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Draft

For release
Monday, December 14, 1959
at 7.00 P.M.

"CREDIT AND CAPITAL"

Remarks by
Mr. J. E. Coyne, Governor of the Bank of Canada,
prepared for delivery at a meeting of the
Investment Dealers Association of Canada (Ontario District)
in Toronto, December 14, 1959

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Members of the investment banking industry are particularly interested in the role played by credit and capital in the economic growth of the nation. It is in their interest, as it is in the interest of their customers and of all other groups in the economy, that growth should be maintained on a sound basis without violent fluctuations every few years, that a high and stable level of employment should be sustained to the maximum degree possible, that inflationary and deflationary tendencies alike should be resisted and counteracted, and that in the furtherance of these goals, the financial resources of the country should be employed as soundly and effectively as possible.

Although the proper use of credit poses many problems, some form of credit is necessary in any kind of economic society other than one carried on by direct barter with settlement effected every day. In theory all credit could be provided directly by those immediately concerned, but in practice no economic society could develop very far or operate efficiently if there were not specialized financial intermediaries seeking out those who are in a position at any given moment to extend credit and channelling it to those who feel they can best make use of it and are prepared to pay appropriate prices for it.

Canada as a nation extending over vast distances comprising many different geographical and climatic areas, has been particularly dependent not merely on such obvious nation-knitting activities as government and transportation, but also upon a nation-wide system of credit by which surpluses or savings arising in many different parts of the country could be made available to meet the needs of many other parts of the country.

Most of our chartered banks have grown to be very large institutions operating in all ten provinces and consciously fashioning their activities on a national basis. The chartered banks also serve through clearing arrangements to provide some degree of inter-connection between other purely local institutions in different parts of the country. All this has become quite familiar to Canadians. What is perhaps not so widely recognized is that we also have in Canada a well developed nation-wide capital market, particularly in respect of the distribution of securities issued by governments, local authorities and business corporations. This is primarily the field of activity of investment dealers. I think there is little doubt that the financial machinery existing in Canada for the placing of new issues of securities on the market is the equal of that of any country in the world and, in proportion to our size, it probably arranges, year in and year out, for the provision of a greater quantity of new capital to those requiring it than is the case in any other country in the world. The results achieved are a reflection of the industry and enterprise and broad national outlook of our investment dealers, just as the results achieved by our banking system bear witness to the similar qualities of those who built up and operate our great chartered banks.

The Bank of Canada's interest in the Canadian capital market is threefold. In the first place our open market operations, which are the main instrument of monetary policy, can be carried out most effectively and smoothly in a market where there is a large and continuous volume of trading and where there are financial intermediaries with substantial resources of their own which enable them to take a position from time to time in anticipation of the future needs of either borrowers or investors. The Bank of Canada is also greatly concerned with the capital market because of its responsibilities as fiscal agent for the Government of Canada, the largest borrower in the market. And thirdly, we take the same interest in the capital market that all must take who are concerned with the general economic welfare and progress of the country because a thriving capital market is an essential requirement for an efficient and growing economy.

The Bank's own operations other than as fiscal agent for the Government of Canada are, of course, mainly in the so-called money market or market for short-term securities. This was a part of our financial machinery which was not well developed when the central bank came into existence twenty-five years ago. Since 1935 we have been able to assist and participate in a number of developments leading up to the present situation in which we feel we have in Canada a broadly-based liquid money market which operates just as freely and smoothly as that in any other country and more so than in most and which is able to adapt itself flexibly to changing circumstances. We have seen the development of the market for treasury bills which began before the war, but really came into full operation only after 1954 with the inauguration by the ch bks of a system of day-to-day loans to ~~by which the chartered banks~~ assist in the financing of those investment dealers who specialize in short-term securities, with the underlying support of the Bank of Canada as the lender (though purely a temporary lender) of last resort. We have seen the development of a much broader market for short-term government bonds as well as treasury bills, and in the last few years a quite striking development in the market for short-term notes and debentures of business corporations. We have not yet developed a system of bankers' acceptances of corporate short-term obligations in this country, but if a workable method can be agreed WES among upon by the chartered banks and investment dealers suited to Canadian conditions, which of course differ somewhat from those existing in other countries in the days when bankers' acceptances were first developed, the Bank of Canada will, I am sure, be able to co-operate and assist in such a development.

One of the most notable features of the Canadian capital market has been the extent to which our investment dealers have cultivated and developed a very broad retail market, that is to say the placing of securities with private individuals and small local institutions, estates and trusts. In most other countries, including the United States, the market for government bonds and other high grade securities is largely confined to banks and other savings institutions, including notably the life insurance companies. In Canada too these institutions are a substantial source of funds for the capital market, but in addition the retail market has been developed to the point where it is more broadly based than in any other country I know. With the tremendous need for savings and capital investment in this country, it is obvious that the cultivation of the retail market has been a very healthy development and one upon which our future growth will also depend to a significant degree. Borrowers such as provinces, municipalities and corporations, which succeed in providing savings instruments suitable to the small investor will find here a very useful and proper source of funds which may be particularly helpful to them in periods when the total demand upon the resources of the larger institutions is abnormally strong.

I believe the development of our financial market has been materially assisted by the flow of statistical information which has been built up and published over the years. The quality of performance of any market must depend to quite an extent on the rapidity and completeness of the feed-back of information about its operations to the participants in it, which enables them continuously to adjust their affairs to latest developments. The Bank of Canada for its part has always attached great importance to furnishing up-to-date and comprehensive information on its own operations, on those of the banking system as a whole, and so far as possible on the operations of the capital market, and we have had the full cooperation of the chartered banks in this endeavour. Each Thursday night we publish our Weekly Financial Statistics covering for the week ending the day before, the central bank's operations, changes in interest rates and in the distribution of Government of Canada debt, and the chartered banks' Govt of Can. bond operations in the money market. The same release includes comprehensive statistics of the chartered banks' operations for the week ending eight days before. This is supplemented by additional material which is available monthly or quarterly in our monthly Statistical Summary. I believe there is no other capital market which receives as up-to-date and comprehensive information about matters which are of concern to it, and we are constantly trying to make improvements. It is sometimes suggested that we should also be publishing commentaries indicating our expectations about the future, as for example the trend of interest rates, but of course, as members of this audience will readily appreciate, nothing would be more calculated to produce convulsive movements of funds and changes in interest rates, and to discourage the development of a strong and independent market.

The market for credit -- whether to finance investment in new capital assets, or to finance personal or governmental spending for current purposes in excess of income -- is to some extent a single market with many borrowers able to choose between different sources of funds and many lenders able to choose between different outlets for their funds. Some borrowers, however, have very little real choice between alternatives and are heavily dependent on a single source, particularly for working capital funds where the only source may be their banker. Similarly, the chartered banks in Canada have to a considerable degree specialized their field of lending. Although they participate as investors in the long-term capital market by way of the purchase of government and corporate securities in the market and make insured housing mortgage loans, their primary credit function has been to provide (in addition to other banking services) short-term working capital for Canadian businesses -- including investment dealers -- and a certain reservoir of funds for personal loans.

The banks have by their actions and their pronouncements come more and more to assume the status of national institutions with a recognized social function or responsibility. Considerations of this sort play a part in their decisions as to the allocations of the credit resources at their disposal. In particular they have declared unequivocally that it is their purpose and policy, at a time when a quite selective approach has to be taken in the field of bank lending, to pay particular attention to those credit-worthy borrowers who are most dependent upon bank credit in their business operations and least able to find other sources of borrowed funds.

Although the total amount of bank credit has a tendency to increase over time, with rather large fluctuations in the rate of increase from year to year, the increase is itself only a very small part of the total credit extended by the banks each year. On the average year in and year out 95% or more of

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the volume of bank loans being made represents a re-lending of funds which had already previously been lent (usually within the preceding twelve months) and either repaid or allowed to be renewed. [The chief function of the banks is to manage a pool of credit in which the changes from borrower to borrower are quantitatively much more important than the aggregate changes in the total amount of credit outstanding.] New businesses are, of course, constantly being started and new loans are being arranged for such new businesses every year, every month, every week. Many other businesses will at any given moment be growing in the scale of their activities and in the degree of bank credit which they need and obtain, but at the same time other businesses will be declining or their need of bank credit will be falling as a result of the accumulation of internal funds from earnings or depreciation or because they have issued bonds or stocks. Moreover, a bank's view of the amount of credit that can appropriately be provided will in some cases be revised downward. There are also important seasonal movements which vary greatly from one type of industry or commercial enterprise to another, and the structure of bank loans will also reflect changes in trade credit relationships between producers, wholesalers and retailers and consequently in the amount of banking accommodation required by the enterprises in these various categories.

Most of the lending business of the banks would, therefore, be carried on in substantially the same way as before even if there were no year-to-year increase in the total volume of the banks' resources over a considerable period .... although I am certainly not suggesting that that will ever be the actual experience in this country.

Within a given total volume of bank credit, there are certain fields of credit that the banks can expand or contract more easily than others, fields in which the trend can be made the opposite of the cyclical trend in other fields. One obvious example is consumer credit whether direct loans by banks to individuals for the purpose of buying consumer durables, or loans by banks to instalment finance companies and merchandisers to enable them to finance such consumer purchases. Such loans by banks have tended to expand when other demand is slack, but may be contracted at a time when there is strong business demand for credit for normal working capital purposes. There is in other respects also a great degree of flexibility in the short-term loan accounts of the banks, both between different categories of borrowers and within each category between borrowers who are entirely dependent on bank credit and those which have other possibilities for raising funds.

Turning now to the Canadian capital market outside the banks, the volume of securities sold in recent years has reached very high figures. In the four years 1954-57 covering a full business cycle, net sales to non-bank investors of securities payable in Canadian dollars amounted to $5,725 million, which was nearly three times the increase in chartered bank loans and investments during the period.

Such net sales of securities to non-bank investors thus amounted to an average of $1,430 million per year over the period 1954-57. In 1958 the corresponding figure was $1,255 million (composed of net new issues of $2,560 million less net purchases of securities by banks of $1,305 million) and in 1959 to the end of November the figure reached an extraordinarily high level of $2,865 million (net new issues of $2,085 million plus net sales by banks ~~purchases by the public from the banks~~ of $780 million).

Net new issues in Canada by category of borrower and kind of securities issued have been as follows:

	1954-57 Average	1958	1959 (11 months)
Government of Canada and C.N.R.			
Treasury Bills and Notes	55	-130	580
Canada Savings Bonds	255	245	370
Marketable Bonds	- 365	1,135	80
Total	- 55	1,250	1,030
Provincial governments (and agencies)	340	455	300
Municipalities (and agencies)	190	210	150
Corporate bonds and finance company notes	535	350	215
Corporation shares	455	295	390
	1,465	2,560	2,085

Nevertheless, the requirements of Canadian borrowers have greatly exceeded the supply of funds made available in Canada for investment at going rates of interest, and have resulted in substantial placements of new issues of foreign-pay securities in the United States and other markets abroad. Aside entirely from funds obtained by Canadian subsidiaries from their parent companies abroad by way of direct investment here, net new issues of foreign-pay Canadian securities (other than Government of Canada) securities have averaged $450 million per year for the last four years.

Of the four-year total of $1,800 million of net new issues of securities whose principal and interest are payable in foreign currency, $600 million was issued by Canadian provinces, $400 million by Canadian municipalities, and $800 million by Canadian corporations. Some of these corporations, unlike provinces and municipalities, have substantial revenues or export proceeds in foreign currency which may be used to pay interest and repay the principal amounts of their foreign-currency borrowings, and which provide a natural hedge against the exchange risk involved in servicing the foreign-currency borrowings.

The raising of funds by sale of securities or by direct loans is, of course, only one method by which savings, domestic or foreign, are channelled into investment in capital development. For example, substantial amounts also become available for direct use by the saver in the form of depreciation allowances earned and undistributed corporate profits, and the personal savings which are invested in owned houses and in unincorporated businesses.

In discussing the role of credit and capital, I should explain that by capital I mean real capital or physical capital such as buildings, machinery, equipment, improved land, and works and undertakings of many kinds which are not consumed or used up as soon as they can be transferred from producer to user but which continue in existence for some time and are either used for the production of other goods and services, or are themselves of use and enjoyment to their owners or to the general public. Real capital can only come into existence through the application of human labour to produce durable things, not by the multiplication of money or credit.

While there are limits to the amount of real capital that can be brought into existence at any time, there is no similar limit to the amount of money or credit that can be created and transferred. In addition to agencies which lend the savings of others -- such as life insurance companies, pension funds, savings institutions of various kinds -- there are other agencies whose business also involves them in the creation of money or credit. The central bank can create credit, credit which is usually called money and which has the unique quality that it must be accepted in full settlement of any debt. Banking institutions, in so far as they create credit, are in much the same position.

Undoubtedly there are times in which the rate of spending is declining when a moderate increase in the total amount of money or credit created or circulated by central banking and other agencies can properly operate to stimulate economy activity.

There may be other circumstances ~~of an opposite nature~~ in which it would be in the public, interest for the central bank and other agencies to hold the total supply of credit constant or to bring about a decrease or to slow down the transfer of credit in order to offset an excessive tendency on the part of spending bodies to attempt to make use of an already existing volume of credit too rapidly.

The possible useful degree of action by a central bank in modifying the supply of credit upwards or downwards for general economic reasons of this character has I believe been greatly exaggerated. My own view, which I admit has evolved over the years, is that the most desirable way in which this influence can be exerted is through relatively small movements in the total supply of money and credit of the kind created by the central bank and the commercial banks.

This view has so far been generally accepted or at any rate practiced only with respect to possible decreases in the supply of money. There has in fact been no period since the war, even when major inflationary tendencies were apparent, when there has been any significant decrease in the total volume of money or when public opinion would have tolerated such a decrease, and I do not say that any such decrease would in the circumstances have been desirable. I do not think that a major reduction in the money supply should be looked to as a means of countering inflationary trends, particularly if sufficient restraint has been exercised in previous expansions of the money supply.

In a time of recession a modest increase in the total quantity of money should I think be sufficient to provide a climate of opinion in financial matters which was favourable to expansion and ~~together with~~ some decrease in the level of interest rates. Agreement on acceptance of this half of the general view I have indicated is apparently much more difficult to achieve. At any rate there appears to have been too easy an acceptance of the contrary opinion that in a recession there is virtually no limit to the amount of monetary expansion -- and perhaps to the amount of government deficit -- that can be justified as being necessary to stimulate spending throughout the economy and thus the level of economic activity and employment. Indeed, even at times of virtually full employment we find voices in every quarter urging further monetary expansion for one reason or another. The refusal to accede to such urgings is not, of course, founded on any bias against expansion, but rests on the firm conviction that in periods of full employment reliance on monetary expansion to facilitate particular expenditure programmes, no matter how worthy in themselves, does much more harm than good.

Turning to the current situation, it may be of interest to refer to the approximate magnitude of capital expenditure in Canada on physical works and equipment during the present year. The mid-year review of private and public investment in Canada indicated a total capital expenditure of more than $8, 500 million. The addition of investment in inventories would bring the total to approximately $9, 000 million, which is 26% of our gross national production. A large part of this is provided out of depreciation and capital cost allowances earned, to the extent of perhaps $4, 100 million, and of government capital expenditures totalling $1, 600 million about $1, 000 million was financed out of revenues. The remaining amount of roughly $3, 900 million had to be financed by net new savings, domestic or foreign. Of this, net personal savings provided about $1, 700 million and net retained business earnings provided about $800 million, so that $1, 400 million was required from the savings of foreigners.

In connection with net personal savings, we should bear in mind that the figure used <u>is</u> net; it is the difference between savings resulting from consumption falling short of income on the part of some people, and dissavings or consumption in excess of income by others. A change in net personal savings may come about either by a change in the amount of new savings by those who save, or a change in the amount of dissavings by those who spend for consumption in excess of their incomes, either by liquidating previously acquired money or financial assets, or by borrowing. Large changes in consumer credit from year to year can and do make the net figure for personal saving fluctuate erratically. Consumer credit of fairly constant volume does not have any such effect, the repayments of old borrowings being a form of savings that offset an equal volume of new borrowing, but large increases in the total volume of consumer credit of all kinds in a relatively short period can add to instability in employment, prices, interest rates and the degree of foreign borrowing. The use of savings to finance levels of consumption that cannot be covered out of current income means, of course, that less is available to finance additions to our capital assets.

Private capital expenditure is subject to cyclical fluctuations which no doubt can never be completely ironed out. On the other hand it is clearly an objective of economic and social policy to try to hold to a minimum the fluctuations in the total level of economic activity and to encourage steady growth. Fluctuations in consumer credit and in governmental capital spending would assist this objective if they could operate in the opposite direction to fluctuations in private business capital expenditures to the extent that the latter are not amenable to some method or methods of fostering greater stability in themselves.

In this connection, while we are accustomed to think of the United States economy as being subject to sharper fluctuations than our own, and indeed to be the source of a good part of our own fluctuations through effects on our exports and on capital expenditures in new plant and equipment for the production of goods for export, we must also recognize that the United States finances all of its own continuing economic growth out of the savings of its people, with enough savings left over to make a substantial net contribution to the capital requirements and economic growth of a large part of the rest of the world, including Canada. There can be no doubt that some seriously under-developed countries urgently need foreign capital, real goods and services provided out of other people's savings, if they are to make an effective start to raise their standard of living above the subsistence level by moving into the industrial age.

In Canada we have had a scale of capital expenditure by the private economy and governments together at the rate of 26% of our Gross National Product as compared with 18% in the United States. Though our own personal savings rates have been high, they had not been sufficient to match this rate of capital expenditure and we have in recent years therefore had to import capital to the tune of $1,000-$1,500 million per year. I believe that one of the questions we shall have to give more and more thought to is whether it is appropriate for us to have so wide a gap between our savings rate and our capital expenditure rate, involving as this does such heavy borrowing abroad.

Some may feel that capital expenditures on this scale are necessary to maintain full employment. On the other hand it seems clear that no economy as advanced as ours should allow itself to be moulded into a pattern of employment which is dependent on capital expenditures financed by foreign borrowing on such a scale. The alternative to this is to cut our coat rather more in accordance with the cloth, and through policies of moderation and self-restraint in every field (including the fields of government expenditures, housing and consumer credit) to increase our rate of domestic saving or moderate our demands for capital to those which can be satisfied with smaller supplements of resources from abroad.

The heavy demand for capital is not a condition peculiar to Canada. Total demands on the resources of the United States, including large demands on the part of Canada and other foreign countries, have for years been tending to strain the resources of that great country. At the present time the North American economy has progressed a long distance from the low point of the recession in the Spring of 1958. It looks as if the Gross National Product in Canada in 1959 will confirm the Minister of Finance's assumption in his budget last April of an increase of 7% over 1958, and many economists are now prophesying that the increase in 1960 over 1959 will be just as great. In the United States, growth of production in the latter part of 1959 has been considerably slowed, indeed set back, by the effects

strong

of the long steel strike, but there appear to be virtually unanimous forecasts of a

increase the GNP

large rise in total production and in investment in fixed plant and equipment expenditures planned for 1960.

Trust & dealers will think forecasting higher int rates

If these forecasts turn out to be correct, then both in Canada and in the United States the demands for capital by private business, by individuals (for such things as housing and consumer credit) and by governments and government

be heavy

enterprises would continue to press on the supply of savings which currently becomes available. If it should turn out that demands in total were so large that

pressed hard on the available supply

they could not be accommodated one would hope that the decision on the part of some to withdraw temporarily from the race would be made before the competition became fierce enough to produce a significant rise in prices. In these circumstances, excessive creation of credit in order to produce artificially low interest rates would merely increase the upward pressure on prices.

In the field of government expenditures also the test of interest rates plays ~~has~~ a role ~~to play~~, although a less important one than in the case of private expenditures. Governments whether national, provincial or local, must consider the alternatives of continuing to borrow at high interest rates with ultimate results in the form of higher taxes, as against the desirability of slowing down or postponing capital works programmes, or of paying for them out of immediate increase in taxes, which would mean a lower overall tax level in the long run. There is another factor which must be taken into account when considering whether it would be sound public policy to encourage the granting of credit to governments at lower interest rates than would otherwise have to be paid in the market. It is clear that not all governments in a given category operate with the same degree of efficiency, frugality and prudence. Some have higher tax rates or lower expenditures and rely less on borrowing than others. The provision of loans to governments at artificially low interest rates would ~~redound chiefly to the benefit of those among them which in the management of their affairs were less efficient, less frugal or less prudent than others. It would~~ in effect subsidize borrowing, as against pay-as-you-go programmes. It would remove some of the relative advantages of efficiency and deprive the more frugal and the more prudent of some of the benefits which they have a right to expect.

If the total demand for resources and funds becomes excessive, it is a matter for individual decision by each element in the governmental sector how vigorously to press its claims. It is in some ways easier for governments to reduce or postpone spending programmes than it is for an individual business enterprise~~s~~ voluntarily to give up plans for capital investment which will affect its long-run competitive position. It is well known, of course, that the federal government endeavours to modify its capital spending programmes in such a way as to provide a stabilizing influence in the business cycle. This is by no means an easy thing to do with complete success, but it can scarcely be denied that some success has been achieved. The provinces and municipalities on the other hand for reasons which are understandable have, if anything, a tendency to increase rather than mitigate the fluctuations which arise in total economic activity. Is it too much to hope that a broader view of the situation will be taken, that considera-tion will be given to the question whether it would be advantageous to reduce their programmes in periods of general prosperity and increase them in periods of reduced economic activity? In addition to other considerations this would undoubtedly mitigate fluctuations in interest rates and over a period of time save money for the governmental bodies concerned. If it is necessary to maintain ~~expand~~ capital programmes without reduction even when the level of economic activity is very high the question arises as to whether they could not be financed in part at least through increased revenues.

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Even if it should develop that the total public and private demand for capital in money terms is so large as to be incapable of being realized in physical what if there is worried more exp. in '60.

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terms, it does not necessarily follow that the only way or the best way to restrain inflation arising from this source would be to use the instruments of monetary policy to bring about a contraction in the total volume of credit. Central banks, it is true, are charged by their statutes to use their best efforts to prevent inflation. But to attempt to do too much by monetary means alone might have undesirable side effects. ~~which~~ These could be avoided or minimized ~~if~~ to the extent that fiscal and other measures were could be employed by the appropriate authorities — measures to provide checks or incentives which would affect the balance between savings and investment. These are problems of public policy which I believe warrant serious thought by all those who wish to see continuous balanced economic growth with a minimum of dislocations and other damage done by inflation. Are we as a people sufficiently serious about these objectives to be prepared to explore the feasibility of striving for the goal of balanced economic growth with price stability along a broad front of — public and private, national and local — policies so that we shall not rely excessively on monetary policy? Monetary policy cannot possibly do the whole job by itself, and would be severely handicapped if left in sole possession of such responsibility. To say this is not to say that monetary policy cannot make an important contribution. How great that contribution can be is not preordained but must develop in accordance with changing circumstances in the economic environment.

Are we as a people