"SOUND MONEY FOR SOUND GROWTH"

Remarks by
Mr. J. E. Coyne, Governor of the Bank of Canada,
prepared for delivery at the 47th Annual Convention
of the
Retail Merchants' Association
in Saskatoon, March 22nd, 1960

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Twelve days ago the Bank of Canada completed the twenty-fifth year of its operations. Contemporary students of our economic history are often surprised to find that not until 1935 did Canada, last of all the western nations, establish a central bank. The reason why that development was so long delayed need not detain us now, but it may be of interest to recall the circumstances in which the Bank of Canada was established twenty-five years ago.

The great decline in economic activity throughout the world during the depression of the early 1930's was accompanied by and aggravated by a loss of confidence in financial markets. Even in countries which had central banks, it now appears, looking back, that action taken to relieve credit stringency and to guard against progressive collapse or near collapse of financial institutions was far from being as prompt or substantial as would now be expected of any central bank in similar circumstances. In Canada, however -- without a central bank and with only the imperfect machinery of the Dominion Finance Act in lieu of a central bank -- nothing was done for several years to prevent or relieve a very severe contraction of credit, including bank credit. Lenders individually sought to realize on their outstanding loans in the face of widespread defaults and refrained from undertaking new loans except on a very limited basis. Long term interest rates remained high, and even rose during the depression, reaching in early 1932 levels that had not been seen during the prosperous twenties. The exchange rate of the Canadian dollar, which had depreciated sharply when Britain went off the gold standard in September 1931, moved up to a premium against the United States dollar for a time after the latter currency depreciated in late 1933, a movement in the exchange rate of the Canadian dollar which increased the impact on Canadian producers of deflationary trends abroad.

In these circumstances it is no wonder that there was widespread dissatisfaction with the working of the Canadian financial system. In 1933 the Government appointed a Royal Commission under the chairmanship of Lord MacMillan to explore the desirability of establishing a central bank in Canada. The Commission received briefs and took evidence from a wide variety of groups and individuals throughout the country, and in its report recommended that a central bank be established in Canada as a new financial institution, "a single banking authority on which should lie the primary responsibility for regulating the volume of credit and currency...". The Bank of Canada was established by Act of Parliament in 1934 and after a period for organizing its affairs commenced operations on March 11th, 1935.

The fact that the central bank was established in a period of depression meant that people associated the Bank of Canada with the need at that time for an expansionist monetary policy which would provide credit-granting institutions with more liquidity and with a ready source of liquidity, to the end that loans would be more freely made, that interest rates would decline, and that movements in the exchange value of the Canadian dollar would not reinforce within Canada the deflationary effect of severe declines in commodity prices in world markets.

Neither in Canada nor elsewhere was the depression fully overcome by the time World War II broke out, and perhaps, some of our thinking has been conditioned by that fact. Most people now recognize, however, that from the time of the outbreak of World War II right up to the present a major problem throughout the world has been to fight against overall inflationary tendencies rather than overall deflationary tendencies, even though there have been short intervals of relatively mild recession during the post-war period.

In a serious depression, unemployment is of such a magnitude and of such a widespread character that general measures of monetary expansion and deficit financing may be expected to make a major contribution towards encouraging an increase in production and employment throughout the country. Of course, no great assistance will be derived by industries dependent upon export markets from an increase in spending and spending power merely within Canada itself. If, however, industries producing for the domestic market are also suffering from serious and general under-employment -- and if this is not due to high costs and inability to compete with imports but is a reflection of a low level of spending within the country -- it is apparent that general measures to increase the ability of people and businesses to spend, and to undertake new projects with the aid of borrowed money, may have a quite pronounced beneficial effect. Such measures can in such circumstances improve the rate of activity in industries producing for the domestic market, including of course a wide variety of service industries as well as goods-producing industries.

On the other hand, what has not been so widely recognized is that if unemployment is not general but is chiefly apparent in the export industries, or is scattered in particular industries or particular localities for reasons peculiar to those industries or localities, a general increase in money and credit, with or without a general degree of deficit spending by the government, will not necessarily have any useful effect on the particular areas of unemployment in question. Moreover, if at such a time industries producing for the domestic market are for the most part operating at a high level -- or even if they are under-employed where the cause is inability to compete with imports -- one would expect that a general expansion of the money supply and of credit available through the banking system, or large scale government deficits, would tend to result in increased imports -- that is to say in a stimulus to production and employment outside Canada -- rather than increased production and employment inside Canada.

For some years there has been no deficiency in total demand for goods and services in Canada. Total spending for goods and services of all kinds, including production of capital facilities as well as consumer goods and services, has in recent years been greater than the amount of goods and services that could be produced in Canada, although productive capacity has increased every year to a greater degree than in most other countries. Total capital expenditures in Canada for new construction and for machinery and equipment, amounted to $8.4 billion in 1959 and in recent years have averaged 26 per cent of Gross National Product, as compared with 18 per cent in the United States, but this large annual increase in Canada's capital facilities, in productive capacity, has not enabled production to close the gap because total spending has increased as fast or faster than production. Notwithstanding this scale of total spending, there has been unemployment of persons and under-employment of plant and equipment in particular localities and particular lines of industry in Canada, and failure of employment in the aggregate to expand commensurately with the increase in the labour force. At the same time there has been a very large deficit in our international balance of payments, that is, an excess of imports and payments for goods and services of all kinds over our exports and receipts for goods and services of all kinds. Under these conditions the presence of unemployment in particular industries and particular localities shows, not that there has been any deficiency in total demand or in the total rate of spending, or in the availability of money and credit in the aggregate, but that total demand and total spending has been directed, to a greater degree than is desirable in the general interests of the national economy, towards the importation of goods and services produced outside Canada.

In other words, for some years total demand and total spending in Canada have been excessive rather than deficient, and have been misdirected, from the point of view of maintaining balanced economic development and the lowest possible degree of unemployment in Canada. This kind of situation cannot be corrected by further expansion of the supply of money and credit in the aggregate. The chief effect of such an expansion would be either to create inflation -- despite the existence of unemployed domestic resources -- or to increase the deficit in our international balance of payments. What is required is rather a reduction in total spending, and re-orientation of part of our total spending towards the purchase of efficiently produced goods and services of domestic origin in place of imports, together with whatever increase can be achieved in the efficient production of goods and services for export.

A central bank in any country has, by virtue of its central banking function, only one significant avenue for stimulating economic activity. This is its ability to increase the supply of "central bank money", that is, currency or deposits at the central bank. The way in which such an increase is brought about in Canada is by the central bank purchasing Government of Canada securities in the market.

Persons who sell the securities receive payment in the form of a cheque of the central bank which they normally deposit with their chartered bank. The chartered bank remits the cheque to the Bank of Canada for credit of the chartered bank's account with the Bank of Canada. The chartered bank by this means acquires an increase in its deposit at the Bank of Canada, that is, in its cash reserves, accompanied by a similar increase in its own deposit liabilities. The chartered banks are required to keep reserves of central bank cash equal to 8 per cent of their total deposits, and so over a period of time they are able as a group to increase their total loans and investments, and correspondingly their total debt to their depositors in the form of deposit liabilities, by an amount equal to about twelve times the increase in central bank money created by the central bank. The exact size of this multiplication factor is incidental, and varies from country to country, and the fact that the chartered banks are able to increase their total assets and liabilities by a particular multiple of the increase in central bank money should not be misinterpreted. All other kinds of financial institutions -- and for that matter ordinary businesses and individuals -- are able to borrow and lend, that is, to increase both their liabilities and their assets, to any degree that their competitive position and financial standing permit and earnings prospects justify. The significant feature in the case of the chartered banks is not that the fractional cash reserve system enables the chartered banks to increase their assets and liabilities, which is something anyone can do, but that it places a legal limit on the amount of their expansion. It is by virtue of this limiting factor that the central bank is able to exercise a restraining influence over the total expansion of credit by these particular institutions, namely the chartered banks who are members of the central reserve system and whose debts to the public, that is, the banks' deposit liabilities, constitute the major part of the money of the public. The central bank is unable to exercise any direct restraining influence over the credit-granting and near-money-creating activities of other financial institutions, which also create deposits, including deposits subject to withdrawal by cheque, and other forms of money or near-money in the hands of their creditors.

Similary, it is because there is a recognized relationship between the amount of central bank credit and the amount of chartered bank credit that a central bank can under most conditions induce the chartered banks to expand the total amount of their loans and investments when that seems to be desirable in the public interest, or at the very least make unnecessary the pursuit by them of a restrictive credit policy. Whenever the central bank increases the supply of central bank money or credit available, the chartered banks individually find themselves with so-called excess reserves, that is more cash reserves than the law requires them individually to keep in relation to the existing level of chartered bank assets and liabilities. If the cash reserve in the preamble to the Bank of Canada Act, which states that the Bank should endeavour "generally to promote the economic and financial welfare of the nation", and more particularly should seek "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". A consistently high level of employment with a minimum of fluctuation in the general level of prices is clearly a desirable objective in any modern society, and so is the maintenance of an economic climate favourable to sustained economic growth. We all want to see new productive facilities of the right kind added to the nation's supply of such facilities year after year on as high a scale as can be made possible by the community's aggregate savings each year, that is, by real physical resources released for the production of capital goods and facilities as a result of total consumption being less than total income or production. It is therefore the object of the central bank, so far as it may exercise influence in that direction, to encourage overall economic growth on a sound and sustainable basis, and to facilitate economic development with a view to increasing employment opportunities and eliminating unemployment or reducing it to the lowest possible level.

This does not mean that the central bank should be continuously inflating the money supply, or that credit of any kind should be constantly expanded without limit. Under normal conditions, new capital expenditures should not exceed new savings during the same period, and aggregate borrowings by those who spend more than they earn or produce should not exceed the aggregate new savings of those who save more than they themselves wish to expend on capital projects. To encourage financial institutions to expand their total lending beyond the supply of new savings available would be to create serious inflationary pressures and aggravate balance of payments deficits.

The first requirement for sound money, therefore, is that central banks should see that there is a sufficient supply of money to facilitate the extension of credit in the degree justified by real economic considerations, but the second requirement is no less important, namely, that the total supply of money should not be increased beyond that point. What the actual degree of variation in the total supply of money should be from time to time will depend on many considerations, which I shall not develop in detail, but I should perhaps mention two factors of a limiting character. One is that if non-bank financial institutions were growing very rapidly and expanding total lending beyond the supply of real new savings, it would not be necessary or desirable for the central bank to facilitate a corresponding increase in lending by the banking system as well, based on an increase in the money supply. A second general example may be given -- at any moment there is a huge volume of temporarily inactive bank money in existence, that is to say, bank deposits which are not used by their owners but remain untouched for months or years at a time. Under some circumstances the owners of such dormant money may decide to spend it or to lend it, that is to say, there may be an increase in the rate of turnover or the velocity of circulation of the existing money supply. This can happen at times on such a scale as to make it unnecessary and undesirable for the total quantity of money to be increased at all, or on occasion it might even become desirable that the total quantity of money should be decreased because with its higher velocity of circulation the existing supply of money was sustaining an excessive rate of money-spending in the aggregate.

We had a very large increase in the quantity of bank money in Canada in 1958, for reasons connected with the management of the public debt and the financing of the large government deficit. During most of that year the chartered banks found ordinary loan demand rather slack, and they bought over $870 million of Government of Canada securities in the market. In 1959, without any further increase in the total stock of money, the chartered banks increased their loans and non-government investments by $800 million to a total of over $8 billion, the increase being very largely financed by chartered bank sales of Government of Canada securities in the market. The total volume of credit of all kinds, long-term as well as short-term, including funds raised by new issues of securities by corporations and by provincial and municipal governments, and by the federal government, and including funds raised by foreign borrowing, increased by a very large amount and reached a new record high level. The total volume of credit that will be utilized in 1960 will, it now seems, be even greater, without necessarily having any increase in the stock of money in the sense I have used that phrase.

This refers only to the aggregate quantity. In its operations the central bank can only affect the aggregate supply of money, and in so far as it can affect the volume of credit here too its influence is only on the aggregate, not on particular elements within the total. When the quantity of central bank money is increased as a result of purchases of securities by the central bank, the central bank does not know in what proportions the various chartered banks will receive an increase in their cash reserves. Likewise, the central bank does not know to what use the chartered banks receiving the additional reserves will put them, or what spending or lending decisions will be made by the corporations or individuals who acquire additional bank deposits. The central bank has no power to regulate or direct the making of loans by any particular lender or class of lenders, or the extension of short-term or long-term credit to a particular industry or a particular firm within the industry, or to businesses or individuals in a particular locality. It is by the voluntary decision of the financial institutions and others who make loans, or by such degree of regulation, if any, as public authorities choose to exert over the making of loans, that the allocation of credit is from time to time determined, not by the normal operations of the central bank which do not influence the allocation of credit, but at most the aggregate quantity of credit.

If the aggregate supply of credit is adequate -- even though there may be some kinds of economic activity or some areas of the country which it is felt are not getting as much credit as they could fruitfully use -- the central bank should not be expected to increase the total any further. A further increase in the total supply of credit would not ensure that the deficient activities or areas received any more. The increase would naturally gravitate towards the areas and activities which already had shown their greater attractiveness as fields for loans and investments. In any case, the increase in total credit would, in the circumstances described, be inflationary. Indeed, if for any reason or combination of reasons spending is stimulated to a level well in excess of income, the usual result is inflation of prices and costs. In exceptional circumstances such as we have witnessed in Canada in recent years the inflationary consequences and need for adjustment can be avoided in part, or at any rate postponed in part, by having a large import surplus, an inflow of goods and services in excess of exports, financed by borrowing abroad and by foreign investments in Canadian industry and resources. Such a course is obviously not possible on a continuing basis - it is at best an unstable and undependable palliative.

The subject of interest rates has received a good deal of attention in the course of public discussion of monetary policy. The purchase or sale of Government securities in the market by the central bank may have an influence on the general level of interest rates, either directly or through the transactions undertaken by the chartered banks in response to changes in their cash reserves, but the influence of central bank operations is only one among many other influences, and it can be overborne by changes in the direction or amount of lending and investing by financial institutions, business corporations and private individuals not affected by central bank action. Of even greater importance are changes in the demand for borrowed money, changes which are often very large and forceful. An increase in demand will tend to put up interest rates, and some increase in the availability of loanable funds may come about in response to that rise in rates. The interest rate applicable to any loan is determined by supply and demand and represents an agreement between borrower and lender. The prices which borrowers are willing to pay, or find it economic to pay, for borrowed money will obviously depend on many different factors which change from time to time and differ from place to place. Similarly, the view which lenders may take of the compensation which they should receive for lending their money at all, or of the varying degrees of attractiveness or risk which attach to different types of borrowing propositions presented to them, will be constantly changing over time, and will be different from place to place and from industry to industry. This is more true of non-bank lending than of loans by the chartered banks, which tend to be made at a fairly uniform interest rate regardless of the business of the borrower or the locality in which he operates.

The central bank has no bias in favour of a high general level of interest rates, or for that matter in favour of a low general level of interest rates, whatever "high" or "low" may be taken to mean in that connection, and it cannot control or regulate what interest rates shall apply in relation to particular kinds of transactions. Ideally, the general level of interest rates should be such as to encourage new savings each year equal to the level of new capital expenditures, without large inflows of capital from abroad.

From time to time some borrowers have felt that they were entitled to loans at lower interest rates than the going market rates and that banks, or other lenders, or some governmental authority or even the central bank, should provide them with loans at a specially favoured rate. To provide loans to one borrower at lower rates than its competitors had to pay in similar circumstances, would be unfair discrimination. To provide loans at less than market rates to any group or groups on a large scale, would have the effect of encouraging borrowing and spending in excess of the level of savings and production in the economy. Moreover, to subsidize borrowing in any way would be to discriminate in favour of borrowers against non-borrowers, that is, against other similar persons, enterprises or bodies which may manage their affairs with less resort to borrowing because in some cases they operate with more frugality, more efficiency or more prudence, and either get along with a lower level of spending or manage to finance their spending out of their earnings or revenues.

Whether any form of economic or social activity is to be subsidized as an activity is, of course, a matter of policy for public discussion and decision by the appropriate authorities. But to subsidize only borrowing, rather than the economic activity itself, to subsidize only borrowing entities within each group whose activity is to be subsidized and not those who get along without borrowing, to provide for those who borrow most a greater subsidy than for those who borrow least, would tend to encourage excessive borrowing, inefficiency and improvidence. Unless other borrowers were by some means correspondingly restrained, it would also increase the total level of borrowing beyond the available supply of new real savings. The use of money and credit in the aggregate must be based on physical reality, and for every man who spends and consumes more than he earns or produces, there must be another who spends and consumes less than he earns or produces, if we are not all to be caught up in an inflationary race.

I need hardly add that there would be special dangers involved in subsidized loans if they were obtained from the central bank. In addition to the disadvantages of subsidized interest rates I have noted, such loans would increase the cash reserves of the chartered banks by a corresponding amount and would in due course lead to an expansion of bank loans and investments and of the money supply by roughly twelve times as much. The use of "high-powered" central bank money to make subsidized loans would be actively inflationary, and would tend to create distortions in financial markets and misallocation of resources even if steps could be taken to offset the direct inflationary impact by other operations on the part of the central bank which would reduce the total volume of money and credit, or prevent it from rising.

If I may revert now to the general subject of the central bank's operations in relation to the level of production and employment throughout the economy, I should re-emphasize that a central bank does not know how increases in the total volume of credit will be allocated, and therefore a central bank cannot by increasing the total volume of credit ensure a beneficial effect on the economic activity of any particular or predetermined person, enterprise, government or region. It follows that where unemployment exists for reasons other than a deficiency in the aggregate supply of credit there is no way by which a central bank can operate to reduce that unemployment. A central bank must not be thought of as possessing governmental powers or responsibilities.

It is clear, of course, that governments, even in a free economy, can and do exert an important influence both on the general level of economic activity and on various particular types of activity. Governments can increase or reduce their own spending. They can increase or reduce their own revenues. Decisions as to spending and taxing, or charging for services, will result in increases or decreases in government debt, and borrowing operations can have broad effects on financial conditions and the climate of opinion in financial markets. In addition to controlling their own financial and other operations, governments at all levels can if they wish encourage or discourage various forms of economic activity carried out by private individuals and private business. Decisions on such matters have to take account of many different and perhaps conflicting considerations, and are of necessity influenced by the philosophy or outlook of different groups and of the community as a whole. It is important to make clear in this connection the distinction between governments and central banks. Governments can regulate the allocation of credit, the distribution of income, the conduct of economic activity and the provision of employment in particular industries or areas, if this is felt to be desirable in the light of all the circumstances. Central banks cannot, by their operations, exert any direct or significant influence on these matters.

Again, governments can encourage or discourage exports and imports, or activity in particular industries which provide exports or which compete with imports. They can control and direct the nature and size of urban development or of the distribution of industry throughout the country, if society wishes this to be done. Governments can in various ways encourage or discourage the growth of savings, or regulate consumer credit, or influence the rate of house building or the direction of private capital development. They can, if the community so desires, ensure that the total volume of spending within the economy is of such a magnitude as to be capable of being financed out of the annual production or income of the country as a whole, without involving the building up of a large foreign debt. All these things people have from time to time seemed to think could be achieved by central bank action, but none of them lie within the power of the central bank, certainly not in any specific action it can take with a view to specific results.

But it is equally to be emphasized that these things are not in any way prevented or limited by the central bank, or by a sound money policy. There is no financial obstacle to the carrying out of any programme which is physically possible, if people are willing to make the appropriate arrangements and accept whatever diversion of physical resources and changes in real incomes may be involved in such programmes. There are, of course, both inflationary and non-inflationary ways of carrying out such programmes. Inflation is the worst of all possible ways of taking from one person in order to give to another, and of forcing some people to change their way of living or their productive activity. So far as it can, a central bank should discourage inflationary methods and try to offset inflationary pressures arising from any source. But central banks' policies and operations constitute no obstacle to the carrying out in a non-inflationary way of any economic programme that the communtiy as a whole or any subdivision of the community may decide to pursue.

What the central bank can do of a constructive nature is to exert an influence on the general temperature of the financial climate, an influence which if not frustrated by other influences may be quite pervasive and important. The central bank's objective should be to maintain the financial temperature at a level which will facilitate a high rate of economic activity -- real physical activity, not just speculative or monetary activity -- and the maximum rate of sustainable economic growth. In order to achieve this, a central bank must strive to maintain stability in the value of the currency, and to create public confidence that it will be maintained. The financial temperature should be such as to encourage the channelling of all the savings which the economy can generate, into capital investments of kinds which will make the maximum contribution to future production and welfare. Equally, the central bank should try to keep the temperature of credit extension from rising to the point where capital spending is stimulated or forced beyond the level that can be supported by real savings, or to such a level that consumer spending is overstimulated and saving discouraged. A general hot-house atmosphere is not conducive to sustainable growth of enduring value. It leads to distorted growth, to the kind of new growth that easily withers. Forcing or attempting to force an unsustainable degree or kind of growth in any industry, or in the economy as a whole, merely lays up problems of adjustment and unemployment and retarded growth for the future. Growth based mainly if not entirely on our own production and saving would be sounder, more sustainable, and in the long run larger.

So far as your central bank is concerned, it is the object of the Bank of Canada to further the goal of sound Canadian growth, and to contribute to the economic and financial welfare of Canada, by maintaining the soundness of our Canadian currency. Sound growth can only be based on sound money.