MONETARY AND CREDIT DEVELOPMENTS

Statement by Mr. Louis Rasminsky
Governor of the Bank of Canada

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I am pleased to have the opportunity of appearing before this Committee. There is reason to be concerned at the size of some of the recent increases in Canadian costs and prices, and I wish to do everything possible to assist the Committee in its work. I know that you are giving highest priority to a consideration of food prices and that you have heard and will be hearing from witnesses who are qualified to give expert evidence in that field. The most suitable ground for me to attempt to cover is the general area of monetary and credit developments. In particular, I would like to explain the way in which the Bank of Canada has approached its responsibilities in relation to the country's major economic goals, including that of reasonable price stability.

May I begin by reviewing briefly some highlights of the current economic expansion. It has now lasted for five and one half years and is by far the longest expansion in our peacetime history. It has brought us some very substantial benefits. When the final results for 1966 are in, I expect that our gross national product will be over 50 per cent higher than it was in 1961 in dollar terms, and 35 per cent higher in real or physical terms. Our population has grown rapidly in this period but on a per capita basis GNP will still be 40 per cent higher in dollar terms, or about 25 per cent in real terms. This represents a very major improvement in the average standard of living in this country over a brief five-year period. Employment has risen enough to look after a sharp rise in the labour force and at the same time to bring the level of unemployment down from just over $7\frac{1}{2}$ per cent in the early part of 1961 to the $3\frac{1}{2}$ - 4 per cent range of the past twelve months. Taking the expansion period as a whole, the Canadian experience also looks very good when it is compared with that of other countries. The rate of growth in physical output achieved here has been among the highest in the world, averaging 6 per cent per annum, while the rate of increase in consumer prices, although higher than we would like to see, has until quite recently been among the lowest in the world, averaging about 2 per cent.

REAL OUTPUT AND CONSUMER PRICES
Percentage Changes in Selected Countries

	Compound Annual Rate of Change 1961 to 1966		1st Half/61 to 1st Half/66	Change in Consumer Price Index 1965 to 1966 (Average of Latest 3 Months Available)		
	Total Output*	Per Capita Output*	Consumer Price Indexes	Total	Non-Food	Food
Canada	6.2	4.4	2.0	3.9	2.9	6.8
United States	5.4	4.0	1.5	2.9	2.6	3.9
United Kingdom	2.8	2.1	3.7	3.8	3.3	4.8
Germany	4.6	3.2	3.1	3.6	4.4	2.7
France	5.1	3.6	3.8	2.2	1.9	2.5
Italy	4.5	3.6	5.0	2.3	2.3	2.2
Netherlands	5.1	3.7	4.5	5.8	6.0	5.6
Belgium	4.4	3.6	3.2	4.5	n.a.	n.a.
Sweden	4.5	3.8	4.4	7.0	6.2	7.9
Switzerland	4.6	2.7	3.8	5.0	n.a.	n.a.
Japan	7.8	6.7	6.5	6.0	7.1	4.4

* 1966 output figures estimated.

I do not believe that it was an accident that we simultaneously enjoyed markedly rising output and relatively stable prices over this long period of expansion. On the contrary, I believe that our record of comparatively stable prices over most of this period, notwithstanding the depreciation of the Canadian dollar, made an important contribution toward maintaining a vigorous rate of economic expansion for such a long time. It protected our international competitive position and enabled us to avoid some of the distortions and imbalances in the internal structure of our economy which arise when prices are rising rapidly. The concern that we feel about the more rapid cost and price increases we have been experiencing recently springs partly from the inequities that they inflict on some sections of the community and partly from the risk that they may jeopardize the continuance of the long period of expansion we have enjoyed.

I said a moment ago that the performance of our economy from 1961 to 1966, both in terms of total output and prices, has been relatively good by international standards. I now have to make an important qualification, or rather to provide an important part of the explanation. We had in fact more scope than most countries for increasing output without this generating upward pressure on prices because we began the current expansion under conditions of high unemployment, substantial underutilization of productive resources, and a rapidly growing labour force. Productive capacity grew rapidly and it was not until well along in the expansion that the economy was again operating close to its effective limits. For example, it was not until the end of 1963 that unemployment came down to less than 5 per cent of the labour force and not until late 1964 that it fell below the $4\frac{1}{2}$ per cent level. For the past year or more, however, there has been very little effective slack left in the economy and this avenue of relief from price pressures has disappeared. As a result, our powers of effective resistance to rising prices have been subjected to a much sterner test, and our price performance has unfortunately deteriorated. This deterioration has been a matter of widespread concern, as evidenced by the deliberations of this Committee, because one of our major economic objectives is to have the economy operate with reasonable price stability as well as a minimum of unemployment and underutilization of other productive resources.

There appear to be some special factors associated with the price rises of the past two years, particularly in the case of food and some services, to which the Committee will no doubt be devoting particular attention, but there can be no doubt that the general situation has for some time been one of substantial general upward pressure on prices. In my last annual report, dated February 28, 1966, I made the following comment on price movements:

> " ... Although the principal measures of final prices were affected during the year by some special factors, it seems clear that prices were responding to influences of a more general nature and were beginning to rise more rapidly over a wide range of goods and services."

In the same report, I summarized some of the factors that were at that time producing general pressure on our resources in the following terms:

"At the present time, against the background of continuing vigorous expansion in the United States, a number of domestic factors are combining to produce very strong demands on our resources. Private business is engaging in a major round of capital expenditures. The public sector of the economy is proceeding with a rapidly growing volume of capital outlays on educational facilities, hospitals, highways and other social capital while at the same time increasing its other expenditures. Consumers are well placed, as a result of rapidly growing employment and rising wages and salaries, to increase their spending substantially. In these circumstances, the aggregate of all demands on the Canadian economy may outrun the effective capacity of the economy to increase its output of goods and services. In short, we now run the risk of overloading the economy."

Before turning now to a description of the way in which monetary policy has developed over the economic expansion, I would like to make some general observations about the nature and significance of the central bank's operations. These matters are set forth in some detail in the Bank of Canada's submissions to the recent Royal Commission on Banking and Finance, but perhaps it would be helpful in understanding the role that monetary policy plays if I were to comment on three main points.

First, how does monetary policy work? In essence the central bank is able to influence credit conditions, by which I mean the ease or difficulty of raising money and the cost at which it can be obtained, and changes in credit conditions in turn have an influence on the total amount of spending on goods and services. The Bank of Canada exerts its influence mainly in an indirect manner, through the banking system. The chartered banks are required to maintain cash reserves in the form of deposits with the Bank of Canada and Bank of Canada notes in an amount equal to at least 8 per cent of their deposit liabilities. The Bank of Canada Act gives the Bank powers which enable it to control the level of cash reserves, the most important means being the purchase and sale of Government securities. The extent to which the chartered banks as a group are able to increase their loans and investments is therefore determined by the amount of cash reserves provided by the central bank. The rate of expansion of the banking system has in turn an influence on the position of other financial institutions and on the terms and conditions under which financing may be obtained throughout the credit system.

Changes in the cost and availability of credit have an effect on private spending decisions and therefore on the total level of demand, and this in turn has an influence on the rate of growth of output, the level of employment and the behaviour of prices. Changes in the total level of demand naturally affect the level of spending on imports as well as the level of spending on domestically-produced goods and services. It is also the case that changes in credit conditions have an influence on decisions to borrow or invest funds outside Canada. Indeed, at times in the past quite small changes in market yields in Canada relative to those in other countries, particularly in the United States, have induced funds to flow into or out of Canada. In some situations, changes in the relative availability of credit in Canada and the United States may be as important as changes in interest rates. On balance, in a relatively open economy such as ours, action to ease credit conditions tends to draw in goods and services from abroad but to reduce inflows of capital; movements of credit conditions in the opposite direction have, of course, the opposite effect. This means, of course, that the central bank must always take into account the effect of its operations on the country's external financial position as well as on the level of aggregate demand.

This brings me to the second main point on which I wish to comment, namely, limitations on the use of monetary policy. I have indicated that there are practical limits to how far we can permit credit conditions in Canada to diverge from those in the United States and other countries without setting in motion massive and destabilizing inflows or outflows of capital. There are also practical limits of a purely domestic nature on how far we can let credit conditions tighten. For one thing, tight credit conditions have an uneven incidence on different classes of borrowers and on different parts of Canada whose economic problems are not identical. Within the different classes of borrowers, large corporate borrowers appear, on the whole, to feel the direct impact of credit restraint less and later than small borrowers: large corporations normally have substantial liquid resources which they can draw on and they have more ready access to the capital market if bank borrowing becomes difficult. Some categories of borrowers find it easier than others to draw funds from foreign countries through the use of foreign capital markets or from foreign parent companies. There are differences in the responses of different sectors of the economy to changed credit conditions. You will be aware, for example, that housing expenditures are particularly likely to be affected when money is difficult to raise. In addition to these inequalities, excessive reliance on monetary policy could result in the development of financial conditions so extreme as to involve a real risk of impairing the functioning of the financial system and impeding the flow of funds for productive purposes through capital and credit markets. The central bank must always be conscious of these practical limitations.

A different kind of limitation, one that applies to all economic policies because they have their impact on the economy only with a considerable time lag, is the difficulty of forecasting economic developments accurately. I do not wish to take up the time of the Committee on this matter and I will simply observe that a striking illustration of this problem is that the full strength of the current economic expansion in North America could not have been foreseen without also anticipating the development of the war in Viet Nam.

The third and final point I wish to make in regard to the use of monetary policy is that the operations of the central bank are only one element in public economic policy as a whole. As I have explained, monetary policy affects the level of economic activity through its influence on the total level of demand; so do decisions regarding the level of government spending, the level and structure of taxes and the form of government financing. Monetary policy can have important effects on our balance of payments and external financial position; so can the Government's transactions, spending commitments, and tax and tariff arrangements insofar as they affect trade and capital flows with other countries. And then there is an entirely different range of policies affecting the performance of the economy, such as those concerned with raising productivity, improving labour mobility and protecting the public interest against the abuses of market power. Because this is so, monetary policy must be regarded as only one element in a whole mix of policies which have to be combined in a purposeful way if the over-all performance of our economy is to meet the varied and exacting criteria imposed by contemporary society. Monetary policy must bear its full share of the load but if it attempts too much it will run into some or all of the limitations that I have mentioned.

I should like to devote the remainder of my remarks to a brief description of the monetary policy followed by the Bank of Canada since 1961 and the main considerations on which it was based.

As I mentioned earlier, the current economic expansion got underway in early 1961 in conditions of high unemployment and underutilization of plant capacity. In these circumstances, the basic policy of the Bank of Canada was to permit enough expansion of the banking system to enable the growth in economic activity to be financed without any appreciable tightening of credit conditions. With the major but temporary exception of the period of the exchange crisis of 1962, this basic policy did not undergo any significant change until the spring of 1965, by which time the growth of the economy was rapidly bringing us back close to the full utilization of the country's effective productive capacity. The relatively stable credit conditions which prevailed after the exchange crisis are indicated by the yields on Government securities. The 91-day treasury bill rate remained below 4 per cent and the average of yields on long-term Government bonds moved within a range of about 5 - $5\frac{1}{4}$ per cent. In 1964 the Bank of Canada managed the cash reserves of the chartered banks in such a way that a part of the resources needed by the banks to accommodate the large increase in their loans had to be obtained through a reduction in their holdings of Government securities and other liquid assets. This reduction in bank liquidity was not such as to prevent the banks from continuing to follow strong lending policies but it brought them to a position where their lending policies could be expected to be sensitive to any appreciable further decline in the proportion of their total assets which they held in relatively liquid form.

There were occasions during this period - 1961 to the spring of 1965 - when the course of events posed a serious threat, for a time, to the soundness of our external financial position, and the Bank of Canada felt it necessary to respond to these dangers. The most serious of these threats was the exchange crisis of mid-1962; here the response was to tighten credit conditions very sharply during the summer months of that year as a part of a programme to deal with the situation. You will recall that the Bank Rate was raised to 6 per cent and market rates of interest rose sharply. By early autumn our external finances had improved to the point where credit policy could be eased substantially and in a matter of months interest rates were back down to about the same levels as had prevailed before the exchange crisis arose. From 1963 on, other problems affecting our external financial position arose as a result of measures taken by the United States to deal with her balance of payments difficulties, the most serious being the announcement of the interest equalization tax in July 1963. In these cases, however, the danger to our foreign exchange position was averted by adjustments of the American measures without any marked shift in the general posture of Canadian monetary policy becoming necessary.

In my annual reports for 1963 and 1964 I drew attention to the fact that the Canadian economy's margin of unused resources was rapidly being taken up and that as we approached the limits of our effective capacity it would become more difficult to achieve as rapid rates of real growth with as moderate rates of price increase as in the past. The report of 1963, dated February 29, 1964, includes the following statement:

> "The success of the Canadian economy in achieving sustained and balanced growth in the years ahead and in continuing to reduce its current account deficit will depend to an important measure on its response in terms of prices and costs, to further increases in demand. The existence of large amounts of unused resources has undoubtedly contributed to the relative stability of costs and prices during the past three years of economic expansion. Some of the aggregative measures of economic slack, for example the number of persons recorded by the Labour Force Survey as being without jobs and seeking work, suggest that there is still substantial slack in the economy, but ... the geographical distribution of unemployment is very uneven, and it is known that the availability on the labour market of many types of skills which are in demand is limited and patchy. Surplus plant capacity also seems to be quite unevenly distributed industrially and geographically. The special characteristics as well as the aggregate amount of the slack in the economy must of course be taken into account in the continued efforts of the public authorities to follow policies which will facilitate the absorption of slack without generating price increases and a deterioration in our balance of payments."

And a year later, at the beginning of 1965, I made a somewhat similar observation:

> "The margin of unused capacity in the Canadian economy has been considerably reduced as a result of the expansion of the last few years. In certain major industries there is for practical purposes no unused capacity, and in some geographical areas shortages of certain types of labour skill have appeared. It seems clear that the absorption of the remaining amounts of unused resources in the economy will be more difficult, and that we shall have to rely to an increasing extent on improving the adaptability of our growing resources in order to avoid serious bottleneck problems and price pressures. Even in 1964, when we were absorbing slack in the economy and when unemployment averaged 4.7 per cent of the labour force, the Consumer Price Index in Canada rose by nearly 2 per cent. While it is true that this increase was a relatively modest one by current international standards, it underlines the need to do everything we can to improve the performance of the Canadian economy in the years ahead."

The concern that I expressed on these occasions about bottleneck problems and the uneven geographical distribution of unused capacity reflects in part the fact that the central bank is itself powerless to deal with these particular difficulties because monetary policy can be directed only at the aggregate level of demand in the country as a whole.

The general posture of monetary policy through most of 1965 and in 1966 has been quite different from what it was in the earlier years of the economic expansion. In recognition of the fact that most of the existing slack in the economy had been taken up, the pressure of heavy demands for funds on financial markets was increasingly allowed, under the policy followed by the central bank, to have an effect on credit conditions. The chartered banks found it necessary to adopt more selective lending policies and the difficulty of obtaining accommodation from other types of lending institutions, notably those specializing in mortgage finance, increased markedly as the result of the intensified competition for funds. Interest rates rose. The Bank of Canada raised its Bank Rate from $4\frac{1}{4}$ per cent to $4\frac{3}{4}$ per cent in December 1965 and to $5\frac{1}{4}$ per cent in March 1966. The average yield on 91-day treasury bills is now about 5 per cent compared to about $3\frac{3}{4}$ per cent in the spring of 1965. Other short-term rates are much higher, in many cases well over 6 per cent. The average rate on long-term Government bonds is about $5\frac{3}{4}$ per cent as against 5 per cent in the spring of 1965. For a time this August, under the influence of strongly rising interest rates in the United States, yields on some of the major long-term Government issues went above 6 per cent. Yields on prime conventional mortgages have risen from $6\frac{3}{4}$ per cent in early 1965 to $7\frac{3}{4}$ - 8 per cent and yields in excess of 8 per cent are not uncommon. Credit conditions in Canada have, of course, also been influenced by broadly similar developments in the United States and Europe.

INTEREST RATES

		Sept. 1961	Sept. 1963	Sept. 1964	Sept. 1965	Sept. 1966
Bank Rate		2.67%	4.00%	4.00%	4.25%	5.25%
3-month rates	- Treasury bills	2.42	3.68	3.80	4.12	5.02
	- prime finance co. paper	3.02	4.09	4.25	5.16	6.33
Long-term rates	- Govt. bond average	4.98	5.22	5.22	5.30	5.79
	- Non-Govt. bonds (McLeod, Young, Weir)	5.47	5.54	5.56	5.85	6.71
	- conventional mortgages	7.00	7.00	6.75-7.00	7.25	7.75-8.00

Today's credit conditions have not been brought about by calling a halt to the expansion of the banking system. On the contrary, bank loans and the money supply have continued to rise, though at a lower rate than earlier in the expansion. In the past twelve months general bank loans have increased by 8 per cent. Within this category business loans have increased by $7\frac{1}{2}$ per cent and consumer loans by 11 per cent but in recent months the banks' consumer loans have levelled off as has the over-all total of all forms of consumer credit.

CHARTERED BANKS
(Average of Wednesdays)

	Sept. 1961	Sept. 1964	Sept. 1965	Sept. 1966 (prelim.)	Annual Average Percentage Increase Sept/61 to Sept/66	Sept/64 to Sept/66	Sept/65 to Sept/66
	(millions of dollars)						
Currency and chartered bank deposits							
Total (inc. Govt. deposits)	14,432	17,342	19,477	20,687	7.5	9.2	6.2
Held by general public	14,259	16,762	18,913	20,213	7.2	9.8	6.9
Chartered banks							
Total assets	13,356	16,053	18,025	19,122	7.4	9.1	6.1
Liquidity ratio	37.1	32.1	30.2	29.9			
Canadian dollar loans							
Total	6,418	8,831	10,555	11,420	12.2	13.7	8.2
General	5,539	8,095	9,407	10,150	12.9	12.0	7.9
Business	3,560*	4,880*	5,572*	5,997*	11.0	10.9	7.6
Consumer	995*	1,715*	2,126*	2,357*	18.8	17.2	10.9

* Month-end August.

In 1965 and 1966 monetary policy has had to take account of a number of special developments, primarily the collapse of Atlantic Acceptance and the effect of United States balance-of-payments measures. In the case of the shock to confidence resulting from the finance company failure, the Bank of Canada added to the cash reserves of the chartered banks in order to ease the liquidity of the banking system and financial markets generally. The Bank also enlisted the help of the chartered banks in seeking to avert wider repercussions on the position of other financial institutions. However, these actions did not stop the trend towards less easy credit conditions. On the contrary, the effect of the episode on confidence produced a marked tightening in some areas of the financial market and a further upward movement in interest rates.

Throughout the whole period of the economic expansion it has been necessary for monetary policy to be concerned with the need to obtain a large enough inflow of capital to finance our deficits on current account and at the same time to try to avoid a larger inflow than necessary. This problem has been complicated by a number of measures taken by the United States to improve its balance of payments position, including "guidelines", and by arrangements regarding the level of Canada's foreign exchange reserves which were necessary in order to maintain the access of Canadian borrowers to the United States long-term new issue market. I do not think that the Committee would wish me to go into the details of these matters at this time. They are in any case set out in my last annual report. The main point I would like to make here is that though the

Bank of Canada naturally had to take into account the agreements regarding reserves, this consideration did not in fact seriously interfere with the development of our monetary policy. During 1966 purchases of securities from U.S. residents by the Government have made it possible for the agreement regarding reserves to be met without placing too many constraints on the use of monetary policy.

This concludes my account of how monetary policy has developed over the whole of the economic expansion. As I have indicated, the recent credit situation, with its unusually high interest rates, has been part of a world-wide condition. There is now a widespread view, which I share, that in the western industrial countries monetary policy has had to carry too much of the burden of resisting inflationary pressures.

The general course of prices is the result of all the forces of demand and supply that operate throughout the economy. Monetary policy and certain other broad instruments of policy have an influence on the aggregate demand for goods and services and it is necessary that these instruments be deployed in a way that encourages demand to expand in line with, but not in excess of, the productive capacity of the economy. Today I have been discussing with you only the particular instrument, monetary policy, for which I have some responsibility, and I shall be glad to answer any questions that members of the Committee may have in this area. There are, of course, as I have indicated, other important public policies which influence the demand side of the picture.

In addition, the movement of prices is influenced by a whole host of public and private policies, including those affecting our productivity and efficiency, the skill and training and mobility of our labour force, the relationship between incomes and productivity, the degree of competition in the economy, tariff and trade policies and many others that go far beyond the scope of central bank action.

It is clear that, like other countries, we in Canada have a great deal to learn about living with prosperity without permitting it to degenerate into inflation. This problem must be solved, because reasonable price stability is an essential element in continuing economic growth. We must search for more effective measures and better combinations of policies to reconcile the goals of reasonable price stability and sustained economic growth. I am sure that your deliberations will make a contribution in this direction.