could prevent the rise in interest rates by providing an unlimited increase in the money supply. Normally the rising demand makes itself known through a rise in bank loans and bank deposits, and a fall in the prices of securities as sellers seeking to raise cash exceed those wishing to buy securities at existing levels. Banks too will have to sell securities to accommodate the increase in loans, unless the central bank increases their cash reserves, which would be a consequence of the purchase of securities in the market by the central bank. In fact, at a time of rising demand for money, a central bank will usually buy some securities and so add somewhat to the money supply, but not at a fixed level of interest rates or of security prices.

One effect of the normal reaction of a central bank to an increase in the demand for money is therefore to meet part of the demand and to that extent damp the rise in interest rates. Central bank action does not usually cause changes in interest rates, but restrains them, moderates them. But since only part of the demand is filled by an increase in the total supply of money, interest rates do rise until there is some abatement of demand, and/or there is a change in the distribution of the existing supply of money, some existing holders being found who will put their money at the disposal of some at least of those who are seeking to borrow. There is thus an increase in the rate of use of the existing money supply, a shift from inactive deposits to active, as it were. It is important to recognize that this potentiality always exists to a greater or less degree, and can at times work against central bank policy. It is particularly important that the process of activation of inactive money should commence before inflationary developments gain too much strength, rather than that expansion of the total supply should continue without limit until it is found necessary to restrict the supply under conditions where very drastic action might be necessary, because the restriction would then have to be sufficient to offset the belated process of activation of previously inactive holdings on a very large scale. The change in interest rates when it finally occurred would then be violent rather than gradual, and failure to moderate earlier the expansion of credit would lead to a severe contraction.

Perhaps all this sounds rather theoretical, but it is in fact a very practical matter in central bank operations and was very much in our minds in connection with the developments of the past twelve months.

Returning to what happens when the demand for money continues to rise after a condition of generally full employment has been reached, the rise of interest rates in the market may continue to the point where another method of increasing the total money supply may be involved, namely recourse by the chartered banks and by money market dealers to the central bank for short-term loans or purchase and re-sale arrangements. To meet emergency situations and for the smooth functioning of the money market the central bank occupies the position of a lender of last resort. It must always be ready to act in that capacity, for a price, and the price is represented by the rate of interest which the central bank charges on its advances, in this country called the Bank Rate. As long as money can be obtained elsewhere at a better rate, no one tries to borrow from the central bank, but if other interest rates rise to the point where it is more expensive for a chartered bank to call its day-to-day loans or sell Treasury Bills, or more expensive for a money market dealer to borrow on day-to-day loans in the market, than to borrow at the existing level of Bank Rate, then there is a natural tendency to turn to the central bank with its cheaper rate.

We are speaking of a situation in which the central bank has been conducting its open market operations from day to day according to its best judgment of what is appropriate in the circumstances. If it is not prepared to increase the overall money supply without limit by purchasing all the securities offered to it at a given level of security prices, it would be frustrating its own objectives to do so by making loans on a large scale. It must, in such circumstances, raise its lending rate, the Bank Rate.

In theory the Bank Rate could be changed every day in very small fractional amounts, but it is usually considered more convenient to do it in rounder amounts at intervals. The Bank of Canada Act requires that the Rate shall at all times be made public.

I will not take time on this occasion to relate the history of developments in the use and significance of Bank Rate and of the short-term money market in Canada. This was covered in some detail in our Annual Reports for 1955 and 1954. There have been changes in other countries too. Before the first world war a central bank's discount rate was chiefly significant in terms of movements of foreign exchange and the maintenance of the gold standard; for awhile in later years changes in central banks' discount rates, though recognized as instruments of domestic policy, tended to be rather infrequent and to occur only when it was desired to emphasize a major change in the economic outlook. In recent years much more frequent and more flexible use of Bank Rate has been noticeable, particularly since 1951 in the United States, and by February 1955 the development of our own money market had reached the point where Bank Rate could be put into commission as an operating factor rather than merely as a symbol.

The question of timing remains of importance. Unless the central bank is going to tie its rate to some fixed relationship with other rates, Treasury Bill rates, for example, the time of a change in Bank Rate may seem on occasion to lag behind, or alternatively to lead the market. A change in the Bank Rate in either direction may be followed by further market change in the same direction, though not invariably so. Upward movements are more likely to synchronize closely with market changes than downward ones, and an upward change retains some symbolic significance, arising out of the circumstances which give rise to it, for it indicates that the central bank feels that the increase in the demand for money at current levels of interest rates is excessive.

A description of the movement of bank deposits over the past twelve months will provide a good illustration of several points made above and will lead me into a discussion of the part played by investment dealers in the adjustment of demand and supply in the financial field. Total Canadian deposits of the chartered banks (adjusted for changes in "float") rose by $550 million in the 12 months ending May 30, 1956. This was more than accounted for by a rise of $310 million in personal savings accounts and of $325 million in Government of Canada balances. All other deposits (adjusted for changes in total float), i.e. the bulk of the "commercial money", fell by $80 million for the period as a whole, despite the great rise in bank loans, in general economic activity, and in spending of all kinds.

In the twelvemonth, bank loans and non-Government investments rose by $1,500 million, or 29%. During the early part of this period there was in consequence some expansion of total bank assets (and therefore of deposits) but to an increasing extent the expansion of the chartered banks' loans and non-Government investments had to be financed by the liquidation of their holdings of Government securities. The one has been fully matched by the other for the past six months, and for the twelve months as a whole the reduction in chartered bank holdings of Government securities amounted to $925 million. This was the net result of an increase of $325 million in Treasury Bill holdings and a decrease of $1,250 million in holdings of Government bonds.

Accommodating such a huge adjustment in the distribution of Government securities (in addition to the large sale of Canada Savings Bonds) was quite a challenge for our financial machinery, and those who worked together to make it possible, and particularly the investment dealers, can take a considerable measure of satisfaction from the manner in which the challenge was met.

You may be interested in the figures, on the basis of preliminary estimates for the end of May. It appears that, apart from Canada Savings Bonds, $400 million in Government securities was taken by the general public, another $400 million by Government investment accounts (using money which originated with the general public), and about $40 million was accounted for by net reduction in the outstanding amount of direct and guaranteed marketable securities of the Government of Canada. Only $80 million was added to the holdings of the central bank; this was approximately equal to the increase in active note circulation.

The $440 million taken in one form or another by the Government and Government accounts was not provided by running down Government cash balances; on the contrary these rose by about $300 million. Notionally, you might say that the increase in Canada Savings Bonds bought by the general public to the net amount of $340 million (net of redemptions during the period) provided most of the funds used in the acquisition of securities by Government accounts; an alternative way of looking at it would be to match off the net increase in Canada Savings Bonds with the increase in the Government's bank balances. On this view, the funds used to purchase market securities for Government accounts were provided by the general public in a different form, namely, in part by an excess of Government revenues over expenditures, in part by public purchase of Government annuities, in part by funds accruing to the Superannuation Fund, and in part by other capital receipts of the Government.

While the net increase in total holdings of Government securities by the Bank of Canada was not large, there was a big change in the character of our holdings, chiefly as a result of the retirement of our holding of $675 million in 6-month Treasury Notes. The Government effected this retirement by increasing the Treasury Bill issue at intervals during the period, by a total amount of $700 million, of which the Bank of Canada took $190 million, the chartered banks $330 million, and the general public $180 million. In the category of Government bonds, as distinct from Treasury Bills and Treasury Notes, the Bank of Canada added $565 million to its holdings, so that its total portfolio, as already stated, rose by about $80 million.

Having in mind the effect of the sale of the new series of Canada Savings Bonds in absorbing a substantial amount of personal savings, the achievement of investment dealers in the redistribution of marketable Government securities was very notable. This was also a period in which life insurance companies were further reducing their holdings of Government bonds in order to increase their mortgage loans and other investments -- i.e. for the same general purpose as the chartered banks. Non-residents on the whole were also selling Government bonds in Canada. Finally, outside the field of Government of Canada securities, it is no news to yourselves that Canadian investment dealers probably raised more money in the period in question than in any other 12 months, on behalf of Canadian provinces, municipalities and corporations. The job of encouraging and mobilizing the savings of the Canadian people, and of directing them into useful investment, and of facilitating the most efficient use of money already in existence, was, I think, carried out with great success.

After having paid you all these compliments, I had better go on to say there is still much to be done, bigger challenges to be faced in the future, greater achievements to be sought. The short-term money market has made remarkable progress in the last two or three years, but should be expected to expand and improve substantially in the years ahead. Here, as in the other areas of investment banking, there is need of more capital, for one thing, for the carrying of larger positions, and of improved facilities for arbitraging one maturity against another. Again, the sale of equity-participation in Canadian enterprise to Canadian investors, although you come up against the stonewall of the life insurance companies, will offer an increasing field of activity for a long time to come. Progress was very noticeable last year, particularly in the case of "blue-chip" stocks of long standing. In the case of both new issues of common and preferred stocks and of re-distribution of holdings up for liquidation, I know that the members of the Investment Dealers' Association of Canada are as keen as anyone to maintain and increase the Canadian share. This is a field in which several of the chartered banks have on occasion given a lead and played a prominent role by aiding with temporary financing, and I am sure they will be responsive to further opportunities of the same sort.

Another field in which the public interest would be served by an expansion of the activities of investment dealers is the development of a secondary market for mortgages on residential properties. In relation to securities, dealers have long recognized their responsibility to develop and improve secondary markets, the after-issue or between-issues market, in the interest of borrowers and lenders alike. Only in this way can investments be rendered liquid, that is, provided with a market in which sellers can find buyers at any time without too great a change in value resulting from the activity of any one buyer or seller.

The more active and progressive investment dealers, the real architects of our capital market, are now considering ways and means of filling what has become a very noticeable gap in our market apparatus. We do not yet have in Canada broad smoothly-functioning secondary market in mortgages. The entry of the chartered banks into the field of making and servicing insured residential mortgages under the National Housing Act offers the possibility of a large and fairly continuous supply of such mortgages for re-sale to other investors. The banks, with their widespread branch system, can initiate and service a much larger volume of mortgage loans than they themselves would normally wish or be able to add to their portfolios. They can put together a representative bundle of mortgages--on properties located in any area or throughout the whole country--with good spread of risk, or what small risk is left after the 98% insurance feature is taken into account.

With a supply of merchandise available, it is up to the investment bankers to make a market for buyers and sellers alike. Some large parcels of insured mortgages have already been sold direct by the original lenders to investors such as pension funds, but there is an obvious need for comprehensive facilities to promote broader distribution. The fact that the servicing function, in the case of insured mortgages, can be separated from the investment function is a great help in finding a broader market, --an investor need not confine himself to his own area. On the technical side, there is need for more study of the costs involved and of the relationship between them--costs of acquisition, of transfer, of servicing the mortgage, cost of money, and cost of servicing the investor. This is familiar ground for investment dealers. I will only make one suggestion. I believe there is a place for intermediate corporations issuing their own debentures secured by mortgages--conventional as well as N.H.A. mortgages--debentures which could be closely held or broadly distributed according to circumstances. Investors who fear, rather unnecessarily I think, that some opprobrium or loss of goodwill might result from occasional foreclosure action might be interested in a mortgage corporation with only a few owners or debenture holders, thus combining impersonal ownership with very small costs of operation.

Among the advantages which would accrue from the development of a broad secondary market would be not only a marked improvement in the investment quality of mortgages because of the increased liquidity, but also a closer integration of mortgage interest rates within the general market pattern because of the greater ease of trading from one kind of investment to another, consequent upon the elimination or lowering of barriers which now deny access to the mortgage market to various classes of investors.

Incidentally, this is a field in which, once any technical problems are overcome, it should be possible for the smaller investment houses to operate as successfully as the larger ones.

I have talked about several specific matters in which the central bank is interested, including a number which are of direct concern to investment dealers, and I have tried to bring out to some degree the relationship between the central banking function and the investment banking function. The interest of the central bank in all these matters affecting investment banking might be summed up by saying that the central bank believes that its own operations will be the more successful if carried on through a well-established, smoothly functioning financial structure designed to do the best possible job of bringing together saving and investment at the highest level that the Canadian economy can sustain.

It is the objective of any central bank today, and it is written into the preamble of the Bank of Canada Act, though I am not using the exact words of that preamble, that monetary policy should use its influence to encourage the full employment of productive resources without inflation of the price level, and to assist in the processes of economic growth on the highest sustainable level, which means, if at all possible, stable growth solidly based.

No one recognizes more clearly than a central banker that there are limits to the effectiveness of monetary policy. It is by no means the only factor influencing economic activity. The non-monetary fields of domestic policy, including fiscal policy and the various economic activities of all levels of government, are of the highest importance and may have more effect on the overall situation than monetary policy under certain conditions. I have said nothing today about international influences although we all know that events entirely beyond our control, developments in large countries abroad, can have a very great impact on Canadian production, employment and prices, and produce fluctuations which domestic policy could at best mitigate, not entirely overcome. And finally there are numerous decisions taken in the economic sphere by producers and consumers alike for reasons which are sometimes wholly beyond the influence of overall monetary factors.

There is one other point I should like to make in relation to monetary policy in its proper sphere of action. That is that by its nature it must be general rather than specific in its effects, national rather than regional in its application, and that its economic impact is of necessity indirect, through its influence on money and credit and the total financial environment, rather than acting directly upon any particular kind of economic activity. It is the object of monetary policy to exert its influence gradually and in the most flexible manner, preferably by continuous small adjustments, rather than abrupt drastic changes; it must be ready at all times to adapt to actual conditions rather than adhere to preconceived ideas.

One factor which I need hardly emphasize in talking to investment dealers is that effective monetary policy in a free economy would be completely incompatible with rigidity of interest rates. Variations in interest rates, especially those applying on marketable securities, are evidence of changing conditions in the supply of and demand for money and credit, and a necessary and desirable consequence of such changes. Fluctuations in the price of money are to be preferred to fluctuations in the price of goods, that is to say, in the cost of living and the costs of production of our economy, and can be an important influence in minimizing unemployment and facilitating healthy growth of the economy as a whole.

Monetary policy as such operates indirectly without specific direct controls. Direct controls, whether of fields of credit or of production and distribution, may under some circumstances appear temporarily necessary in the public interest, but monetary policy in the strict sense of the term is within the limits of its effectiveness, the alternative to direct controls. It is an essential instrument of freedom in the economic sphere. Indeed, the whole of our financial structure in this country as it has developed and as it is further developing today is an instrument for the buttressing of economic freedom and the encouragement and development of the highest possible degree of economic and social welfare. All those who are concerned in the overall financial process, all of you here today, are contributing to this objective and share the responsibility for the degree of progress that may be from time to time achieved.