

October 31, 1966

OPENING STATEMENT
BEFORE THE HOUSE OF COMMONS COMMITTEE ON FINANCE,
TRADE AND ECONOMIC AFFAIRS

By Mr. Louis Rasminsky, Governor of the Bank of Canada

Mr. Chairman, I am pleased to have the opportunity of appearing before this Committee and shall of course be glad to be of whatever assistance I can in your consideration of the proposed changes in the Bank of Canada Act and related banking legislation. I should like, if I may, to make a few general observations on two main aspects of the proposed legislation, without getting into a detailed clause-by-clause discussion. First of all, I want to say something about the effect of the proposed legislation on the position of the central bank within the broad framework of Government and on its working relations with the Government. Secondly, I want to refer to those provisions which are designed to improve the central bank's technical powers with respect to monetary management.

The first matter I want to mention is the proposed new section 14 of the Bank of Canada Act, which gives the Government the power to issue a directive to the Bank of Canada in specified circumstances and subject to specified conditions. If members of the Committee wish to examine the statement I issued at the time of my appointment as Governor in July 1961, they will find that this proposal is in accordance with the views I expressed at that time. The underlying ideas are new to the legislation but not new in other respects; indeed, they have always been a part of my

understanding of the realities of the central bank's position in relation to the Government.

To my mind there has never been any basis for doubt that in a democratic society the ultimate responsibility for monetary policy must rest with the Government and Parliament of the day. In this connection, you will recall that in speaking on second reading of the bill to amend the Bank of Canada Act, the Minister of Finance said: "The intent of the proposed amendment is not to change the basis of the existing relationship between the Government and the Bank, which is based on these general principles and is working well in practice, but rather to give it clear legislative recognition."

The question may be raised whether the formal recognition which it is now proposed to incorporate in the law of the Government's responsibility for monetary policy will subtract from the ability of the central bank to operate without being subject to day-to-day political pressures -- an objective which I assume Parliament had in mind in giving the Bank the special status it enjoys under the Bank of Canada Act, and one which seems to me to be in the public interest. I do not think that it will. The bill makes it clear that the issuance of any directive on monetary policy must be preceded by consultation between the Minister and the Governor, that it must be approved by the Governor-in-Council, that it must be written in specific terms and applicable for a specified period, and that Parliament and the public must be informed of its terms without delay. These are very important safeguards.

Moreover, and this is a crucial point, there is nothing in the bill which diminishes the personal responsibility which the Governor bears for the monetary policy being followed. So long as he occupies the position of Governor the public is entitled to assume that the policy being followed carries his personal judgment. As the Minister said in the second reading debate in the House of Commons, if the Government of the day ever issued a directive to the Governor to execute a monetary policy which he felt was contrary to the public interest, it may be taken for granted that he would resign rather than accept such a responsibility.

In the normal course of events, the existing process of regular consultation between the Minister of Finance and the Governor (which is made a statutory requirement under the bill) should provide a satisfactory means of resolving any serious differences of view on monetary policy which might arise between the Government and the Bank, and it is to be hoped that a situation calling for the exercise of the directive power will never occur. In actual practice, I have had no serious difference of view on monetary policy with any of the four Ministers of Finance with whom I have been associated as Governor. But whether or not the proposed directive power is ever actually used, it would seem to me desirable in all the circumstances to include such a provision in the Act so as to remove any possible future grounds for doubt as to where the ultimate responsibility for monetary policy lies.

I come now to proposals for improving the technical arrangements under which monetary control is exercised by the Bank of Canada.

Perhaps it might be helpful if I took a moment to remind members of the Committee of the essential features of the mechanism of monetary control in this country. A full and detailed account of these matters is contained in the Bank of Canada's submissions to the Royal Commission on Banking and Finance.

Briefly then, each chartered bank is required by law to maintain a reserve of cash in the form of deposit balances at the Bank of Canada or Bank of Canada notes. The amount of this cash reserve, on the average each month, must not be less than a specified proportion (at present 8 per cent) of the bank's total Canadian dollar deposit liabilities. Thus the total amount of cash available to the chartered banks to hold as reserves effectively limits the ability of the banking system to expand the total amount of its Canadian dollar deposit liabilities. The supply of cash reserves made available depends on the operations of the Bank of Canada. Cash reserves are increased, for example, by the payments which the Bank of Canada makes when it buys Government securities, and they are decreased by the payments which the Bank of Canada receives when it sells securities.

The mechanism I have outlined gives the central bank control over the rate of increase of the Canadian dollar assets and deposit liabilities of the banking system. This affects the cost and availability of credit in Canada which, in turn, have an influence on the rate of spending, saving and borrowing in Canada and thus on our domestic economic situation and our external financial position.

The banking bills now before Parliament propose three changes in the cash and secondary reserve arrangements. Under the new Section 72 of the Bank Act, the present 8 per cent minimum cash requirement would be replaced by requirements of 4 per cent applying to term and notice deposits and 12 per cent applying to demand deposits. Based on the present structure of the banks' deposits, the proposed formula gives an average requirement of about 6.6 per cent. The bill provides for a period of gradual transition to the new system. As the Minister of Finance explained when introducing the Bank Act amendments, these new arrangements will enable banks to compete more actively with other financial institutions for term deposits. From the central bank's point of view it is important that the cash ratio which the banks are required by law to maintain should be at least as high as they would wish to keep to meet normal ebbs and flows of cash if they were subject to no legal requirement. It is only if this is the case that the banks will have a strong incentive to work closely to the specified minimum and will therefore respond reasonably quickly and predictably to changes in the reserves made available by the central bank. In my judgment the proposed requirements meet this test and will therefore have no adverse effect on the efficiency of monetary control. Members of the Committee will realize, of course, that the proposed reduction in the required level of cash reserves will not necessarily lead to a different rate of increase in the Canadian dollar deposit liabilities and assets on the part of the banking system, than would occur if the legal cash ratio were left unchanged at 8 per cent.

The Bank of Canada can offset the effect of the change in the legal cash ratio by changing the level of actual cash reserves which it makes available to meet the requirement, and its actions in this respect will be determined by its view of the monetary policy which it is appropriate for it to follow in all the circumstances of the time.

It is also proposed in Section 72 of the Bank Act to shorten the time period to which the cash reserve requirement applies. At present the banks are allowed a full month over which to average their cash reserve holdings for purposes of satisfying the minimum reserve requirement. In my opinion, the existing arrangements leave something to be desired, for they do not always produce a quick and predictable response by the chartered banks to changes in the level of their cash reserves and this sometimes complicates the task of monetary management. The monthly averaging period gives the banks considerable scope to postpone their response to a change in the level of central bank cash in the system if this occurs early in the month. It also means that if the average level of cash has been comfortably in excess of the minimum requirement during the first part of a month and if some tightening of the system should become desirable, rather strenuous action by the central bank in respect of cash reserves will be needed to produce much response during the latter part of the month. The proposed amendment to the Bank Act to reduce the length of the cash reserve averaging period to a half-month should, in my judgment, improve the efficiency of cash reserve management as a control technique by reducing the possibility of unduly slow responses on the part of the banks.

The other main proposal with respect to the technique of monetary control concerns secondary reserve requirements and appears as subsection (2) of Section 18 of the proposed Bank of Canada Act. This would empower the Bank of Canada to impose and vary a minimum secondary reserve requirement applicable to the chartered banks, replacing its existing power to vary the minimum cash reserve requirement.

I should explain in this connection that it is the practice of banks to hold some portion of their assets in very liquid form, such as day-to-day loans to the money market and treasury bills, as a secondary reserve which can be used to replenish their cash reserves quickly when necessary. The short-run impact of the Bank of Canada's cash management operations is normally on the chartered banks' holdings of these liquid assets. The week-to-week changes in the amount of loans outstanding reflect mainly customers' utilization of credits authorized some time previously. The trend of the chartered banks' loans outstanding and indeed their policies regarding authorizations of loans are rather insensitive to short-term fluctuations in their cash position except when the banks regard their holdings of Government securities and other liquid assets as being close to minimum levels.

Since 1956, by agreement with the Bank of Canada, the chartered banks have maintained a minimum average level of secondary reserves each month which, taken in conjunction with their cash reserves, has been equivalent to 15 per cent of their total Canadian dollar deposit liabilities. The secondary

reserve assets to which the agreement applies are cash reserves in excess of 8 per cent, day-to-day loans to investment dealers and Government of Canada treasury bills. The existence of this agreement has played a limited but nevertheless useful role in making the response of the chartered banks' lending policies to cash management somewhat more predictable.

In certain situations the usual techniques of cash reserve management may need to be supplemented by some more direct and immediate method of influencing chartered bank lending policies. Circumstances could arise, for example, in which it was important to exert some temporary restraint on bank loan expansion while at the same time minimizing, so far as possible, a rise in market interest rates which would result from chartered banks selling Government securities to get the resources needed to meet the increased loan demand.

Under the existing legislation, the Bank of Canada could try to deal with a situation of this kind by invoking its power to increase the required cash reserve ratio applicable to the banks. The effect would be to impound liquidity which the chartered banks might otherwise be able to draw upon in order to postpone an adjustment in their lending policies, since the banks would have to sell liquid assets to the Bank of Canada to meet the higher legal cash requirements. The use of this power would, however, have incidental effects on the earnings position of the institutions to which it applied, since cash reserves earn no return.

To replace this power to vary the required level of cash reserves it is now proposed that the Bank of Canada should have the power to impose and vary a secondary reserve requirement. This would provide an alternative means of impounding chartered bank liquidity. The exercise of this power would be subject to specified limits and notice requirements. If a secondary reserve requirement were imposed under this section of the Act, it could not initially be fixed at more than 6 per cent of the chartered banks' Canadian dollar deposit liabilities, and the maximum level to which it could eventually be raised would be 12 per cent. Increases in the required ratio would be limited to one per cent per month and would be preceded by one month's notice, as would the initial imposition of such a requirement. The secondary reserves included would be any cash in excess of the statutory cash requirement, day-to-day loans and Government of Canada treasury bills. The requirement would apply to the banks' average holdings of such assets each month.

The bill contains several provisions which affect the existing arrangements regarding directors and management of the Bank of Canada. Partners, officers or employees of firms of investment dealers which act as primary distributors of Government of Canada securities would be added to the list of those ineligible for appointment to the Bank's Board of Directors. This is proposed on the ground that their business activities involve direct dealings with the central bank. The membership of the Bank's Executive Committee would be enlarged by the appointment of an additional director and the aggregate

annual amount of directors' fees would be raised in order to permit more frequent meetings of the full Board. It is also proposed that certain pension provisions relating to the Governor and Deputy Governor be made subject to the approval of the Governor-in-Council, as their appointment and salary now are. These features of the bill are in accord with the recommendations of the Royal Commission.

It is also proposed to eliminate from the Bank of Canada Act certain sections which have become obsolete or have never been operative. Thus it is proposed to remove the section of the Act which requires the Bank of Canada to redeem its notes in gold on demand (old Section 22) and to maintain a reserve of gold and foreign exchange against its note and deposit liabilities (old Section 23). This reserve provision has not been in effect since 1940 when all of the Bank's gold and foreign exchange holdings, other than working balances of foreign exchange, were transferred to the Government's Exchange Fund. In a related amendment, the words "payable to bearer on demand" are to be removed from the description of Bank of Canada notes in Section 21(1) of the Act in recognition of the fact that the notes of the Bank have not in fact been convertible into gold since the Bank was established. It is also proposed to eliminate the section of the Act - 20(1) - covering the power of the Bank of Canada to act as banker or fiscal agent of the government of a province. These are changes which were recommended by the Royal Commission.

I should also mention the new section (117) in the proposed Bank Act which, following a recommendation of the Royal Commission, would give the Bank of Canada power to require information from the chartered banks subject to the proviso that they shall not be required to furnish information with respect to the accounts of an individual customer.

This covers the ground which I thought it might be helpful to the Committee to refer to in my opening statement. There are a few other minor changes of a technical nature in the bill on which I shall, of course, also be glad to answer questions if members of the Committee wish.