REMARKS OF
MR. L. RASMINSKY, GOVERNOR OF THE BANK OF CANADA,
BEFORE A JOINT MEETING OF THE CANADIAN CLUB
AND THE EMPIRE CLUB
TORONTO, OCTOBER 21, 1963

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I thank you for the opportunity of appearing before you today. For me this is very much an occasion. It is the first time that I have made a public speech since my appointment as Governor of the Bank a little over two years ago. I cannot honestly say that I have found the effort to avoid making speeches for this length of time to be a great hardship. On the contrary, I confess to an occasional twinge of longing for the olden days when it was not considered good form for central bankers to either speak or write a single word to explain the mysteries in which they were engaged. But those days are gone forever and I have to say that I approve their passing. I strongly support the contemporary view that central bankers have a responsibility to try to talk understandably about what they have been doing.

In any case, my silence has not been nearly as complete as the absence of public speeches might suggest. Apart from the very considerable amount of monetary and financial information which is made available each week and month, the Bank has published two Annual Reports during my term as Governor, and in these I have tried to explain what the Bank was doing and why. I have also issued press statements on the six occasions that the Bank Rate was changed. I have never been really hopeful that these Reports and press statements would earn me the Governor General's prize for literature, but they represented an effort to be as forthcoming as seemed possible at the time.

In addition, the Bank made a long written submission to the Royal Commission on Banking and Finance in May of 1962, and this was supplemented by some extended opening remarks I made when I appeared before the Commission in Ottawa last January. The Chairman of the Commission, Mr. Chief Justice Dana Porter, and his fellow Commissioners then questioned me for three and a half days. When it was all over I had the strong impression that if there was anything of any consequence about the Bank of Canada that the Commission had not got on to the public record it was not because the Commissioners had failed to ask the right questions but because I did not know the answers.

As this is my first public speech I thought that the most appropriate thing for me to do was to say what I think the business of central banking is all about and what view I take of my own responsibilities.

Nearly a century ago, Walter Bagehot, the English banker and journalist, said "Money will not manage itself", and the essential task of the central bank is to manage the nation's money. This task is obviously a public responsibility. The central bank is therefore, in all countries, a part of the general apparatus of government. But most countries, including Canada, have established their central banks on a basis which removes them from the ordinary machinery of government and endows them with a degree of independence, and thus of responsibility, which is not to be found in a government department. Presumably this reflects the view that the interests of the community will, over a period of time, be best served by arrangements of this character.

But since monetary policy is an instrument of public policy, and since it is conducted by the central bank under a statute passed by Parliament, it is clear that the Government must also feel responsibility for the policy which is followed. In the nature of things, the responsibility for day-to-day operations lies with the Bank of Canada, but the Government, in the person of the Minister of Finance, is kept fully informed about the policies being followed by the Bank, and the Government has the opportunity and the responsibility to form its own views as to the appropriateness of the Bank's policies. If the Government should find the Bank's policies unacceptable it must make its views known and this would naturally give rise to efforts to reach a common view as to the policies that should be followed. If this should not prove possible, then in the final analysis, in a democratic society, the views of the Government must prevail on this as on other matters. But this fact would not relieve the Governor of his own responsibility. The public is entitled to assume, so long as the Governor remains at his post, that the monetary policy followed is one for which he is prepared to take responsibility.

This is the principle of joint responsibility for monetary policy as I see it. I think this principle is now well understood and widely approved in Canada and that it is working well at the present time.

I should like now to go on to be more precise about what the Bank of Canada does. Virtually everything we do is done either as adviser to the Government, or as agent for the Government, or as a principal operating on our own account.

I attach great importance to the role of the Bank as adviser to the Government and the Bank tries hard to equip itself to discharge this role satisfactorily. But I am afraid that there is not much more that I can say about it here. The Bank's advice is given in private, and the Government is of course completely free to accept it or reject it, as it sees fit.

The Bank's activities as agent for the Government cover a wide area. Its operations in connection with the issue and retirement of Government of Canada securities and almost all of its foreign exchange operations are of this character. These involve extensive direct contacts with financial markets which are of course very useful in our role of adviser to the Government. Though it is the Bank rather than the Government that financial markets see carrying on debt management and foreign exchange operations, our role is essentially that of adviser and agent.

It is in discharging its monetary policy function that the Bank acts as a principal: this is the sphere of its own accountability. Essentially, the Bank carries out its monetary policy function by varying the rate of growth of the cash reserves of the banking system, and thus influencing the rate at which the chartered banks add to their assets, in the form of loans and securities, and to their deposit liabilities. Changes in the rate of expansion of the commercial banking system tend, in turn, to have effects on interest rates and other terms of access to credit throughout the economy. The main duty of the central bank in the discharge of its monetary policy function is to control the trend of asset and deposit expansion of the chartered banks in such a way as to influence credit conditions in the direction that is appropriate in the economic circumstances.

The big question, of course, is what is "appropriate"? Unfortunately, there is no simple formula that will tell the Bank what kind of influence on credit conditions is appropriate in any particular economic circumstances. Monetary policy naturally receives a good deal of attention from people outside the central bank as well as from its practitioners, and for this we are very grateful, as we need as much help as we can get. But I am sure that all who have thought seriously about this matter agree that there is no simple set of rules which will tell the central bank at all times what it ought to be doing. I would be pleased beyond measure if there were a simple formula. It would be a great relief to have the central bank freed of the difficult judgments involved, judgments which we know to be beset with human fallibility. But I am afraid that it will never be possible in this business to turn to the back of the book and find the right answer, or even to feed the data into a computing machine and confidently wait to be told what to do.

So I have to confess that I am not able to give you a formula which we in the Bank use to tell us what to do in particular circumstances. In our submission to the Porter Commission, we set out in some detail the factors which we seek to take into account in deciding how to proceed. If I were to attempt to summarize a very complicated matter in a single sentence, I would say that we spend a great deal of time and effort trying to understand what is actually happening throughout the economy, and we then come to a view about the conditions in credit markets that are most likely to encourage the sort of economic performance that public policy is endeavouring to achieve, and we try within the powers available to us to foster such conditions.

The precise contribution that monetary policy and changes in credit conditions can reasonably be expected to make varies with the circumstances. There can, of course, be all sorts of reasons for unsatisfactory performance of the economy, just as there can be all sorts of reasons for poor physical health of a human being. Changes in credit conditions are no more a cure-all for our economic ills than any single kind of treatment is for our physical ills. Monetary policy is only one among the instruments of public policy which influence the performance of the economy, and even the whole armoury of public policies cannot assure good performance if the basic trouble lies elsewhere -- for example, in inefficient performance or lack of imaginative policies in any important part of the private sector of the economy or in conditions outside the country.

In fact, there is a great deal of difference of opinion about the extent to which moderate changes in credit conditions can be expected to influence the performance of the economy. I am inclined to think that most people tend to over-estimate the importance of monetary policy taken by itself, but I also know from my own experience that there are occasions in which the vigorous use of the monetary instrument can be of very substantial help. I regard monetary policy as a necessary condition, though not a sufficient condition, for good economic performance. I therefore believe that monetary policy is a proper subject for worry at all times, and that it is worth a good deal of effort to try to get it right.

This may all sound very abstract. Let me make it more concrete by giving to you a series of snap-shot pictures of the economic situation on various dates during my period as Governor of the Bank, and let me recount how at those times the Bank arrived at its conception of what was the right monetary policy.

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The date of my first snap-shot is June 24, 1962. This was the date on which the Prime Minister of the day announced that Canada was faced with a foreign exchange emergency, that the Government was determined to defend the exchange value of the Canadian dollar at the fixed rate established several weeks earlier and that a number of special measures were being implemented by the Government immediately to deal with the situation. On the same day the Bank issued a statement saying that the Bank Rate, which is the minimum rate at which the Bank of Canada makes advances to chartered banks, was fixed at 6% effective immediately.

The Bank Rate statement signalled a change to a very tough monetary policy. The principal elements going into the decision to make this change were these. First, Canada's foreign exchange reserves had fallen sharply because capital inflow had dried up at a time when Canada was buying more goods and services from abroad than it was selling abroad and therefore needed an inflow of capital to balance its international accounts. Second, higher interest rates in Canada, as part of a co-ordinated programme to defend the Canadian dollar, would induce some Canadians to borrow abroad and to help restore capital inflows. Third, if the exchange emergency were not effectively dealt with, our entire trade with the outside world would be seriously disrupted, and economic expansion in Canada would receive a severe setback.

Under these conditions the need for a tough monetary policy was crystal clear, and the advantages of hindsight have not given me any reason to feel that less vigorous monetary restraint would have served the country better. As things turned out, the critical exchange position was soon overcome and the tough monetary policy was soon relaxed.

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The date of my next snap-shot is any day in the first part of September 1962. By then a substantial net capital inflow had been re-established, and the threat to good performance of the Canadian economy from the exchange side was declining. In these circumstances, and in view of the large under-employment of Canada's labour force and plant capacity and the absence of any substantial upward pressure on prices, it seemed that the Bank could, consistently with the necessary maintenance of external equilibrium, make some contribution to economic expansion by encouraging an easing of credit conditions. This change in monetary policy was reflected in the reduction of the Bank Rate to 5 1/2 per cent that was announced on September 7.

Economic developments in the next several months seemed to warrant a continuation of the policy of moving towards easier credit conditions, and the continued monetary expansion was reflected in further reductions of the Bank Rate to 5 per cent in October, to 4 per cent in November, and finally to 3 1/2 per cent in May of this year. By that time interest rates in Canada had declined to the point where the difference with rates in the United States was no longer offering much inducement to Canadian borrowers to go to the New York market for their money. From April to mid-July there was only a relatively small volume of Canadian borrowing in the U.S. new issue market.

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I take as my third snap-shot the situation on October 23, 1962. What happened on that day illustrates one aspect of the way in which the Bank of Canada reacts to developments in financial markets. This was the date of the "Cuban crisis". The sharp increase in the tension between the United States and the Soviet Union over Cuba severely shook the Canadian bond market -- more severely, indeed, than it shook the bond market in the United States. Bond prices threatened to fall, and bond yields to rise, drastically. Even though the international political outlook was most disturbing, it nevertheless seemed to the Bank that there was nothing to be gained by the tightening in credit conditions that was threatening. The Bank therefore gave strong support to the bond market. We bought \$73 million of Government bonds on this date, and a total of \$111 million in three days. When market confidence recovered during the next few days, we resold many of the bonds we had bought.

This incident provides an exceptionally dramatic illustration of direct central bank intervention in the securities market to moderate the movement of prices and yields. There have been other occasions within the last two years in which the Canadian bond market has shown such an extraordinary degree of volatility as to warrant substantial central bank intervention. But we believe that in more normal circumstances it is preferable that the Bank of Canada should bring its influence to bear on interest rates indirectly, that it should refrain from large direct intervention in the long-term market and leave the market free to exercise its own judgment on the day-to-day pricing of government bonds. This approach seems to us to be the one that over time will be most conducive to the development of financial machinery and practices best suited to serve the needs of the economy.

While on this subject of financial machinery, I would like to add that the Bank is also interested in other ways in which it can contribute to the development of financial institutions and practices best suited to serve the needs of the economy. I believe that we have taken useful initiatives, and have played a useful part, in a number of developments of this kind. One example is the rapid growth of the so-called money market in Canada. The closer the associations that we can maintain with financial institutions and financial markets, the more helpful shall we be able to be in matters of this kind. I hope that we shall continue to be able to play a constructive role as opportunity offers in the future.

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My last snap-shot is going to be a very quick exposure. Between September 1962 and May 1963 interest rates in Canada fell. Subsequently, and particularly after the proposal for the U. S. interest equalization tax announced on July 18 (even as modified in Canada's favour three days later) an atmosphere of uncertainty developed in Canadian financial markets which was reflected in somewhat higher interest rates and also in a falling off in new capital issues. On August 12 the Bank of Canada recognized the situation by raising the Bank Rate from 3 1/2 to 4 per cent. We made it clear that this was a technical adjustment which did not signal a basic change in policy. In the circumstances, this action helped to re-establish new issue activity.

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This is as far as I intend to go with snap-shots. I stop, not because the scenery has stopped changing but because prudence restrains me from showing you any of our more recent photographs. And happily, what I have been trying to do -- that, is, to give you some illustrations of how various kinds of developments affect the central bank's ideas of appropriate monetary policy -- does not require it.

The illustrations I have chosen to indicate some of the thinking behind monetary policy at certain points during the past two years have contained several references to Canada's external financial position. This is no accident. Whether one likes it or not, monetary policy in Canada in the last two years has had to give a good deal of attention to shoring up our external position. I would like therefore to conclude these remarks with some very general observations on this subject.

I spent the first few days of this month attending, along with the Minister of Finance, the annual meetings of the Bretton Woods institutions -- the International Monetary Fund and the World Bank. These meetings are always interesting to persons involved in financial matters for they bring together representatives of treasuries and central banks from virtually the whole of the non-communist world. They provide a very useful opportunity for public and private discussion of national economic problems and the functioning of the financial system.

The most newsworthy feature of this year's meeting of the Fund was the wide agreement among the countries represented that it would be useful at this time to step up the tempo of the consideration being given to the adequacy of the present arrangements governing the operation of the world financial system. The International Monetary Fund will intensify its work in this area, and the Ministers of the 10 countries (including Canada), who in 1962 brought into effect a special arrangement to supplement the resources of the Fund, instructed their Deputies to carry out together a companion study to that of the Fund.

I welcome this development. I think that continuous flexibility will be needed to keep the international financial system developing in accordance with the world's future needs. But I am sure that it would be a mistake to suppose that this intensified study heralds any radical change in the present system. The purpose is rather to find the lines along which the system should continue to evolve in order that it can gradually and smoothly adapt to changing circumstances.

There was another feature of the discussion at this year's annual Fund meeting which, though less newsworthy, seems to me to be of at least equal importance to the interest in possible modifications of the international financial system. This was the widespread recognition that no conceivable international system will work satisfactorily unless the major trading countries follow national policies that are consistent with an acceptable international equilibrium. It has long been recognized by the major trading countries that, unless the international financial system works reasonably well, there is little chance that they will be able to achieve their own national economic objectives. This in fact explains their interest in the international financial system. But it has not always been so clearly recognized that the international system cannot work well unless each major trading country pursues its national economic objectives by domestic policies that permit its balance of international payments to develop in a way which is appropriate to its position in the world community.

It is challenging to reflect upon the recent experience and the present position of Canada in this respect. There is increasingly wide agreement that our external economic performance has not been altogether satisfactory. It is happily true that during the past few years we have been making good progress at reducing our net import surplus of goods and services -- in the late 1950's this was running at a rate of about $1,300 million per year, and by the twelve months ending June this year it had been reduced to about $600 million. But our current account deficit is still high. Our dependence upon capital from abroad to pay for the import surplus of goods and services, and the associated increase in our large international indebtedness, have been elements of instability in our position. Our foreign exchange crisis of June 1962 was a very unpleasant experience for us, and it was also an unsettling experience for the world outside. Again this summer, at the time of the announcement of the proposed U.S. interest equalization tax, we got a sharp and unpleasant reminder of the risks involved in substantial reliance on foreign capital. In referring to reliance on foreign capital I have in mind net inflows; a reduction in our reliance on net capital inflows need not, of course, preclude continued large gross flows of capital in both directions across our international borders.

Our large and persistent reliance on net inflows of foreign capital to finance a current account deficit would have a different aspect if Canadian productive resources were being used to capacity. But this has not been the case. On the contrary, our levels of output and employment have been much lower than we are capable of sustaining. And it is certainly not without significance that the improvement in domestic economic conditions in Canada during the last couple of years has been accompanied by -- and indeed has been closely related to -- the sizeable reduction which has occurred in our current account deficit.

There is, in fact, a good deal of economic experience around the world indicating a direct connection between a country's good international performance and its good domestic performance. Over the period about which I have just been talking, those countries that have shown a strong external economic performance -- notably the countries of Western Europe -- have also had the best records of employment and productivity, and those countries which have been in a relatively weak international financial position -- notably some of the English speaking countries -- have had the least satisfactory growth rates. There is no mystery about this. Countries which, whether through good fortune or good management of their affairs, succeed in achieving dynamic, flexible and efficient economies tend to find that they are strongly competitive internationally. And their good external performance in turn reinforces their good internal performance.

Part of Canada's economic difficulties in the last several years has arisen from a change in the external economic environment. This was extremely favourable in the first half of the 1950's and much less favourable since then. There is no practical way of insulating ourselves from such a change. But we need to find out how to float more buoyantly in whatever external economic environment we may encounter.

The recent improvement in Canada's economic position, both external and internal, is encouraging, but we must endeavour to keep up the momentum of improvement. What we need for that purpose is a combination of public and private policies that is favourable to the increase of our economic efficiency and to our capacity to adapt to change so that we can hold our own in a dynamic and competitive world. I am hopeful that this approach to our problems will commend itself to us, and that we shall more and more measure all our policies against this yardstick. I am confident that, to the extent that we do, we shall improve our prospects both of strengthening our balance of international payments and of increasing our levels of employment and output and our rate of economic growth. In other words, we shall improve our prospects of achieving an economic performance that is satisfactory both in its internal and external aspects. As we accomplish this, we shall find that we are better able to play our role as mature and responsible members of the world community.