EXTRA

THE ROLE OF THE BANK OF CANADA IN THE FINANCIAL SYSTEM

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I have come here today to talk to you about where the Bank of Canada fits into the financial system and how it operates. In attempting to say something interesting about the central bank before a gathering of trust companies, I admit to feeling somewhat at a disadvantage. It seems to me much more difficult to explain what central banks do than to explain what trust companies do. I cannot honestly say that I have ever come across an exposition of central banking that did not put unusually heavy demands on the reader or listener. Perhaps I should add that I do not subscribe to the view that the absence of easy guides to central banking is the result of a conspiracy by central bankers designed to restrict entry into the profession or to limit criticism of their efforts. It seems to me a possible explanation that the subject is inherently complex. For those of you who do not mind working at it a little I would suggest that you look at the submissions prepared by the Bank of Canada for the Royal Commission on Banking and Finance. These submissions deal with such matters as the constitution and functions of the Bank of Canada, the role and techniques of monetary policy, and the central bank's debt management and foreign exchange responsibilities. Together with the evidence of the Governor before the Royal Commission, these submissions are available from the Bank on request. I think you will find that this material covers all aspects of the Bank's operations, although I would not claim that all of it, particularly the submission on The Role of Monetary Policy, is easy going.

Why can't the affairs of the Bank of Canada be described in a straightforward manner like those of any other financial institution? Why couldn't one say something like this, for example - that in 1964 the total assets of the Bank, which consist mainly of Government of Canada securities, grew by about $200 million, with a corresponding increase in its liabilities, mainly notes in circulation and deposit claims of the chartered banks. The public continued to find Bank of Canada notes reasonably attractive to use - the $20 and $100 bills

went particularly well last year - although the total amount outstanding did not grow as fast as the short-term obligations of some other financial institutions, including those of the trust companies. Since the Bank of Canada receives interest on its investments but pays no interest on its obligations, its income was again substantially greater than its expenses and its net earnings, $128 million, were paid to the Government, the Bank's sole shareholder. All in all, one could say, not a bad year.

But the Bank of Canada is not a bank like other banks, nor for that matter a near-bank like other near-banks, and this description of its activities will not do. The powers given to the Bank by Parliament through the Bank of Canada Act place it in a special position in the financial system where it is required to pursue important economic policy objectives. I propose to begin today by saying something, in very broad terms, about the role of financial intermediaries, to look at where the Bank of Canada fits into this system, and then to talk in much more specific terms about the operations of the Bank and their impact on the financial system.

Financial institutions and markets perform important functions in the process of economic growth. In an expanding economy, business firms and individuals who are attempting to step up their expenditures for such things as new factories and office buildings, new machinery and equipment, new houses and automobiles, and so on, are rarely able to finance the whole of their outlays out of current income. Success in carrying out their plans will generally involve borrowing on a substantial scale from other members of the community. In recent years, for example, the annual increases in private and public debt outstanding which have been generated by Canadian borrowers and absorbed by financial markets and institutions have been well in excess of $5 billion. Mortgage debt alone increased by $1¾ billion in 1964, of which over $300 million was taken up by trust companies. The funds supplied in this manner by the trust companies were of course obtained by persuading the public to take up a corresponding amount of additional trust company obligations. There are many

other kinds of private financial institutions in addition to the trust companies which perform the same sort of intermediary role between final borrowers and lenders in the process of credit expansion - the chartered banks, the Quebec savings banks, the mortgage loan companies, the life insurance companies, the sales finance companies, the credit unions, the caisses populaires, and others. As a group, these institutions provide major channels through which growth occurs in the total amount of credit extended and used in our economy.

It is no accident that financial intermediaries have come to play such an important role in transferring command over goods and services from those in the community who are not in a hurry to exercise it to those who are. The existence of financial intermediaries, by taking much of the risk and inconvenience out of lending, has the effect of greatly increasing the amount of credit extended in the economy and greatly reducing its cost. To illustrate this point I need only ask you to try to imagine a mortgage market without institutions like trust companies who specialize in mortgage lending.

This is by the way, however. My immediate concern is to make the point that an expanding flow of total expenditure and income in our economy depends in part on the success of financial institutions and markets in finding holders for a growing volume of financial obligations. There is, of course, nothing automatic about the process by which the economy absorbs a growing volume of debt: indeed, it is typically accompanied by a good deal of bargaining over the interest rates to be paid and received, the other terms and conditions under which funds are to be advanced, the prices at which securities are to change hands in financial markets, and the criteria according to which the credit demands of marginal borrowers are to be scaled down or rejected. The readiness with which lenders are prepared to take up the supply of debt obligations offered by borrowers will be reflected in the kind of credit conditions which emerge in the course of this bargaining. A relatively strong demand for credit puts lenders in the driver's seat, enabling

them to enforce stricter conditions on borrowers and exact higher rates of return. A relatively weak demand for credit shifts the balance of bargaining power toward borrowers, enabling them to obtain credit on less onerous terms and at lower cost. Changes in credit conditions are thus a mixture of price and rationing effects by means of which borrowers and lenders are forced or induced to adjust their individual plans until they are mutually consistent. Upward or downward revisions in spending plans are almost certain to be involved in this adjustment process, with effects on the course of economic activity of some importance for public policy.

This brings me to the role played by the Bank of Canada in the process of economic and credit expansion. The central bank is unique among borrowers in that it can issue obligations which have the status of legal tender in Canada and thus serve as the ultimate means of settling debts in the economy. The debts of other borrowers, including the chartered banks and non-bank financial institutions, depend for their acceptability on the fact that they entitle the holder to repayment in legal tender on demand or at some future date. The existence of this repayment obligation acts as an important restraint on the amount of debt private borrowers are willing and able to incur. The Bank of Canada is under no such restriction in expanding its debts; it is not limited by the need to redeem its obligations. The Bank itself can determine how much of its obligations are to be held by the community as a whole and the community has no option but to adjust its financial affairs accordingly.

The fact that it is the ultimate source of cash in the economy is the technical basis of the central bank's influence on the behaviour of the financial system and the course of economic activity. The large and complex network of financial claims which has developed in our economy rests ultimately on the relatively narrow cash base provided by the central bank. Unless there is adequate growth in the cash base, the expansion of private credit soon runs into difficulties.

What this means, then, is that the central bank's control over the cash base of the economy gives it strong potential leverage over conditions

in financial markets. Given the strength of credit demands, the ease or difficulty with which they can be accommodated will depend to an important degree, though by no means entirely, on the extent to which the central bank is willing to facilitate the process of credit expansion through its management of the supply of cash. In deciding how to employ its influence over credit conditions, the central bank is of course concerned with economic policy considerations. A tightening of credit conditions, if it goes very far or persists for very long, may be expected to exert some braking influence on the strength of spending pressures in the economy; an easing of credit conditions tends to work in the opposite direction. Changes in credit conditions in Canada relative to those prevailing in other countries, notably the United States, are also likely to have important effects on movements of capital across our borders, and hence on our balance of payments and foreign exchange reserves. For this reason the Bank of Canada must pay close attention both to the internal and external aspects of Canada's economic situation, and monetary policy, budgetary policy and other economic policies must be effectively co-ordinated.

So far I have described in general terms the basic role of the Bank of Canada. Now I would like to become more specific by tracing the effects of central bank operations in the particular institutional circumstances which now exist in Canada.

The most direct and important way in which the central bank is linked to the financial system is through the cash reserves of the chartered banks. The behaviour of the banks can be taken as an example - a very important example - of the way in which the financial system as a whole adjusts to the central bank's operations.

Each chartered bank is required by the Bank Act to maintain an average reserve of cash during each calendar month equal to not less than 8 per cent of its Canadian dollar deposit liabilities. This cash reserve must be in the form of Bank of Canada liabilities - notes and/or deposits. In practice the banks need both forms of reserves: notes to meet withdrawals

by customers and deposit accounts at the central bank through which final settlements can be made with other chartered banks and with the Bank of Canada. The chartered banks as a group keep about one-third of their reserves in notes and about two-thirds on deposit at the Bank of Canada.

There are a number of ways in which the Bank of Canada can bring about changes in the available supply of cash reserves. The most important is the purchase and sale of Government securities. When the Bank of Canada purchases a security in the market it makes payment with a Bank of Canada cheque. If the seller of the security happens to be a chartered bank, it will deposit the cheque in its account at the Bank of Canada, thereby increasing its cash reserves. If the seller is someone other than a chartered bank, the Bank of Canada cheque will follow a more roundabout route but when final settlement takes place the result is the same - some chartered bank will have gained cash reserves. A sale of securities in the market by the Bank of Canada works the opposite way, producing a reduction in cash reserves.

There are a number of other techniques available to the Bank of Canada for controlling the level of cash reserves, but I don't propose to go into these today since they are described in detail in the Bank's submissions. There are also certain influences on the level of cash reserves which originate elsewhere than with the central bank, and which the central bank must take into account - and sometimes offset - in order to achieve its cash reserve objectives. A major influence of this kind is the amount of Bank of Canada notes in circulation. The public are free to decide for themselves how many notes to hold, at times increasing their holdings by cashing cheques on their deposit accounts at the chartered banks and at other times redepositing them. The note circulation is subject to a strong seasonal movement, building up to a peak during the Christmas shopping period, and then falling off sharply at the beginning of the year. The Bank of Canada can offset the effect on cash reserves of changes in note circulation and does so mainly through transactions in Government securities.

The essential point is that the Bank of Canada is able to control the cash reserves of the banks quite closely and thus to exert an important influence on their operations. The chartered banks cannot add to their earning assets and deposit liabilities unless the central bank permits a proportionate increase in their holdings of cash reserves. Cash reserve requirements are a matter of law, but even in the absence of a legal requirement the need would still exist for banks to acquire increased reserves of cash before embarking on an expansion of their loans and investments which would expose them to the risk of increased cash withdrawals and clearing losses.

With an audience like this I do not need to spend much time on the way in which banks respond to changes in their cash positions. An individual bank experiences changes in its cash balances in the same way and for the same reasons as any other financial intermediary and responds in basically the same way. The chartered bank gains cash when its customers deposit cash or cheques on other institutions, including the Bank of Canada, and when loans are paid off or it sells securities; it loses cash when its customers withdraw funds (including funds that represent the proceeds of loans) and when it buys securities.

The chief way in which banks respond initially to changes in their cash reserves is by adjusting their holdings of money market assets. The first reaction of the banks to increases in their cash may be to add to their day-to-day loans and treasury bills. When they regard their holdings of these very liquid assets as satisfactory they may add to their holdings of securities. And if the improvement in their over-all liquid positions goes far enough they may at some stage adopt more aggressive lending policies. By contrast they will reduce their holdings of liquid assets if their cash reserves decline and may eventually shift to more restrictive lending policies.

Each of these patterns of response has repercussions in other financial markets. Thus an expansion of the banking system will tend to make credit less expensive and less difficult to obtain than it would otherwise have

been, not only for bank borrowers but for borrowers generally throughout the capital market.

As you know from your own experience trust companies are subject to essentially the same influences as the banks. Your companies are in competition with banks and others for profitable financial business. Trust companies, like banks, gain cash when their customers deposit cash or cheques on other institutions, when mortgages or loans are paid off and when securities are sold; they lose cash when they invest in earning assets and when customers withdraw funds. Like banks, trust companies will gain or lose cash and share in any general expansion or contraction of credit in accordance with their success in finding holders for their liabilities. This is true of other financial institutions as well.

To take a simple example, suppose that in a particular period credit demands are being accommodated in part by an expansion of the cash base and of the banking system. As the banks expand their assets by acquiring securities or making loans, additional money balances will be put into circulation and those receiving them - whether in exchange for securities sold to the banking system or in payment for goods and services - will look for attractive ways to employ at least part of these additional funds. Thinking only of the short-term financial investments available to them, they will be able to choose among a range including interest-bearing bank deposits, mortgage loan company deposits, shares and deposits of credit unions and caisses populaires, finance company or commercial paper, balances placed with investment dealers and brokers, treasury bills and other government securities and - by no means least important - the demand and term liabilities of trust companies. Unless for some extraordinary reason the trust companies decide to drop their rates below competitive levels, or the public loses its taste for the liabilities of trust companies, they must share in the expansion of credit. Funds will be attracted to their liabilities and more cash will become available for investment in mortgages and other earning assets. Thus so long as there are reasonably

close substitutes for bank deposits being offered on competitive terms the expansion of chartered bank deposits will tend to be accompanied by an expansion in the volume of other short-term obligations. And as funds seek investment there will be a tendency for yields to fall and credit to become more readily available - both directly and through financial intermediaries like the trust companies.

Similarly, when the central bank is restricting the expansion of the banking system and forcing credit flows to find their way through more difficult channels the trust companies and other financial intermediaries will feel the impact of tighter credit conditions. There will be relatively less money seeking investment and borrowers will find it necessary to pay more. With cash harder to come by, trust companies, like banks, may run off liquid assets to meet loan - that is mortgage loan - demand. At some point they may find it necessary to restrict the availability of mortgage money and raise its price.

I am sure that this pattern of broadly parallel behaviour by different types of financial institutions is a familiar story to you. There are important differences among them in the character of their business which condition their responses to the kind of market developments I have been talking about. One example of such differences arises in the chequing account business, an extremely high proportion of which is handled by the chartered banks. In the case of savings and term deposits there are also differences among institutions in the form and liquidity of these liabilities. On the asset side, there are substantial differences in the extent of specialization in business loans, consumer credit and mortgage credit. These differences have important implications for the rate of growth of the various groups of financial institutions as well as for their response to changes in credit conditions. If the demand for one form of credit - for example mortgage credit - is relatively stronger than for other forms of credit, institutions specializing in mortgage credit are likely to experience a higher growth rate than other institutions because they are in

a relatively stronger position to compete for savings. There are many other factors affecting the ability of groups of financial intermediaries to compete for funds. These include the legislation under which they operate, which in some cases sets out certain requirements regarding the assets they may acquire and the rates of interest they may charge. It is not surprising therefore that the rates of growth of financial intermediaries which compete for short-term funds may vary considerably. None of these variations, however, are caused by the operations of the central bank or by the form in which individual institutions hold their cash reserves.

This completes my review of how the financial system reacts to operations of the central bank. I am, however, most anxious not to leave the impression that the direction of influence is all one-way. The fact of the matter is that the Bank of Canada, in its management of cash reserves, is also continuously reacting to current and prospective developments in credit conditions, in financial markets and in the economy generally. In other words, it does not operate on the basis of a precise view about the trend of cash reserves, chartered bank assets, the money supply or any other group of financial claims. As the Bank said in its submissions:

> Although it would be possible for the Bank of Canada, with its power to control the cash reserves of the chartered banks within narrow limits, to operate on the basis of a precise view about the appropriate trend, over some period, of total chartered bank assets (or of the "money supply" in the sense of currency outside banks plus chartered bank deposits), it does not in practice do so. The central bank is, of course, inevitably influenced in its judgments by developments in the "money supply", but it must also take a view of the kind of credit conditions that would seem to be appropriate in the light of the current and prospective state of the economy including the external financial position and it must be prepared within limits to vary its control of cash reserves as the situation develops in whatever direction is necessary to try to bring about and maintain these conditions.

I have tried to show how heavily the Bank of Canada relies on responses to the changes which it brings about in the cash reserves of the chartered banks. Perhaps I should mention in passing that theoretically it

would be possible for the Bank of Canada to achieve its credit condition objectives much more directly by undertaking operations on a much larger scale. It might use its capacity to buy or sell securities to bring about desired changes in Government security yields and rely on market mechanisms to ensure that these were accompanied by appropriate changes in the availability and cost of money in the financial system. There are, I believe, serious disadvantages to this approach which I will not go into here. The position of the Bank in this matter is recorded in its Submissions as follows:

> It is the view of the Bank of Canada that its responsibilities can best be discharged under arrangements which give the securities market and private lending institutions the maximum scope to perform their important functions in determining the terms and allocation of credit, and that central bank operations should leave as much room as possible for the exercise of private judgments in these matters. In most circumstances the aims of public financial policy can be pursued effectively without the central bank intervening in the Government securities market on a broad front with precise objectives for bond prices and interest rates,
> ....

This is not to say that in certain circumstances a more direct approach may not be required and there have been occasions when the Bank has found it necessary to intervene in the market on a large scale. Outstanding examples were at the time of the Cuban crisis in October 1962 when the Bank purchased $111 million of Government securities in three days and again at the time of the British Bank Rate increase during the sterling crisis in November 1964 when the Bank purchased $159 million of securities in one day. On both occasions the Bank succeeded in restoring confidence in the market after it had been dealt a severe blow by external developments and thus avoided a drastic and unwarranted change in credit conditions.

In this brief discussion of the role of the Bank of Canada in the financial system I have left out a great many things. I have not talked about the important role of the Bank in the field of debt management and foreign exchange as fiscal agent for the Government. I am very much aware that I have said

nothing about the limitations of monetary policy. Instead I have tried to concentrate on the basic role of the Bank. The Bank plays a very different role than a trust company, but they belong to the same financial system and they operate in highly interrelated markets. The way the central bank conducts its operations is not without importance for your affairs, and your operations are certainly of interest to the central bank in the pursuit of its objectives.