REMARKS OF LOUIS RASMINSKY
GOVERNOR OF THE BANK OF CANADA
BEFORE THE U.S. BANKERS' ASSOCIATION FOR FOREIGN TRADE
QUEBEC CITY, MAY 25, 1964.

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I am very pleased to add my word of welcome to those offered earlier this morning. This is your third meeting in Canada and on each occasion the central bank has been present to greet you and to take part in your proceedings. You can take this as an indication of the vital importance that foreign trade, with which you are concerned, continues to have in our economic life. And you can reasonably take it too as a recognition on the part of the Bank of Canada of the contribution that this Association has made, over the years, in helping to keep the channels of trade open. I know that your Canadian members value their membership in the Bankers' Association for Foreign Trade and that the intimate relationship you have helped to establish among the foreign exchange departments of the commercial banks of the two countries has served many constructive purposes.

I have had occasion to look over the remarks that my predecessor, Graham Towers, made when he spoke to you in 1942 and the speech that Sydney Turk, the former head of our Foreign Exchange Department, made when he addressed you ten years later. Their themes were in a sense quite different -- Mr. Towers spoke about some of the problems of war finance, including foreign exchange control, while Mr. Turk was concerned mainly with explaining our transition to a fluctuating exchange rate system. But in both speeches, and indeed in the whole record of your proceedings, there is reflected a recurrent theme of understanding of each other's problems on the part of Canadians and Americans and of cooperation in dealing with them. I would like to think that my own remarks will be in this same tradition.

What I am going to say falls into two parts. In the first part I am going to follow the examples set by Messrs. Towers and Turk and give you a brief review of recent Canadian foreign exchange experience; in my case it will be a review of the period since the present par value for the Canadian dollar was established with the International Monetary Fund just over two years ago. I am then going to turn for a few minutes to some general observations on the longer-term development of the international financial system.

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Since Canada re-established a par value for the Canadian dollar in May 1962 our payments position has been buffeted by some rather violent winds. I do not propose here to recite the developments which led to the exchange crisis of June 1962 but it might be well to recall how fierce that particular storm was. The drain on Canada's official foreign exchange reserves amounted to more than one billion dollars. To those of you who are used to the vast magnitudes of the United States economy you should of course multiply our figure by something between 10 and 15 and think of yourselves as experiencing gold losses of this magnitude to appreciate how large it seems to us.

A comprehensive programme of emergency measures designed to deal with this crisis was announced by the Government on June 24th. The measures included the temporary imposition of import surcharges, a reduction in the Government's spending programme, and a reduction in the exemption from customs duties on goods brought back into Canada by returning tourists. At the same time the Bank of Canada announced a six per cent Bank Rate, which signalled a very tough monetary policy. This diversified programme was bolstered by arrangements for international financial support amounting to more than one billion United States dollars. This total was composed of a drawing of the equivalent of U.S. $300 million from the International Monetary Fund, a line of credit for $400 million from the Export-Import Bank, a reciprocal currency arrangement for $250 million between the Federal Reserve System and the Bank of Canada and a comparable arrangement with the Bank of England for $100 million. The readiness with which central banks and other institutions were prepared to lend their support to the Canadian programme and the speed with which they responded to our requests were indeed warmly welcomed and deeply appreciated in Canada.

The monetary policy followed in response to the exchange emergency had the primary objective of establishing a level of interest rates in Canadian markets that would encourage a net inflow of foreign capital large enough to cover the current account deficit and to rebuild the depleted reserves. This policy was successful in encouraging Canadian borrowers to raise a very substantial volume of funds in the New York market. It was also helpful in encouraging non-residents to buy outstanding Canadian bonds and short-term paper.

The series of measures taken to deal with the exchange crisis turned out to be very effective, and Canada's official foreign exchange reserves recovered rapidly. As the reserves rose it was possible to ease credit conditions, starting in September of 1962 and continuing through the first half of 1963. The Bank Rate was reduced by stages from 6 per cent, and is now 4 per cent. Since the early part of 1963, capital inflows of various sorts have just about balanced the deficit in our balance of payments on current account. With the exchange emergency surmounted, the attention of public policy in Canada could again be directed to the longer-run problems connected with Canada's balance of payments.

For the past decade Canada has consistently run a deficit in its international transactions on current account. The deficit on current account reached a peak of one and a half billion dollars in 1959, and since then has fallen year-by-year to just over half a billion dollars in 1963. This improvement has been due to an encouraging change in our balance on merchandise trade. After running a deficit in our merchandise trade from 1955 to 1960 we moved into surplus in 1961. In 1963, with an extra boost of approximately $200 million from the sales of wheat and flour to the Soviet Union, our merchandise trade surplus rose to nearly

$500 million. But Canada's transactions in services continue to give rise to a deficit of about one billion dollars a year. While a considerable improvement has been made in our international travel account, much of the gain has been offset by the steady growth in the deficit on interest and dividend payments, which now exceeds $600 million a year. On balance the scope for reducing the deficit on non-merchandise transactions seems to be fairly limited. Our goal is therefore to further reduce our total current account deficit by increasing our merchandise trade surplus through an expansion in the output of our traditionally export-oriented resource industries and by a continuing growth in efficient and competitive manufacturing in Canada.

If we look for a moment at our transactions with the United States we find that Canada has characteristically run a very large current account deficit with that country. This deficit has been financed in part by a net inflow of capital from the United States, but in part also by the excess of receipts over payments in our current and capital account transactions with the rest of the world. Let me illustrate by quoting from our experience in recent years. According to our estimates, Canada has run a current account deficit with the United States over the last half dozen years which has been on the average about $250 million larger than the net flow of capital into Canada from the United States. To put it another way, on balance the United States received from Canada an average of about $250 million a year in foreign exchange which it used to help finance its deficit with other countries, thereby reducing its exposure to gold losses. I am aware that there are some problems in reconciling the statistical series prepared in Canada with those prepared in the United States, but I can see nothing in the United States estimates that casts doubt on the main point that I am making here, which is that for many years the sum total of transactions between Canada and the United States has not added to the balance of payments problem of the United States, but on the contrary has been a source of strength to that country.

Of course, the United States over-all balance of payments has not received an equal amount of support from transactions with Canada in every month or every quarter in recent years. During the first half of 1962 our foreign exchange losses gave massive support to the United States balance of payments. Then in the latter part of 1962 and early months of 1963, when there was a heavy concentration of deliveries of the proceeds of new Canadian security issues sold in the New York market, and when our badly depleted reserves were being restored, transactions with Canada contributed temporarily to the balance of payments deficit of the United States. However, during the second quarter of 1963 the earlier relationship was being re-established. Long-term interest rates in Canada fell to a level which provided little interest-rate incentive to Canadian borrowers to raise funds in the capital markets of the United States, and new security offerings by Canadians there fell off sharply. One could then foresee that the extraordinarily high level of new-issue capital flows from the United States to Canada would be substantially reduced by mid-year, and that thereafter transactions with Canada would not be putting strain on the United States dollar but rather would return to the characteristic position of strengthening it.

I stress a little this matter of the nature of the over-all Canada-United States balance of payments relationship because much that has been said and written on the subject seems to me to lack sufficient perspective. It frequently fails to take account of all the transactions between the two countries. Viewed in proper perspective, transactions with Canada have not contributed to the over-all payments deficit of the United States, and they cannot be a significant element in the reduction of that deficit.

This is why the announcement of the proposed interest equalization tax in the United States last July came as such a surprise to Canada. Canada was, of course, aware of the balance of payments problems of the United States and of her need to reduce her payments deficit. But it seemed clear to us that any attempt to reduce suddenly the United States balance of payments deficit by blocking the flow of United States capital into Canadian securities could not fail to be self-defeating from the point of view of the United States. Canada could not expect to raise enough capital in other foreign markets to cover its current account deficit with the United States and it was not practicable to count on covering this deficit out of reserves. The only alternative to continuing to import capital from the United States would have been a disorderly reduction in our imports of goods and services, and any such attempt would undoubtedly have affected most severely the United States, from whom we obtain two-thirds of our imports. After week-end consultations between the two governments a joint statement was issued which included the announcement of the intention of the United States Administration to ask for an exemption for Canada from the proposed tax in respect of new issues. As you are aware, we indicated that we did not intend to take advantage of the exemption to encourage borrowing in the United States on a scale that would add to our reserves. We had in fact not been adding to our reserves since the beginning of 1963.

It is now 10 months since the intention to impose the interest equalization tax was announced. The relevant legislation, which will be retroactive to last July 18th, has not yet been enacted and I think all would agree that the delay in enacting the legislation has presented more of an obstacle to new capital flotations by foreigners in the United States capital market than the legislation itself was intended to present. However, thanks to an exceptionally high level of exports, the Canadian foreign exchange position has on the whole been strong during the past 10 months. At the end of April our spot holdings of gold and U.S. dollars were only about $200 million less than they were just before the announcement of the interest equalization tax. Moreover, about three-quarters of this decline reflects a reduction in our indebtedness to the International Monetary Fund.

The new and unforeseen favourable factor in our foreign exchange position has, of course, been the large and unexpected sales of wheat and flour to the Soviet Union. The contract arranged last September called for the shipment of wheat and flour amounting to nearly $500 million in the current crop year -- that is, by the end of July of this year. The physical movement of the wheat is going well, and our foreign exchange position has been bolstered both by the payment for wheat shipped and by the demand for forward Canadian dollars to cover future shipments. The demand for Canadian dollars in the forward market has caused a substantial inflow of short-term capital into Canada, a flow which is in effect a prepayment for wheat. During the last several months we have on occasion fended off further short-term inflows, in part by operating in the forward exchange market in order to moderate any tendency of the covered interest-rate differential to widen sufficiently to induce this type of inflow.

From what I have said, it will be apparent to you that at the present time Canada has two main objectives as regards her international balance of payments: the first is to continue the steady progress made during the past few years in reducing the current account deficit and our need for foreign capital, and the second is to import enough capital to cover our reduced current account deficit. The current and the capital side of our balance of payments need not, of course, be equivalent in each and every month; there is a great deal of seasonality and irregularity in the components of our balance of payments and we should expect to see sizeable temporary fluctuations in our reserves. Broadly speaking, however, we would like to see a net inflow of capital of the same order of magnitude as our current account deficit.

The instrument of policy that is most directly available to the public authorities in an attempt to influence capital flows is, of course, the influence they can exert over interest rates. As I have already indicated, we used the technique of influencing interest-rate differentials between Canada and the United States to re-establish long-term capital inflows after the foreign exchange crisis in the spring of 1962. The relationship between interest rates in Canada and other countries and their effect on our international position must always be given due weight in forming views about what credit conditions are appropriate in all the circumstances to the needs of the domestic economy.

There are, of course, some capital movements that are not sensitive to interest rate changes. They may be motivated primarily by considerations such as long-run business expectations, corporate ties between related Canadian and foreign businesses, or tax arrangements. Occasionally the consideration is sheer size -- some issues are just too large to be absorbed at one time in the Canadian market. There are times, moreover, when expectations about future conditions in the foreign exchange markets influence capital flows. The sum total of these long-term flows that are not sensitive to interest rates is unpredictable and is often "lumpy", and in the short-run it may not always be feasible to attempt to offset them by those capital flows that are more responsive to changes in Canadian public policy. Consequently, the reasonable aim for public policy is to try to achieve an approximate balance between the current and capital accounts over the longer term.

The amount of Canadian new-issue borrowing in the United States that would be required in order to achieve this balance depends of course on what happens to the other items in the balance of payments. As I have already indicated, the other components of the capital account include large and variable flows in both directions. Let me illustrate. In 1963 direct investment inflows amounted to $200 million and they have exceeded $500 million in some recent years, while outflows in the form of Canadian direct investment abroad have varied between $50 million and $125 million. The net trade in outstanding Canadian securities in 1963 resulted in a capital outflow of $130 million; as you know, purchases of outstanding Canadian securities by Americans are not to be exempt from the interest equalization tax, and during the past 10 months the outflow of capital from Canada to the United States under this heading has been running considerably higher than the figure I just mentioned, and has varied a good deal from month to month. A final item I might mention is the retirement of outstanding issues at maturity or in other ways; these retirements have varied between $150 million and $325 million in recent years, with most of the securities paid-off being held in the United States. I think that you will appreciate that it is not possible to forecast with confidence the total of these various flows, and that it is therefore not possible to know in advance what level of new-issue borrowing will be consistent with over-all balance in our international accounts and with reasonable stability in our reserves. Perhaps I should add that to the extent that there is any uncertainty about the size of the current account deficit in the future the situation is further complicated. In these circumstances one cannot afford to have any fixed view about the appropriate amount of new-issue borrowing, but must be prepared to modify one's view in accordance with the behaviour of other items in the balance of payments.

Considerations like these seem to me to explain why it was that in the joint statement of July 21, 1963 announcing the intention of the United States Administration to ask for an exemption for Canada to the proposed tax in respect of new issues, it was made clear that the two governments would rely on continuous and flexible cooperation between them to achieve their joint objectives rather than on rigid rules or arbitrary pre-judgment of balance of payments magnitudes.

This brings me to the end of my account of developments in our external financial situation since the establishment of the present par value for the Canadian dollar in May 1962. I know that you will not expect me to forecast the future, and that is fortunate because I do not know what problems we may be faced with in the external financial field. I am hopeful that we shall react constructively to any problems that arise, and I am sure that in doing so there will be many opportunities for cooperation with the United States. Canada's major external financial goals are not in conflict with United States interests or United States policy -- on the contrary, the basic external financial goals of the two countries are compatible, and over much of the area of the balance of payments between them there is a substantial identity of interest. In these circumstances it seems inevitable that United States-Canadian consultation and cooperation will play an important role in the years ahead.

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Our financial relations with the United States, though extremely important to us, must of course be seen against a wider background of international cooperation.

In embarking on this theme, I automatically cast my mind back to the 1930's when I was on the staff of the League of Nations, working with the Financial Committee. The work done in Geneva may well have laid the groundwork for some of the developments in international financial cooperation which took place later, but these later developments have been on such an impressive scale that the pre-war arrangements now look quite rudimentary. There was, to be sure, valuable consultation and occasional mutual support operations by central banks. The Tripartite Agreement of 1936 between the United States, the United Kingdom and France was rightly considered at the time as a major advance even though its substance was confined to a readiness to agree on the maintenance of exchange rates and on the holding of each other's currencies for a period no longer than twenty-four hours.

The establishment of the International Monetary Fund at the end of the last war ushered in a new phase of the international payments system. The Fund represented a much more ambitious approach towards cooperation in the successful functioning of the international financial system than governments had attempted before. The member-governments of the Fund undertook to contribute to international financial stability by following certain practices in respect of the establishment, maintenance and alteration of exchange rates and the avoidance of exchange restrictions. In addition they provided a large international fund to back up these arrangements with credits to members that were in temporary balance of payments difficulty.

Since its establishment, the Fund has grown in membership and in resources and it has adapted its policies in ways which have increased its usefulness. We in Canada benefited directly from the Fund's facilities in 1962 when we made our first drawing. More recently a new and constructive development occurred when the United States made a drawing on the Fund for the first time.

In the last few years there has also been a rapid development in the nature and effectiveness of central bank cooperation. Following the re-establishment of convertibility of the major European currencies in 1959 there were occasions when short-run capital movements of a speculative nature threatened the stability of the exchange system and central bank action proved to be an effective first line of defence. This was demonstrated in 1961 when sterling came under pressure following the revaluation of the mark and the guilder and credits were extended to the United Kingdom by European central banks. The Federal Reserve System has now entered into a number of stand-by agreements with central banks, including the Bank of Canada, for a total amount of more than $2 billion. The existence of central bank facilities of this kind, and their successful use on several occasions in the last few years have, I believe, reduced the vulnerability of national currencies to speculative attacks.

At the present time there is a good deal of interest in questions having to do with international liquidity. Liquidity in the international monetary system consists of the gold and convertible foreign exchange that governments hold in their exchange reserves and the credit to which they have access in case of need. There is widespread agreement that there is at present no general shortage of such liquidity, but there are some reasons for starting to think about future requirements. A large part of the increase in international liquidity in the last several years has taken the form of an increase in holdings by other countries of the United States dollars resulting from the large over-all balance of payments deficit that the United States has experienced. Since the United States is aiming at reducing its international deficit, the continued availability of substantial additions to international liquidity from this source becomes much less likely. It is appropriate, in these circumstances, to give consideration to sources from which the world's growing needs for international liquidity can appropriately be met -- not as an urgent problem but as one to be considered over a period of time. These are, as you know, questions that are currently being studied both by the International Monetary Fund and by the so-called Group of Ten, that is, by the group of countries (including the United States and Canada) who in 1962 brought into effect a special arrangement to supplement the resources of the International Monetary Fund in case of need.

It is still too early to know what the results of these studies will be, and I do not propose to engage in any speculation about them. But I would like to say that I think that the most important thing about these studies is that they are taking place. The studies are collective acts, taken not at a time of crisis, but in an atmosphere of calm, with a view to understanding any difficulties that seem likely to emerge in the future, and to anticipating them by collective action so that they do not interrupt the healthy growth of the international payments system. These studies seem to me to be in themselves further steps in the evolution of the international monetary system.

I think that we are entitled to take a reasonable amount of satisfaction from the development of facilities for international cooperation in the financial field that has occurred during the past 20 years. There is certainly no reason to think that progress has now come to an end or that further developments and innovations will not be required; on the contrary the system must be in a continuous state of evolution and change. But there is little doubt that the changes that have occurred, and the habits of cooperation that have been developed through the International Monetary Fund, through the central bank swap arrangements, through the O.E.C.D. and the Bank for International Settlements have added a new dimension of strength and flexibility to the international monetary system.

Having said this, one should recognize that no arrangements can make the international economic system perform well unless countries follow internal policies that are consistent with balance of payments equilibrium. It is desirable that the world's liquidity be adequate to allow countries to meet temporary swings in their balance of payments, and to allow them to adjust smoothly to longer-term imbalances. But it would be a serious illusion to suppose that any international monetary arrangements can relieve countries of the need to adjust to underlying changes in their external positions. One does not have to look very hard to find cases where efforts by countries to avoid such adjustments have resulted, after a period of time, in much more disruptive measures than would otherwise have been needed. It is also, in my opinion, an illusion to suppose that there is any fundamental conflict between the pursuit simultaneously of external balance and of internal prosperity. There is much in both Canadian and United States experience to indicate that the pursuit of domestic economic goals is best served if countries respond flexibly and efficiently to changes in their international payments positions.