Extra

MONETARY POLICY AND THE DEFENCE OF THE CANADIAN DOLLAR

Remarks of
Louis Rasminsky, Governor of the Bank of Canada,
before a joint meeting of The Canadian Club of Victoria
and The Federated Council of Sales Finance Companies,
Victoria, October 17th, 1968

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Mr. Chairman, I have a number of reasons for being particularly happy to be with you in Victoria today. Having already made a speech in one of our island extremities, Newfoundland, early in the year I am pleased to be at the other, on Vancouver Island, as the year begins to draw to a close. I wonder whether this entitles me to say that I have been seen and heard, in the words of the Canadian Coat of Arms, "a mari usque ad mare" during the course of the year.

This is by no means my first visit to British Columbia but it is my first time in Victoria, and this, of course, is another source of gratification to me. Being a newcomer I shall steer clear of any attempt to make sage comments on local matters and shall content myself by saying what is evident to my tourist's eye, that Victoria, as befits the capital, is keeping up with the development of Canada's most dynamic province. It is highly gratifying that the pace of growth in British Columbia has not slackened. Spectacular development and dramatic achievements are, of course, nothing new in British Columbia's history. But what impresses me most is that the intermittent and irregular growth of earlier years, which in a pioneer community was necessarily based to a considerable degree on speculative enthusiasm and acts of faith, has been replaced by steady and persistent development resulting from a great expansion in your markets in the Pacific regions, particularly Japan, in the states to the south of you, and to your prairie neighbours as well as in the rest of Canada. British Columbia must have gained enormously in internal strength and in the ability to promote self-generating growth by the doubling of its population that has taken place since the war. The province has also, of course, benefitted greatly from technology, a factor which was brought home to me when I reflected that crossing the mountains by air did not take many more minutes than the number of days it took Alexander Mackenzie in his epic crossing to tidewater in 1793.

My visit to this beautiful capital city comes at a time when the Federated Council of Sales Finance Companies is holding its annual meeting here and I also greet the members of this group. I am looking forward to an exchange of views with representatives of the sales finance industry this afternoon.

My final reason for being glad to be able to accept your invitation to be here today is that it gives me an opportunity to report on the way in which the Bank of Canada has been carrying out its responsibilities this year.

My last public review of the activities of the Bank was given in the Bank's last annual report. This was dated February 29, a moment when the pressure on the Canadian dollar that developed last winter was still very severe. The turning point in the defence of our currency, which was in serious danger, had not yet been reached, and this was therefore not the most convenient date on which to end the story, but it is the latest date on which the law permits me to submit my report. That particular episode, I am glad to say, has had a happy ending. Now that it is possible to breathe easier - and I can assure you that we passed through some anxious moments - I would like, in these remarks, to take time to look back on that period and explain the role played by the Bank of Canada in helping to defend the exchange value of the Canadian dollar. Some explanation is appropriate since the defence, although very much worthwhile, was by no means easy or without cost for the Canadian economy. As part of the defence it was necessary for Canadians to experience the highest level of interest rates in our history. However, we succeeded in avoiding the serious inflationary developments and the economic dislocation that would have resulted from a failure to protect our exchange rate. Moreover, apart from our own great interest in defending our currency, a failure on Canada's part might well, in the uneasy conditions of the time, have had serious repercussions on the whole international monetary system.

The exchange problem of last winter was above all a crisis in confidence. This has been demonstrated with unusual clarity by the information which has become available since our period of greatest difficulty. It is now evident that the balance of our international trade in goods and services was strong throughout the whole period, stronger than it had been for many years, and much stronger than was generally realized at the time.

Let me remind you very quickly of the trend of our international accounts. In 1965 and again in 1966 we had a current account deficit of over $1. 1 billion, that is, our imports of goods and services exceeded our exports of goods and services by this amount. The financing of these deficits naturally required substantial net inflows of capital to cover them. A marked improvement in our foreign exchange earnings was expected in 1967 because of the large tourist receipts which would be generated by Expo and other centennial attractions. This expectation was in fact fully realized. Indeed there were some additional favourable factors and the deficit was cut by half - to $550 million. But this improvement was expected to be temporary. With the ending of the flow of special tourist receipts in the autumn of the year it was widely anticipated that we would revert to something approaching the large deficit positions of 1965 and 1966. This time the general expectation proved to be wrong; our merchandise exports were strong through the fourth quarter of 1967 and have continued to be strong so far this year, with the result that even with the return to more normal tourist income our current account balance has improved. Unfortunately, owing to the unavoidable lags in gathering information, the full strength of this underlying position was not generally known during the period when the Canadian dollar was under pressure.

Although the major causes of the weakening of confidence in the Canadian dollar last winter were of external origin, they were superimposed on a domestic situation which in some respects was not reassuring. We had been going through a period of substantial rise in prices and costs and there was concern about the effect which these developments might ultimately have on our international competitive position if they persisted. Taking the whole period since say 1960, our record with regard to costs and prices looked relatively good by comparison with other countries, but in 1966 and 1967 costs had been rising more rapidly than those of most of our major trading partners, including the United States. Indeed, by the autumn of last year we seemed to have developed an inflation psychology in this country. I tried to draw attention to this problem in a speech in Winnipeg last November. At that time I expressed the view that it was essential to break inflationary expectations by making it clear beyond doubt that inflation would not be accepted as a way of life in Canada and that this was the most urgent task of public policy. I am still strongly of this view, and my conviction is not lessened by the fact that Canada has been fortunate enough in recent months to have experienced a very strong international demand for many of its principal exports, or by the evidence that the deterioration in our cost and price structure has not gone so far as to undermine our international competitive position.

The worsening of our cost and price position does appear to have weakened our capacity to withstand the shocks from abroad that we have had to face. The first of these came on November 18th when sterling was devalued. The devaluation of one of the world's two major reserve currencies was bound to cause strains in the international financial system, particularly when the United States, the country which provides the other major reserve currency, was also experiencing balance of payments difficulties. It immediately raised the question of how other currencies would fare. It was remembered that in the 1930s, and again in 1949, when the exchange value of sterling declined this was followed by some drop in the value of the Canadian dollar. The fact that the proportion of Canadian trade which would be directly affected by the devaluation of sterling in 1967 was very much smaller than on earlier occasions was perhaps not so widely recognized. In any case, in a situation where there is concern about the international financial system I am afraid that it is inevitable that any country which, like Canada, has to depend heavily on inflows of capital appears to many to be in an exposed position.

At the time of the devaluation of sterling the Bank of England raised its Bank Rate from $6\frac{1}{2}$ per cent to 8 per cent and the Federal Reserve Banks in the United States raised their rediscount rates from 4 per cent to

$4\frac{1}{2}$ per cent. The Bank of Canada reacted immediately by raising its Rate from 5 per cent to 6 per cent and market rates of interest soon moved up. Continued concern about the stability of the international financial system gave rise to heavy purchases of gold by private speculators, the first of a number of "gold rushes" which were to come in the next few months. In this connection, as a measure of international co-operation, the Bank of Canada in December requested Canadian banks and other financial intermediaries not to extend credit on gold nor to facilitate forward purchases of gold.

The Canadian dollar appeared to withstand the first disturbance reasonably well. In late November its exchange value declined from its upper limit but this development had been generally expected because of the ending of the special tourist receipts connected with Expo and for seasonal reasons. However, what turned out to be the second major shock was not long in coming. On January 1st the United States announced a new and much stiffer programme to control capital outflows and strengthen its balance of payments position. It was clear that in designing this programme, efforts had been made to minimize its difficulties for Canada but nevertheless one of its immediate effects was to raise questions about the basic viability of our position, dependent as we have been on large imports of capital from the United States to finance our current account deficit. More generally, the new programme gave rise to concern as to how the world was going to accommodate itself to the prospect of quick and substantial improvements in both the American and British balance of payments positions.

This combination of circumstances led to weakening of confidence in the Canadian dollar in January. One of the first indications was an unusual degree of hedging of Canadian dollar positions, including the sale of Canadian dollars forward for quite long periods. The forward discount on the Canadian dollar deepened sharply and the spot rate fell. There were indications that some subsidiaries of foreign companies were among the earliest to be involved in these hedging operations on a large scale. Once confidence was shaken there was danger that residents and non-residents alike would take steps to protect themselves against the possibility of a change in the exchange rate.

A number of measures were taken promptly to help restore confidence and restrict speculation. On January 21st the Bank of Canada announced that following discussions with the chartered banks it had been agreed that the banks should discourage the use of bank credit to facilitate abnormal transfers of funds abroad by Canadian subsidiaries of foreign companies or to meet requirements in Canada which had in the past normally been met by parent companies. At the same time the Bank Rate was raised from 6 per cent to 7 per cent and in the subsequent period the Bank of Canada pursued a policy that put upward pressure on market interest rates. The purpose was to increase the incentives for investors to keep their funds in Canada and for borrowers to bring funds into Canada. Also on January 21st, following discussions between Canadian and United States authorities, the U.S. Treasury Department released a statement making it clear that the new U.S. programme was not intended to produce abnormal transfers of funds from Canada to the United States and that the programme left room for large flows of capital to Canada. To offset a rapid decline in Canada's reserves of gold and U.S. dollars in January the Bank of Canada drew U.S. $250 million of its U.S. $750 million reciprocal credit facility with the Federal Reserve System.

While these measures helped the situation they did not correct it. Pressure on the Canadian dollar continued through February and into March. Uncertainty developed about Canada's fiscal position and concern about the international financial system, reflected in a large increase in gold purchases in free markets, continued to grow in this period.

At the end of February Canada drew U.S. $426 million from the International Monetary Fund. Of this amount only U.S. $185 million involved a repayment obligation and the balance represented Canada's creditor position with the Fund. In early March, when Euro-dollar interest rates began to move up again, it seemed desirable to supplement reliance on interest rate policy with more direct measures to reduce the outflow of capital. Accordingly, the Bank of Canada asked the banks and other financial intermediaries not to facilitate the outflow of funds through certain foreign currency deposit transactions and this request was widened by the Minister of Finance with an appeal which included all investors. I am glad to be able to say that a high degree of co-operation was forthcoming.

Weakness in the Canadian dollar continued, however, and our situation became grave. It became clear that confidence could not be restored without a fundamental improvement in the conditions of our access to foreign capital. Such a change - and it was an important and dramatic one - occurred on March 7th when it was announced that following discussions between Canadian and United States authorities, the United States had undertaken to exempt Canada completely from all U.S. balance of payments measures affecting capital flows that were being administered by the Department of Commerce or the Federal Reserve System. For our part, Canada stated its intention to take any steps necessary to ensure that the exemption from the U.S. programme would not result in Canada's being used as a "pass-through" by which the purpose of their balance of payments programme would be frustrated. Guidelines to banks, non-bank financial institutions and non-financial corporations have since been issued to help fulfil this commitment. The Canadian Government has also agreed to invest a substantial proportion of its U.S. dollar reserves in special non-market obligations of the U.S. government. Such investments have the effect of reducing the U.S. balance of payments liquidity deficit as measured by the U.S. government while at the same time the funds continue to be available to Canada in case of need.

On the same date, March 7th, additional standby credits to supplement Canada's depleted foreign exchange reserves were arranged by the Bank of Canada in the amount of U.S. $150 million with the Deutsche Bundesbank, U.S. $150 million with the Banca d'Italia and U.S. $100 million with the Bank for International Settlements. The Export-Import Bank of the United States opened a standby credit for the Government of Canada in the amount of $500 million. These standby credits were in addition to the $500 million still available to the Bank of Canada under our reciprocal arrangement with the Federal Reserve System and the large credits which were still available to Canada from the International Monetary Fund.

Developments also took place within Canada around this time which helped to restore confidence. It became clear that a tax increase would be passed by Parliament and the Government indicated that it was considering new policies in regard to prices and incomes.

The exchange tide finally turned in March, and the turn was assisted by the announcement on March 17th that the Gold Pool countries had taken steps to halt the drain on their gold reserves and to establish a two-price system for gold. The Bank of Canada immediately announced that it would co-operate with the central banks of the Gold

Pool countries. At the same time our Bank Rate was raised to $7\frac{1}{2}$ per cent following an increase of $\frac{1}{2}$ per cent in the rediscount rate of the Federal Reserve System. Finally, the reciprocal credit facility with the Federal Reserve System was increased to $1 billion, including the $250 million which had been drawn.

From that time on the outlook for world currency stability improved and our foreign exchange reserves rose steadily. The coincidence in timing is further evidence of the link between our problem and the general concern about the stability of the international monetary system.

Confidence was further strengthened by the announcement on March 30th, following the meeting of Ministers and central bank governors of the Group of Ten at Stockholm, that plans to strengthen the whole international financial system by establishing a scheme for special drawing rights in the International Monetary Fund would be proceeded with. By April 19th, when the Federal Reserve Banks increased their rediscount rates by a further $\frac{1}{2}$ per cent, our situation had improved to the point where it was not considered necessary to raise the Bank Rate here.

After the Bank Rate had reached its peak of $7\frac{1}{2}$ per cent, market interest rates continued to rise, partly as a result of upward movements in the United States. During the spring months both Government of Canada treasury bill and long-term bond yields reached peaks of around 7 per cent, with mid-term yields even higher. Other bond yields rose to high levels and mortgage rates reached the $9\text{-}9\frac{1}{2}$ per cent range. This period of very high interest rates was necessary to attract funds from abroad to rebuild our foreign exchange reserves. To encourage confidence in the Canadian dollar, to hasten the rebuilding of reserves and to shorten the period during which such high interest rate levels would be required, Government bond issues equivalent in total to U.S. $262 million were sold in Germany, Italy and the United States in May and June.

Continued improvement in our foreign exchange reserves permitted us to begin dismantling the extraordinary defences for the Canadian dollar in June. Short-term interest rates declined in the market. The special guideline on foreign currency deposits issued in March was cancelled about mid-June. The Bank Rate was reduced from $7\frac{1}{2}$ per cent to 7 per cent on July 2nd, to $6\frac{1}{2}$ per cent on July 29th, and to 6 per cent on September 3rd. One half of the U.S. $250 million drawing on the Federal Reserve arrangement was repaid at the end of June and the remainder late in July. The special credit facilities arranged by the Bank of Canada with the central banks of Germany and Italy and with the Bank for International Settlements had been terminated by the end of July. No drawings had been made under them, but I believe that these credit facilities made a valuable contribution to the restoration of confidence in the Canadian dollar, and I have already publicly expressed the Bank of Canada's gratitude to the institutions concerned for their timely help. The reciprocal credit facility with the Federal Reserve System remains in force, with the full amount of $1 billion available in case of need. On September 13th the Government announced that it had discharged in full its obligation to the International Monetary Fund and that the standby credit from the Export-Import Bank had been terminated. The Bank of Canada has withdrawn the request made to the banks in January regarding loans to subsidiaries of foreign companies. Market interest rates have come down significantly from the peaks reached this spring though, as in the United States, they remain considerably higher than they were twelve months ago, and in both countries they have risen somewhat in recent weeks.

I have recounted this story in some detail mainly to show why and how monetary policy was used to help defend the Canadian dollar over a period of seven months. As our external position improved, along with international financial conditions generally, it became possible to follow a policy that allowed interest rates to decline during the summer months. This decline in interest rates was accompanied by a relatively large expansion in the total assets of the banking system and in the total of currency and bank deposits, often referred to as the "money supply". If one were to look only at the rate of expansion of these particular magnitudes, it would appear that the Bank of Canada was following an aggressively easy monetary policy this summer, but I do not feel that this was the case. As I have explained on a number of occasions, the Bank of Canada does not regard changes in the "money supply" as the sole or even the chief criterion of its policy. The central bank's policy is directed towards the whole range of credit conditions. This involves an assessment not only of the availability of credit, including the rate of expansion of the banking system and of various classes of bank deposits and many other factors, but also of the cost of credit, including the general level of interest rates. Interest rates are still high by any historical standard.

Perhaps I should mention here that there have been a number of special factors affecting the rate of expansion of the banking system since the Bank Act was revised a year and a half ago. For many years before, the banks operated under certain competitive disadvantages and they grew at a slower rate than other financial intermediaries. With these competitive disadvantages removed the banks have been regaining some of the lost ground. This relative shift back to the banking system has meant that banking statistics taken by themselves have given an exaggerated impression of the increase in the liquidity of the economy. In addition, increasingly keen competition between financial intermediaries, including banks, has I believe tended to increase the proportion of the public's financial claims which it holds with financial intermediaries rather than in the form of direct holdings of securities. For example, there are now new types of bank deposit instruments with yields that are more attractive in relation to yields on securities than used to be the case.

A particularly striking example of this was seen in the summer months when many holders of Canada Savings Bonds cashed their bonds and acquired deposits with banks and other institutions. While this development led to an increase in the rate of expansion of the banking system it did not alter the volume of liquid assets held by the public. A new series of Canada Savings Bonds is now available on very competitive terms and it seems likely that some reversal of this shift may take place.

All financial institutions have been affected in one way or another by the changes that have occurred in the competitive situation during the past few years. Some of them have had to go through a difficult period of consolidation and in some cases, retrenchment. Some groups have had more difficult adjustments to make than others. The sales finance companies, who are at present meeting in Victoria, not only have had to cope with changed competitive relationships resulting from revisions to financial legislation but they have been among those most affected by United States balance of payments guidelines and, of course, they were affected by the unfortunate troubles of one firm in their industry three years ago. The exemption of Canada from the U.S. balance of payments programme last spring has removed one of their handicaps. The industry has been tackling its problems in a constructive way and it has also done much to improve the confidence of investors by increasing substantially the information that its members make available. It has been experiencing renewed growth this year.

Now that the problems connected with maintaining a sound external financial position have eased it is possible to concentrate once again on our other economic problems. I am afraid that none of them has gone away. Prices and costs are still rising too rapidly despite the emergence of considerable unemployment and unused capacity. The growth of the economy has been well within our potential for more than two years but so long as the strong upward trend in prices and costs continues, there are real risks in taking steps to accelerate the expansion of total spending in the economy. Our recent trade performance has demonstrated that Canada is still competitive internationally but it is also true that our recent exchange problems have shown how important it is to avoid any undermining of confidence by a further extended period of poor cost and price performance.

It is plain that in addition to following sound fiscal and monetary policies we need to do everything we can to increase the efficiency of the economy and to bring about more realistic attitudes toward the size of the increases in the incomes, all forms of income, which we can really afford to pay ourselves. There has been a good deal of discussion in recent times about guidelines for increases in incomes and other aspects of incomes policy and I have made it clear that I favour action in this area. I am not going into that matter further today except to say that the basic limit for the non-inflationary increase in incomes in any economy is not set by the authorities. It is set by our actual performance. The basic limit is the increase in real output per person employed. If we ignore that limit and settle for larger increases in money incomes all we are doing is guaranteeing that prices will rise.

I have devoted most of my time today to the story of how we came through some rather dark days last winter. Not only was our own currency under pressure but the whole international financial system seemed at times to be in jeopardy. In this area the skies are brighter now. I have recently returned from the annual meeting of the International Monetary Fund where I was encouraged by the evidence of much greater international financial stability and by the progress which is being made toward improving arrangements for international liquidity. We seem to have in prospect a further opportunity to pursue our economic objectives in a relatively favourable international environment. Let us try through exercising reasonable restraint, to make the most of our opportunity.