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"TWO BANKS - ONE AIM"

Remarks by
Mr. J. E. Coyne, Governor of the Bank of Canada,
prepared for delivery at a joint meeting of the
Canadian Club and Board of Trade
in Vancouver, June 29th, 1960

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For the last two days the Directors of the Bank of Canada and of the Industrial Development Bank have been holding their regular June meeting in Vancouver. The reason for these occasional meetings in different parts of Canada outside of Ottawa is twofold:, both to enable the Directors to become better acquainted with the people and the economic situation in different parts of Canada, and to provide an opportunity for publicizing the work of the two banks and helping to improve public understanding of what they are seeking to achieve and the methods by which they operate.

The Industrial Development Bank, as is well known, is in the business of making capital loans for a term of years to a wide variety of business enterprises. The impression sometimes wrongly arises that the Bank of Canada is engaged in an unconstructive activity, restraining the making of loans by others. In fact it is an essential part of Bank of Canada operations to provide the chartered banks with a rising volume of cash reserves over the years on the basis of which they may expand their loans and investments of various kinds. What the most desirable rate of expansion should be and at what particular periods the expansion should be most facilitated will always be matters of opinion and one should encourage rather than deprecate the widest possible public discussion of these matters and well-informed objective controversy.

I am going to speak first about the work of the Industrial Development Bank in order to emphasize, if I can, the interest of the Directors and management of the two banks in their constructive role of promoting and encouraging and facilitating the expansion of the Canadian economy, the growth and development of Canadian industry, the maintenance of full employment to the extent that this can be influenced by monetary and credit action, and the greatest possible increase from year to year in the real standard of living of the Canadian people. The Bank of Canada and the Industrial Development Bank have one and the same Board of Directors and the same chief executive officer. They have the same ultimate objectives though they work by entirely different methods.

The Industrial Development Bank was established by Act of Parliament in 1944 in order to help fill what had been generally recognized as a gap in the Canadian financial structure and one which there seemed little likelihood would be filled or could be filled by privately-owned institutions. The job of the Bank was to assist the development of small and medium sized industrial enterprises which needed additional fixed term capital but which because of their relatively small size or lack of an established earnings record, or for other reasons, could not expect to obtain the necessary outside capital by selling a bond or stock issue in the market or from other private sources. (If and to the extent that funds can be obtained from private sources on terms and conditions which are reasonable in the circumstances, the Industrial Development Bank is not permitted to intervene.) The Industrial Development Bank was established as a wholly-owned subsidiary of the Bank of Canada in order that it might benefit from both the financial support and the position of relative independence which Parliament had already given to the Bank of Canada. It is not, however, intended to operate at a loss if that can be avoided, or to make loans in the nature of subsidies. It can only be helpful to the borrowers to which it makes loans and to the nation as a whole if its borrowers are thereby enabled to operate successfully at a profit and pay off their loans over a reasonable period.

It is not to be expected that such an institution will in any way be a rival of the chartered banks, either in size or in the nature of its activities. The number of small businesses that obtain Industrial Development Bank financing is growing, and we hope will grow faster in the future, but it will never be a large proportion of the total number of small businesses of all kinds, most of which do not need or could not properly benefit from fixed term capital loans. The chartered banks, on the other hand, provide current operating loans to all kinds of businesses and to an increasing extent are paying special attention to the needs of small business. The Industrial Development Bank is not expected to provide financing of that character, that is, operating loans. Indeed, in every case in which the Industrial Development Bank makes a fixed capital loan the borrower also has an ordinary line of credit with a chartered bank for his current operating requirements. However, the chartered banks have not in the past made many term loans to small business and should not be expected to do so. Our experience indicates that a specialized institution such as the Industrial Development Bank is needed for this purpose.

The business enterprises eligible for loans from the Industrial Development Bank are not confined to manufacturers and processors, but include a very wide range of other industrial operations and services. By and large, all business enterprises are eligible which in their nature require the use of machinery and equipment for productive purposes or for purposes ancillary to production, including of course transportation in all its forms, installation, overhaul and repairing of machinery and equipment, cleaning and packaging, cold storage and general warehousing, the operation of a mine or quarry, production and distribution of electricity, the construction industry, engineering and scientific services, including scientific research; generally, all businesses except farming, fishing, the professions, retail and wholesale trade and the hotel, tourist and entertainment trades.

As the facilities of the Bank have become better known the volume of business has grown at an accelerating pace. Over the past four years the annual number of loans made to new borrowers has tripled, and during the first three quarters of this fiscal year, which ends September 30th, our new loans are running 30% or more above the corresponding period last year. At the last fiscal year-end the Bank had loans outstanding or committed for 1,609 separate industrial enterprises, of which 93% by number were for amounts of $200,000 or less, and 43% by number were for amounts of

$25,000 or less. Over the preceding years, of course, many other loans have been made and paid off. In a large number of cases old customers who have done well come back for second or third loans in order to continue to expand their operations, and the most successful of them, if they are ambitious for further expansion, reach the point at which they can sell their bonds or stock in the market and no longer require the special facilities of the Industrial Development Bank.

The Bank now has 12 offices throughout the Country, of which six were opened in the past two years, and a staff of 200 credit officers, engineers, lawyers, accountants, insurance specialists and other employees, both men and women. It operates at a small profit and has been fortunate in its loss experience, which has been very small. All losses to date plus the special reserve for losses which has been built up on the basis of an estimate of possible future difficulties, together amount to only 1.3% of total loans which have been made or which are presently on the books as commitments. After making provision for possible losses, all the profits of the Bank are required by Act of Parliament to be used to build up a general reserve fund, which is of course invested in the lending operations of the Bank. In addition to the capital provided by the Bank of Canada and the reserve fund provided out of the operating profits, the Bank obtains additional lending resources as required by the issue of its debentures. So far these have been sold only to the Bank of Canada, at rates of interest which are somewhat higher than the corresponding rate on Government of

Canada securities, but it is hoped at an appropriate time to finance the additional requirements of the Industrial Development Bank by the public sale of its debentures at whatever may prove to be market rates of interest for such securities.

It may be of interest to a Vancouver audience to record that over the past five years loans made in British Columbia have been 17% of the national total by number and 18% of the national total by dollar amount. The average size of loan has been decreasing in recent years, and was about $50,000 in 1959, both as a national figure and in British Columbia.

If I may recapitulate, the conditions for obtaining a loan from the Industrial Development Bank are that the business enterprise be of an industrial character as defined in the statute, that the required funds be not available from other sources on reasonable terms and conditions, that the business should have had an investment in it by the owners of adequate size and character to afford security to the Bank, and that the business appear to have a reasonable chance to succeed, that is to operate at a profit sufficient to repay the loan over a period of years. In this connection two basic principles for lending of this character have been confirmed again and again in the Bank's experience. One is the necessity for good management ability within the business in order that the loan should prove fruitful, that is, that it will indeed be of benefit to the borrower and be repaid within a reasonable period. The other, which I have already mentioned, is the importance of the amount and character of the owner's investment in the business. It would confer only an illusory and temporary benefit on any borrower to make a loan if these two major requirements for success are not present. In our experience, however, these two requirements do exist in thousands of cases of small and medium-size businesses throughout Canada and we are ready and anxious to be of every possible assistance to enterprises of this character.

The Industrial Development Bank has been in existence for 15 years. The Bank of Canada antedates it by 10 years. Canada's central bank was established in 1935 after a study and recommendation by the MacMillan Royal Commission. The objectives of the Bank and the general directive provided to the management by Parliament are set forth in the preamble to the Bank of Canada Act, which reads as follows:

> "Whereas it is desirable to establish a central bank in Canada to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment; so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion: . . . "

The Bank was originally established with private shareholders subject to a limitation of dividends to a rate of $4\frac{1}{2}\%$ on the paid-up capital, but within a few years by a two-stage operation all the shares of the Bank were bought by the Government and virtually all the profits have in consequence been paid to the Government. The amounts so transferred over 25 years to the end of 1959 have amounted to $675 million. These profits were, of course, earned by the Bank of Canada by way of interest received on its holdings of Government securities which it acquired in the market in the course of satisfying growing public requirements for Bank of Canada notes in circulation and expanding the cash reserves of the chartered banks. Notes outstanding plus deposits with the Bank of Canada, which are almost entirely deposits by the chartered banks and which bear no interest, now amount to approximately $2.6 billion, and Government securities holdings of the Bank of Canada are of the same magnitude. In effect, the notes issued by the Bank and the deposits maintained with the central bank by the chartered banks are an offset to a similar amount of the Government of Canada's interest-bearing debt outstanding and correspondingly reduce the net burden of the interest on the public debt.

The amount of currency in the hands of the general public could be described as the stock of money in the narrowest sense of that term; the other main form of money in Canada consists of deposit balances at the chartered banks. The central bank does not determine as a separate quantity the amount of currency in circulation; it merely makes available, in the form of notes, that relatively small part of the total money supply which people decide as a matter of convenience to hold in this form at any particular time. The central bank does, however, broadly determine the total volume of bank deposits plus currency, by reason of a legal requirement in the Act of Parliament regulating the chartered banks. The Bank Act provides that they must hold a cash reserve equal on the average to 8% of their Canadian deposit liabilities, and their cash reserve for this purpose consists only of their own holding of Bank of Canada notes plus their deposit accounts with the Bank of Canada Whenever the Bank of Canada buys securities in the open market, the payment which it makes for those securities ends up as an increase in the deposit with the Bank of Canada of one or other of the chartered banks, the use of which, unless other factors intervene, enables the chartered banks as a group over a period to expand their loans and investments on the one hand, and their own deposit liabilities on the other hand, by 12 1/2 times the increase in their deposit with the Bank of Canada. There cannot in fact be any increase in the total cash reserves of the banking system, and subsequent expansion of the assets and deposit liabilities of the chartered banks as a group, unless the Bank of Canada is prepared to add to its total holdings of securities, or unless some other change takes place in the various asset and liability accounts of the Bank of Canada, which in general have only a minor influence.

For those who are interested in the study of banking and central banking, it is important to realize that the ability of chartered banks to increase their deposit liabilities, which serve others as money, is no different in principle from the ability of any other person or company of good credit standing to increase its liabilities. The capacity of the chartered banks as a group to increase their liabilities is however limited by law in a way that does not apply to other persons or businesses, namely, through the requirement in the Bank Act that they must keep a fixed percentage of cash reserves, and through the fact that there is no way by which total cash reserves, in the particular form that is required, can be increased by action only of the banks themselves, or of anyone other than the central bank.

In carrying out its functions over the past 25 years, which of course included the Second World War and the Korean War and other periods which involved great changes in money and credit, the level of prices and many other economic factors, the total assets of the Bank of Canada have grown more than tenfold from an initial figure of about $250 million, and the total quantity of currency in circulation plus chartered bank deposits has grown from a little over $2 billion at the end of 1934 to more than $13 billion at the end of 1959. A great part of this money consists of quite inactive deposits, particularly savings deposits. The amount of inactive money varies from time to time, and naturally whenever there is a strong demand for money and credit for actual use, there is a marked tendency for inactive money to become activated, either through increased spending by the owners of such deposits, or as a result of those who desire to borrow offering attractive rewards to the owners of idle bank deposits to make them available for loans and investments. The central bank has to keep in mind that at all times, in varying degree, there exists a large volume of temporarily inactive but potentially active money which may become active and thus increase the effective money supply without any further action on the part of the central bank. There are also other kinds of deposits in institutions other than the chartered banks, and other very liquid assets held by various persons and enterprises which are so close to being money that they are often called money substitutes, and these are not subject to any requirement as to cash reserves which might be controllable in total amount by the central bank. In a practical sense, therefore, the volume of money in use is not exactly measurable and only partly controllable. Central banking cannot be an exact science, and the operations of the central bank must have regard to many tendencies and factors, including expectations, in addition to statistical measures of certain types of financial assets and liabilities.

The other side of the banking picture, corresponding to the volume of bank deposits which represent money in the hands of the public, is of course the assets of the chartered banks, that is, their loans and investments. These can be and usually are expanded by the chartered banks if the transactions of the Bank of Canada result in an increase in the cash reserves of the banking system as a whole. Similarly, the total of bank loans and investments would have to be contracted if the Bank of Canada's actions resulted in a decrease in the cash reserves of the banking system as a whole. The long-term trend has of course been markedly upward, and over no year has the trend been downward, although at times, when the central bank felt that no further encouragement to the expansion of credit was desirable, there has been a levelling out of the cash reserves of the banking system and a consequent levelling out in the total loans and investments of the chartered banks.

Within the total of their loans and investments the banks are able to vary the proportions of each category and in particular, since the banks normally hold a large volume of Government bonds, they can if they deem it desirable reduce their holding of such bonds by sales in the market and increase the amount of their loans, even though the combined total of their assets may not have increased.

It has been a typical experience, of the post-war period at any rate, that in times of business recession total loans and investments of the chartered banks have increased, with the increase taking the form at first of greater purchases of Government securities by the banks. As business recovery gathers strength and the demand for loans increases the total volume of bank assets has tended to level off but the banks have for some time gone on increasing their loans, and have been able to do so by their ability to find buyers for a large volume of Government securities. I have on several occasions in the past said that I thought it has been unfortunate that such large swings in the proportion of bank loans to total assets, and similar large swings in the other direction in bank holdings of Government securities, should have taken place, and indeed have been made possible by the changes which the Bank of Canada's transactions in the securities market brought about in the cash reserves of the chartered banks. It would be undesirable to repeat such large swings in future, and I trust it will not happen. Greater stability in the lending policies of banks and other lending institutions would be beneficial to all concerned.

It may be of interest to review recent experience in this field. It will be recalled that with the onset of the recession in the latter part of 1957 bank loans tended to fall off as a result of reduced demand. Other non-government investments such as mortgages increased but there was no increase from September 1957 to September 1958 in the total loans and non-government investments of the chartered banks. There was, however, a very large increase, over $1,350 million, in the banks' holdings of Government of Canada securities, approximately equal to the increase in the total money supply in the same period. This expansion was facilitated by the Bank of Canada partly in order to encourage business activity to recover from the recession, and partly for reasons which I have discussed elsewhere, connected with serious problems affecting the management of the public debt, which however were largely overcome with the successful carrying out of the Conversion Loan in the autumn of 1958.

Since the end of September 1958 there has been no persistent or sizeable trend upward or downward in the total money supply or in the total assets of the chartered banks. There has, however, been a very great change in the composition of those assets. The previously mentioned increase of $1,350 million in the banks' holdings of Government securities had by September 1959 been very largely reversed, and the proceeds of such sales of Government securities by the banks to the public made possible an equivalent rise in the loans and non-Government investments of the banks. This was an extraordinarily large rise in loans for such a period of time; the rate of increase seemed larger than was desirable and certainly larger than the banks' resources could accommodate much longer. In August and September last year the banks effectively brought their lending policies under control. A substantial decline in total outstanding loans followed, partly of a seasonal nature, but partly, it seems, a reaction from the fact that a certain amount of the loan demand earlier in 1959 had been of an anticipatory nature or had been borrowings which could be and have since been funded by security issues in the market on the part of the larger customers of the banks.

At any rate, from mid-August 1959 to mid-February 1960 there was a decline of $450 million in the general loans of the banks, that is the total of ordinary loans to business enterprises, to private individuals, and to farmers. Since mid-February the total volume of general loans has risen again by $250 million, which is about the normal rate of increase for this season of the year.

Despite some exaggerated talk of "tight money", the banks have continued to provide operating loans to Canadian business and individuals. New businesses have been established and have obtained bank loans, and existing businesses whose operations were expanding and were of a type which would normally be financed by bank credit have been able to get increases in their bank loans. The banks have paid particular attention to the requirements of small business, knowing that such businesses do not have access to other sources of financing such as the issue of bonds and stocks in the market by larger business corporations. Since last autumn the banks have also added to their holdings of treasury bills and Government bonds, (and to their mortgage loans outstanding, based on earlier commitments, as new lending in this category has been negligible) and they have made a large volume of personal loans of the instalment type to persons desiring to purchase consumer goods on credit. Rapid expansion of consumer credit can hardly be regarded as conducive to stable growth, and the use of bank credit for this purpose obviously cannot take priority over the requirements of normal commercial loans. The fact that the banks have chosen to employ or re-employ funds for such purposes indicates that adequate funds are available also for their primary business of commercial lending to producers, distributors and service industries.

I should like to make special mention of recent trends in the field of smaller business loans. The Bank of Canada obtains reports from the banks every three months giving a breakdown of the various loan categories, and showing separately the amount of loans under $100.000 and those over $100,000. By September 1959 the smaller loan category was $150 million greater in total than the previous peak in September 1957, a rise of 17%, while loans over $100,000 increased by $80 million or 4%. From September 1959 to March 1960 the smaller loans showed virtually no change although the normal seasonal trend would be a decrease. By contrast loans over $100,000 declined by $130 million in this six month period. The indications are that since the end of March the increase in total business loans has been mainly in the area of the smaller loans.

In recent months, conditions have eased in financial markets generally as well as in the field of bank credit. The bringing of the Federal Government budget into balance is a very significant development which greatly reduces the total demand for funds, particularly as that expresses itself in security markets. It leaves more room for the demands of other would-be borrowers to be met. At the same time, the supply of funds for loans and investment by persons and institutions other than the chartered banks has increased. Personal and corporate savings grow by large amounts each year, and a number of financial institutions entrusted with personal savings have more money than ever to invest this year. The volume of various kinds of liquid assets held by the general public is now very large and a changed attitude is apparent with respect to the purchase of government bonds and other high-grade fixed-interest securities. These developments have brought about an appreciable decline in the interest rates on such securities during the past five months both in Canada and in the United States.

With this improvement in credit conditions on both the supply side and, particularly through the great reduction in federal government requirements, on the demand side, it would be difficult to argue that the total volume of money and credit in the nation as a whole is inadequate for economic growth and full employment of physical resources. I would be the last to express satisfaction with the volume of unemployment existing today, or any level of unemployment, but I do not believe that the kind of unemployment existing today in certain localities and certain industries is evidence of an over-all shortage of purchasing power or credit or money. Rather it would seem to be a symptom of specific economic problems in particular localities and activities which require more particular, pinpointed solutions, and would not be cured by expanding the total money supply or the volume of credit or the flow of purchasing power on an across-the-board basis. The continuation of imports of goods and services into Canada from abroad at a level far in excess of our exports of goods and services is further evidence that there is not a shortage of total effective demand in Canada, but rather that total spending is considerably greater than production. If Canadian production for export is finding difficulties in competing for business in export markets, or if Canadian production for domestic use is finding difficulties in competing with imported products, the operative causes will not be overcome by monetary expansion in Canada.

Adherence to the principles of sound money may sound old fashioned to some, but it is not a question of orthodoxy or tradition, it is not a matter of adhering to a fetish, it is not a matter of putting obstacles in the way of economic progress or restricting as by a check rein the level of economic activity. The maintenance of sound monetary conditions, of a sound currency, is itself a constructive force which is vital to the continuation of economic progress. The object of monetary policy in this country is to assist and encourage maximum growth and expansion of the economy, and rising standards of living, not just for short periods or in hectic spurts, but on a stable basis, over long periods, and without the social strains and injustices and economic distortions that are the offspring of inflationary policies. Let us not be fooled by the suggestion that easy money means easy production or easy sales, either at home or abroad. Sound money is the foundation on which all financial and economic policy must be based if the economy itself is to be sound and progressive and equitable, for all members of the community.