

THE STOCK MARKETS AND SECURITIES LEGISLATION

The organized stock exchanges and the over-the-counter markets in preferred and common shares perform much the same functions for equity securities as the bond and money markets do for debt obligations. They serve as convenient trading centres, as guides to values and as mechanisms for enhancing the liquidity of shares. They are not, however, so intimately influenced by changing credit conditions, although affected by them, since equity prices are influenced mainly by current and prospective profit levels and by investor confidence. The stock brokers also differ from the investment dealers in that they act almost entirely as agents in the execution of orders, serve only rarely as principals, and carry very small inventories. Moreover, most new issues of industrial and major mining and oil companies are handled by investment dealers despite the increasing activity of stock brokers in underwriting. A third category of dealer, the broker-dealers, are however engaged principally in the business of distributing speculative issues to the public, often through the facilities of a stock exchange but also in the over-the-counter markets. Since it is in connection with these equity markets that the main issues of securities legislation and the protection of the investing public arise, they are dealt with in this chapter even though some of the discussion relates to the bond market as well.

Although the average level of skills required in the stock market industry is somewhat lower than that of the average I.D.A. member, partly because of the agency nature of the business and

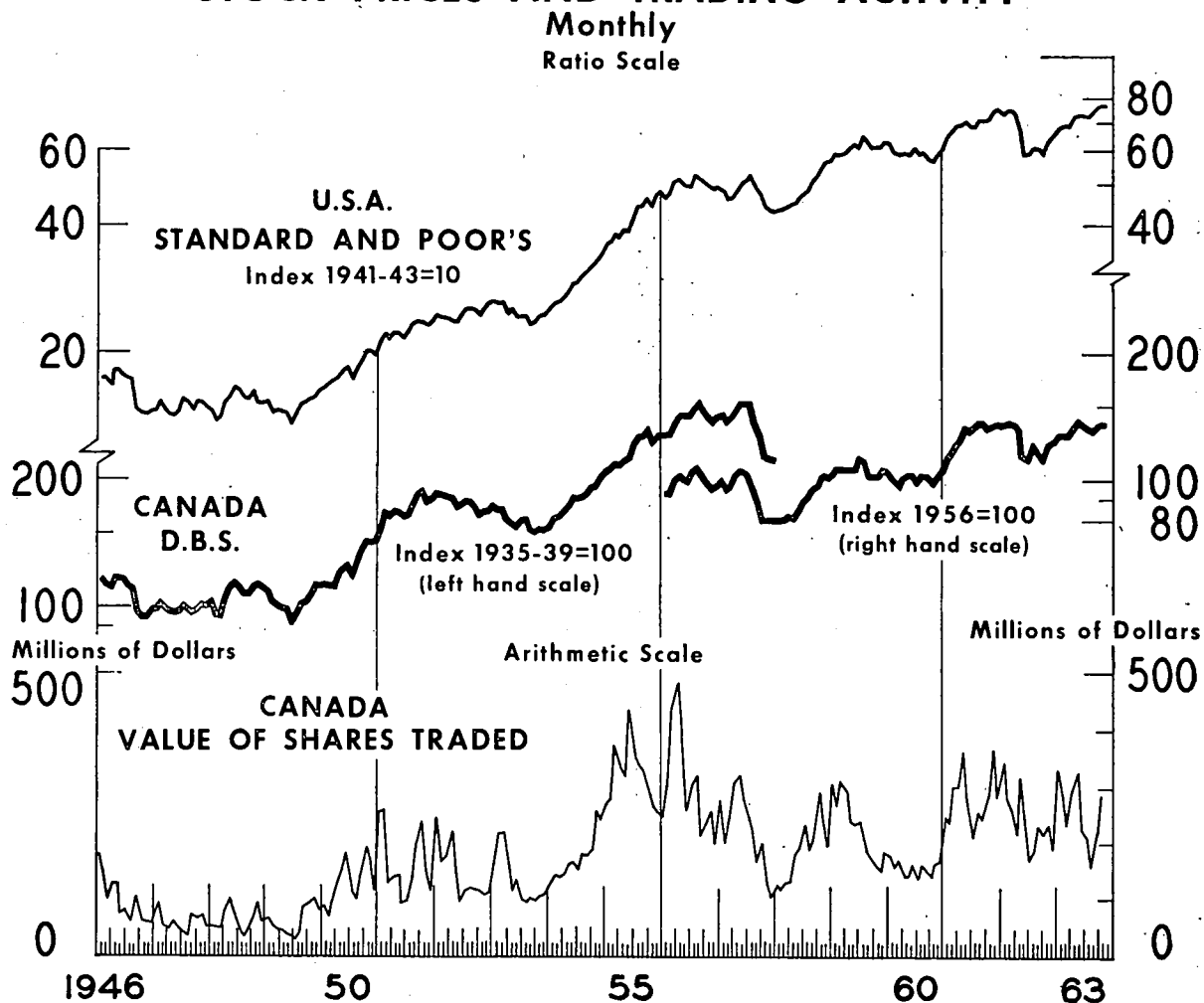
partly because uninformed investment still seems as rewarding to some investors as a more intelligent approach, the same basic forces are leading to the evolution of a more competitive and professional industry. The growing role of institutional stock market buying can be seen from the expanded equity holdings of mutual, pension, and trust funds cited in earlier chapters. It appears that purchases by these and other institutionally managed accounts have been equivalent to at least 60% of net new stock issues in recent years. While the institutional percentage of market trading is nothing like as high, these buyers do constitute an increasingly important share of the business. They, and other clients, now expect more expert security analysis and advice, a factor which has created a demand for university-trained people and has led to the gradual abolition of over-long and under-paid routine apprenticeships which failed to attract top-calibre personnel. As with investment dealers, these large buyers have demanded, and received, price concessions on large orders and this too has contributed to the search for more efficiency and more competent management in stock firms.

Moreover, the ending of rapid economic growth, which had been accompanied by high demands for funds, rising profits and commodity prices, and over-exuberant estimates of future prospects, has had its effects on the industry. Stock market activity has subsided considerably from its levels in the mid-50's when markets were rising from the under-valued levels of 1949,

and this has significantly affected the revenues, profitability, and business volume of the stock brokers. Business has thus become more competitive and the penalties of inefficiency more severe. The combined value of trading on the Toronto and Montreal exchanges and the performance of the D.B.S. industrial stock price index (Chart 17-1) show these trends. It will be noted that trends in Canada closely parallel those in the New York market, owing as much to the similar pattern of economic activity and business senti-

ment in the countries as to the close links between the markets themselves. Stock market prices and volume naturally will continue to fluctuate with business activity, investor sentiment, corporate profit trends, and the level of yields on alternative investments. They will probably also continue to lead business cycle turning points since they are a sensitive barometer of consumer and business confidence. Nevertheless, the average level of activity may well remain at lower levels, and this, combined with the growing demands of

Chart 17-1

STOCK PRICES AND TRADING ACTIVITY

more sophisticated investors, will confront the industry with more exacting competitive conditions.

There are about 200 brokers and broker-dealers in Canada, most of whom belong to at least one stock exchange. The largest exchanges are Toronto, with 98 members, and the Montreal and Canadian exchanges with a combined membership of 103; the Vancouver and Winnipeg stock exchanges have some 45 and 30 members respectively. There are in addition 66 members of the Broker-Dealers' Association of Ontario, some of whom are members of the Toronto Stock Exchange. About three-quarters of the members of the main exchanges belong to the I.D.A. or are closely affiliated to I.D.A. members. Both in number of firms and in capitalization the Canadian industry is about one-fifteenth that of the United States, approximately the same relationship as that between the gross national products of the two countries. The number of stock-broking firms has tended to be fairly stable in recent years, but broker-dealer membership has fallen precipitously from 179 firms at the peak of the resource boom of 1950-51 to 66 firms in March 1963.

Even more than the investment dealers, the brokers are highly concentrated in Toronto and Montreal, although one-quarter of the T.S.E. firms have branches elsewhere in Ontario and 10% have wider branch networks. A few of these branch systems are quite extensive and there is a tendency for firms to become more national in scope; this has, if anything, led to more business for the Toronto and two Montreal exchanges which account for 97% of the value of stock exchange trading in Canada. However, there is less concentration of business than in the dealer industry; for example 17% of the reporting membership in Toronto earned about 38% of the commissions while about the same proportion of firms in a Montreal survey earned 50%. It will be recalled that less than half this proportion of I.D.A. members had about half of the income and capital of that industry. The type of firm in the brokerage business also varies enormously, from small two-man operations of an unskilled

and personal nature, or perhaps trading only for their own account, to very large firms, some of them quite highly specialized and some with very high standards of competence. There are also firms of all sizes which specialize in the underwriting and distribution of speculative mining and oil company shares.

Brokerage commissions accounted in 1961 for almost 80% of the total revenue of Toronto Stock Exchange members and 77% of the total revenue of members of the Montreal exchanges. Trading and underwriting income, mainly the latter, made up 13% of revenues, almost twice the proportion in 1951. This represents an attempt to diversify, encouraged by sharp fluctuations in net income which in the five years reported in the special T.S.E. survey fluctuated from 1.3% of capital and surplus to 19.8%, averaging the reasonable figure of 8.5%. These figures may, if anything, exaggerate true profitability since salaries and bonuses to partners and shareholders are under 10% of revenue and have shown no pronounced tendency to rise.

The stock exchanges establish the minimum amounts of capital required by member firms and relate them to the volume of business transacted, usually insisting that this capital be additional to that invested in exchange seats, fixed assets, and office equipment. The balance sheets of Toronto member firms showed that they had assets of \$138 million, mainly arising out of routine customer receivables and margin accounts; inventories of shares were under \$4 million. The main sources of financing, apart from client credit balances, were call and other loans, mainly from the banks, and their own capital, which stood at over \$31 million. As the following table shows, the combined capital of Toronto and Montreal members has doubled in the past decade despite the decline in earnings rates in the interval.

The capital requirements of the stock exchanges seem to protect the public adequately, although the minimum standards of the Broker-Dealers' Association appear to be unduly low, calling only for a minimum of \$5,000 of free capital; in our view, this should be raised and related to business liabilities. Regular and surprise audits are made

CAPITAL AND INCOME				
	1951	1959	1960	1961
	(\$ millions)			
Toronto stock exchange.....	14.0	32.8	30.2	31.2
Montreal and Canadian stock exchanges.....	9.6	16.1	14.9	16.0
TOTAL.....	23.6	48.9	45.1	47.2
Net income as % of capital (T.S.E. reporting members only).....	19.8%	11.4%	1.3%	7.9%

For additional data, see Submissions of the Exchanges.

to ensure that the standards are being maintained and the stock exchanges have their own examiners to ensure that this task is properly carried out, a matter of particular importance since the provincial securities administrations are for the most part satisfied to leave these functions to them. The stock exchanges also require minimum insurance coverage against risks which could involve loss to the public and relate this to the size of the business transacted. However, the B.D.A., which requires a broker's blanket bond or securities insurance in a minimum amount of only \$10,000 for members in five major cities and of only \$2,000 elsewhere, ought in our view to relate the minimum more closely to the size and nature of the risks. Our comments in the previous chapter dealing with publication of regular industry financial statistics, the net worths of individual firms, and full disclosure of each firm's financial position to depositors and those holding credit balances, apply with equal force to brokers and broker-dealers.

The stock exchanges have among their aims the protection of the public, and do encourage sound financial practice and high ethical standards. Despite the progress that has been made, however, these bodies lack the funds and authority to do the whole job themselves, occasionally find themselves in conflict with their members, and quite frequently encounter massive indifference from a public anxious to make a quick profit on speculative securities.¹

¹ See, for example, evidence of Vancouver Stock Exchange, Transcript pp. 70-75.

Unfortunately, moreover, the securities administrators are often all too willing to pass the difficult regulatory problems on to the self-regulating associations. The stock exchanges are public corporations incorporated under provincial legislation and supervised by provincial securities commissions, but their powers of disciplining and controlling members are not always clear: where they are, there is frequently no appeal to an outside agency. In general, the exchanges control the admission of new members, set the terms for continuing membership, determine trading, margin² and delivery regulations, and establish the conditions to be met by companies whose shares are listed for trading. In addition to these self-regulatory functions, they carry on investor education programs through publications and advertising (this activity being restricted by limited budgets), provide a comprehensive quotation service, and represent the industry in discussions with public bodies and others.

The Broker-Dealers Association of Ontario was created by a public act of the Ontario legislature in 1947 to provide for a measure of self-government and internal self-regulation among that segment of the securities industry principally engaged in raising speculative capital for natural resources exploration and development. The conditions existing in resource financing prior to this period have been described as "something in the nature of a jungle."³ While the Association also represents its members more generally, its primary function is the enforcement of financial and ethical standards in the industry. Here again substantial improvements have been made, although the present situation is still something less than perfect.

THE STOCK EXCHANGES

The primary function of the stock exchanges is to provide a well-known centre where close and

² The amount that a customer may borrow against the collateral of securities.

³ Testimony of Hon. C. P. McTague, former Chairman of the Ontario Securities Commission before a Select Committee of the Legislature in 1951; cited in B.D.A. Submission, paragraph 1.

continuing markets are made and equity securities trade freely in response to basic investor preferences. By increasing public awareness of share prices, reducing the costs of investing, and increasing the marketability of equities, stock exchanges can make a valuable contribution to the broader ownership of listed shares. These wider holdings, and the resulting reduction in yields, also enhance the ability of issuers to raise funds through equities. However, as we will point out later, there are certain features of stock exchange operations in Canada which may operate to increase investor costs and impair the free workings of the markets: to the extent that they engender investor distrust of common stocks, these factors inhibit the growth of Canadian share ownership.

The range of equities available to the Canadian public is somewhat narrower than that in the United States because of the different pattern of our industrial development—for example, there are no Canadian companies engaged in the production of certain types of chemicals, electronics, and specialized industrial components. It is also limited by the extent of foreign ownership, by the smaller size of many Canadian companies which makes them less suitable for widespread investor participation, by the extension of government ownership over relatively large segments of the utility industry, and by the mutualization of insurance companies. On the other hand, shares in natural resource companies have more prominence in Canada, and “penny” mining shares abound on both the stock exchange and the informal “over-the-counter” market. We have already noted that Canadian corporations have taxation reasons for raising new funds by debt issues whenever possible, but this factor tends to limit the supply of common stocks with equal force in the United States.

However, more of the equities available for public investment are listed on stock exchanges in Canada. In the United States, the number of unlisted issues quoted in daily newspapers is some three times the 1,600 stocks listed on the New York Stock Exchanges, while in Canada—excluding the penny mining shares—the proportions are

about reversed. This is partly because of the lower listing standards of Canadian exchanges but partly also because of the fact that American supervision of unlisted stocks has been relatively less stringent than that applying to listed shares. In Canada, the difference between the two standards of supervision—while real—is less marked, and companies in this country have thus not had the same incentive not to list their shares.

As we noted in Chapter 2, a relatively small proportion of the population owns common stocks in both Canada and the United States. In both countries the proportion of shareowners is rising, although the rate of increase seems faster in the United States. As might be expected in view of the costs and difficulties of managing small holdings of common stocks and of the desirability of acquiring other more liquid assets first, some 63% of aggregate dividend payments to Canadian individuals filing taxation statements for 1960 were made to those with incomes of \$10,000 and over and 35% to those with incomes of \$25,000 and more, even though these groups represented only 3.2% and 0.4% of the number of taxpayers respectively.

In the United States, a similar high concentration of stock ownership exists, although in that country the under \$10,000 income group accounted for 64% of the number of shareowners compared to 56% in Canada. There is nevertheless a striking contrast between the attitudes of shareowners in the two countries: whereas 62% of the American holders surveyed in 1961 (and 51% of those surveyed in 1963) had bought shares for long-run investment, only 35% of the individuals (excluding members of the Exchanges themselves) who bought stock during a three-day survey conducted by the Montreal exchanges in June 1962 did so with the intention of holding the stock for longer than six months.⁴ While un-

⁴ Submission of Montreal Stock Exchange and Eleventh and Twelfth Public Transaction Studies of the New York Stock Exchange—September 13, 1961 and October 16, 1963. The New York results may be somewhat biased by the more stringent taxation of short-term trading profits in the United States and the relatively favourable treatment of profits on stocks held more than six months; the latter are subject to a reduced capital gains tax rather than ordinary income taxes.

due reliance should not be placed on one Canadian survey taken in a time of falling markets, this evidence does seem to suggest that a high percentage of Canadians regard equity ownership as a short-term speculation rather than a longer-term investment.

We have no evidence of the extent to which stock ownership in Canada is affected by the 20% tax credit on dividends from Canadian corporations and the absence of a capital gains tax, and a review of these arrangements in any case falls within the terms of reference of the Taxation Commission. However, we believe it important to encourage individual Canadian ownership by providing more information to investors, reducing the cost of modest share purchases and tightening up securities legislation. As to institutional buyers, who accounted for about 20% of purchases in the Montreal survey already referred to, we noted in Chapter 13 that relatively small amounts of equities were held by life insurance companies and made suggestions which we hope will encourage them to expand their holdings. Pension funds and the estate, trust and agency accounts of trust companies are already substantial and increasing buyers of common shares, while banks and other deposit-taking institutions cannot ordinarily be expected to be.

Although it is difficult to make comparisons of United States and Canadian dividend yields on companies with similar prospects and risks, such yields in Canada appear to be lower than in the United States and do not support the view that there is a lack of buyers in the Canadian market.⁵ Rather, these yield data suggest that there may be some shortage of Canadian equities available for public ownership, a conclusion which is reinforced by the quite high proportion of all equity holdings in the estate and personal trust accounts of trust companies, 6% and over 20% respectively, which is invested in foreign equities. Moreover, as members of the Montreal Stock Exchange told us, a number of American brokerage firms have found it profitable to establish in Canada to

meet the demand of our investors for American issues, particularly of the variety not found in Canada. These firms had about 25% of the commission business of reporting members of the Montreal and Canadian Stock Exchanges in 1961. This and other evidence suggests that if wider Canadian ownership of equities is to be achieved, measures must be taken at the same time to encourage non-resident owned Canadian firms to make their shares available to the public in Canada. While it is not within our competence to suggest any concrete taxation measures which might be taken to foster such a development in sound ways, we welcome the attempts of the stock exchanges to promote the issuance of shares in such companies to the public. We also strongly urge that those firms whose earnings records and size justify this course should do so wherever possible.⁶

There are a number of ways in which the stock exchanges themselves could help to encourage more widespread ownership of listed stock. First, some amendment might be made to the commission structure to make it more logical than the present one, which has evolved in a somewhat haphazard way. The Toronto Stock Exchange submitted evidence that rates per share on its exchange are substantially lower than those in New York for shares selling below \$5.00—in which trading volume is greater than in New York—somewhat higher in the \$5.00-\$30.00 range, very slightly lower for shares between \$30.00 and \$80.00, and considerably higher for shares selling above \$150.00.⁷ The Toronto Stock Exchange has recently allowed the commission scale to be reduced to one and one-half instead of two commissions on a buying and selling transaction of over \$100,000 and to one full commission on transactions of over \$250,000. These concessional rates were devised as part of an attempt to discourage the large amount of block trading being done off the exchange.

Without wishing or feeling qualified to make detailed recommendations, we believe there would be merit in simplifying the commission structure, in

⁵ The more generous dividend credit for tax purposes in Canada affects these yield comparisons.

⁶ See also the discussion of this subject in Chapter 5.

⁷ Submission, paragraph 55, and Appendix 35.

keeping commissions at a low level, and in providing a greater reduction in the commission costs of large transactions. These advantages might be obtained by commission rates which were a low fixed percentage of the value of a transaction and which provided for a discount on transactions above a certain value. Such a system would also facilitate stock splits designed to encourage wider equity ownership. At present, if a company splits its shares, it almost invariably increases commission costs for the buyer or seller of a given dollar amount of stock, as shown by Table 17-1. This irrational cost increase, which acts as a deterrent to splits designed to attract those with small amounts to invest, would be eliminated by an appropriately revised commission structure.

We received a suggestion that bond-holding by investors would also be encouraged if these securities were listed on stock exchanges. Some bonds are listed on the New York exchange but trading is insignificant in relation to that in the over-the-counter market. In fact, bond-trading is not well-suited to a market where client orders must be exactly matched, in addition to which the commission structure would inevitably be higher and the present highly efficient bond-trading arrangements might well be disrupted.

The exchanges should, however, raise their listing standards for shares. No distribution of

share ownership other than that of "adequate public distribution", is officially required in Canada, and even this has been fairly liberally interpreted. By contrast, the New York Stock Exchange believes that close, continuing and broad markets will only be attained if companies applying for listing have a public holding of at least 500,000 shares, exclusive of concentrated or family holdings, distributed among at least 1,500 shareholders; a relatively low weight is given in these calculations to holders of fewer than 100 shares. Moreover, a minimum trading volume of 100,000 shares a year is expected. While these standards would be too high even for the biggest of our exchanges—only a minority of industrial issues listed in Toronto traded more than 100,000 shares in 1962—some increase in distribution requirements would be desirable. These standards have been so low as to permit stocks to be listed with as few as 8% of the shareholders controlling over 93% of the common shares outstanding and to retain listings of some issues which trade fewer than 500 shares in a year. The resulting wide spreads reduce the liquidity of shares and make their markets susceptible to easy manipulation. While the exchanges are conscious of this problem and have raised their requirements somewhat, it would be helpful if they were to raise them further to ensure that there is an adequate auction market,

TABLE 17-1
BROKERS' COMMISSIONS BEFORE AND AFTER STOCK SPLITS

Pre-Split Price per Share	Pre-Split Commission	Pre-Split Commission	Shares Split 2 for 1		Shares Split 4 for 1		Shares Split 8 for 1	
			Commission	Commission	Commission	Commission	Commission	Commission
	\$	%	\$	%	\$	%	\$	%
\$110.00-119.99.....	60.00	0.55	80.00	0.73	140.00	1.27	200.00	1.82
100.00-104.99.....	55.00	0.55	80.00	0.80	140.00	1.40	200.00	2.00
75.00- 75.99.....	45.00	0.60	70.00	0.93	120.00	1.60	160.00	2.13
50.00- 52.49.....	40.00	0.80	70.00	1.40	100.00	2.00	120.00	2.40
35.00- 35.99.....	35.00	1.00	60.00	1.71	80.00	2.29	80.00	2.29
25.00- 26.99.....	35.00	1.40	50.00	2.00	60.00	2.40	56.00	2.24
20.00- 20.99.....	30.00	1.50	50.00	2.50	60.00	3.00	36.00	1.80

NOTE: The pre-split commission is based on 100 shares. The commission after the stock split is based on a sale of shares with the same total value as the pre-split block. The price used in calculating the percentages is the lowest price per share in each category.

SOURCE: David F. Wright: *Stock Splits from the Company Viewpoint*. Unpublished paper for the University of Toronto School of Business.

even if this involves losing some listings. Typical spreads between the bid and offering prices of more actively traded industrial stocks of reasonable quality are as little as one-eighth of a dollar (for some reason the exchanges have not adopted the more convenient decimal system).⁸ Buyers and sellers can thus be brought together with a minimum concession on one side or the other, a condition which does not apply on less broadly-held issues where the spreads between buyer's bid and seller's offer may range up to several dollars and represent a significant percentage of the amounts involved.

Other aspects of listing requirements which could stand improvement are those related to the size and earnings of listed companies, standards of disclosure, and the de-listing policy of the exchanges. In New York, for example, listed companies are required to demonstrate net profits of \$1 million annually under competitive conditions and should have net tangible assets of at least \$10 million. Toronto has no set standards for industrial listings but considers them on the basis of earnings records, "proof of consistent earnings being regarded as removing the security from the highly speculative field".⁹ Moreover, the absence of consistent earnings does not necessarily disqualify a company for listing if it can show net tangible assets of \$1 million, working capital of \$250,000 and a "projection of earnings satisfactory to the Listing Committee".¹⁰ Present listing policy on exploratory mining companies is of course somewhat different. They may be listed if sufficient exploratory work has been carried out to enable them to provide a competent engineer's report and if they have cash on hand or a "plan to raise sufficient funds to carry out the recommendation".¹¹ Oil and natural gas companies may be listed on the basis of adequate financing and a cash flow sufficient to ensure the continued life of the company—i.e. about \$25,000 to \$50,000 annually.¹² While these stand-

ards have been imposed over the years, they are still so low that they involve the listing of many speculative issues and lead some investors to believe that all listed common shares are speculative in nature. In some cases this discourages equity investment, a difficulty that would be avoided by significantly raising listing standards on the main exchanges and transferring other issues to either a subsidiary exchange or the over-the-counter market.

Moreover, while the New York exchange requires high annual disclosure standards, regular periodic reporting, solicitation of proxies, and publication of all transactions by "insiders"—officers and controlling shareholders—no such requirements exist in Canada. The Canadian exchanges do, however, insist on certain minimum disclosure standards to be described later, although they are comparatively reluctant to de-list dormant companies and those that fail in other ways to maintain original listing standards. We were told that de-listings for reasons other than voluntary choice or outright fraud were very infrequent, not amounting to half a dozen in recent years. The Toronto exchange, which has long been conscious of the problem, has recently adopted a more stringent de-listing policy. However, because of the undesirable competition for listings between the Montreal and Toronto exchanges, which goes well beyond the point of a normal healthy rivalry in some instances, it may prove difficult to pursue this desirable program with sufficient vigour. It is also claimed that de-listing for failure to meet exchange standards would further hurt the shareholders concerned, although we feel that on balance a lax de-listing policy can only harm the interests of both the shareholders concerned and the broader investing public. A final reason for these difficulties is that, unlike the situation in the United States, there is no sanction from securities or companies legislation to support the exchanges in such efforts as they have made in this direction. For example, the Toronto Stock Exchange a few years ago approached almost 400 listed companies urging them to publish interim reports; just over 50 agreed to do so and the majority

⁸ Very low-priced stocks trade in steps of $\frac{1}{4}$ a cent, while stocks under \$5 trade in 5¢ steps.

⁹ Submission, paragraph 216.

¹⁰ *Ibid.*

¹¹ *Ibid.*, para. 217.

¹² *Ibid.*, para. 218.

did not even bother to answer. While Canadian listing requirements could not as a practical matter be as high as those in New York, we will make recommendations designed to raise both listing and disclosure standards later in this chapter.

The stock exchanges have a heavy responsibility to ensure that the ethics, trading practices, and standards of qualification of brokers dealing through the exchanges are adequate. Significant progress has been made in many directions but qualifications for salesmen are still minimal compared to those in New York. Moreover, the minimum requirements for membership in an exchange are extremely low: in Toronto, for example, they are that a candidate be a British subject of twenty-one with three months experience in the industry and that he be able to meet the minimum capital requirements mentioned earlier. In addition, a seat must be available for purchase by him, he must be acceptable to the Governors of the Exchange, and his application must be approved by 80% of the members voting (in Montreal the figure is now 66⅔%). While the members exercise considerable discretion in admitting new applicants, we believe that the basic standards ought to be raised substantially and that rejected applicants should have the right of appeal to the relevant securities commission in order to ensure that the exchange's decisions have not been biased or prejudiced. This would still enable the industry to make judgments based on its intimate knowledge of the applicants but would guard against the abuses inherent in unsupervised self-government.

It will probably also be necessary for the main exchanges to enlarge their membership as the demand for their services expands, a factor which they are no doubt taking into account in making plans to move into new quarters. Certainly the national exchanges in New York and London have a very much larger membership than those in Toronto or Montreal; London has about 3,500 members and almost 500 member firms while New York has 1,366 members and 681 member firms compared to the approximately 100 members of Toronto and Montreal. Study might be

given to the merit of altering the method of obtaining membership only by purchase of an existing seat if this can be done in ways which protect members who have invested sizable sums in such assets.¹³ The rules of both the Toronto and Montreal exchanges also provide that in the case of the failure of a member the seat may be forfeited and sold by the exchange for the benefit of the creditors, including other member firms, the exchange, and the public, with any balance being returned to the defaulting firm. The exchanges take pride that, partly as a result of this system, the public has never suffered as a result of the failure of a member firm. This advantage could however, be retained by requiring new members to pay a fixed entrance fee related to the present value of memberships. Members would be entitled to a refund on resignation, and a supplementary fund could be built up out of the exchanges' earnings to meet withdrawals in excess of new memberships. By removing the fixed limit on membership and tightening up on basic membership requirements, public confidence in the exchanges would be strengthened, the financial soundness and experience of member firms would be improved, and competitive forces would be allowed more play.

A number of other steps might be taken to improve public confidence in the exchanges. First, the exchanges should continue to expand the size, skills, and responsibilities of their full-time staff. This trend, already well under way, has not yet gone as far as in New York, particularly on matters relating to listing and de-listing of shares, the policing of floor transactions, and disciplining members for infractions. The Boards must have the final verdict, but by giving increased powers to permanent officials with intimate knowledge of the business many of the advantages of self-discipline can be retained. At the same time, a number of its disadvantages—particularly the tendency to be unduly lenient in some instances and unduly harsh in others—can be reduced or eliminated. Second, the governing boards of the exchanges—now elected from the membership—

¹³ Seats in Toronto sold for as much as \$130,000 and \$140,000 in 1955 and 1959.

might be supplemented by the appointment of a minority of public governors from outside the industry. This has worked well on the New York Stock Exchange where good public governors have been recruited and given real responsibilities. Both major exchanges have moved in this direction by appointing full-time presidents from outside the industry, but there is still a good case for drawing on the experience of participants from other industries who can bring fresh perspectives to the exchanges' functions and problems.

The exchanges should also reinforce the commendable efforts they have made to prevent trading abuses and the manipulation of markets. Both the main exchanges have rules which provide that client orders must be given priority over those of member firms and professional traders, although of course they are difficult to police.¹⁴ The right of the customer to such priority is incontestable, and although professional traders can promote greater price continuity and minimize market fluctuations by being willing to take risks and speculate, they can in certain circumstances also aggravate price swings. Very little is known about the effects of such trading in Canada, although studies in New York indicate that the overwhelming majority of trading by specialists with particular responsibilities is stabilizing in nature. This, however, is apparently not true of activity by floor traders.¹⁵ The Montreal survey in 1962 showed that almost 30% of transactions were by members for their own account, while an earlier Toronto survey showed a more modest proportion, 10-12%. While the recent S.E.C. study recommended prohibition of professional trading by floor members, we have not carried out the detailed examination of Canadian trading necessary to make recommendations at this time. In view of its importance in total trading, however, we believe that member trading should be closely supervised, both by the exchanges and securities

administrators, and that strong action should be taken if evidence of abuse is uncovered.

The Toronto Stock Exchange has twice experimented with the use of specialists on the trading floor. These experiments were limited to three specialists with about 30 stocks and were carried out over approximately a three-month period. In the first experiment, the specialists were given the same powers as those on the New York and American Stock Exchanges; that is, they traded for their own account, maintained a "book" in which they listed all "limit orders"—orders to buy or sell at specific prices given them by other brokers—and handled "odd-lot" orders.¹⁶ The results of the experiment suggested that the market was not significantly improved by these operations and that many members resented the substantial advantage the specialist had trading in the securities for which he kept the book. In the second experiment, officials of the Exchange were used. They undertook only two functions: to keep a book on limit orders and to deal in odd lots. Somewhat more enthusiasm was engendered for this system but the members were reluctant to provide funds with which the specialists could operate and undertake the risks involved. The latter system might be more efficient than the present one because fewer floor traders would be needed to fill limit orders, especially in rapidly changing markets. It might also improve the market in odd-lots and reduce the costs of these transactions, although some floor traders now do in fact specialize in this field. In any event, the price at which odd-lot sales can take place should be regulated, as it is on the New York Stock Exchange. This would protect and encourage the small investor in higher-grade securities.

Much more serious possibilities of abuse arise from the unique practice of some Canadian exchanges of permitting the primary distribution of shares through their facilities. In the course of such a distribution, which normally involves the sale of treasury shares but may also entail dis-

¹⁴ This is particularly true of undisclosed short sales by floor traders, which we understand is a problem on some exchanges.

¹⁵ S.E.C. *Special Study of Securities Markets*, Washington: 1963. This study was prepared by the S.E.C. staff and does not necessarily carry the approval of the S.E.C. itself.

¹⁶ Odd-lots are blocks of fewer than 100 shares for most industrial securities selling below \$25 a share, fewer than 25 shares of securities selling between \$25 and \$100, and fewer than 10 shares if the stock sells at \$100 or more.

tribution of existing shares by the controlling interests, a true auction market no longer exists. The offering price is not established by the independent judgment of numerous individual shareholders but by the offering price of the underwriter or his agents. Moreover, unrealistic bid prices may also be maintained by these same interests in the hope of attracting public buyers anxious to make a profit on a rising and active market which by one means or another they are led to believe may be going higher still. The arguments in favour of allowing such distribution to take place through the exchanges are that there would otherwise be a primary over-the-counter market existing side by side with the exchange's true secondary market and that this would result in two relatively thin and more easily manipulated markets. Moreover, it is argued that it is easier to regulate malpractices on the exchanges than in the unlisted market. For these reasons the exchanges require the entire authorized capital of mining, oil, and other speculative issues to be listed, whether issued or not, so that any additional shares can only be issued under the supervision of the exchanges. This rule does not apply to seasoned issues where the exchanges will only list the issued shares.

The broker-dealers are usually involved in such speculative underwritings, whether or not carried out through the exchanges. Although underwriting for the exploration and preliminary development of mining and oil and gas properties may take a variety of forms, it is usually on an option basis.¹⁷ In part because of the high costs of direct mail and telephone solicitation in relation to the small amounts of new funds involved, only about 40% of the total funds raised go to corporate treasuries, the balance going to dealer costs and profits. When it is considered that public interest in these shares usually becomes most intense after the market has risen substantially above the issue price, the difference between the average price paid by the public and the amount actually finding its way into company treasuries may be even greater. Moreover, our concern about the appropriateness of

this means of financing is heightened by the conclusion of a study prepared for us that of the approximately \$340 million of cash raised for junior mining treasuries (i.e. after deduction of expenses) by such underwritings in the 1953-60 period, no more than \$150-\$160 million was actually spent on exploration by those companies.¹⁸ If the \$340 million represented 40% of the amount paid by the public, the public paid over \$750 million to finance this amount of exploration—odds which are highly unfavourable in view of the fairly remote chance of such enterprises ever getting into production and paying back more than was put into them in the first place.¹⁹

As some 86% of prospecting expenses each year are now in fact made by producing mines, and as large amounts of capital are now required to bring a property into production, the role of the stock exchanges in financing natural resource development through primary distribution is a questionable one. This is especially true since the independent prospectors remaining have sufficient potential financing sources to safeguard their bargaining power. Some recent mines, particularly uranium producers, were financed in this way, but in our view there is a considerable difference between raising funds from the public for the financing of large mining units with established ore reserves, substantial backing, and long-term contracts on the one hand and raising \$25,000-\$50,000 for a purely speculative enterprise which has no assured ability to finance itself to production even if something is found. Moreover, a disturbing feature of such underwriting is that the broker-dealer, by owning or controlling a large block of shares in such companies, in many cases controls the issuer. The possibilities of conflicting interests, market manipulation, and other activities such as treasury-robbing—i.e. selling claims or other assets to the company at inflated values, paying himself and his associates high

¹⁸ See the working paper, *Finance in the Mining Industry*.

¹⁹ *Ibid.* From 1907 to 1953, over 400,000 claims were recorded in Ontario and 6,679 metal-mining companies were formed. Of these only 348 got into production—sometimes after repeated stock exchange promotions—and only 54 paid any dividends.

¹⁷ Submission of Broker-Dealers' Association of Ontario.

salaries and consulting fees, etc.—are both obvious and real in such circumstances.

While the stock exchanges are fully aware of these dangers and have taken many commendable and useful steps to try and protect the public from abuses, we do not believe they should lend themselves to primary distribution. In doing so, they lead many people to distrust all common stocks and discourage the provision of true venture and equity capital by Canadian investors. It is true that requiring junior exploration companies to issue a prospectus, file an audited statement, and comply with the regulations applying to other issuers would perhaps raise their costs and might lead to some additional delays, but it would also achieve the more important aim of protecting the public and encouraging bona fide equity investment. New issues would also be more carefully considered, and if this discourages some financing which is not seriously aimed at bringing natural resources into production in any event, there would scarcely be any loss to the economy. Clearly, such a proposal would also entail hiring additional skilled staff in the securities administrations.

In the meantime, the Toronto Stock Exchange ought to intensify its efforts to police the activities of the primary distributors in order to minimize their effects on the reputable majority of the securities industry. At present, junior companies—in addition to providing an annual report to their shareholders and the Exchange and to complying with other requirements relating to the payment of dividends and rights—must also notify the Exchange of any material change in their affairs. This is defined to include changes in management, directors and control, acquisition or sale of new properties or shares in other companies, new management contracts, etc. Such companies must also give notice of any new option or underwriting, and when primary distribution is contemplated they must comply with certain conditions and make full disclosure of all material facts in a “filing statement”.²⁰ The more important of these requirements relate to the minimum size of under-

writing (normally \$30,000), the prohibition of options without a firm underwriting agreement, limits on the size, price and term of options, and provision for the acceleration of options if the price of the shares rises sharply. They also require full disclosure of beneficial interests and responsibility on the part of the underwriter for any sub-underwriter. These features are designed to minimize the possibility of market manipulation and ensure that reasonable sums are raised for the treasuries.

A filing statement committee meets weekly to review filing statements, and the underwriter may not proceed if his proposals are not acceptable or if they fail to disclose material facts relating to the company's property, past and proposed development expenditures, vendor's consideration, controlling interests, etc. Limitations are now also placed on non-arm's length transactions to try to curb treasury-robbing. The Exchange told us that this system was working reasonably well, although it takes up some 90% of the time devoted to self-regulation and led to complaints that it was being “too strict”. However, one area where some strengthening is apparently needed is in the follow-up of such underwritings to ensure that the funds have been put to proper use. While we commend the Exchange for these efforts, a serious weakness in the system is that filing statements need not be delivered to the buyer of shares undergoing primary distribution, although the Exchange makes them available to member firms and the press. The buyer of such shares does not therefore have the protection and information provided by the prospectus which accompanies a new industrial issue—with the right of rescinding the transaction if a study of the prospectus reveals something unsatisfactory to the purchaser.²¹ In view of these considerations, and the value which a listing has for unscrupulous promoters, we believe that all new issues should be sold off the exchanges under the direct supervision of the securities commission

²⁰ This right exists for seven days after delivery of the prospectus. See, for instance, Section 49 of The Securities Act of Ontario for full details.

²¹ Submission of Toronto Stock Exchange, paras. 179-188.

with whom the final responsibility in any event lies.

It has been argued that the problem of self-regulation in Canada has been made more difficult by the absence of a single national exchange such as is found in London or New York. This may indeed be so, although most of the problems involved could be eliminated if the two main exchanges would co-operate more in future in raising listing and other standards. As can be seen from the following table, the Toronto exchange comes closest to being a national exchange, having over 70% of the value of all trading compared to the 84% of United States business done by the New York Stock Exchange. While there are small amounts of trading in Winnipeg, Calgary and

Vancouver, the main volume of business has remained concentrated in Montreal and Toronto, with the latter tending to grow in relative importance in response to the westward shift of Canadian economic activity and the replacement of overseas countries by the United States as the primary source of external capital. The predominance of Toronto is also illustrated by the fact that between 60% and 75% of the stocks listed on the other exchanges are also listed on the Toronto Stock Exchange.²² Listings which are

²² Montreal 62%, Winnipeg 67%, Calgary 63%, Vancouver 73%. Toronto has further strengthened its position by setting up special market facilities where American residents may trade with each other in order to avoid incurring the "interest-equalization tax" proposed by the U.S. administration in 1963. Volume on this market has, however, remained small in its first few months of operation.

TABLE 17-2
VALUE OF SHARES TRADED ON CANADIAN EXCHANGES 1952-1961
(\$ Millions)

	Toronto	Montreal ^a	Vancouver	Winnipeg	Calgary	Total
1952.....	1,109.7	593.6	40.2	1.1	52.1	1,796.7
1953.....	1,143.2	509.7	25.4	1.7	17.6	1,697.6
1954.....	1,349.7	766.0	32.1	3.0	16.5	2,167.3
1955.....	2,699.0	1,161.7	56.1	2.7	14.9	3,934.4
1956.....	2,510.8	1,164.2	59.9	1.1	24.2	3,760.2
1957.....	1,864.8	846.6	48.1	1.0	18.8	2,779.3
1958.....	1,505.9	544.1	43.1	1.0	9.6	2,103.7
1959.....	1,860.4	663.1	58.8	1.7	6.3	2,590.3
1960.....	1,223.3	481.3	35.3	1.6	2.8	1,744.3
1961.....	2,526.3	948.5	101.8	3.7	2.3	3,582.6

VALUE OF SHARES TRADED AS A PERCENTAGE OF TOTAL

	Toronto	Montreal	Vancouver	Winnipeg	Calgary	Total
1952.....	61.8	33.0	2.2	0.06	2.9	100.0
1953.....	67.3	30.0	1.5	0.10	1.1	100.0
1954.....	62.2	35.3	1.6	0.14	0.76	100.0
1955.....	68.6	29.5	1.4	0.07	0.38	100.0
1956.....	66.6	30.9	1.7	0.03	0.64	100.0
1957.....	67.0	30.5	1.7	0.04	0.67	100.0
1958.....	71.5	25.8	2.1	0.05	0.46	100.0
1959.....	71.8	25.6	2.3	0.07	0.24	100.0
1960.....	70.1	27.6	2.0	0.09	0.16	100.0
1961.....	70.5	26.5	2.8	0.10	0.06	100.0

^aThe Montreal Stock Exchanges' figures for 1952-57 are inflated but to an unknown degree.

SOURCES: Briefs of the Toronto and Vancouver Stock Exchanges. Data for the other exchanges were provided on request.

found only on the western exchanges are usually local mining, oil, and industrial companies with a local following that are not widely known across the country.

While a single national exchange would concentrate all trading, cause the markets to be broader and more resilient, and might reduce trading costs per unit, it would fail to take account of the country's significant regional variety and of the need for local exchanges to provide a centre for the shares of smaller and less nationally-known companies. Some of these exchanges also provide convenient centres for trading national stocks after the main eastern markets have closed. It might thus be constructive if the Toronto exchange were to do more to encourage associate members from other centres to join the exchange and accept its standards in return for a reasonable share of the commission business they generated. We are not, however, in favour of measures such as the elimination of arbitrage between exchanges, a rule which Toronto has considered introducing. Arbitrage takes place when prices in two market centres temporarily diverge and a member trading for his own account buys in one market and sells in the other. In doing so he of course makes a profit but, more important, his activity equalizes prices in both markets. This can also occur if the broker places a client's order in whichever market the best "fill" or price can be obtained, normally the most active market in that issue. He should naturally be required to do so where possible, but it is not always feasible to find out which market has the most favourable price. The arbitrageur thus has a useful role to play in the interests of investors as a whole, even though in the trade for which he acts he prevents a single investor, and that investor's broker, from getting the best price possible. While the New York Stock Exchange has prohibited arbitrage between itself and other markets in the United States, we believe arbitrage can play a useful function in the Canadian situation, especially if measures are taken to ensure that brokers execute orders in the best market where possible. Moreover, its existence need not im-

pede any natural or desirable development for one or more markets to develop as primary national centres for the trading of particular issues.

The main exchanges have greatly strengthened their trading standards and raised the ethics of their members in recent years, and have also showed themselves increasingly aware of their responsibilities to both the investing public and the broader national community. Trading facilities have been modernized and improved and further progress lies ahead, even though the day when all trading will be carried out through computers rather than any personal agreement on a trading floor is not yet at hand. In a further attempt to reduce the costs and inconvenience of trading, the exchanges are exploring with the trust companies the possibility of establishing a central depository to hold share certificates and reduce transfer, delivery and safe-keeping fees. The trust companies so far have been reluctant to make the necessary price concessions, and many other problems remain to be solved, but this service to the investing public may ultimately prove worthwhile.

SECURITIES LEGISLATION AND REGULATION

We have suggested a number of areas in which the exchanges might further improve their standards and encourage informed equity investment by the public, but because it is a field in which hanky-panky at the fringes is temptingly easy there is also a role to be played by the securities commissions and laws. If broader ownership of Canadian equities is desirable and if larger numbers of people are to be encouraged to invest in common shares to provide Canadian businesses with equity capital at moderate cost, several conditions must be met. The public must have the means and the knowledge to make such investments without undue expense; corporations must believe in broader ownership, recognize the importance of individual investors as a source of growth capital and be willing to provide them

with the information necessary to make sound investment decisions; and the brokerage and financial community must be competent to serve the needs of the investing public and command their full confidence. The role of securities regulation is to assist and encourage the securities industry to develop and maintain a deserved reputation for skill and integrity, to protect investors from deception by either the financial community or corporate "insiders" who stand in a fiduciary relation to them, and to ensure that adequate information is made available to them to allocate their savings rationally. The provincial securities administrations have, along with the industry itself, done much to raise industry standards and improve the disclosure requirements of prospectuses, but we have discovered areas where substantial improvements might still be made.

The philosophy of securities regulation in Canada is based on two principles, full disclosure and the prevention of fraud, although neither is fully implemented. The first is supported by securities and company legislation and the regulations of the stock exchanges, while the second rests on the preventive and punitive powers of the securities laws and the federal Criminal Code as well as those of the by-laws and regulations of the self-regulating associations. In Canada, unlike the United States, the full disclosure principle is supplemented by giving the securities administrators discretion to refuse registration of an issue even when the disclosure is "full, true and plain" if it fails to meet other standards. Unlike the United States also, direct securities regulation in Canada has been implemented exclusively through provincial acts administered by provincial securities commissions or, in a few instances, by a branch of the Attorney-General's department. In addition, of course, both federal and provincial company legislation impinges indirectly in this area, as does the Criminal Code of Canada.

Our studies of the securities administrations across Canada revealed that they are inadequately staffed both in quantity and quality, that salary scales have not been attractive enough in general to interest and retain sufficient able and ex-

perienced men, and that few securities commissioners have had much practical industry or regulatory experience prior to their appointments. The understaffing problem is exemplified in the Ontario Securities Commission which, with an effective registry staff of about five, in their 1961 fiscal year registered some 345 prospectuses, many of which went through several drafts, and considered but failed to register others. In addition, it registered 387 brokers, dealers and security issuers—56 of whom were new applicants—and 2,418 salesmen, 529 of whom were new applicants. Indeed, the 10,800 salesmen registered across Canada in 1961 received only a cursory glance by the securities administrations. About one-third of these were mutual fund salesmen who were not at that time operating within the framework of a self-regulating association. With the exception of Ontario, the securities administrations were able to provide us with only the most limited historical data about their registrations, again reflecting persistent shortages of staff. Indeed, some of the Commissions have no one on their staff who is in a position to analyse financial reports. Some of these problems may be inevitable with the fragmentation of administration over ten jurisdictions, some of which do not have sufficient securities activity to warrant trained full-time staffs. In general, however, securities administration seems to have been a low priority item for provincial governments, a fact which is reflected in the particularly low salaries paid for legal, administrative, and accounting skills: for example, the registrar, the chief full-time officer, is paid only between \$6,000 and \$10,000 depending on the jurisdiction.

One of the principal objectives of some of the administrators and practically all the brokers, dealers and corporation lawyers is uniformity of legislation across Canada. Some faltering progress is being made; the Alberta, British Columbia and Saskatchewan acts have been modelled on the Ontario act although in no case has the Ontario act been adopted without at least several minor changes. The Quebec act is much like the Ontario act although it provides the com-

missioners with greater powers. The securities issuer seeking a national distribution for a new issue is thus faced not only with the requirement of registration under ten securities acts which are dissimilar in varying degrees but with the requirements of the relevant companies legislation, although the administrators of the latter seem to fulfill only the functions of a registrar, accepting filings with little regard for their accuracy or completeness. In some instances, these or other authorities are responsible for prospectus clearance—for example, utilities issues in British Columbia are cleared by the Public Utilities Commission, a function we think would be better performed by a securities commission.

This hodgepodge of legislation increases the legal difficulties of bringing a new issue to market and leaves the issuer and underwriter open to the risk of delay caused by the failure to meet the requirements of a single jurisdiction, although in fact most administrators will register quickly prospectuses which have been accepted by the Ontario Commission; such co-operation, however, cannot always be counted on. Even where the legislation is similar, the discretionary powers allowed the commissions and adequacy with which they are staffed can result in important differences in administrative practices. We were told that, "substantive security law is comparable to the visible part of the iceberg, while the procedural law and policy represent the submerged mass. So long as such discretions exist (our) experience would indicate that true uniformity can never be realized".²³

In 1963, the provincial administrators began to meet semi-annually rather than annually to discuss the policies and problems of securities regulation. Between meetings they exchange information pertaining to registration and enforcement of the anti-fraud laws, an arrangement which has worked fairly well in the past, although more frequent meetings might well provide for closer personal relationships and still better co-operation. Moreover, all the securities acts, except that of New Brunswick, provide for the execution of warrants

for arrest issued by another provincial jurisdiction, a provision designed to prevent offenders avoiding arrest merely by moving to another province. There have been occasions, however, when the experience or warnings of other jurisdictions have gone unheeded and known racketeers have been left free to operate. In part this reflected inadequate staffs and faulty co-ordination, but this situation sometimes also arose because some governments were apparently unwilling to run the risk of taking action that they believed might diminish natural resource exploration and development in their province.

Co-operation between the provincial securities administrators and the United States national Securities and Exchange Commission (S.E.C.) has been irregular but has improved in recent years. Perhaps the major problem bedeviling relationships was the high-pressure telephone selling from Canada of speculative mining stocks in the United States market. In many instances, such sales were not contrary to Canadian legislation although they were in breach of the United States securities laws. The American authorities attempted to stem the flood by returning to the sender any mail addressed to Canadian broker-dealers, but this proved a costly system of enforcement. In March 1961, the Broker-Dealers' Association of Ontario bowed to pressure from the provincial Securities Commission and the Toronto Stock Exchange (the latter had threatened to withdraw listing and membership privileges) and notified its members to make no securities solicitations or offerings which did not comply with the appropriate laws of the jurisdiction where offerings were being made. This prevented the broker-dealers from selling stock in the United States unless a prospectus was registered with the S.E.C.—a long, arduous and expensive process—and helped to close the market in other provinces. This virtual exclusion from the American market, where 75% of sales were previously made, was the principal factor in the recent sharp decline in broker-dealer activity.

As already indicated, the securities administrators have quite wide discretionary powers since the laws of all provinces leave the registration

²³ Submission of the Broker-Dealers' Association of Ontario, para. 56.

of dealers in securities to the judgment of the commissions and also give them the power to "suspend or cancel any registration if in their opinion it is in the public interest". The Ontario Act and those modelled on it further provide that the commissions may initiate sweeping investigations where a statement has been made under oath making it appear probable that a person or company has contravened the provisions of the Act or committed an offence under the Criminal Code in connection with a trade in securities. Without the receipt of a statement under oath, these commissions must receive an order from the Attorney General before an investigation can be undertaken, although the Quebec Commission may make an investigation at any time on its own authority. The commissions also have the right to freeze the assets of a person or company which they are about to investigate. While the range of discretion is broad, and must in our view remain so if the investing public is to be protected and quick action taken to safeguard them against a short-lived but virulent deception or market manipulation, it should also be accompanied by an adequate appeals procedure to guard against arbitrary and capricious actions.²⁴

We have already stressed the important role played by self-regulation of the securities industry in Canada, a part made particularly significant by the inadequacies of the under-staffed securities administrations. We believe a substantial measure of self-regulation is vital, both because the industry possesses an intimate knowledge of its own workings and problems that no outside agency can hope to equal and because self-discipline helps to develop a broader sense of public responsibility. In this connection, we have made a number of suggestions which we hope will lead to still further improvement in the industry's general ethics, trading practices, and listing and disclosure standards. With few exceptions, we found the associations' audit and capital standards to be satisfactory, although we believe that other

requirements for entry into the industry at both the firm and personal level could be raised. In this connection, the tightening by the I.D.A. of its control over salesmen and the establishment of an examination to set minimum educational requirements for new entrants is particularly to be welcomed and should be pushed further by all the self-regulating bodies. We also found that in some respects the disciplinary committees of the associations have adequate powers to reprimand, fine, suspend, or cancel the membership of a firm or individual registrant for infractions of their rules, although in others the position is not so clear. In general, however, a firm or individual cannot be put out of the securities business altogether unless the Securities Commission cancels its registration.

We believe the various securities commissions should take a more active role in these matters to ensure that the standards of the self-regulating associations are adequate in all respects and to ensure that they do not become either too lenient or too arbitrary with their members. It is for this reason that we suggest there be appeal provisions from the disciplinary and membership rulings of the self-governing bodies, even though we would not expect to see such rulings set aside unless there were clear grounds for doing so. This would in fact be quite similar to the relationship of the Ontario Securities Commission with the Broker-Dealers' Association of Ontario, whose act authorizes them to make regulations only "subject to the approval of the Ontario Securities Commission". Together, they have established regulations controlling maximum price spreads on option underwritings and escrow arrangements for shares paid for sale of properties or other services to mining and oil exploration and/or development companies. The Toronto Stock Exchange regulations on these matters, referred to earlier, were also developed after discussions with the Ontario Securities Commission. A more active role by the securities commissions would, in our view, put the final responsibility for governing the industry more squarely on their shoulders while still maintaining the many advantages of intelligent self-regulation by the industry itself.

²⁴ The Ontario Securities Act was amended in the Spring of 1963 to improve and extend the coverage of the appeals procedure in the Act.

THE DESIRABILITY OF UNIFORMITY

The desirability of uniform legislation and administration for the Canadian securities industry was stressed by many of our witnesses. Such uniformity would facilitate the preparation and distribution of new issues, the trading of outstanding securities, and the enforcement of uniformly high standards of disclosure, competence and ethics. This might be achieved either by establishing a national agency under federal legislation which would take over the major responsibility in this area from the provinces, or by provincial co-operation to implement a uniform act and regulations across Canada. Neither proposal would achieve its aim unless the legislation were soundly conceived and intelligently enforced by securities commissioners and officials of undoubted capacity, while the latter would also entail the various commissions working very closely together to attain uniform standards of administration and enforcement.

We suggest that the federal government ought to use its influence to encourage the development of high and uniform standards of security legislation and regulation in Canada. Progress by the provinces themselves has been slow and no formal committee has been established by these governments to bring about a uniform securities act. Moreover, even though such a committee was established to draft a uniform companies act and has met intermittently for several years, the two drafts it has produced are still far from being accepted by the governments concerned. This work has been given low priority by many governments and a committee to draft uniform securities legislation would undoubtedly receive the same treatment. We believe that the federal government might provide the needed leadership by establishing a federal regulatory agency which might at first require only registration of issues being distributed interprovincially and internationally. In co-operation with the provincial administrations and the Royal Canadian Mounted Police, it might also enforce the securities fraud clauses of the federal Criminal Code.

In time, the federal agency might open regional offices to facilitate its operations, especially if

some of the provincial governments found it practical and desirable to delegate at least some of their responsibilities to the federal body. While our recommendation therefore requires the establishment of an eleventh regulatory body in the first instance, it is our hope that it will eventually lead to agreement and co-operation which will eliminate much of the existing duplication and lack of uniformity. This might be achieved quickly, especially if high federal standards lead provincial governments to clear automatically issues which have been federally registered. This would give the provincial administrations more time to deal with local matters such as the licensing of security dealers and their salesmen and the registration of issues to be offered only within their own province.

In addition to the uniform high standards that a federal agency would establish within its sphere of operation, it might lead—as did the establishment of the S.E.C. in the United States—to a raising of standards in other jurisdictions. Indeed, as we were told on many occasions, the existence of S.E.C. rules and regulations has played a significant role in raising Canadian standards of disclosure, ethics, and securities regulation generally. Moreover, by establishing closer control over international securities transactions, a federal securities agency might help to attract both the sound portfolio investment from abroad and the expanded capital from domestic sources which will be needed for our continued development. Co-operation with the S.E.C. could also be more readily improved and maintained, a not unimportant consideration in these days when fraudulent securities operations are often carried out on an international scale. Also, for the first time a single agency would be responsible for and interested in the growth, development and efficiency of the whole Canadian securities industry. In this connection, the federal body might be made responsible for collecting data on the industry's general financial and inventory position and on the extent of activity in the secondary market for bonds and in the over-the-counter market for stocks as well as other industry statis-

tics useful to the public, monetary authorities and the industry itself. In brief, we believe establishment of a federal regulatory body working in co-operation with provincial administrations could lead to higher standards, both in the industry and in the securities commissions, to better enforcement of the laws, to improved investor information, and to a reduction in duplication.

The principal arguments against a federal regulatory body are that it might become unduly bureaucratic and costly and that most security regulation problems are only of local or regional significance and best dealt with at the provincial level. However, the industry itself agreed that a single federal agency would be preferable to ten provincial agencies, and there is no inherent reason for believing that a federal agency would lead to costly delays, especially if sufficient latitude were given to its regional officials. As to the second argument, it seems to us that the experience of the S.E.C. and the fact that the Canadian securities administrators have recently found it necessary to increase the frequency of their meetings and tighten their co-operation indicate that a great many problems are more than local. Moreover, speculative capital raised in one province is often spent in another, and we would not consider, for example, that the raising of funds for oil exploration is a matter of interest only to the oil-producing provinces, nor that securities abuses in one jurisdiction are of no concern to the others. We are thus led to the conclusion that, despite the improvements which have taken place in provincial co-operation and despite the devotion, reasonableness and unstinting efforts of some of the securities administrators, the job which remains to be done is likely to be accomplished most effectively if a federal agency takes the lead in setting high and uniform national standards.

We recognize the danger that a federal body might take the image of the S.E.C. which, despite its undoubted usefulness, exercises a highly detailed and comprehensive control over trading in securities in the United States. Indeed, its staff numbers well over 1,000 and it has annual ap-

propriations of about \$11 million, only a little over 30% of which is covered by fees collected.²⁵ However, the S.E.C. was born in the midst of a depression marked by collapsing securities markets in which there had been widespread trading abuses and fraudulent practices. The present Canadian situation is sufficiently different that comparisons are not likely to be fruitful. We hope, therefore, that a Canadian federal agency, supported by the existing self-regulatory associations, would be able to avoid some of the excesses of detail and delay that have been experienced by the S.E.C., particularly in the area of prospectus registrations.

IMPROVING INVESTOR PROTECTION

We have already discussed a number of inadequacies in the existing securities or companies legislation and administration, detailed remedies for which have been discussed by interested parties and outside observers in Canada and other countries. It is not our intention to review all these arguments fully here, but we would like to set out briefly the main areas which seem to us to call for improvement.

(i) *Disclosure and Related Matters*

Standards of disclosure in this country are still generally inadequate. Even in the case of prospectus requirements, where the greatest improvements have taken place, more information should be required on the salaries of executives and material contracts affecting the business, on the names of beneficial owners of 10% or more of the voting stock and how much they own, and on details of executive stock options, bonuses and pension plans. Most important, the financial statements accompanying the prospectus should be in the form normally required by good auditing standards and should contain sales figures. Canadian prospectuses would also be more comprehensible if they were prepared in the narrative style of United States prospectuses rather than in

²⁵ Established by the Securities Exchange Act of 1934 to administer that Act and the Securities Act of 1933, it now administers in whole or part a total of seven acts.

a legalistic manner in which the statutory information is presented point by point in a way which often deters the reader.

The enforcement of "full, true, and plain" disclosure ends in Canada with the securities acts: as representatives of the Chamber of Commerce and the investment industry told us, the provisions of the companies acts are neither so exacting nor so well enforced. In our view, companies should be required under these acts to provide annually prompt and comprehensive information containing sales figures, comparative data going back several years, and information about long-term lease payments and contingent liabilities such as obligations to unfunded pension plans.²⁰ Accounts of subsidiaries should be consolidated, and wherever there are securities of a subsidiary in the hands of the public, a balance sheet and profit and loss statement for the subsidiary should be published. Moreover, corporate financial data should be available, not necessarily in audited form, more frequently than once a year. While we are not prepared to recommend the legal requirement of quarterly reports at this time, such a step may well be necessary to arrive at standards of disclosure already practised in the United States and essential to the development of an informed investing public. These are matters in which the proposed federal agency could play an important and constructive role.

We believe that more stringent disclosure laws are essential if the stock exchanges are to be successful in their campaign to achieve more extensive and frequent corporate reporting in Canada. While the situation is improving, the attitude of too many corporations is that the intelligent and informed investor is a nuisance rather than a partner in the enterprise and that, if necessary, listing on the stock exchanges could be sacrificed rather than provide the full disclosure found in the United States. Given this attitude, and the fears that interim or sales information will be of benefit and interest only to

a company's competitors, some legal sanction is necessary. That full financial disclosure is not harmful or misleading is shown by the fact that virtually all listed companies in New York provide their shareholders with sales and quarterly financial statements and that the 25% of Canadian companies which do so have had a favourable experience with the practice. Quite independently of stricter company laws, we think the stock exchanges should be more insistent on requiring high standards—we cannot believe that all companies whose disclosure practices are inadequate would be prepared calmly to contemplate delisting of their shares. In this connection, the Toronto Stock Exchange's provisions relating to the disclosure of material changes in a company's affairs could usefully be broadened to require more companies to inform their shareholders of such changes. Nevertheless, the requirements of company laws should be actively enforced and their administrators should work closely with the securities commissions and investment community to ensure full and continuous disclosure, to protect the rights of shareholders and to provide shareholders with sufficient information about their rights to enable them to protect themselves. Indeed, it may be found convenient to have the securities agencies act as the enforcement authority.

Requirements to disclose corporate "insider" trading are also extremely weak in Canada. The director or officer of a company is in an advantageous position to use special knowledge of the company's affairs for his own benefit, often to the disadvantage of the shareholders at large, yet the Ontario Corporations Act provides for the disclosure of directors' trading at an annual meeting only upon the request of a shareholder or shareholders representing at least one per cent of the issued capital of the company. This right appears to be little known, is seldom used, and its force is much impaired by the restriction that it can be exercised only once annually. The federal companies act goes further, requiring every director to "furnish annually to the secretary for the information of the shareholders" details of his transactions in the company's shares over the

²⁰ We also recommend that where capital cost allowances claimed for tax purposes exceed those recorded in the shareholders' accounts, the amount of the difference should be stated, both annually and cumulatively.

past twelve months. The phrase "for the information of shareholders" has been interpreted to mean that the information will be available only if requested. This law also prohibits directors from speculating in their companies' shares and provides a penalty for such speculation, which is not, however, defined. In the United States, insiders²⁷ are required to report monthly on transactions in their companies' stock, and these reports are made public; their trading profits from the sale of shares held for less than six months are recoverable by the company; and they are prohibited from selling the stock short. Moreover, a recent S.E.C. report to Congress recommends the extension of these policies to companies whose shares trade on the over-the-counter market.²⁸

The Canadian shareholder is relatively exposed to insider abuse. We recommend therefore the adoption of disclosure requirements similar to those now in effect in the United States but extended to all public companies. These requirements might be included in the securities acts and administered by the securities commissions, although the stock exchanges should take an independent lead in this matter.²⁹ A similar tightening up in the enforcement of stock exchange and securities act provisions with respect to the dissemination of insider tips and rumours could well be carried out. Finally, the law should provide for fuller disclosure of how funds raised for natural resource exploration and development have actually been spent and should provide for express shareholder approval of all contracts with "insiders" or their agents.

²⁷ Directors, officers, and beneficial owners of more than 10% of any class of any equity security of companies listed on an exchange.

²⁸ *Special Study of Securities Markets, op. cit.*

²⁹ The recent report of the Jenkins Committee in the United Kingdom goes further, recommending that directors should be required to notify the company of any of their transactions in the company's shares within seven days of the transaction, the information to be registered and made available to the public; and that a director who in any transaction relating to the securities of his company or any other company of the same group makes use of confidential information that might be expected materially to affect the value of the securities should be liable to compensate a person who suffers from his action.

Another and closely related problem on which we believe some legislation is necessary is that of take-over bids. New management or amalgamation can play an important role in improving the efficiency of Canadian corporations, but if brought about by take-overs there can be undesirable side effects if shareholders are not given the time or information necessary to judge the proposal on its merits. The directors of the company receiving the offer have a duty to protect the rights of all their shareholders in such circumstances, and particularly must be responsible to ensure that insiders do not take advantage of their special knowledge. We recommend therefore, that the companies acts be amended to give statutory effect to these responsibilities along the following lines:³⁰

1. Secrecy should be maintained during the negotiations.
2. There should be no trading by a prospective bidder or by directors or their associates while negotiations are taking place.
3. Shareholders should be informed immediately an agreement has been reached.
4. The directors should satisfy themselves that the bidder can complete the transaction.
5. The directors should make a recommendation to the shareholders and indicate whether they propose to accept the offer.
6. Directors should ensure that all the shareholders are given a reasonable opportunity to consider the offer and that, if less than all shares proffered are accepted, shares are purchased pro rata from all shareholders meeting the offer's conditions.
7. The name of the buyer should be disclosed together with sufficient information about the future prospects of their own and the combined companies (if the offer is not for cash) to enable the shareholder to make a rational decision. This would include information not

³⁰ These recommendations owe much to the voluntary *Code of Procedure on Take-Over Bids*, drafted in May 1963 by the Trust Companies Association of Canada, the I.D.A., and the Toronto, Montreal, Vancouver and Canadian Stock Exchanges.

only about the buyer but about any material change in the company since the last report to shareholders. It should also disclose any special management payments or pensions to be made to directors or officers of the company receiving the offer.

8. The conditions on which the offer becomes binding on the bidder or the conditions on which the bidder has the option of declaring it binding should be stated. If the offer is for all the shares the bidder should also state whether he intends to use Section 128 of the Companies Act (Canada) or one of the corresponding provisions of the provincial acts, where possible, to acquire minority shares.

9. If a commission is being paid in connection with the solicitation of acceptances, its amount should be disclosed.³¹

Another area where Canadian corporations, including mutualized insurance companies, are not required to fulfil their normal obligations to shareholders is in the solicitation of proxies. It was pointed out to us that notification of a shareholders' meeting in Canada all too often is confined to a brief and very general agenda and a request for a proxy signed in favour of the management.³² Generally, no provision is made to allow the shareholder to direct the voting of his shares, either for directors or on particular issues, no space is provided for him to appoint any other person as his proxy, and no information is provided to enable him to form judgments about the matters on the agenda. As a consequence, investors are discouraged from taking a responsible and intelligent interest in their company.

We strongly urge, therefore, that both the stock exchanges and the securities commissions require that proxy material be expanded to include information on the qualifications and financial interests in the company of persons standing for election as directors, including any changes in

their holdings of the company's shares in the previous twelve months. It should also set out the details of important measures to be proposed at the meeting in a full and objective manner. Finally, the proxy form should give the shareholder an opportunity to direct his votes. These provisions are all required of stocks listed in New York and their application in Canada could help to develop a more active and informed body of shareholders.

(ii) *Other Needed Measures*

One of the more glaring deficiencies of securities legislation which has become evident in recent years relates to the solicitation of short-term capital from the public by smaller financial institutions, usually dealing in mortgages or instalment receivables but sometimes in business lending as well. Many provincial securities acts exempt from registration all negotiable promissory notes or commercial paper maturing not more than a year from the date of issue. Moreover, some of these institutions solicit deposits, often offering high rates on these and other short-term liabilities (hence their sobriquet "the eight per centers"). While federal companies legislation prohibits companies chartered under it from engaging in the business of banking, banking has not been given a legal definition; similarly, the comparable Ontario and Quebec laws, as well as those of four other provinces,³³ have nothing to say about the acceptance of deposits or banking. The first step towards stemming abuses by these unregulated companies is obviously to withdraw securities act exemptions from those companies soliciting short-term liabilities in the form of notes from the general public, and at least four provinces³⁴ have recently taken the necessary action. These commissions, with their broad discretionary powers, are thus in a position to demand that such companies seeking registration maintain a reasonable level of capital to assets and of liquid assets to total liabilities and that full disclosure be made to purchasers of their liabilities.

³¹ A discussion and detailed proposals for the regulation of take-overs can be found also in *Notes on Amalgamation of British Business*, prepared by the Executive Committee of the Issuing Houses Association, and the *Jenkins Committee Report*, London, H.M.S.O. Cmd. 1749.

³² Submission of the Security Analysts' Association of Toronto.

³³ Prince Edward Island, Nova Scotia, New Brunswick and Manitoba.

³⁴ Ontario, Manitoba, Saskatchewan and British Columbia.

ties. Other provinces might well follow this lead. Ontario has also recently passed legislation providing for the regulation by the securities commission of companies accepting deposits, other than those already supervised. The securities commission must approve all advertising for deposits, receive quarterly reports from those accepting deposits, and has the right to inspect their books at any reasonable time. The act sets out high liquidity requirements related to the size of the deposit liability. We shall have more to say in succeeding chapters about the regulation of those who engage in the business of banking.

While we did not regard it as within our terms of reference to make a thorough study of the many facets of possible fraudulent or misleading securities activity and are thus not prepared to prescribe in detail on this subject, we did find evidence of some weaknesses in the regulatory framework. One of the principal deficiencies relates to the supervision of securities salesmen dealing with the public who are, with certain exceptions, registered with the securities administrations but who are not closely regulated by them. Indeed, almost anyone without a criminal record has been able to obtain registration and some fringe operators have gained entry to the business. Many mutual fund salesmen have had no experience in the securities industry, are working part time only, and are poorly-trained; moreover, the high rate of turnover of these salesmen has provided a chronic problem for the hard pressed securities administrators. One commission reported to us that the doubling of salesmen's registrations in the two years ending in 1961 was due almost entirely to the heavy influx of mutual fund salesmen.³⁵ During this period the sales agencies of mutual funds had no self-regulating organization. While the self-regulating associations should be required to establish high standards for the enlistment, training and supervision of their sales forces, and we hope the new mutual funds association will do so, there will still be gaps to be filled and overall supervision to be carried out by the securities commissions.

These bodies will require more adequate staffs to do these jobs properly.

Some of the provincial securities laws, most notably that in Ontario, do not require registration of salesmen selling only exempt securities (mainly government issues) presumably on the principle that the quality of the product ensures the quality of the salesmen or at least minimizes the damage he can do. The validity of the principle is not obvious, and at least one known case of fraud has occurred in these circumstances. While Section 19 (3) of the Ontario legislation does provide for the removal of the registration exemption where the person or company has been guilty of acts or conduct not permitted to a registrant, this does not alter our view that the investor would be more adequately protected if all salesmen were registered. We recognize that this would necessitate a change in the Ontario requirement that salesmen must be full-time employees in the securities industry. Many exempt issues are in fact now efficiently distributed in rural areas by the use of part-time, exempt salesmen but this advantage would not be lost if registration were specifically provided for such salesmen.

Selling techniques, particularly the exposure of the public to high-pressure telephone selling by fringe operators, has in the past given the investment industry a bad name. Section 53 of the Ontario Act and similar sections in other provincial laws prohibit salesmen from calling at or telephoning to a residence except when the person being called is a close personal friend, business associate or a customer with whom the dealer or broker—or more usually the broker-dealer—has been in the habit of trading. Such calls are also allowed if a customer has requested information on that specific security in writing. We wish to support the continued need for such legislation, including that aimed at mutual fund salesmen, to prevent the harassment of the public. We would, however, urge the commissions to publish policy statements setting out how they would interpret in practice such phrases as "in the habit of trading".

We have already discussed the need for the stock exchanges to tighten up listing and de-

³⁵ In Quebec registrations grew from 1890 in 1959 to 3757 in 1961.

listing standards to protect both the public and the industry's own reputation. If virtually defunct companies, described as "company shells", remain listed on an exchange, they provide an opportunity for an unlisted speculative company to obtain a listing by merger or acquisition. The latter then issue shares without needing to meet the registration and disclosure requirements of the securities commissions and, sometimes, despite the filing statement requirement, the exchange's own listing standards. The worst abuses may be eliminated by our earlier recommendations that primary distribution through the exchanges be discontinued and that full registration for all new issues of shares be required. We strongly urge, nonetheless, that the stock exchanges require all listed companies to maintain current listing standards of the exchange or be de-listed, and that all listings be reviewed periodically to ensure that these standards are being maintained. Where an unlisted company merges with a listed company the new company should without exception be required to file a listing statement and meet the listing requirements of the exchange. If it fails to do so within a short period of time, it should be de-listed. Rules for the control of mergers have been established by the New York Stock Exchange and these might well be considered by the Canadian exchanges.

Little is known about the extent of market manipulation in Canada and we have not tried to undertake the sweeping and highly-detailed enquiry which would be required to establish the facts, although we have the impression that such activities are carried out by only a small minority of securities dealers. The Criminal Code provides for criminal liability arising from fraud (Section 323), false advertising (Section 306), wash sales (Section 325), bucket shop operations (Section 326), and sales of shares held for customers (Section 327).³⁶ The securities acts and the

by-laws of the Toronto Stock Exchange cover much the same ground. However, only one conviction has been obtained under Section 325 of the Criminal Code, and in this case the accused pleaded guilty. One notable case was twice brought before the courts under this section and on each occasion the jury failed to reach a decision. There have been no charges laid under the relevant by-law of the Toronto Stock Exchange.

The major problems in this area seem to be inadequate policing, perhaps due to under-staffing of the securities administrations, and a reluctance to press charges in view of the difficulty of obtaining convictions under Section 325 of the Criminal Code which, unlike American legislation, requires that the "*intention* to create a false or misleading appearance of active public trading . . ." be proven. We believe the relevant provisions of the Criminal Code ought to be reviewed by the federal Department of Justice in consultation with the investment industry and securities administrators with a view to making the legislation stricter and easier to enforce. As under some provincial laws, the federal authorities might also be granted the power, subject to the proper safeguards and appeal procedures, to freeze the assets of those suspected of fraudulent operations contravening federal securities legislation when such a step is necessary to protect the interests of the public. This provision helped to save some funds for depositors in a recent case of fraudulent "eight per-center" activity.

Another area which we commend to the securities authorities for further consideration is that of regulations governing escrowed shares. These shares are paid by a company to a vendor, usually in exchange for property, although not necessarily so. Such shares are, in the instance of a new issue, required to be placed in the custody of a third party to be released according to the regulations of the securities commission. Their release is normally scheduled according to the various stages of the development of the company, in relation to the sale of treasury shares, or at fixed time intervals. Since the escrowed shares in most cases supplement a cash payment for a property of unknown value to the company, and since the

³⁶ Wash sales are orders to buy and sell placed with the intention of creating a misleading impression of public activity and interest in a security or to establish misleading market prices; bucket shop operations are those in which an agreement to buy or sell shares is entered into without the bona fide intention of executing the order or of making or receiving delivery.

vendor might be an "insider" or obtain effective control through such shares, special care needs to be taken to prevent abuses.

We have made a number of observations or recommendations in other chapters which are relevant to the subject of securities legislation, particularly in Chapter 10 when we noted the importance of the trust companies and authorities ensuring that the standards of investor protection in trust indentures be in no sense lax. We also made a recommendation in Chapter 16 designed to require disclosure when a chartered bank is an underwriter—a requirement now applying to other underwriters. Finally, we noted in Chapter 13 the possibility of conflicts of interest in mutual fund investment management and the problems of "front-end loading"—charging off all expenses in the early months of a long-term savings contract entered into with the buyer. Our view is that the public interest will best be served by requiring full, true and plain disclosure of these and other material facts so that the investor may judge for himself whether each fund's practices are sound. At the same time, the industry should raise its own standards of self-regulation and the securities administrators should take steps to ensure that all salesmen are properly qualified and that improper or fraudulent practices are prosecuted with vigour and dispatch.

Despite the weaknesses which still exist, we have been impressed by the improvements which have taken place in the functioning of the Cana-

dian stock markets and by the responsible attitude shown by the great majority of the securities industry's members in their attempts to raise industry standards. We cannot stress enough the importance of high standards of industry self-government—relating to skills and competence as well as to ethics and financial responsibility—in achieving an informed and increasing body of Canadian investors willing to supply true venture capital to finance the nation's development. We have made a number of recommendations designed to serve this end and hope that they, and an expanded industry program of investor education, will bear fruit in the years ahead.

At the same time, more stringent disclosure and securities laws will be needed to support and encourage these efforts and to ensure that the broader public interest is protected. We have suggested establishment of a federal securities body to work in co-operation with the understaffed provincial administrations in bringing about high and uniform standards of regulation in a more flexible way than its American counterpart, and made proposals for improving existing regulations and standards of enforcement. None of the weaknesses to which we have pointed will be new to the industry and the responsible authorities, but we hope that our attention to them will speed the process of improving private and public regulation which is so vital to the achievement of a satisfactory and soundly allocated flow of Canadian investment funds.

AN APPROACH TO BANKING LEGISLATION

The changes in banking laws we will now recommend, like the various legislative and other recommendations made in earlier chapters, are designed to promote continued evolution of the financial system, to encourage it to be creative and competitive, and to ensure that it is sound. In our view, an appropriate regulatory environment is one which permits quick and efficient adaptation of our banking machinery to the changing needs of borrowers and lenders, while offering reasonable protection against loss or exploitation to those who deal with the banking institutions. At the same time, good banking legislation should also ensure that measures of monetary policy have an equitable and broadly predictable effect on the operations of the institutions concerned, and should encourage the development of effective contacts and consultation between them and the central bank. Finally, the framework of banking law should provide for a fair and acceptable pattern of regulation which does not discriminate among those doing an essentially similar business.

We have explained in earlier chapters that no regulatory framework can protect the investor in financial assets from losses if he is determined to speculate or if he does not investigate the financial position or reputation of the institutions with which he plans to deal. Nor can regulation guarantee that there will never be incompetent, negligent, or even dishonest management in the financial system, unless every transaction were to be investigated ahead of time and our economic

life brought to a complete halt. Nevertheless, we believe the case for appropriate regulation of financial and banking institutions is not now in dispute: the workings of the financial system are complex and not always understood by its customers, and the handling of the public's funds for more or less prolonged periods of time opens possibilities of serious abuse in an unregulated system.

At the same time, we have indicated throughout the report that an effectively executed and well-designed system of regulation need not lead to excessively rigid and detailed procedures which increase the costs and reduce the efficiency and flexibility of the financial system. In our view, the goal of protecting the public against loss can best be achieved with three basic legislative safeguards—adequate disclosure, competent supervision, and legal powers giving the authorities the right to force the correction of unsound or careless practices and to prosecute those engaged in fraudulent or criminal activities. Complete and continuing disclosure of the affairs of institutions should enable the public without unreasonable cost and inconvenience to obtain the necessary information about the reputation and strength of any financial concern, while competent and frequent self-regulation under the ultimate supervision and inspection of government is the best safeguard against an institution becoming insolvent although—of course—not a guarantee that it will not do so.

Given these essential features of any regulatory system, one can take either of two broad approaches to other features of the legislation. Under the first, it would in principle be possible to devise a set of laws defining the markets in which institutions may operate in such a way that the needs of the moment are met and there is adequate competition within and between the various parts of the capital market. This approach puts limits on the types of business which may be conducted, the assets that may be acquired and liabilities that may be issued by any class of institution, and may lay down in fairly tight detail the terms on which even the circumscribed activities may be carried on. The legislation thus formalizes a particular pattern of specialization in the financial system, and involves the risk that in a changing economic environment the financial system will become unduly compartmentalized and will contain pockets of activity which are relatively free of vigorous competition. Even if the legislation is so carefully drawn that such consequences are avoided for the moment, it is certain that the community's needs will change. Although carefully drawn legislation could be modified from time to time, change and innovation will be impeded and institutions will be unable to become more efficient by adding to their services when they could otherwise do so at economic rates. In short, the financial system will not be able to do its job as well as it might. Moreover, if the terms on which some institutions are able to compete for funds are restricted by limits on their borrowing powers or on their assets and earnings, there is an added danger that changes in monetary policy will have a differential impact on their ability to attract funds and to meet the needs of borrowers who rely particularly on them.

We have argued earlier that detailed asset ratios and investment rules do not serve effectively to protect the public which deals with the institutions. It has also been pointed out that the Bank Act—the most effective of our regulatory laws—is relatively free of such restrictions and that those in the Quebec Savings Bank Act

have been whittled down over the years. Indeed, some of the restrictions which remain in the two acts are contradictory, the one limiting mortgage investments and permitting business lending and the other in effect doing the reverse—even though the liabilities of the two classes of institutions are in large part identical. This is not to argue that some guide-lines as to cash, liquidity arrangements and certain types of assets are inappropriate—we will have recommendations to make on this subject later. We are, however, convinced that excessive use of asset ratios and investment rules adds little to the protection of the public and can have serious effects on the adaptability and competitiveness of the financial system. We therefore think it unwise to rely heavily on them.

An alternative approach recognizes the spread of competition and seeks to encourage it. A broader and less restrictive regulatory framework which permits each institution to do the sort of financial business it finds most profitable does not stand in the way of the system's competitive evolution. Nor does it replace legislated specialization with required uniformity. If institutions find that the flexibility stemming from smaller size, special skills, and continuous attention to one particular phase of financial activity gives them an edge on their more cumbersome competitors who have elected to follow the "department store" approach, they are entirely free to continue to conduct business in this manner. Moreover, if the community's needs for a particular type of financial service increase and it becomes attractive for the institutions to devote more resources to meeting them, they are all free to do so. Finally, this wider approach does not mean that the public is less well-protected. It does mean that much depends on the sound judgment of management and the government supervisors, particularly in meeting new developments in financial markets, but if properly conceived and administered it can provide sounder and more effective safeguards than a more detailed and less flexible framework.

Our legislative and other recommendations might well have been different had we found se-

rious "gaps" or deficiencies in the financial system or major evidence of failure to respond to competitive forces and the changing pressure of public demands. Had witnesses argued before us, for instance, that the facilities for export finance or for the provision of credit to consumers or some types of business were so inadequate that major reform was called for to ensure that the development of the economy was not hampered by its financial machinery, our approach might have been different. Convincing evidence of this sort, supported by our own studies, might have led us to recommend sweeping changes in the structure of the financial system, including the establishment of new institutions by private interests or government. We might have been persuaded that government should intervene more directly in financial activities to promote flows of capital to economic uses being neglected by the financial system; such intervention might be carried out by extending government guarantees, introducing subsidy and tax incentive schemes and by regulating the portfolio policies of institutions to ensure that particular borrowers had a captive market to which to turn. The inefficiency and inflexibility of such a system would impose heavy costs, but if the financial system were failing to perform its functions adequately, these costs might well be less than those of failing to take such action.

We have, however, had little evidence of this sort, and in fact the events of recent years have shown the Canadian financial system well able to adapt itself to the changing needs of the community it serves. We have been impressed with the extent to which institutions and markets have responded to new demands within the limits permitted by the laws which govern them, although no arrangement of the financial system can solve all our economic problems. The institutions and markets cannot conjure up goods and services, but can only facilitate their production and assist in allocating them among the multitude of competing demands. This being the case, we cannot expect that all borrowers will obtain the funds they want at prices they like, and it is therefore not surprising that we have heard suggestions

that the needs of some types of borrower have been inadequately met. Well-founded as such suggestions may be, and they have all received serious consideration, it is significant that there were few of them and that they seemed to be directed not so much at major "gaps" in the spectrum of financial markets as at adjustments which might improve existing markets.

We have drawn attention to some of these problem areas in earlier chapters; for example, the difficulties which some small and remote municipal borrowers appear to encounter in attracting institutional funds.¹ However, we attribute this as much to absence of information on the borrowers' status as to biased investment policies. Similarly, it is undoubtedly true that the big mortgage institutions invest more freely in large than in small communities and that mortgage borrowers find it easier to obtain conventional mortgage funds in areas in which local mortgage institutions such as the *caisses populaires* are well established. This is an instance of the important role which smaller institutions with their knowledge of an interest in local situations can play in a balanced financial system, although the banks with their highly-developed branch systems could also play a part if the laws permitted. Despite these shortcomings, the broad statistical and other evidence supplied to us does not support the view that the national institutions follow investment policies which discriminate between different provinces or regions of the country, and many of them make conscious efforts to balance their investments regionally, not least because business considerations dictate that they do so.

It was also noted that some smaller business borrowers, in addition to needing somewhat freer access to medium and long-term finance and equity funds, would be greatly assisted if lending institutions were staffed and organized to offer them business information and management and financial advice as well as funds. There have been some important recent developments in this

¹ It will be recalled from Chapter 4 that in some regions these borrowers are able to attract funds on particularly favourable terms.

area of the market, but we hope to see more and have suggested that the Industrial Development Bank should put more emphasis on its role of advising small borrowers and encouraging private institutions to serve them and rather less on competing actively with private lenders in the field.

In our discussion of the residential mortgage market, we made a number of recommendations designed to free rates in the mortgage market—or at the very least make them considerably more flexible—improve the availability of information to investors and ease the restrictions on institutional lending. This approach should provide a larger and more regular flow of private funds into mortgages on new properties, permit the federal government's gradual withdrawal from direct mortgage lending to home owners and builders and bring the financing terms on new and existing property more closely into line. Taken with the changes already occurring in this market—such as the new arrangements under which loans of up to 80% of the appraised value of existing houses may be obtained at reasonable rates from reputable institutions—and our recommendations about mortgage lending by chartered banks discussed below, these should result in continuing substantial improvements in mortgage facilities in Canada.

In Chapter 13, we also put forward a number of other recommendations affecting the long-term institutions. These were intended to increase their investment freedom and flexibility to meet changing needs, while providing efficient government supervision. Changes in their valuation procedures and in the restrictive clauses of the insurance company legislation, particularly those relating to equity investment, should contribute to this end. The present arrangements for supervision of the insurance industry are satisfactory, but we referred to the need to ensure that pension funds are in an actuarially sound condition and that their investments meet certain broad tests of acceptability. We also drew attention to inadequacies in the regulation of mutual funds and welcomed the recent steps taken by the industry and the securities administrations in this area.

In some areas of the security markets, the problem is also to ensure that the freedom enjoyed in this central part of the financial system does not invite unsound or unethical practices and lead to the subsequent imposition of excessively rigid controls. Thus, we have recommended that securities regulation be greatly strengthened, that the federal authorities take the lead in bringing about inter-governmental co-operation in this important area and that a greater flow of information be provided for the borrowing and investing public. We drew attention to a number of specific abuses which should be controlled, but must emphasize again that success in combating them and ensuring the healthy development of stock and bond markets hinges no less on alert self-regulation than on sound supervision by well-staffed government agencies and adequate public information and disclosure. These measures, and the broader investment powers recommended for financial institutions, should also help to ensure that inadequacies in the financial system do not inhibit Canadians from investing in Canadian industry, although the heavy inflows of capital from abroad in much of the postwar period have resulted primarily from other causes.

Thus while the financial system has developed and changed enormously, there are a number of areas in which it functions imperfectly. In some instances lack of information or knowledge is responsible, in some cases institutional or investor attitudes have been slow to change or insufficiently venturesome, and in still others legislation and supervision have been inadequate. However, the most important source of these defects has been legislative rigidities such as those which prevent the institutions from adequately serving the conventional mortgage market or which inhibit the purchase of equities by life companies.

We turn now to the financial institutions which deal mainly in short and medium-term claims. Within the limits allowed by the legislation, the institutions concerned—the chartered and savings banks, trust and mortgage loan companies, sales finance and small loan companies, credit unions and caisses populaires as well as other institutions

not so easily classified—have diversified their activities and developed new lines of business. In the process, they have come into increasingly close competition with each other and the long-term institutions. Thus in the mortgage market, the chartered banks became an important lender for five years or so after their legislation was changed in 1954. Similarly, the savings banks entered the conventional and N.H.A. mortgage markets following amendment of their legislation in 1948 and 1954, the caisses populaires have become a substantial force in the mortgage market, and more recently some sales finance companies have found it profitable to establish mortgage departments or subsidiaries. These new lenders have at times offered strong competition to the life insurance, trust and loan companies which were formerly the only institutional lenders in this market.

In another lending market, the chartered banks have since 1957 so expanded their personal loan business that they are now the largest participants in a market which the sales finance companies had pioneered. At the same time, credit unions and—to a lesser extent—caisses populaires have catered increasingly to their members' personal financing needs, competing with the finance companies and small loan companies which specialize in cash lending. Because of the inroads of this competition, the finance companies have dramatically expanded their business lending, mainly in medium-term finance where the banks by tradition or as a result of restrictions were not very active. The banks are still the main source of short-term business finance but they have felt the impact of the growing commercial paper market on their lending to large borrowers, including loans to the sales finance companies themselves.

The institutions have also moved more aggressively into each other's borrowing markets. Trust and loan companies, credit unions and caisses populaires have all expanded their deposit borrowing, offering services basically no different from those of the chartered and savings banks. In addition to providing chequable and demand deposit facilities, the trust and loan companies compete for term accounts by offering attractive

interest rates: the banks in turn have responded to this pressure and to that coming from the availability of finance company and commercial paper by raising the rates paid on certain of their notice deposits.

These examples of recent developments reflect a vigorous state of competition which has improved the efficiency of the financial system and provided better returns and lower costs of financial services to the community. At the same time, it should be recognized that this has given rise to problems of inadequate regulation and supervision of some of the deposit-taking institutions. Moreover, the banks have not always competed sharply on a rate basis and they and other institutions have sometimes not developed new borrowing and lending instruments as rapidly as might be desired. In part, as we argued in Chapter 7, this reflects the legal limitations under which the banks are placed in competing for funds because of the existence of the 6% ceiling and the prohibition on investing in conventional mortgages with their relatively high yields. In addition, the market in business term lending, especially to smaller businesses, has been inhibited by these factors as well as by the prohibitions on certain types of business lending applying to other institutions dealing in short-term claims. Moreover, as already suggested, the mortgage market has been significantly affected by the banks' inability to lend.

We would not want to overstate the impact of the legislation in restricting the services provided by the financial system or in lessening competition in some areas of the markets, but it is nevertheless clear that the legislation has had this effect. Indeed, the impact would have been more serious if the banking legislation had been differently interpreted, with the "near-banks" being prevented from soliciting deposits and the banks being prevented both from making personal loans at effective charges of over 6% and from investing in enterprises which make business and mortgage loans at higher rates. The increasing overlapping of functions between the short-term institutions; and the extra competition which it has brought, is a healthy and logical evolution, but it is neces-

sary to revise the legislation designed for an earlier stage in the history of the institutions concerned if it is to be in tune with the facts of market development and the needs of the country. The banks and the so-called "near-banks" now carry on essentially similar business. However, they do so under a variety of widely differing federal and provincial laws which inhibit desirable competition in some respects and prevent the institutions from serving the public as well as they might.

It is worth briefly recapitulating here the present legal and regulatory position in Canada. Section 91 of the British North America Act gives the federal government exclusive power to regulate currency and coinage; banking, incorporation of banks and the issue of paper money; savings banks; bills of exchange and promissory notes; interest; and legal tender. However, there is no definition of banking there or in any other Act, governments having neatly sidestepped the issue by "defining" banks as those institutions listed in Schedule A of the Bank Act and by naming the two savings banks in their legislation. The Inspector General of Banks told us of many legal cases involving the terms "bank" or "banking", but they also fail to provide any precise answer. As far as we have been able to determine, Canada is not alone, for we have not come across an exact definition of banking in the statutes of any country: in view of the difficulties of a narrower definition, some have legislation governing all "credit institutions", including banks.

The basic regulatory pattern in Canada can be traced back almost 100 years to the time when the provincial governments first enacted legislation governing the deposit-taking and related activities of loan and trust companies. The result of the federal government's acceptance of such provincial legislation—partly perhaps from a view that banking was confined to institutions with note-issuing powers—has been the emergence of a mixed and sometimes confused pattern of regulation. The federal government supervises the banks and savings banks listed in its legislation, some trust and loan companies, and certain activities of the small loan companies. Provinces

regulate the other trust and loan companies and all credit unions and caisses populaires other than the recently established national central society (although the caisses tried in the early part of this century to persuade the federal government to extend its regulation to them). Moreover, some financial institutions are only governed by the general provisions of company law, as for example the sales finance and miscellaneous deposit companies. As a result of this rather haphazard approach there are illogical differences in legislation which prevent some institutions from contributing as they might to an efficient financial system and which lead to unevenness and inadequacies in the regulation and supervision of institutions now dealing with a large segment of the public.

IMPROVING THE FRAMEWORK OF BANKING LEGISLATION

Banking can be either a broad term or a narrow one. On some definitions it would embrace virtually all institutions other than the collectors of long-term savings, while on others it would be restricted to those issuing chequable deposit liabilities. However, the essential fact is that the borrowing and lending activities of those institutions which we in Canada happen by tradition to call banks and those of other institutions which we happen to call by other names have become very similar, and in some respects indistinguishable. Any distinction between the different institutions dealing in short-term claims is bound to be somewhat arbitrary, but the legislation must be drawn to reflect the basic reality that many of the activities of these institutions, whatever their names, overlap as they compete for funds and lending business. An efficient banking system, alert to the needs of all classes of borrower and saver and adjusting rapidly to changes in their requirements, will contain a variety of basically similar institutions, some dealing in a fairly broad range of markets and others specializing more narrowly. There must be sufficient competition among these institutions that borrowers and savers have alternatives open to them, but we have argued that

this will best be achieved under a system which applies equitably to all and enforces a minimum of legislated specialization.

The chartered banking legislation is in most respects soundly conceived, but it now applies to too narrow a group of institutions and contains a few restrictions which do not effectively contribute to the protection of the public and hinder the provision of needed financial services to the community. With these exceptions, however, we agree with its underlying philosophy. We therefore recommend that its system of inspection and supervision be extended to a broader group of institutions now doing essentially a banking business, some of them without adequate public safeguards. At the same time, we believe the legislation should leave the banking institutions free to borrow and lend as market forces and their own skills and preferences dictate, subject only to the requirements necessary to ensure the protection of the public and the efficient operation of financial policy. The following two sections discuss the extension of basically uniform banking legislation to a larger group of institutions, and the consequences of removing some of the main restrictions on their business, following which a third section discusses some of the legislative changes necessary to ensure that the banking system remains truly competitive.

(i) *More Comprehensive Federal Banking Regulation*

The difficult and technical question of defining banking, and of drawing the inevitably arbitrary dividing line between banking institutions and others, will be discussed in detail in the following chapter. However, our view is that it should be less arbitrary than the present legislation, which applies only to ten named institutions, and should encompass all financial institutions issuing demand liabilities, transferable and short-term deposits, and other short-term banking claims (subject to limited exceptions to be specified later). It would thus include the present chartered and savings banks, many trust and loan companies, some other deposit-taking institutions and such sales finance companies as issue banking

claims not exempted by the legislation. It would also include the caisses populaires and credit unions, but we propose that it apply only to the central societies for the reasons set forth in Chapter 9.

We have concluded that federal regulation and supervision should apply to all institutions deemed to be banking institutions, and that all institutions not chartered or licensed by the authorities should not be permitted to engage in banking activities. Provincially-incorporated companies desiring banking powers would thus have two alternatives open to them—to apply to the federal parliament for a charter or to apply to the federal authorities for a licence to operate as banks; the latter procedure is used, for example, by provincially-incorporated money-lenders to which the Small Loans Act now applies. Some initial distinctions might be made between the powers of the present chartered and savings banks and other federally-incorporated banks on the one hand and other banking institutions on the other hand. These, however, may well turn out to be transitional, and for the most part both groups of institution would be free to carry on the same range of business and be subject to the same regulation.

An alternative approach would be to make federal regulation voluntary while offering inducements to institutions to submit themselves. Unfortunately, however, those few institutions which are now virtually unregulated are precisely the ones which are likely to remain outside the regulatory framework. In fact, the inducements of coming under good regulation and of using the name "bank" are probably not strong enough to lead all banking institutions to accept federal charters or licences. Many such institutions are already free to undertake most phases of banking business, in addition to some business from which the banks are excluded. They do not feel the need of central bank borrowing privileges because the chartered banks have served them effectively as lenders of last resort; they are unlikely to be attracted by the offer of a federal deposit insurance scheme because most of them believe they do not need it, while those for whom it might in fact

be desirable are quite likely to have their own reasons for refusing it and the regulation it would entail; improved or cheaper clearing arrangements for their deposit accounts might tempt some institutions, but most would no doubt continue to be able to come to terms with chartered banks for this service. Finally, the federal legislation might offer trust, loan and other companies a means of broadening their lending and borrowing powers, but the provinces could extend any powers not specifically declared to be subject solely to the federal authority. Thus while there is some attraction in a voluntary approach it is not likely to improve the present unsatisfactory state of affairs.

Another possibility would be to give the federal authorities standby power to bring the broader group of short-term institutions under regulation at a later date. However, we can see no merit in leaving some banking institutions outside a uniform regulatory framework because the public has thus far suffered only occasional losses. Moreover, the uncertainty which would be created by such an approach might have undesirable side effects and tempt some institutions to disguise their activities in order to avoid regulation. Thus, we conclude that federal regulation should be compulsory for all private institutions doing a banking business and that other institutions should be prohibited unequivocally from operating as banks, that is from accepting funds from the public in demand form or short-term accounts.

Federal legislation and supervision need not, indeed should not, be burdensome. The next chapter will discuss our view of the nature of this legislation, and such matters as the need for capital, cash and liquid asset ratios and their role in ensuring that the banking institutions are soundly run and suitably responsive to monetary measures. Our concern here, however, is with the broader investment philosophy of the banking legislation. The imposition of numerous balance sheet ratios achieves little in the way of protecting the public: ratios drawn broadly enough to allow investment flexibility may be almost meaningless, and those drawn narrowly may impair both competition

and service to the public. The present chartered banking legislation has functioned well without them, while those applying to other institutions like the Quebec Savings Banks and trust and loan companies have had to be gradually whittled down as they became burdensome. We therefore see little advantage in building them into the legislative framework—indeed there might be serious disadvantages in doing so.

(ii) *Interest Ceilings and Mortgage and Other Lending Prohibitions*

The prohibition on conventional mortgage lending by chartered banks and the interest rate ceiling are the most serious barriers to free market forces in the present chartered banking legislation, while the restrictions on ordinary commercial and personal lending by trust and loan companies are the most significant restrictions imposed on other deposit-taking institutions: restrictions on business lending applying to caisses populaires and credit unions are of less importance in view of the unique demands of their members for financial services. We have already pointed out that there is no reason why the investment of a reasonable share of a bank's funds in mortgages should endanger its position and the safety of depositors' funds. At the same time, the entry of the chartered banks into conventional residential lending would do much to improve this part of the capital market: access to mortgage security would enable the banks to improve their service to business borrowers, particularly smaller enterprises. These are weighty arguments for removal of the prohibition.

The 6% interest rate ceiling introduces undesirable rigidity in the financial system and hampers and distorts the working of markets. It also has arbitrary effects on the institutions' competition for business and on their ability to serve the community well which were not contemplated when the ceiling was originally introduced and subsequently amended. We recommend that it be removed regardless of other changes in the legislation. The ceiling stands in the way of flexible lending by the banks in that it frequently prevents them from making loans on which higher rates must be charged to cover administrative costs and risks.

Obviously, this is to the banks' disadvantage; more importantly, however, it discriminates against borrowers such as small businesses which, if they are to obtain funds at all, must turn to other lenders which charge rates well above those the banks would ask if free to do so. As already noted, the banks have only been able to compete in the personal instalment loan market—in which they have substantially improved the facilities and lowered the average cost of funds—because the authorities have accepted what some might argue is a breach of the spirit of the 6% law. This, however, is not an argument for forcing the banks out of this business, but is instead one for amending an outdated law.

The distorting effects of the 6% ceiling have been most acute in periods of credit restraint when the banks have been prevented from raising their rates on loans and deposits in line with market forces. At such times they cannot compete equally for funds and thus have no choice but to resort to arbitrary rationing procedures in their lending. The problem is further complicated by the fact that borrowers tend to press in on the banks because their lending rates remain artificially attractive while others rise. We do not wish to suggest that interest rate freedom would remove the need for some non-price rationing of credit demands—in fact other institutions which are free to adjust their rates also select their investments partly on other grounds—but a free rate structure would contribute to a more rational response to changing market forces.²

There are three possible grounds for maintaining an interest rate ceiling on banking institutions—that it enhances control of the system by the monetary authorities, that it shelters other institutions from undesirable competition and that it

protects small and inexperienced borrowers against exploitation. As we indicated, the ceiling will lead to severe bank rationing of credit if the authorities push market rates above it, but it is doubtful if it is a very useful aid in curbing credit flows and spending. Its main effect is to encourage credit to flow through channels less directly under the influence of the authorities. Moreover, its impact on those with no sources of credit but the banks is blunted by official urging to ration credit to these borrowers less severely than to those with alternative sources of funds. We will discuss the techniques of monetary control more fully in Chapter 22, but it can be said here that the imposition of interest rate ceilings is an uncertain and inequitable mechanism for controlling credit conditions and that there are more suitable ways of curbing bank lending directly if this should prove necessary.

None of the major competing institutions opposed the removal of the 6% ceiling on grounds that it would unduly injure their competitive position; most, in fact, explicitly recommended its removal on grounds of equity. Even if they had argued otherwise, we would not have been inclined to feel that the public interest would be served by sheltering higher-cost lenders from effective competition. Removal of the 6% ceiling would clearly extend competition and over time lead to substantial and desirable changes in banks' lending policies. However, the changes are unlikely to be abrupt or startling, although there would almost certainly be a comparatively rapid "fanning out" of lending rates, with well-secured short-term loans being made at low rates—perhaps lower than at present to meet the money market competition. On the other hand, riskier loans for longer terms would carry rates above 6%, but below those now charged by some lenders. When market rates are high, banks would undoubtedly raise their own lending charges but the force of competition and the higher deposit rates necessary to attract funds would temper the tendency for bank earnings to rise and thus limit the amount of additional business they are able to obtain.

² Interest rate ceilings on deposits, such as are found in some jurisdictions outside Canada, would also limit the ability of the institutions concerned to compete for funds and allow the unregulated institutions to improve their position in the market. They would lead to still further distortions and would play little if any role in ensuring the soundness of the banks. Interestingly, when the interest maximum applying to U.S. time deposits was recently raised, the result was to bring about a fall in mortgage and long-term interest rates because the institutions were able to attract more funds and employed them actively in those markets.

In our view, there is more merit in the argument that the uninformed borrower should be protected against the possibility of exploitation by being charged rates which are out of line with the costs and risks involved. At the same time, the imposition of unduly low ceilings only results in the discouragement of credit flows and drives these borrowers to unregulated and often extremely high-cost lenders. Since the present legislation on personal loan rates is in some respects inadequate, we believe that all cash lenders, not just the licensed small loan companies and money lenders, should be subject to regulations which prevent the charging of excessively high rates but still enable them to earn a reasonable profit. The banks, like other lenders, should be subject to such regulation: our recommendations on this subject are given in more detail in the following chapter.

It has been argued before us that if each institution were free to move into markets from which it has been excluded, the resulting freedom of the chartered banks to enter the mortgage market would give them an overwhelming advantage because of their size and financial strength, their extensive branch systems and their evident interest in expansion. If the present banks were in fact to increase significantly their share of financial business by expansion or by acquisition of existing companies, the financial system might become unduly concentrated and less competitive, thus defeating the main purpose of amending restrictive legislation.

It must first be recalled that the chartered banks have not in fact grown as rapidly as their competitors, partly because of their own competitive attitude and partly because the 6% ceiling, the mortgage prohibition, and—to a much lesser extent—the earnings foregone on required cash and liquid asset holdings have placed them at some disadvantage. The result has been that bank customers and those who might have borrowed from banks have either gone without the funds they wanted or have obtained them at higher rates from other sources. In these circumstances, other institutions have enjoyed the advantage of some protection from bank com-

petition and the community has paid the price of this protection in the form of higher average borrowing rates and lower rates on deposits than might otherwise have prevailed in the financial system as a whole.

We are not persuaded, however, that other institutions have grown more rapidly than banks solely because they have been sheltered from the full force of competition in some areas of their business. A good measure of their success has been due to their own willingness and ability to experiment and innovate, to expand and reorganize their operations, and to enter new markets as circumstances have changed. In spite of restrictions laid on them by law—including for instance those which prevent trust and loan companies from competing with banks for attractive personal lending business and those which prevent finance companies from lowering their borrowing costs by accepting deposit funds from the public—these institutions have found ways of competing successfully. The same management skills will help them to adjust to new competition and take advantage of new opportunities.

Neither they nor the banks would all adjust rapidly or in the same way to the removal of these prohibitions. The bankers told us that they would react in different ways to the removal of present restrictions and that the nature of their business would not change overnight. There would undoubtedly be a desirable increase in term lending to small business secured by mortgages, and the banks would also begin to take on conventional residential mortgages. However, it is unlikely that they would shift the direction of their investment so drastically as to desert their present borrowing customers. Moreover, if they wish to establish a position in the residential mortgage market, they will have to be prepared to continue in it at all times, although naturally the size of their participation will vary. Thus, there are unlikely to be large and disrupting swings in the banks' mortgage lending such as have occurred with their N.H.A. lending when rates have risen above 6%. Quite apart from reluctance to court ill-will by making large and sudden shifts in their lending activi-

ties, it would take time to adjust the training and organization of bank staffs to meet the new opportunities. The problems of making these adjustments should not be exaggerated for the banks have already had experience as N.H.A. lenders and some of them are now moving indirectly into conventional mortgage lending through associated companies. Nonetheless, the present mortgage lending institutions would have some time to prepare for the new situation and those that wished to do so could take the steps necessary to enter fields of business, such as personal and business lending, which have been closed to them.

It must be recognized however that no one can be certain how big or how rapid a readjustment might result from removal of the mortgage prohibition. The economy is certain to benefit from the substantial N.H.A. lending by chartered banks which might follow removal of the 6% ceiling and from increased term lending, particularly to smaller business, which is now impeded by the ceiling and the mortgage prohibition. We have also put forward the view that bank entry into conventional residential mortgage lending would greatly improve the services available in this market. If it is demonstrated, however, that bank lending in this area would have so sudden an impact on other lenders as to hinder the long-run objective of developing a larger group of well-established banking institutions, some temporary limit might be placed on the annual rate of conventional residential lending by the present chartered banks. Any such temporary restriction would have to take account of the position of different banks. For instance an annual limit based on some percentage of assets might restrict small banks to the point that they could not develop a large enough business to justify the costs: the limit might therefore be the larger of some absolute amount or a specified share of assets. It would not be easy to devise a formula which would be flexible enough to allow for changing conditions and requirements in the conventional residential mortgage market from year to year while still providing some shelter to established lending institutions during the transition period.

However, despite our reservations about both the principle and the practicability of such measures, some temporary regulations could be devised if a strong case were made that the long-run competitiveness of the financial system would otherwise be prejudiced.

Regardless of whether or not such transitional devices are used, some banks and other institutions will no doubt find it advantageous to specialize in one or another area where their skills and organization give them particular advantages. Indeed, the partially restricted areas in the capital market created by the present laws have not been without a considerable amount of this sort of diversification. Within the trust company industry, some companies have aggressively competed for deposit balances and short-term funds and developed their money market activities, while others have concentrated more exclusively on longer-term borrowing and mortgage investment. Sales finance companies have in differing degrees moved into such new types of business as capital lending, leasing, commercial financing and factoring as well as personal lending. Credit unions, as we have seen, are developing in a variety of ways according to local circumstances and their own preferences. It is very probable that this trend to a diversity of emphasis will continue. In fact, we would expect it to affect the banks themselves, which have so far all tended to develop along rather similar lines. In changed circumstances, some banks might attempt to offer a "complete" financial service, but others would probably choose to concentrate more of their attention on some lines of business than on others, since a bank which tried to meet the competition in all markets might find itself unable to deal as efficiently with customers as the institutions catering more directly to their individual needs.

It is undoubtedly true that in banking as in other businesses there are advantages in being big and in being able to provide specialized services in many fields. However there are disadvantages as well and we do not subscribe to the view that size alone will give the banks a necessary advantage. Among the chartered banks themselves this has not been the case, for banks have

grown at widely differing rates and the biggest have not always grown most rapidly. Banks, like other organizations, become increasingly difficult to manage efficiently as they grow, since it becomes less easy to reconcile the need for close co-ordination throughout the organization with that of keeping it alert to opportunities and able to capitalize on them quickly. There is undoubtedly an advantage for large businesses in dealing with a bank that is able to handle their credit needs without difficulty. It is our strong impression, however, that the big accounts are not necessarily the most profitable, for they can and do exert considerable pressure in bargaining with the banks. In any event, there is no reason why smaller banks and other institutions cannot compete successfully for all other types of business: indeed, they may handle large accounts by splitting them among a number of smaller institutions.

The revenue and expense positions of the different types of institution give some indication of their probable ability to stand up to new competitive pressures. After covering administrative expenses in 1961, the chartered banks had revenue equal to 2.80% of assets available for deposit interest, taxes, losses and shareholders' accounts. This was just about in line with the position of the caisses populaires, which provide financial services at the lowest overall cost, but substantially below those of trust, loan and sales

finance companies. At the same time, the cost of borrowed funds was substantially lower for banks than for others. Their after tax earnings in relation to assets were lower than those of the trust, loan and sales finance companies, although about the same as caisse populaire earnings. It would appear that the trust and loan companies and the sales finance companies are in a position to meet stiffer bank competition out of their somewhat higher after-tax earnings. The provision of new services would of course raise the administrative costs of the trust and loan companies, but they would also be able to take on some high-yielding assets now denied them.

The impression that other institutions could compete successfully with the banks is strengthened by the fact that the latter's very low interest cost of borrowed funds—1.69% of assets—is a composite for current accounts, on which no explicit interest is paid, personal savings accounts, with an effective rate of 2.32% in 1961, and larger time deposits on which the average rate was close to 4%. For the reasons suggested in Chapter 7, the banks cannot expect to increase their cheapest borrowing—current accounts—very rapidly but will instead have to increase the rates on interest-bearing deposits and, no doubt, devise new types of accounts if they are to keep abreast of the others. It is likely, therefore, that the cost to banks of new funds will be higher relative to

SELECTED FINANCIAL RATIOS

(1961 fiscal years)

	Chartered Banks	Quebec Savings Banks	Trust Cos.	Mortgage Loan Cos.	Caisses Populaires	Sales Finance Cos.
<i>As a percent of total assets:</i>						
Gross revenue.....	5.12	5.16	8.52 ^a	6.79	5.08	9.68 ^b
Salaries and other admin. expenses.....	2.32	1.94	3.42 ^a	1.20	2.19	2.74 ^b
Net.....	2.80	3.21	5.10	5.58	2.81	6.94
Payments on borrowed funds.....	1.69	2.26	3.48	3.58	2.34	3.69
Net profits after taxes and all other charges	.45	.39	.87	1.14	.55	1.39
Return on equity ^c	8.8%	9.0%	10.6%	8.3%	n.a.	11.0%

^aRevenues and expenses associated with the management of estates, trusts and agency accounts are included.

^bNet of certain acquisition costs amounting to 1% to 1½% of assets.

^cGeneral contingency reserves of the chartered and savings banks are not treated as equity in this calculation.

the average shown in the table than it will be for others, particularly as the latter have not always made full use of shorter-term market and deposit borrowing. Moreover, if other institutions begin to offer borrowing facilities comparable to those which now assist the banks in attracting funds, they may expect to broaden their appeal to deposit customers.

After-tax spreads on total assets have been fairly stable for each of the main groups of institution, although there has been evidence of some narrowing recently in the case of trust and loan companies. However, the capital structure of some institutions has been changing, with the banks increasing their capitalization while trust and loan companies—although increasing the absolute amounts of capital—have reduced their equity ratios from the much higher levels which used to be maintained. At present, published shareholders' equity is equal to over 5% of total chartered bank funds, about 10% of trust company "banking" funds and about 15% in the case of the mortgage loan companies. The published rate of return on chartered bank equity has declined from a level of 11%-12% in most of the 1950's to 8.8% in 1961 and 9.9% in 1962, while the return on equity of the trust companies has risen to a level above that of the chartered banks: in the case of loan companies, however, the return is slightly less than that on bank equity. On the assumption that minimum capital ratios no longer apply to trust and loan companies, as we recommend in the following chapter, it would appear that these companies will have no difficulty either in attracting new capital or operating profitably.

These comments have not been intended to suggest that the banks' competitive position would be unimproved by the removal of present restrictions on them and their competitors. Even if the banks respond to interest rate freedom by lowering some interest charges while raising others, and even if they move rather slowly into conventional mortgage lending, there can be no doubt that their rate of gross revenues will increase over time. This will allow them to cover the cost of higher deposit rates which they must

offer in order to attract additional funds. In any case, the banks or any other institutions can only increase their share of the market under competitive conditions by offering some combination of better service, lower lending rates and higher rates on savings than can be obtained elsewhere. The community as a whole stands to benefit from more open competition and it is this advantage rather than the comfort of any group of institutions which should be sought.

(iii) *Encouraging and Preserving a Competitive Banking System*

The vigorous competition which has improved efficiency and initiative in the Canadian financial system has been part of a world-wide phenomenon. There is much to suggest that the trend will continue, not least the growing international competition in all aspects of the financial business. Both money and ideas for its use move about the western world on an unprecedented scale. The steps which we propose towards freeing our institutions from legal restrictions are aimed at sustaining and promoting this competitive atmosphere in Canada.

At the same time, it should be remembered that competition is an uneasy state and that, however much they may thrive under it, businessmen have an inclination to protect themselves against it. We must therefore be alert to developments which would lessen competition or threaten its vigour. There are two areas to which we draw attention and in which we have proposals to make, the first that of agreements which limit competition among financial institutions and the second that of concentration in the financial system.

The most important agreements among the financial institutions are those governing interest rates paid and charged by the chartered banks. Banking is in many ways a highly competitive business marked by continuous efforts to improve the services offered to customers. On the lending side, this competition centres in the amounts and length of credits which individual banks will extend, but it is a fact that here, and in deposit

business, price competition among the chartered banks is severely limited. There is no evidence that they have resulted in excessive charges, but agreements covering borrowing and lending rates are undesirable in any circumstances because they contribute to inflexibility of rates and restrain innovations. As we have noted, both bank deposit and bank lending rates have been fairly rigid, and comparatively unresponsive to changes in credit conditions. The rigid rate structure has also inhibited the banks from venturing out in new directions, as for example in offering a greater variety of personal savings accounts. While these agreements are not the only reason why the banks have lost ground in the competitive race—the ceiling on interest rates and the restriction on mortgage lending are more important—they have probably been a contributory factor. They are thus bad for the banks and for their customers and should be prohibited. This being true, such a prohibition will have an added importance if the 6% interest-rate ceiling is removed.

To the extent that legislation itself can do so, it should prevent the spread of practices and arrangements which inhibit competition, and to this end we believe that certain prohibitions should be written into the law. First, we recommend that all agreements among banking institutions affecting the terms and conditions of borrowing or lending be prohibited unless specifically approved by the Minister of Finance. While it would be quite impossible to prevent members of a close financial community from discussing matters of common interest, the habit of formal or informal agreement can and should be broken. So far as we can determine, rate agreements serve no useful purpose in the public interest. It might be claimed that rates would otherwise be highly variable and uncertain but the evidence in the United States, where such agreements are not permitted, does not suggest that this would be a problem. The main borrowing and lending rates will tend towards uniformity as a result of competition, but we would expect banking institutions to establish a broader range of lending rates and to vary them more frequently in response to

market forces if their decisions are arrived at independently. The prohibition should also cover agreements directly affecting competition for lending business, such as agreements not to take over accounts, which banks have entered into in periods of credit restriction, and other agreements affecting the cost of loans. If these or other agreements were considered to be in the public interest at certain times, they might be undertaken with the express approval of the Minister.

We have no strong views about agreements relating to banking procedures and charges for routine services. They have contributed to uniform standards of service without being used to enforce unduly high service charges, though it is not clear whether the result would be very different in the absence of agreements. However, we would recommend that any such agreements should be filed with the Inspector General, and he should bring to the Minister's attention any instances where he believes that agreements are against the public interest. The legislation should thus grant the Minister power to hold inquiries, to issue stop orders and to take such other action as may be necessary to prevent undesirable agreements.

Our interest in concentration of the financial system relates mainly to its effect on competition. In some areas there is a good deal of concentration: among several of the institutional groups we have considered a few firms do a large proportion of the business. In addition, there are links—increasing notably in the last few years—between institutions in different groups, the most important being those between the chartered banks and the trust companies. We have no evidence to suggest that this concentration has lessened competition and indeed the broad picture is one of increasing competition. Nor can we see any practical objection to the fact that the firms are often large and getting bigger. Sometimes, though not always, units need to be large to be efficient and competitive and to meet the growing forces of competition emanating from outside our borders: this is more true in the developing world of computers and specialists with its high overhead requirements than it has been in the past.

Nevertheless, in the light of recent tendencies a problem might develop. It will be recalled that each of the banks now has a close relationship involving interlocking directorates or effective control or both with a particular trust company. Banks have recently acquired interests in mortgage companies, a mortgage insurance company, an investment trust, and other enterprises making term loans. These ties have developed in part because of the restrictions in the Bank Act which have limited the banks' ability to operate in the developing fields of term and mortgage lending and thus their ability to pay the cost of holding their former share of deposit business. If our proposals are adopted the banks should be less inclined to acquire interests in other financial enterprises.

In view of this, and of the need to ensure that competition is not reduced by existing institutions acquiring control over their competitors and reducing unnecessarily the number of independent companies serving the public, we recommend that the legislation covering stock ownership and mergers be extended and that the law include limitations on common directorates.

The chartered banks—that is to say the present eight banks and any others acquiring full bank charters by Act of Parliament—should continue to be prohibited from owning shares in one another.³ The savings banks and other banking institutions which will be required to obtain a federal banking licence, whatever the legislation under which they are now incorporated or under which they are regulated, should not be permitted to invest directly or indirectly⁴ in the stock of another licensed banking institution or chartered or saving bank unless Treasury Board approval has been granted; a similar rule should apply to chartered bank investments in savings

banks or licensed banking institutions. Moreover, all mergers or asset acquisitions involving any bank on either side of the transaction should also be subject to prior approval by the Treasury Board, as is now the case with chartered banks. Finally, all banks should be prohibited from acquiring more than 10% of the stock of any financial institution not subject to the banking legislation unless Treasury Board has approved the purchase.

Some qualifications to these rules would be necessary. The ownership prohibition should not apply to prevent the incorporation or establishment for reasons of corporate convenience of wholly-owned subsidiary companies carrying on business within a banking institution's own powers. Nor should it apply to ownership in foreign concerns operating outside Canada, or to companies now operating as essentially a single entity which happen to be set up in dual corporate form. In another direction, we would not wish to see the legislation inhibit useful innovations and improvements in the financial system by preventing or unduly restricting the participation of banking institutions in new joint ventures with other businesses or with other members of the financial community. In situations of this kind, of which there have been a few recently, Treasury Board approval might be almost automatically forthcoming provided that the institution concerned has less than a controlling interest. Another exception would relate to smaller concerns. We see no reason why there should be any interference with the development of corporate ties or amalgamations in terms of the public's interest in competition in cases where the combined published equity is less than say \$10 million or such higher figure as may be appropriate. In some parts of the financial business, the development of larger units would improve efficiency and competition, and this process should certainly not be discouraged.

While transactions involving larger institutions would be subject to review in individual cases by the Treasury Board, we do not find it possible to be precise as to the circumstances in which the Board might exercise its power to waive the

³Section 75(2)(c) states that "a bank shall not, directly or indirectly . . . acquire, deal in or lend money on . . . the capital stock of the bank or any other bank."

⁴All limitations on equity investment should apply to investments by any subsidiary or affiliated companies (including parent holding companies), by groups of directors or by the institutions' pension funds: they should also cover any legal arrangements which give a bank effective ownership or equity in the earnings of other banking institutions. They should not, however, apply to E.T. & A. funds of the trust companies.

prohibition. It was, for instance, suggested to us that no institution should be permitted to obtain more than a specified share of its class of financial business by merger or acquisition of other companies. The arbitrary nature of any such rule and the implication that at some definite point size becomes an evil in itself seem to us to militate strongly against the usefulness of this approach, although we would expect the size of the institutions involved to be one of the considerations which the authorities would take into account. Exceptions might be made when one of the parties to an amalgamation is weak and its future doubtful or when it seems likely that an amalgamation or closer link would increase competition in the area concerned. Another consideration might have to do with a desire to keep control in Canada. There are a variety of possible considerations but the prime objective should be to maintain and increase competition in the financial system.

Our chief concern is not in trying to lay down rules by which future proposals in circumstances now unknown to us will be decided. Rather it is to ensure that the Treasury Board, with the advice of the Inspector General and others, have the opportunity to consider proposed changes and extensions in corporate ownership and functions among banking institutions before they become accomplished facts.

In order to ensure that the government has continuing control over developments affecting competition and concentration, the Treasury Board—or an officer or board it appoints for the purpose—should have power to review all situations where ownership links exist. This authority would cover situations resulting from prior decisions to make exceptions to the general rules. It should also empower the Board or its officials to enquire into the transactions involving banking institutions which have occurred in recent years and which would have required approval under the rules suggested above. In cases where the authorities find that the public interest is in jeopardy, they should have the power to apply effective remedies.

We also believe it desirable to clarify Section 75(2)(b) of the Bank Act which prohibits a bank from directly or indirectly dealing in goods, wares or merchandise or engaging in any trade or business. The purpose of this clause is primarily to ensure that banks do not over-extend themselves in fields in which they are not expert but it also acts to prevent extensive banking control of other businesses. We therefore recommend that a banking institution should be prohibited from holding more than 10% of the stock of any non-financial business, with the exception of subsidiaries established for its own corporate purposes such as companies owning the bank's real estate. A bank would be free to hold equity in excess of the limit if it had been acquired as additional collateral for an unsatisfactory loan or in the event of a forced takeover of a firm. As with the present rules regarding acquisitions of real property not needed for the bank's own business, banks should be required to dispose of such equity within seven years. In a related area we believe it unwise and undesirable for the executive officers of banking institutions to serve as directors of other commercial concerns, with the exception of subsidiaries or affiliates, but we do not feel that this practice warrants a legislative prohibition.

Close ties among competing institutions may depend on directorate relationships rather than ownership. We therefore recommend that the present accepted practice that chartered bank directors do not sit on more than one chartered bank board be embodied in the legislation. In addition, no banking institution should be permitted to draw more than one-fifth of its directors from the board, officers, or employees of any other single banking institution.⁵ Present directors would be exempted from this restriction. However, we would not expect any common directors

⁵ In view of the varying use of advisory committees by some institutions, consideration should be given to covering them as well. Exceptions to the general rule would be made in the case of wholly-owned subsidiaries or other special cases: for example, one savings bank has an affiliated trust company which is owned by its shareholders in proportion to their holdings in the bank itself, and we would see no reason why it should be obliged to meet the 20% rule although it is not formally a subsidiary.

to be maintained if two banking institutions came to compete directly with each other in virtually all phases of their business. Banking institutions, like other corporations, benefit substantially from the advice, judgment and business-getting powers of experienced directors. However, directors cannot perform these functions effectively if they are serving competing corporations at the same time, and the net result may be an unnecessary and undesirable reduction of competition.

We have carefully considered the merits of permitting the present chartered banks to apply to the provinces for trustee powers. In view of the fact that there is no evidence of an immediate need for additional trustee facilities, and bearing in mind that the banks did not request this power, we do not recommend that they be authorized in the coming revision of the legislation to seek it. The other legislative changes recommended will give all banking institutions a wide range of common powers and lead ultimately to substantial shifts in the competitive positions of different institutions. We see merit in a gradual approach to the trustee business in these circumstances, since there might be some tendency for the banks to move too abruptly into the business, not necessarily because they believed it profitable to do so, but in order to match each other's services in a rapidly changing financial environment. The other adjustments which we propose are substantial and in our view important and fairly urgent. At some time in the future—probably a later Bank Act revision—it might be appropriate to give the banks power to go into the trust business. Since the trust companies will be free to go into the banking business without restriction,⁶ there would in time be a certain competitive inequity in preventing the banks from entering the trust business but this should not be a serious problem for a while.

We have suggested a legislative framework in which the banks will be freed of burdensome

restrictions and rigidities on their ability to compete for business at home and abroad and in which services provided to the public will not be restricted by the imperfections resulting from compartmentalization of the market. The different banking institutions will still be free to have ordinary business dealings with each other and moreover will have the freedom to undertake new lines of business now closed to them. While there will be no legislation against size as such—which we believe would be undesirable—the institutions will not be free to enter these new fields through purchases or mergers which reduce the number of independent competitors—unless they are able to persuade the Treasury Board that the public interest is served by their doing so. Nor will they be free to acquire or retain unrestricted ownership or directorate connections or engage in uncompetitive practices which could make for too much comfort and too little challenge in the financial system.

FOREIGN BANKING IN CANADA

In part allied to the broad question of the competitiveness of the Canadian banking system, and to the more specific matter of one bank owning another, is the subject of foreign banking in Canada. Despite the fact that Canadian banks do a substantial business in other countries, our banking legislation has never made formal provision for the establishment of agencies by foreign banks. Some representative offices have in fact been set up under names which do not include the word "bank"—which is restricted to chartered and saving banks—and others do substantial business through their representatives who visit Canadian customers. One Canadian bank was established by Dutch banking interests in 1953, and in 1963 a substantial block of its share capital was acquired by an American bank.

We believe that foreign banks should be able to apply for the right to open agencies which would be free to conduct all phases of their business, other than the acceptance of deposits in Canada: this would be comparable to the position of agencies of foreign banks in New York. Such

⁶ We have argued in Chapter 10 that there is no necessary incompatibility between banking functions and trustee powers—indeed, the experience of the trust companies shows the reverse. We did, however, lay stress on the importance of considering the interests of trust accounts first and of putting all securities transactions through impersonal markets.

offices would be confined to the main financial centres and licences would be required. Such licences should be granted only if the foreign bank concerned has demonstrated to the authorities that the additional facilities are necessary to its agency business and will be a useful addition to banking services in Canada. The agencies would report to the Inspector General of Banks who would have the right to examine their affairs to see that they were not engaging in prohibited business or otherwise harming the public interest.

This change in our banking legislation might open the way for some improvement in the banking facilities available to Canadians and ensure that all foreign banks operating in Canada are subject to appropriate reporting to the banking authorities and inspection by them. Finally, and not unimportantly, it might reduce the pressure on foreign banks, particularly American banks, to acquire ownership in Canadian financial institutions in order to promote their business interests in Canada.

The ownership of Canadian banks by non-residents raises other considerations. The shares of all Canadian banks but the one owned by Dutch and American banking interests trade freely on stock exchanges. Ownership is widely distributed and a high proportion is registered in Canada: in 1961, 93% of individual holdings were under 500 shares and 76% of all bank shares were registered in Canada. Ownership of bank stock by individual non-residents does not seem to us much different in its direct consequences than ownership by a similar broad group of Canadian residents. Widespread ownership, whether domestic or foreign, reduces the concentration of shareholder power in this vital sector of the economy.

Ownership of one bank by another is a somewhat different matter. While this has been prohibited among Canadian chartered banks, and should continue to be, no such prohibition applies to the acquisition of part or all of a Canadian bank's capital by foreign banks. Of course, if foreign banking interests want to establish a new bank in Canada, they—like any other group—are required to obtain Treasury Board approval. However, there is no provision for the authorities

to control in any way their buying stock in an existing bank and thus acquiring an established position in the Canadian banking system. Having regard to the large concentrations of economic and financial power which are sometimes centered in large foreign banks, we regard this as an anomaly which should be corrected.

The infusion of new financial initiative and management by foreign banking interests might in some circumstances improve the Canadian banking system. On the other hand, foreign-owned banks—especially those controlled in the United States—might be in a position to obtain the business of firms whose parent companies already deal with the parent bank, without offering better or cheaper service in our banking market. Allocation of business for non-economic reasons might not occur on a wide scale since large firms can and do normally deal with a number of banks and should be well able to resist pressures which are against their interests. Moreover, the Canadian banks being large themselves would undoubtedly resist such a tendency. Nevertheless, some danger of undesirable practices in competing for accounts does exist.

Another disadvantage of foreign bank ownership which has been suggested⁷ is that these banks might be less sympathetic than those controlled in Canada to the wishes and policies of the Canadian monetary authorities. They would, of course, be subject to the same regulation and control as those owned in Canada and would be affected in the same way by policy actions. Nor would they in practice have much easier access to foreign funds in conditions of monetary stringency than the Canadian-owned banks with their extensive operations in foreign markets.

We think a high degree of Canadian ownership of financial institutions is in itself healthy and desirable, and that the balance of advantage is against foreign control of Canadian banks. Further, we have recommended that stock ownership by one Canadian bank in another be subject to governmental control. For all these reasons, we recommend that all direct or indirect acquisi-

⁷ See, for instance, the *Report of the Royal Commission on Canada's Economic Prospects*, page 397.

tions of shares of Canadian banking institutions by foreign banking interests require specific application to and approval by, the Treasury Board. The phrase "direct or indirect" should be broadly interpreted to cover investments by foreign banks or any associated company, directors or officers. Any banking shares beneficially acquired directly or indirectly in knowing contravention of this provision could be made subject to forfeiture to the Minister of Finance. The relevant stock certificates could be cancelled, and stock exchanges and transfer agents notified. New certificates could be issued to the Minister, who should be required to dispose of the shares in the market in an orderly way within a reasonable period of time, the proceeds less expenses and any penalties specified in the legislation being returned to the foreign bank. In cases where this prohibition was unwittingly contravened by foreign banking interests without Treasury Board approval, they should be required to dispose of the shares on Canadian stock markets within a reasonable period of time. In the event that this recommendation is accepted, the prohibition should have effect from the date of publication of this report.

We prefer this direct approach to the question of bank ownership—foreign or domestic—to other devices which might be used, such as cancelling the voting rights of shares in excess of stated proportions in the hands of non-resident banks or imposing a general limit on the size of individual bank stock holdings.

On balance, we do not think this requirement of Treasury Board approval should apply to existing foreign bank holders of such shares. However, the existing holdings of any individual foreign bank should not be increased, unless permission is granted by Treasury Board.

CONCLUSION

Our basic view of the changes needed in Canada's banking legislation can be summarized quite simply. First, the safety of the public's funds and the responsiveness of the institutions to monetary measures is not promoted by the imposition

of extensive asset ratios or prohibitions on banks and their competitors. Provisions of the former type therefore need not be added to the present soundly-conceived Bank Act, while some of its present investment prohibitions should be removed. Secondly, the institutions not presently regulated by the Bank Act have moved increasingly into the banking field while the banks have simultaneously moved into theirs. The result is that the present network of divided regulation over institutions has become unduly arbitrary, inequitable and—in some cases—inadequate. For these reasons, we recommend that the Bank Act apply to a wider group of deposit-taking institutions and that those not covered by the Act be explicitly prohibited from engaging in banking. Finally, we believe that a system in which all similar institutions can compete equally with a minimum of legislative specialization will best serve the needs of the public while retaining the essential ability to adapt to changing needs and circumstances. We have therefore recommended the continuance of certain features of the present Act, and the introduction of others, with a view to ensuring that competition is not blunted by price agreements or the uncontrolled acquisition of competing institutions by their rivals.

In line with this position, we recommend that the powers of banking institutions be broader than any of them exercises under present legislation. They should all be free to invest in N.H.A. or conventional mortgages, subject in their conventional lending to the 75% loan to value limit recommended in Chapter 14. Similarly, they should all be free to make commercial and personal loans without restriction on the security they choose to take, and should all be entitled to the classes of security now available to chartered banks under Section 88 and related parts of the Bank Act, and to any loan guarantees which are offered by the government to the present chartered banks. Other institutions need the same access to security as chartered banks if they are to compete effectively in this area, particularly as the banks' long experience and established position will give them a great working advantage.

Lastly, the ceiling on bank interest rates should be removed but these institutions and all others making small personal loans should be subject to extended and improved uniform ceilings on their charges for this sort of business.

Although the banking institutions will be under uniform legislation, we envisage that the practical effect of these changes will be to create an increased and desirable diversity of activity among them. We have already noted that this has occurred in some areas, and a wider banking community and increased competition should stimulate the process among the present chartered banks and encourage local and specialized insti-

tutions to apply for banking powers. In short, we believe that a modified and extended framework of legislation which allows competitive forces to be fully effective under a suitable and equitable pattern of government regulation will remove some of the inadequacies and rigidities which time and changing circumstances have created in the present basically-sound Bank Act. Additional changes will no doubt be necessary with experience, but we have tried to design our proposals to encourage creative future development by the system itself and to stimulate the provision of improved banking services to the public.

THE SUPERVISION AND REGULATION OF BANKING INSTITUTIONS

We have described the spirit of competitive freedom which we believe should underlie the Bank Act and the changes necessary to give it effect. We turn now to definition of the institutions to which the Act should apply, and to our recommendations about the provisions which the legislation should contain to safeguard the public's funds and the integrity of the Canadian banking system, and to ensure adequate response to monetary measures and appropriate contacts with the central bank.

As already mentioned, the definition of banking institutions is bound to be somewhat arbitrary. Unfortunately, it is unavoidable if one is to legislate for them: even the re-enactment of present laws would continue to set ten institutions coming under the federal power to regulate banking apart from all the others operating under quite different federal or provincial legislation. We have considered the various possible approaches and have concluded that the most meaningful distinction—and the one best supported by such rather unsatisfactory precedents as exist—rests on the character of each institution's liabilities. Whatever else it may embrace, the banking function is generally taken to include the issuing of claims which serve as means of payment or as close substitutes for such money claims. It is because banks issue such claims, which—as we have seen in Chapter 6—have a particularly strong influence on financial conditions and economic activity, that national governments in Canada and elsewhere are granted jurisdiction over them.

It is worth emphasizing that, so far as we are aware, no legislative distinction exists between banks and others because they each make particular kinds of investments. Earlier banking theory did hold that since a bank's funds come predominantly from the issue of short-term claims, they should be invested principally in "self-liquidating" short-term loans. An institution borrowing heavily on a demand basis must pay close attention to the liquidity of its asset portfolio, but the narrow, dogmatic view has been discarded and our chartered banks have for decades safely invested in a broad range of assets, including private and government securities and longer-term loans and—more recently—in insured mortgages. Although the chartered banks have a higher proportion of business loans and securities than most other institutions, they have been moving into longer-term lending and it would be difficult to draw a clear distinction between them and others based on assets alone.

It is true that trust and loan companies may not now make ordinary and personal loans, but their money market, security and mortgage investments are often close substitutes for such loans and are similar in any event to a large part of the assets of chartered and savings banks. Similarly, the sales finance companies—like the banks—now hold substantial cash and liquidity and engage extensively in personal and business lending. Moreover, there would be no logic in attempting to create a distinct category of banks by preventing other institutions from investing funds

borrowed largely on a term basis in short-term assets: to do so would be to invert the reasoning of the old "self-liquidating" theory of bank investment. In any case, the important point for present purposes is that distinctions related to the appropriate investment of funds by banks or other institutions must be drawn from the nature of their liabilities, not the other way around.

Thus in our view the federal banking legislation must cover all private financial institutions issuing banking liabilities: that is, claims which serve as means of payment or close substitutes for them. With certain exceptions to be noted below, it should cover those financial intermediaries issuing claims which may be transferred immediately or on short notice by cheques or on customers' orders. It should also include institutions offering other demand liabilities, since these non-transferable demand claims pose exactly the same considerations of asset management for the institutions and thus raise the same problems with respect to protecting the interests of the public. The institutions can readily make arrangements so that funds held in demand form may not only be withdrawn at any time but may be transferred on customers' orders in much the same way as funds in directly transferable accounts: no meaningful line between the two can therefore be drawn and administered.

Commercial and savings banks also accept substantial amounts of funds in other short-term accounts which are for all practical purposes very similar to the short-term notice accounts included above. In recognition of the basic unity of all such demand and short-term institutional borrowing from the public—and to avoid the disruption which would arise if institutions were tempted to resort to artificial stratagems—we would include among the banking liabilities all term deposits, whatever their formal name, and other claims on institutions maturing, or redeemable at a fixed price, within 100 days of the time of original issue or of the time at which notice of withdrawal is given by the customer. We select this admittedly arbitrary dividing line, which will embrace three-month claims with a margin to

spare, because to draw it closer to the pure demand claims would be unrealistic in view of the very close similarity of the various short-term claims. Although a reasonable definition of banking and savings banking would equally well allow the line to be set beyond 100 days, we do not believe that the definition need be extended in order to achieve an equitable, sound and uniform pattern of banking regulation.

Having drawn the definition broadly, a number of exceptions should be made in order to exclude financial institutions which need not be regulated by the federal authorities. (The banking authorities need not concern themselves with the incidental deposit borrowing and short-term lending of non-financial firms such as some retail stores which hold funds on account for their customers.) First, we would exclude provincial government agencies accepting deposits because their soundness is assured by their parent governments; however, major steps to extend the activities of such agencies or to establish new ones might raise an issue for the federal authorities and lead to subsequent review of this recommendation. Secondly, we would exclude deposit-taking institutions dealing with less than 50 people. Those who supply funds on a private or semi-private basis to the very small financial institutions, whether they specialize in mortgage investment, sales financing or some other kind of business, presumably know the circumstances well, are willing to accept whatever risk there may be and do not need the sort of protection which should be provided to people investing in the liabilities of larger, more impersonal enterprises. However, provision should be incorporated in the legislation to bring such institutions under control if there is evidence that they are in fact obtaining funds from a broader public.

The banking legislation should also exempt institutions which do borrow from a broad public but whose only short-term liabilities are in the form of marketable paper not redeemable on demand or short notice and which sell these liabilities through independent dealers or other agencies subject to the prospectus and other re-

quirements of the securities acts. Such liabilities are similar to those of other companies raising funds in the central securities markets, and the public interest can be safeguarded in such instances by appropriate securities legislation. In order to ensure that no regulatory gaps arise, the securities legislation should require such companies to register all their issues, irrespective of term. Similarly, investment dealers and stock-brokers holding customers' funds or borrowing from others at short-term should not be made subject to the banking legislation since they can be adequately regulated by securities administrations and the self-governing bodies and since their "banking" activities are only incidental to their main functions. In order to ensure that others are not brought unnecessarily under the banking legislation, the Treasury Board should have the power to make other exceptions. However, it should be emphasized that where an institution does come under the banking legislation, all of its intermediary activities—not simply those relating to the issue of the "banking liabilities" defined above—will be subject to regulation by the banking authorities.

We believe that this definition of banks based on the essential banking function realistically reflects the character of our financial system and can be made the basis of uniform, equitable banking legislation. In addition to the present chartered and savings banks, it embraces many trust and loan companies, some other deposit-taking institutions and the caisses populaires and credit unions. We have already noted the special case for leaving regulation of the local caisses and credit unions to the provincial authorities, subject to certain conditions recommended in Chapter 9, but we believe that the central societies should be integrated into the national banking system in order to bring the movement under the common monetary regulation, to encourage its continuing contact with the national authorities and to ensure that sound liquidity standards will be maintained throughout the system. Sales finance companies and others issuing demand liabilities or those redeemable at short notice would also

come within the purview of the Act, unless they chose to confine their short-term liabilities to marketable paper subject to genuine notice requirements.

We have emphasized in the previous chapter that there will continue to be very real differences in the business done by those institutions which will have common powers, and indeed that we expect the legislation to stimulate diversity. Some institutions will thus continue to do a substantial current account and commercial loan business, others may emphasize personal and business lending although financing these activities largely through term deposits, while still others will tend to concentrate on the attraction of term deposit funds for investment in mortgages and securities. In order to avoid creating the false impression that the new legislation had suddenly removed all differences in the particular types of banking business done by the different institutions, we recommend that only the present chartered banks and others incorporated in the same way by Act of Parliament should be entitled to use the name "bank" without qualification. The two savings banks could continue to use the term "savings bank" if they wished, while other institutions licensed under the banking legislation—some of which would be federal corporations and some provincial—should be required to qualify the word bank in their names by the use of other words indicating the character or background of their business. The *caisse populaire* and credit union centrals would of course be free to retain their present names although they might add the word bank if they wished.¹ Such distinctions would serve to differentiate, say, a sales finance company doing a relatively small banking business in connection with its main activities from an institution dealing more widely in banking liabilities.

Whatever distinctions one may wish to draw within the group of banking institutions, they must nevertheless all have the same borrowing

¹ Central societies may wish to re-incorporate federally. If so, special legislation would have to be drafted so that they could retain their cooperative structure in matters such as share capital, voting rights and management committees.

and lending powers. If one tried to set up a scale of broadening powers to be granted institutions as they developed, one would first of all have to grant the "senior" institutions all the powers possessed by any others: otherwise the developing institutions would be in the impossible position of having to drop a substantial part of their business in order to qualify for "promotion". To be specific, if the chartered banks did not have full mortgage powers and were subject to a restrictive interest rate ceiling, no trust or loan company would ever be able to take on chartered bank status.² Taking the other side of the question it is difficult to see what powers enjoyed by the chartered banks can logically be denied to other banking institutions. While there is some justification in the view that institutions which borrow short should not lend an excessive share of their funds at long-term, there is no logic in the reverse proposition. Thus, there is no logic either in prohibiting trust companies and loan companies from making business and personal loans not fully secured by bonds or stocks or in limiting the savings banks' powers in this direction.

It is entirely possible that some trust and loan companies will choose not to take up banking powers and will thus not come under the common legislation. Provincial companies in this position would continue to operate under provincial legislation and supervision, suitably modified to take account of the new federal legislation, and—we hope—to minimize any restrictive asset ratios which serve no purpose in protecting the public. Comparable federal companies not wishing banking powers might choose to reincorporate provincially, but it would probably prove necessary to maintain federal legislation as well. Non-banking trust and loan companies coming under it should be supervised by the Inspector General of Banks rather than the Department of Insurance, since their functions are closer to those of the banking

institutions under the Inspector General's regulation. In any event, all companies which wish to obtain banking powers, including the sales finance as well as the trust and loan companies, would be free to apply to Treasury Board. If they met the requirements, they would be chartered or licensed as banking institutions, but if they did not they would have to withdraw from any banking functions in which they are presently engaged.

Having thus explained the basis of our recommendations, we come to the main provisions which the banking legislation should contain. In most essentials it should be based on the present Bank Act, which has evolved through generations of banking experience. It will be seen that most of our recommendations simply carry forward the careful development of Canada's banking law in already established paths and apply its provisions more generally to the institutions now doing a banking business.

SUPERVISION AND INSPECTION

The essential feature of banking regulation must be good and thorough supervision and inspection such as that which now takes place within the framework of the Bank Act and contributes so much to the soundness of our chartered and savings banks. We have found considerable variety in the quality of supervision of other institutions across the country, and think it essential to act before there is a repetition of the unfortunate experiences of many chartered banks prior to the establishment of good supervision in the 1920's. It is also essential to make this supervision as flexible and free of rigid rules and regulations as possible in order to avoid inducing an unnecessarily conservative approach by our financial institutions to the conduct of their business.

The main job of the government authority must be to stimulate the financial institutions to create their own internal regulation. The authorities should rely heavily on such self-regulation and on the shareholders' or members' audit once satisfactory standards have been developed; such an approach is both more effective and more eco-

² While we have recommended that the chartered banks should not be allowed to apply for trustee powers immediately, we have stressed that this provision should not oblige the present trust companies to discontinue the trustee business when a banking license is obtained. If they wished to apply for a bank charter, the position of the present chartered banks should in equity be reconsidered.

nomical than building up a large and costly staff which would unnecessarily duplicate work already done. To this end, we recommend that the federal authority have power to require regular returns from the institutions under its jurisdiction (as is now the case for the chartered banks and Quebec Savings Banks) and to require that all such institutions maintain adequate internal inspection procedures and be subject to regular outside audit. The auditors should be chosen from a panel of highly qualified auditors approved by the authorities (as in the present Bank and Savings Bank Acts) to avoid any repetition of the hopelessly incompetent auditing procedures which led to the last chartered bank failure in Canada forty years ago. In addition, the federal authorities should have power, as they now do under the Bank Act, to enlarge the outside audit and to require such additional returns as may be necessary to satisfy them that the creditors' and shareholders' position is safe and that the institution is in sound financial condition.

The authorities should have the additional power, now lacking in the Bank Act, to require institutions to take such steps as may be deemed necessary to achieve these aims. Such power should be used only with the express consent of the Minister and should be subject to appeal to the Treasury Board or some other appropriate body. It should be used only sparingly and when attempts to persuade the institution concerned to modify unsound practices have failed. We do not believe that any weakness serious enough to justify the use of such powers should be left for cure merely to the channels of publicity, particularly if a number of institutions are involved, since a prolonged public correspondence might not be concluded before the institutions concerned had become insolvent.

There is no doubt that if the Inspector General discovered such a situation it would not be allowed to go unchecked, despite the lack of formal power to take action, but we nevertheless think explicit provision for dealing with such situations ought to be made in the Act. It is of course vital to phrase this recommended authority in such a way as to leave no doubt whatever that it

relates only to the solvency and soundness of financial institutions. Its use should be accompanied by a formal statement from the supervising authority that it was being invoked for no other purpose, in order to ensure that it does not become a means for the government to direct financial institutions as to the types or amounts of assets that they must hold for reasons unrelated to the soundness of the institutions.

The staff of the Inspector General of Banks would have to be enlarged to undertake these new responsibilities. The cost of supervision should continue to be assessed on the institutions in proportion to their size, or perhaps on the basis of some more equitable measure of the expenses incurred by the supervisor's office. We have considered whether it would be advisable to replace the position of Inspector General by an inspection board of perhaps three officials to provide a more balanced approach to regulation than it might be possible for one man to take. The enlarged staff which will be necessary would doubtless include individuals with particular knowledge and working responsibility for particular groups of institutions—such as the caisses populaires and credit union centrals. Moreover, there are advantages in focussing final authority under the Minister in one individual. The consequences of appointing one or two inadequately qualified men to the board and the danger that institutions would try to play one off against the others might prove serious. Finally, it might be difficult to continue attracting men of the high calibre needed if they were to share responsibility and authority with others. For these reasons we prefer the present arrangement.

The present difficulty mentioned to us by the Inspector General of training successors to the office could be met readily in an enlarged staff by careful selection of personnel. This would overcome a problem which has led to suggestions that the Inspector should be an official of the Bank of Canada where arrangements for training and succession could easily be made. In any case, the Inspector General can do his job best as an independent official not having other interests or responsibilities which may conflict

with his work. For instance, it is easy to imagine circumstances in which the central bank and the Inspector General might have different views about the need for regulation of bank liquidity. Moreover, this change in the location of the office would deprive the Minister of a valued advisor thoroughly familiar with banking matters.

We believe that the present provisions relating to the Inspector General's tenure of office are appropriate. They provide that he holds office during good behaviour, but may be removed from office by the Cabinet for misbehaviour, incapacity or failure to perform his duties properly; he is also outside the provisions of the Civil Service Act although an officer of the Department of Finance. These provisions ensure the independence and freedom from short-run political pressures so essential in this important job.

Competent supervision can provide the public with a large measure of protection in its dealings with financial institutions, although there should, as now, be no warranty that federal inspection would protect depositors or shareholders against losses. Given such regulation, we do not see the need for imposing a general system of deposit insurance, especially as none of the institutions thought it desirable. Responsible elements in the credit union movement have, however, established mutual insurance schemes for the locals, and we have supported this approach by recommending that all such societies belong to a mutual aid fund in order to provide insurance against the risks of their relatively undiversified local business.

THE REGULATION OF SMALL LOAN CHARGES

At present the small loan companies and licensed moneylenders are regulated by the Superintendent of Insurance under the Small Loans Act, which sets limits on the charges they may levy for cash loans. As noted in the previous chapter, we believe that all cash lenders—including the banking institutions—should be subject to uniform regulation, and we think it appropriate that supervision of the amended legislation be transferred to the Inspector General of Banks.

This would leave the Superintendent of Insurance free to concentrate on supervision of the insurance companies and on the presently almost unregulated area of pension funds, a task which involves special actuarial skills.

Although we are not familiar enough with all the details of the small loans business to prescribe the exact provisions of the law, it would be desirable to raise the maximum size of regulated loans from the \$1,500 now in the Small Loans Act to at least \$5,000 in view of the substantial amount of individual borrowing which is now above the regulated limit. The present maximum charges of 2% per month on the first \$300 and 1% on balances between \$300 and \$1,000 are not unreasonable, but the $\frac{1}{2}$ of 1% per month allowed on balances over \$1,000 is too low and simply prevents most companies from lending amounts between \$1,000 and \$1,500. A maximum of 1% on all balances from \$300 to \$5,000 might be more appropriate.³

There are strong arguments for applying the law to all credit transactions, whether cash loans or sales finance credit, but we have not made a thorough study of all the difficulties of doing so and are therefore not prepared to make such a recommendation. However, we do recommend that it be mandatory to disclose the terms of conditional sales as well as cash loan transactions to the customer. In addition to indicating the dollar amount of loan or finance charges, the credit grantor should be required to express them in terms of the effective rate of charge per year in order that customers may compare the terms of different offers without difficulty.⁴ Different

³ The law should also contain features designed to prevent extortionate charges by the writing of several small contracts for under \$300 rather than for one larger sum to which the lower rate would apply. It should also retain the time feature of the present Small Loans Act which provides for somewhat lower rates on longer-term contracts which are cheaper to administer.

⁴ On small contracts the administrative costs are high relative to the amount of credit and inevitably involve high annual rates. It might be advisable to allow a flat amount service charge of, say, \$1.00 per contract and to exclude this portion of the charge from the amount required to be expressed in annual rate form. If this is not feasible, the main purpose of the legislation could be achieved by exempting all amounts under \$50 from its provisions, while preventing evasion through the writing of numerous small contracts below the exemption limit.

methods of calculation yield slightly different results, but there is no reason why disclosure in terms of the effective rate of charges cannot be made according to an agreed formula, and some lenders already do so:⁵ comparability is more important than the precise level. While we recognize that there is great difficulty in calculating the exact charge if use is made of a revolving credit, there is no reason why the customer cannot be shown the effective charge if he follows a typical plan. Borrowers may indeed be more interested in the dollar amounts of the finance charges and monthly payments than in the effective interest rate, but it will certainly not do any harm—and may well do much good—to let them know the effective rate as well. The distribution of approved rate books by the grantors of credit would minimize any difficulties of calculation from their point of view.

Nor are we impressed with the argument that requiring disclosure would raise the cash price of an article, and thus lead to concealment of the effective interest rate. We believe that, as now, effective competition will keep the cash price at realistic levels, but in order to protect against the possibility of merchants using inflated cash prices for the purpose of calculating interest, the Act should contain a provision that the price of the article must be that at which cash transactions are normally carried out. Finally, this legislation should impose stiff penalties for excessive charges or failure to disclose. At the least, the lender should forfeit all principal and interest on the illegal transactions. In addition, fines should be imposed and, as now, the authorities should have the power to suspend the licenses of lending institutions in cases of flagrant violation.

BANK CAPITAL

A number of recommendations relating to bank capital were made in Chapter 7. It was recommended that the restrictions governing the par value of bank stock and the price at which new stock may be issued should be removed. However,

⁵ See, for example, *1963 Annual Report of Coronation Credit Corporation Limited*.

we recommended that the rule requiring that new stock be issued pro rata to shareholders be retained.⁶ In addition, we believe that the general prohibition against lending on the security of bank stock should be retained since the principle of a bank lending against its own equity is unsound. Moreover, unrestricted lending against the equity of other banking institutions could lead to difficulties and to conflicts with the ownership recommendations made in the previous chapter: we would not, however, object to exceptions being made which enable banking institutions to lend against such collateral to individuals in moderate amounts.

We have carefully considered the arguments for requiring banking institutions to keep a minimum equity capital base in relation either to the total of their deposits and other liabilities or to the total risk assets in the portfolio. Whether or not it is required by law, every sound institution must maintain adequate capital and reserves in order to protect its creditors against the losses which may be suffered on investments. Moreover, it is important that capital be large enough to ensure that the shareholders have a lively interest in the sound management of their company. We have, however, come to the conclusion that there is no formula which can take into account all the factors which are relevant to a judgment about capital adequacy. These include: the age and size of the institution and the experience of its management; the term, riskiness and diversification of its assets, including the nature of the collateral held against loans; any indirect or contingent liabilities it may have incurred, including those arising out of trustee business; its investment in fixed assets and its commitments under lease arrangements for office and other facilities.

Thus, other things being equal, a new, small institution needs relatively more capital than a medium sized one, which in turn needs to maintain

⁶ Subject to limitations on the stock-holdings of foreign banks or others arising out of the recommendations put forward in Chapter 18, and to the present exception that shares need not be offered to residents of countries which would require disclosure of information not revealed under Canadian laws.

a higher capital ratio than a large long-established institution. An institution making risky loans to one industry in one location obviously requires more capital than one dealing in relatively riskless assets or with a wider geographical and industrial spread to its activities. The same type of loan may be less risky to one institution than to another, perhaps because the client and his reputation are well-known to that institution, because the type of formal security taken differs slightly, because the institution has special ability to handle such loans, or because the contract provides for faster repayment. An institution which can resort to supplementary pools of capital such as a mutual aid fund may need less equity on its own balance sheet than one which has no such privileges. Institutions with heavy investment in specialized real estate and premises and other fixed assets or with burdensome lease commitments require more capital than those in a different position. Finally, an appropriate ratio of capital to assets in one set of economic circumstances may be quite inappropriate in another, for example if the national or local economy undergoes some structural change. A formula which requires enough capital to meet all possible contingencies at all times may be unnecessarily burdensome, but a lower requirement may be inadequate for some institutions.

In practice, the capital to assets ratio varies widely among institutions, as can be seen from Table 19-1. During the post-war period, the capital

positions of savings banks, trust and loan companies have declined as a proportion of their total and risk assets in consequence of the adjustment from heavy investment in government securities during the war and the relaxation of lending restrictions on the savings banks and the capital requirement for the trust and loan companies. The chartered banks began to raise new capital on a substantial scale following the Bank Act revision in 1954 which allowed them to do so without offering shares to non-resident shareholders; this would have subjected them to foreign requirements regarding disclosure of their inner reserve positions, executive salaries and other matters not made public in Canada. Prior to that time, the banks had allowed their capital to run below the levels they wished to maintain.

The caisses populaires and credit unions and the finance companies have also tended to increase their capital in relation to their assets. These differing trends have brought the capital positions of different institutions closer together than they were, but there are still wide disparities. A similar pattern is shown by comparisons of the ratio of capital to riskier assets, no matter where the line is drawn between "risk" assets and others such as cash and federal government securities. Statistics alone do not fully reveal the true position of an institution: for example, the risk of credit union lending is substantially reduced by their special knowledge of their customers and by the social pressure which a co-operative

TABLE 19-1

CAPITAL AND RESERVES AS A PERCENT OF TOTAL ASSETS^a

	Chartered Banks	Quebec Savings Banks	Trust Companies	Mortgage Loan Companies	Caisses Populaires ^b	Credit Unions ^b	Sales Finance Companies
1946.....	5%	12%	24%	27%	n.a.	n.a.	n.a.
1954.....	6	9	15	17	5	3	13
1961.....	6	8	10	15	5	4	14

^aSpecific reserves are excluded.

^bEquity includes rest account but not undistributed earnings. Most of the latter are due to be distributed to shareholders shortly after the year-end and are not part of the societies' permanent capital.

organization can exert on those who fail to repay. We have not tried to make a detailed comparison with the position in other countries, but figures supplied to us by the Canadian Bankers' Association confirm that similar variations are apparent in other countries; a table showing the capital to deposit ratio of the world's twenty largest banks indicated there was a range of from just over 4% in the case of an English bank to as much as 14% in the case of an American institution.⁷

We conclude, therefore, that the legislation regulating financial institutions should not establish statutory ratios of capital to assets. It should set a relatively low statutory minimum for starting up a banking institution so as not to discourage the entry of smaller specialized companies, but at the same time it should give the Inspector General power—subject to appeal to the Treasury Board—to set such higher requirements as may be necessary to ensure the soundness of enterprises with more ambitious plans, and in particular to absorb the likely expenses of establishment and early operations. This, we understand, is the actual position under the Bank Act at the moment. The present Bank Act requirement that a new bank have paid up capital of at least \$500,000 as a minimum legal requirement seems appropriate. Other qualifications for a charter or incorporation should be kept to a minimum, although we feel the Act should require that applicants be of sound reputation and proven business experience.

Once institutions are operating, the Inspector General should have power to require that adequate unimpaired capital be maintained to ensure that the business is run on sound lines. While avoiding rigid rules, the Inspector General would doubtless develop guide-lines that take into account the loss experience of the institution concerned, general economic conditions in the area where business was done, the practices of soundly-managed institutions and the various factors mentioned above when reviewing the ratios of individual institutions.

One way in which the capital soundness of an institution can be seriously compromised is by the making of excessively large individual loans or investments. We therefore recommend that all loans or investments in excess of 5% of capital and reserves should be reported to the Inspector General.⁸ The banks should not advance or commit in any form more than a reasonable amount in relation to capital and reserves to a single borrower (other than the federal and provincial governments and similar foreign governments). The Inspector General should continue to see that prudent lending practices are followed. The present provision of the Bank Act which precludes individual directors from participating in decisions about credits to them or to enterprises with which they are associated should be retained, as should the requirement that such credits in excess of 5% of the bank's capital be approved by two-thirds of the other directors present. In addition, copies of the relevant statements regarding directors' interests and details of the individual loans or other credits involved should be forwarded to the Inspector General;⁹ similar disclosure arrangements might be made with respect to the total of salaries and bonuses paid to officers and directors.

The Inspector General would thus be put in a position to notice any undesirable trends and should be given the power to require each institution to publish the amounts involved in its annual return to shareholders or more frequently if deemed necessary. In addition, he would of course have the overriding power to require any institution to desist from making any loans to

⁸ Under the existing rules, which should be retained, the Minister also receives copies of the auditors' reports on loans in excess of 1% of paid-up capital and reserves on which losses are considered likely to occur. In addition, the Inspector General—under his general authority to call for information from the banks—obtains reports on all loans in excess of a certain limit set for each bank, and should continue to call for such additional returns if he considers it necessary.

⁹ At present, banks are required to annex the "aggregate amount of loans to directors and firms of which they are members, and loans for which they are guarantors" to their monthly balance sheet returns under Schedule M.

⁷ CBA Submission, Table VIII, page 148.

directors or others if these seemed likely to imperil the soundness of the institution concerned.

INNER RESERVES

The present chartered banks, like other financial institutions and non-financial companies, may set up specific reserves out of pre-tax earnings to write down the value of particular assets to their estimated realizable value; as with other taxpayers, subsequent recoveries in excess of the written-down value of the accounts concerned must be taken into taxable income. The banks, however, may also set up contingency reserves out of pre-tax income to meet unforeseen future losses, the total of these two types of reserve being subject to a limit set by the Minister of Finance.¹⁰ Both the specific and contingency reserves are disclosed to the Inspector General of Banks but are secret in the sense that they are not disclosed to the public or the shareholders. In addition, the chartered banks—and other taxpayers—are not prevented by tax laws from setting up undisclosed reserves from their after-tax income, but the total amount of income tax paid each year must be disclosed.

From the time when rules for the banks' inner reserves were first drawn up in 1944 until 1954, the Minister of Finance allowed whatever specific reserves a bank might reasonably claim plus contingency reserves of up to 2% of Government of Canada, U.S. and U.K. issues issued for a term of one year or more, 3% of provincial securities

and 5% of other investments, of loans¹¹ and letters of credit and of long foreign exchange positions. The rules were changed in 1955 to apply the percentage limits to the sum of specific and contingency reserves and in 1957 to disallow reserves on Government of Canada and provincial securities which were to be valued on an amortized basis; annual changes in these values, and trading profits or losses, must now be taken directly into income.

In 1960, the fixed percentages were replaced by a single variable percentage which changes each year in proportion to changes in all banks' average loss experience over the preceding 25 years. The original base for this calculation was set at 24 times the average 25 year loss experience, which gave a ratio of 4.944% in 1959—close enough to the previous 5% limit to give continuity. Since then, the ratio has declined because the loss experience of recent years has been low relative to that of the earlier years being dropped from the calculation each year: the maximum permitted ratio in 1963 was 3.504% of reservable assets. If the ratio of specific reserves claimed remained unchanged from 1962, the maximum permitted general contingency reserves in 1963 would have been about 2.8%.

There are two major issues to be considered—the extent, if any, to which the right to accumulate untaxed contingency reserves should be granted to banking institutions and the question of the secrecy of reserves. The arguments and precedents in Canada and elsewhere are not conclusive; we have considered all sides of the question carefully and have reached a view, but one which we recognize is a matter of judgment.

There is no question about specific reserve appropriations for probable losses: it is universally recognized as prudent business practice to provide in a reasonable way for such probable future losses and the tax authorities allow such provisions to be deducted from taxable income.

¹⁰ All mortgage lenders, including the trust and loan companies, are entitled under Section 85G of the Income Tax Act to set aside pre-tax income of $\frac{1}{4}$ of 1% of their conventional mortgage portfolio annually to build up a published contingency reserve to a limit of 3% of the portfolio. This provision, and that for the banks, are the only statutory exceptions to the general rule that taxpayers may not set up contingency reserves. However, some features of the regulations respecting the capital cost allowances which can be deducted from taxable income may provide incentives to both financial and non-financial businesses to invest in fixed assets and may thus in some respects be regarded as akin to the incentives provided by bank contingency reserves; the analogy, though, is not one which we would be inclined to push too far.

¹¹ Other than those to or guaranteed by the Canadian, U.S., and U.K. governments, those secured by Government of Canada bonds being purchased on instalment plans and those to or guaranteed by other banks.

It is the question of untaxed contingency reserves which is contentious: those who argue that they are necessary point to their existence in the United States, to the additional inducement which they give to banks to put aside what amounts to additional capital in good times when they might otherwise be less concerned about their capital ratios, and to the effect which they may have in encouraging bank managements to be more venturesome in their lending policy. Those opposed to untaxed contingency reserves point to the English banks (which must pay taxes on their general reserves), claim that good management and supervision will ensure the adequacy of capital and argue that the venturesome lending policies of financial institutions without untaxed contingency reserves indicate that they are not required.

We recognize that this is a matter in which no absolute assertions can be made, but we are of the opinion that the existence of such reserves has contributed to the soundness of the Canadian banking system. We recommend therefore that the right to accumulate such reserves be continued and, of course, extended to all banking institutions. The extent to which they should be allowed to accumulate free of tax should, of course, be limited. The advantage to the institutions lies in the use of the funds that would otherwise have been paid in taxes. Thus, if contingency reserves are taken for illustrative purposes as being \$300 million, the banks have the use of \$150 million that would otherwise have gone to the tax authorities (assuming a 50% corporation income tax). If they earned something over 5% on these funds before taxes, their pre-tax earnings are increased by \$8 million and their after-tax profits are increased by half as much. These figures may be compared to the banks' pre-tax earnings of \$189 million, dividends of \$60 million, and capital of almost \$1.1 billion in 1962. While some have suggested that these extra earnings benefit the depositors and borrowers, the most direct benefit would appear to be to the shareholders.

The present allowable level of untaxed contingency reserves seems adequate to meet extra-

ordinary losses over a period of years. However, post-war loss experience has been low and may well be misleading, and a formula which is based on it may reduce the maximum ratio to unsatisfactory levels. As a result of the changes in the rules and the recent low levels of bank losses, the ratio of reserves to bank loans and municipal and corporate securities has been just about halved over the past decade. In our judgment it would be wise to bring a halt to this process and we therefore recommend the establishment of a fixed ratio for the maximum of tax-free reserves. The level at which this ratio should be set admittedly involves an arbitrary decision. In the United Kingdom where reserves are taxed, there is no limit, while in the United States the limitation is based on a bank's loss ratio over any 20 consecutive years, starting not earlier than 1927. The maximum allowed is three times this annual average, which in practice we understand puts a lower ceiling on large U.S. banks than that applying to the Canadian banks. However, the Saxon Committee, a committee of bankers appointed by the U.S. Comptroller of the Currency, recommended that the maximum be raised to a flat 5% for all banks.¹²

The loss experience of the Canadian banks is naturally relevant in determining the maximum permitted ratio of reserves. In the favourable years since 1950, bank losses on loans have averaged about $\frac{1}{4}$ of 1%, with the peak year being under $\frac{1}{4}$ of 1%. However, this experience gives no real guide as to what is appropriate for emergencies: it may be contrasted with a five year period in the 1930's when losses averaged over 1 $\frac{1}{4}$ % of loans. While such drastic circumstances seem unlikely to recur, it should also be remembered that bank earnings ratios before losses in those years were much higher than they are today.¹³

¹² *National Banks and the Future*, The Report of the Advisory Committee on Banking to the Comptroller of the Currency, 1962.

¹³ Earnings after taxes in those years exceeded losses by \$72 million, but dividends were cut to 60% of their 1929 level and were only maintained at this level through drawing on inner reserves.

The choice of a ratio depends also on whether or not specific provisions are included in the restricted amount. The present Canadian practice of applying a single limit to the combined amount of specific and contingency reserves blurs the real distinction between losses foreseen on particular accounts and the general risks of the banking business. Moreover, it does not allow for differences among banks depending on their current loss experience. We do not favour the American system of setting each bank's maximum independently on the basis of its own earlier loss experience for this can lead to serious inequities as the composition of a bank's business and the quality of its management change through the years. On the other hand, some room for adjustment to a bank's particular circumstances is desirable and the removal of specific provisions from the restricted reserve category—as was formerly the practice in Canada—is the logical way of achieving this. We therefore recommend that this practice be restored and that general contingency reserves be limited to 3% of the assets eligible for reserves, a modest increase from the present level of about 2.8%.

The separation of specific from contingency reserves might pose problems for the tax authorities and the Inspector General, who would have to ensure that excessive specific provisions are not being taken. At present, some banks tend to make rather generous allocations to specifics since it makes little difference how the reserve appropriations are allocated within the combined maximum. The problem, however, also applies to all other taxpayers and should not be insurmountable. Wide swings in the market values of municipal and corporate bonds and in the banks' long foreign exchange positions might also confront the banks with the problem of switching reserves back and forth from the general to the specific category, but this also is a problem which can fairly readily be handled, assuming that the banks will not substantially vary their total reserve provision, except when business conditions or actual or potential loss experience change. If it is decided that these difficulties outweigh the

advantages of treating specific provisions separately, the maximum applying to the combined reserves should be set at not less than 3½%—that is 3% plus the present ratio of specific reserves—and perhaps at 4%. We mention the higher figure because of the desirability of ensuring that banks with above-average loss expectations have the flexibility to make adequate reserve provisions.

Like the question of contingency reserves itself, the issue of their secrecy has been much debated. In the United Kingdom, the Jenkins Committee in 1962 recommended by a vote of 9 to 5 that secrecy be maintained, while in the United States the Saxon Committee recommended full disclosure, a practice now followed in any event by many American banks. In Canada, enquiries by the House of Commons Banking and Commerce Committee in 1944 and 1954 concluded that publication of unexpected and exceptionally high losses in any one year might adversely affect confidence in a bank or even in the banking system as a whole. Thus, there are precedents and experience to support those who argue that secret inner reserves are necessary to reduce fluctuations in published profits, maintain public confidence, and encourage banking managers to take risks which they might be unwilling to assume if they had to disclose the occasional sharp loss which a more venturesome policy might entail. In support of this view, it is also argued that it is more difficult in any event to determine bank earnings than those of other companies since the result of current bad judgments may only become apparent much later.

On the other hand, the views of informed observers and the experience of other financial institutions in Canada and abroad could be cited just as easily to support the opposite viewpoint that rumours can be more dangerous than facts, that the public is well enough informed to accept occasional severe losses as a normal part of any banking business, that the shareholders are entitled to know how their company and its management are performing and, finally, that the discipline of public disclosure is good for management. It is our view that there is no compelling

case against disclosure, and we are satisfied to leave the matter in the hands of the authorities and the shareholders concerned. If a substantial body of shareholders were in favor of such disclosure—and to our knowledge none is—we do not believe it should be opposed by bank management. However, we believe that tax-paid reserves should in any event be incorporated in published shareholders' equity since there is no case for secrecy when inside reserves are in excess of the ratios deemed appropriate by the authorities. Good accounting practice calls for the disclosure of tax-paid reserves on balance sheets and there is no reason why banks or other financial institutions should be treated differently.

Regardless of how the question of disclosure of untaxed reserves is resolved, we do recommend that the loss experience, specific reserves, contingency reserves and tax-paid reserves of all banks combined should be published each year together with an accounting of the changes in reserve accounts. This will give some indication of trends in the business and may serve the useful purpose of destroying some myths about the size of reserves. If publication of individual bank figures is not undertaken, we also recommend that the Minister of Finance should work out appropriate rules to ensure that reserve allocations and drawings are not used to imply an earnings trend contrary to that which might reasonably be deduced by a person in possession of all the facts. If, for example, earnings are down substantially because of abnormal losses or any other factor, the banks should not be allowed to show an increase in published earnings or nominal declines in profits; the important consideration of depositor protection does not justify misleading the shareholder and the public.

Finally, in line with our own view that corporate disclosure generally should be improved, we recommend that bank profit and loss statements be made more informative: they should be required by legislation to provide shareholders with information about the sources of each bank's earnings and the nature of its expenses and other relevant information necessary for the share-

holders to judge the performance of management. They might be similar in form to the present Schedule 'Q' to the Bank Act, though modified if appropriations to inner reserves were not to be disclosed. Moreover, we consider it anomalous that statutory auditors should not be called upon to certify the earnings statement of any financial institution while they do so for other businesses. We have not explored the problems involved in such certification with the accounting profession, but we suggest that the Inspector General of Banks and a committee drawn from the panel of approved bank auditors should study the matter and reach a conclusion as to the feasibility of such certification and the form it should take. This is particularly important in view of the fact that we have recommended the inclusion under the federal act of many financial institutions now subject to differing reporting and disclosure requirements.

Although the case for untaxed contingency reserves for banking institutions rests primarily on considerations of depositor protection, the authorities may wish to extend similar privileges to non-banking institutions such as those trust and loan companies that do no demand or short-term liability business. These companies, like the trust and loan companies which will come under the banking legislation, including its reserve provisions, are now entitled to build up from pre-tax income reserves equal to 3% of their conventional mortgage portfolios. We see no reason to alter this rule, although it might be desirable to adopt the banking regulations for these institutions as well. The rest funds of the central societies of credit unions and caisses populaires should be treated as tax-free contingency reserves subject to the general rules applicable to other banks: local credit unions and caisses, although not coming under the federal legislation, should also receive the same tax treatment.¹⁴

¹⁴ Those now holding rest funds in excess of the limits should be taxed on further increases, but not on any excess they may have carried at the time the legislation comes into force.

CASH RESERVES AND THE CLEARING SYSTEM

As pointed out earlier, every financial institution needs to hold some cash to meet the payment obligations which it may incur in the ordinary course of its business; these may result from withdrawals of cash or deposits by its customers, or purchases of assets by the institution itself. Clearly, any institution which did not keep sufficient cash—or liquid investments or lines of credit with other institutions which are readily convertible into cash—would be unable to meet its obligations and would sooner or later go out of business. In addition to these usual working balances, each institution must keep on hand, or have immediate access to, enough cash to meet any unexpectedly large payment drains. Thus, while only the chartered banks and Quebec Savings Banks are required by law to observe specified cash ratios, all other financial institutions dealing in short-term claims in fact hold comparable cash reserves to meet the needs of their particular business. Table 19-2 shows the actual cash ratios of selected groups of institutions.

Although any banking institution which wishes to remain in a sound condition must hold adequate cash, it is another question whether the regulatory authority should specify a minimum. In the case of capital ratios, we have recommended against the imposition of ratios, and it might be considered inconsistent to do otherwise for cash reserves. If sound management of the institutions and protection of the public were the only considerations, cash ratios in themselves would be of very limited usefulness. An institution can best meet its liquidity needs, whether arising from its having demand liabilities or from the maturing of notice and fixed term obligations, by carrying an appropriate share of readily marketable assets in addition to cash in its portfolio. However, cash requirements also have a place in the system of monetary control—not, perhaps, as crucial a place as some discussion would suggest, but an important one nonetheless.

All institutions are affected by changes in monetary policy regardless of the form and location of their cash reserves. Their experience over long periods and through the cycles of credit policy was described in some detail in earlier chapters which showed that their position depends on their success in competing for business and not directly on whether their reserves are held at the central bank or elsewhere or whether they are maintained at one level rather than another. These points were developed in Chapter 6 and in the appendix to it. Thus, the central bank's ability to influence institutional behaviour and credit conditions does not depend on the imposition of reserve requirements on all banking institutions since it can always take offsetting action to compensate for changes in credit flows arising out of changes in market preferences and institutional competitive positions. So long as the central bank has the ability to alter the terms on which its own liabilities—the ultimate cash in the system—are available and so long as the institutions are free to compete for funds on reasonably equal terms, their reactions to changes in the available supply of central bank cash will spread and reinforce the tightening or easing effect of the central bank's action discussed in Chapter 6.

However, the simple examples given in the earlier discussion also illustrated that the system's response is less certain and predictable if the main banking institutions do not work to known and stable minimum cash reserve positions. Otherwise, the institutions which lose cash may choose to live with lower reserves at least temporarily (or, in opposite circumstances, to hold more cash than usual) rather than make the adjustments in their asset holdings and rate policies which would immediately transmit the effects of monetary policy measures to other parts of the financial system. If the banking institutions do delay, the central bank would have to take further action in order to bring about the change in credit conditions it wishes to achieve. Markets might then react more violently than desired, with the result that large central bank transactions and irregular response by the insti-

tutions could create uncertainty, even confusion, in financial markets. A system of differing ratios, such as that discussed by the President of the Royal Bank of Canada, in which each bank would choose its own reserve ratio and notify the central bank of its decision, might work tolerably well, but the widely differing ratios and changes in them would needlessly complicate life for all concerned.

Absolute certainty of response can never be achieved—indeed it is important that the banking system be able to assist in absorbing temporary swings in the community's financial preferences—but the difficulties can be reduced if the banking institutions work to known reserve positions. In our system, as the Bank of Canada indicated, it would be sufficient if only the present chartered banks were included, for they bulk very large in the central securities markets and are a major factor in the competition among institutions. Nevertheless, we believe that equity among institutions having the same powers dictates that similar requirements should be imposed on all banking institutions so that all are required to hold the same amounts of non-earning assets relative to their different liabilities. Moreover, if the "outside" banking institutions become bigger and move more directly into short-term lending and money market activities, it might become increasingly difficult to maintain firm control over the whole financial system without subjecting them to specific cash ratios.

The existence of minimum requirements, while of itself of minor importance in guaranteeing an institution's solvency, will nevertheless give statutory effect to the working practices of the sounder institutions and improve the practices of others; it will thus contribute to the protection of the public. Finally, although the required cash cannot itself be used to meet liquidity needs (except to the extent that an averaging formula allows an institution to meet the daily ebb and flow of payments) the knowledge that a cash minimum must be observed should lead institutions to carry adequate liquidity to protect their positions. The recent report of the President's Committee on the financial institutions in the United States

laid considerable stress on this role of required cash reserves and the increased power which they give to the supervising authority to insure that sound practices are followed in all aspects of the institutions' affairs.¹⁵

The actual choice of reserve ratios is bound to be somewhat arbitrary, although it would be difficult to devise a system more arbitrary than the present one. Ratios should not be set far above the level which a well managed institution would maintain in any event, and thus the imposition of new requirements should disrupt soundly established institutions as little as possible. However, the ratios must be set high enough to induce the main banking institutions to work as closely as is practical to them at all times.

There is a significant difference in the amount of cash which need be held against different types of liabilities: a ratio appropriate for purposes of protecting the public in the case of banks doing a substantial amount of volatile demand business would be unnecessarily high for those with few demand accounts and more term liabilities of various kinds. In order to meet this difference, we recommend that a higher ratio apply to liabilities which are transferable by cheque or on customers' orders or which are redeemable on demand or short notice at a set price, and a lower one apply to other banking liabilities issued with an original term of one year or less.¹⁶ It will be recalled that in defining banking institutions we included all those issuing demand claims or liabilities maturing within 100 days which are not sold in securities markets through independent investment dealers or other agents. In setting reserve ratios, we move out to one year in order

¹⁵ *Report of the Committee on Financial Institutions to the President of the United States*, Washington, 1963, esp. p. 17.

¹⁶ "Short notice" might be taken to mean a minimum of 7 days. The distinction between under and over one year liabilities is made on the basis of terms at the time of original issue. If one specified remaining term to maturity, long-term liabilities would automatically be subjected to cash requirements as they approached maturity. It can be argued that since all short-term claims are similar, regardless of their original term, institutions should be required to hold reserves against all liabilities with less than one year to run. However, this would complicate matters, without contributing usefully either to the protection of institutional liquidity or to the efficacy of monetary control.

to avoid distortions which would result from attempts to avoid reserve requirements applying only to the shorter-term liabilities. Longer-term liabilities would not be subject to any specific reserve requirement, although needless to say an institution principally doing longer-term business would need to carry some cash for its normal business needs.

We believe it would be appropriate to set a ratio of 8% on demand or transferable liabilities and those redeemable on short-notice. On the other short-term deposits or comparable liabilities of the banking institutions, a ratio of 4%—that now in use in the United States for time deposits—would be adequate.¹⁷ The higher interest which would have to be paid on deposits subject to genuine notice should eliminate any incentive to the institutions to bid for such deposits merely to minimize their cash ratios. However, if any institution tried to attract funds into the low ratio category with promises to waive the notice requirements, the authorities would have the power to apply the higher ratio to such liabilities.¹⁸

The present and proposed minimum ratios of cash holdings to reservable liabilities are given in Table 19-2. Based on these recent averages for each group of institutions, the chartered and savings banks and the caisses populaires will be required to hold less cash than at present, while the 1962 experience of loan companies was just about in line with the requirement. On the other hand, the average cash holdings of trust companies and credit unions tend to run below the requirements.

The small reduction in the requirement for chartered banks results from the fact that their

¹⁷ We stress that the reason for applying a higher ratio to volatile liabilities is not that the authorities need such a ratio for purposes of monetary control. Thus we see no purpose in relating cash ratios to the annual turnover of deposits as has been proposed in some quarters. (The turnover of current accounts is some 40 times that of savings accounts).

¹⁸ Another possibility would be to relate the low cash requirements only to deposits which proved retroactively to have been immobile—presumably by calculations based on the amount of interest actually paid. This, however, seems unnecessarily complex and would involve the authorities in enquiring into the rate structure of each institution for the purpose of making the calculation.

TABLE 19-2
PRESENT CASH HOLDINGS AND PROPOSED
MINIMUM REQUIREMENTS^a

	As a percentage of			
	Demand and short-term liabilities		Total Assets	
	Present Holdings	Proposed Requirements	Present Holdings	Proposed Requirements
Chartered Banks ^b	7.8%	7.7%	7.4%	7.3%
Quebec Savings Banks ^b	9.2	8.0	8.7	7.6
Trust Companies ^b	3.4	6.8	1.7	3.5
Loan Companies ^b	7.8	8.0	1.3	1.3
Caisses Populaires ^c	9.0	8.0	8.4	7.5
Credit Unions ^c	4.3	8.0	3.9	7.2

^aCalculations are based on cash holdings and liabilities at the same dates and thus take no account of the use of a lagged deposit base: if institutions are growing, the amount of cash required will be lower than indicated. The proposed requirements are based on the current structure of each institutional category's liabilities.

^bAverage of 1962 quarter end data. In the case of trust and loan companies December is not included in the calculations because window dressing produces misleading balance sheet data. The amount of trust company certificates and term deposits maturing within a year has been estimated on the basis of the survey referred to in Chapter 10. It is assumed that all chartered bank "other notice" deposits had an original term of less than one year.

^c1961 year end data on a consolidated basis for centrals and locals. Shares are included with deposits in calculating the first two columns.

corporate notice deposits would call for 4% reserves.¹⁹ The present savings deposits which are in practice transferable on demand would require 8% reserves, but banks might reduce their cash holdings further by offering their customers a clear choice between chequable and term or notice accounts. Such reductions in the overall level of bank reserves are desirable since the present 8% is undoubtedly higher than the banks need keep.

Moreover, the possibility of holding a lower cash reserve against genuine term deposits and the absence of a statutory requirement on liabilities maturing in over one year may encourage the banks to consider new longer-term borrow-

¹⁹ Some of these notice deposits have an original term of one year or more but the amounts are not known and all of them are therefore assumed to be for less than a year in the calculations of Table 19-2.

ing and lending markets. Although we do not favour the formal segregation of assets, the lower ratio will make the banks more aware of the natural division in their business which reflects the differing character of the funds employed.

The situations of individual trust companies differ widely, some having substantial demand and short-term liabilities and others raising a high proportion of their funds through longer-term liabilities against which central bank cash reserve requirements will not apply. Given the changing character of this industry's business and considerations of equity vis-a-vis the chartered banks, we do not consider the required shifting of under 2% of assets into cash to be excessive.

So far as the credit unions are concerned, we have already expressed our view that their cash holdings tend to be undesirably low: an increase of the magnitude indicated would thus not be harmful. In any case, the credit unions could lower the effective requirement substantially by enforcing notice regulations on withdrawals of share funds and deposits. The requirements for credit union and *caisse populaire* centrals should be based on the consolidated share and deposit liabilities of centrals and their affiliated local societies. However, there may be technical difficulties in applying the rules which would call for the formulation of special procedures having substantially the same effects as application of the general rules.

Our objective in this admittedly arbitrary matter has been to devise a system which protects the public and ensures responsiveness to monetary control but which is also simple, equitable and does not needlessly disrupt the institutions.²⁰ We believe that the principle of distinguishing between demand and short-term liabilities is sound and realistic. With the object of allowing some day-to-day flexibility and adjusting to the varying state of statistical reporting by different institutions, we also recommend that the requirement

be based, as at present, on average liabilities in a recent period. The use of a known deposit base introduces certainty and—under a system with three ratios (8%, 4% and 0%)—would overcome difficulties arising from shifting of funds from one type of account to another. As we will argue in Chapter 22, the present lagged base does not lead to undue delays in the banks' response or allow the banks to escape the immediate effect of central bank action on their reserves. The question of giving the authorities the power to vary these ratios for monetary policy reasons will also be discussed in that chapter.

We believe that all banking institutions should be required to hold their reserves, other than till money, at the central bank. We do not make this recommendation primarily because the present position poses serious problems of monetary control—it does not—but because we believe this will help to foster improved contacts and working arrangements between the Bank of Canada and the institutions now holding their cash elsewhere. Moreover, we can think of no valid reason why some banking institutions should be required to hold reserves in one form and others not.

This will lead naturally to a desirable change in clearing arrangements. All banking institutions will be able to settle their clearings at the Bank of Canada rather than being required to make arrangements with one of the present chartered banks, although they could continue to do so if they wished. The Bank would thus have to equip itself to act as clearing agent for institutions at the centres where they are not represented, but there would be no need for it to take over the rest of the normal work of routing cheques and other payment items within the private financial system. The clauses of the Canadian Bankers' Association Act which give the Association the right of operating the clearing system should be repealed, and an association of all clearing institutions formed to manage the system and allocate costs equitably among all members in relation to the work done by each. The Bank of Canada as a member of the

²⁰ The Bank of Canada would have to cooperate with the banking institutions in facilitating the transition to the new reserve requirements, but this poses no great difficulty.

association would be paid a fair price for clearing work it undertook for any institution.²¹

We also recommend that there be a statutory prohibition on charges for the negotiation of out-of-town cheques, the actual handling of which does not involve any significant extra cost to the institutions concerned. This change would reduce the disabilities of those institutions not having an extensive network of branches across the country. It is possible, of course, that over the years the payments system may evolve more towards one of credit transfers similar to those in use in many European countries. Under this system, those with bills to pay go to their financial institution and instruct it to debit their account forthwith and to transfer credit to those individuals to whom they owe money. This system, under which every account in the country has a specified number, greatly reduces the paperwork of the financial system, cuts down on float and clearing charges, and ensures that the recipient gets the full amount owing to him. On the other hand, the present cheque system is extremely convenient for the payer and is so well and efficiently established in Canada that it is unlikely to be altered soon.

Regardless of whether these changes are made, it seems to us unreasonable that the chartered banks should have to negotiate all federal government cheques without charge to the authorities. It is true that the banks gain some advantage from government balances maintained with them in the ordinary course of events, although there is no guarantee of this and balances over \$100 million are paid interest at a rate very close to that on treasury bills. The banks calculate that the net cost to them of handling government cheques is about \$7 million a year, but the government argues that this is fair compensation for the

privilege of extending charters to the banks. Nevertheless, we see no more reason for financial institutions to subsidize government than we see for the government to subsidize the institutions.

LIQUID ASSET REQUIREMENTS

The cash which institutions are required to hold will enable them to meet moderate daily swings in settlements within the averaging period, but will not contribute beyond this to the liquidity of their assets. For their own protection and that of the public, the institutions must all have adequate liquid assets to meet more substantial day to day claims against them or to cover persisting withdrawals of funds. In addition to this crucial need for protective liquidity, a well managed institution will want a cushion of liquid assets to give it flexibility to take advantage of attractive lending opportunities when they arise. However, while all institutions must pay close attention to their liquidity positions, their needs differ substantially.

The most important factor influencing liquidity needs is the character of an institution's liabilities. Since demand deposits and similar claims may be withdrawn unexpectedly at any time, they call for greater liquidity in the structure of assets than true notice deposits, which in turn may be more subject to unexpected calls than fixed-term liabilities. Where there are formal notice provisions much depends on the actual practice adopted. If notice is in fact never required, an institution cannot suddenly impose it without exposing itself at the least to considerable ill-will and at worst to a collapse of confidence in its ability to meet its obligations which could set off a crisis in its affairs. (The credit unions, with their special relationships to their members and their tradition of self-help, have more room to manoeuvre in this respect than the other institutions.)

On the other hand, an institution need not keep itself prepared to redeem all its demand liabilities at any time—indeed cannot do so if it is to fulfil a useful function as a financial intermediary. If a major run on a banking institution were to develop, the authorities and/or the other institutions have the means to supply the liquidity needed. If

²¹ Even if the central bank were gradually to assume a larger role in the mechanical job of clearing, and we see no advantage in its doing so, we find it hard to believe that this would enable it to pry into the affairs of individual banks and their customers, as suggested to us at our hearings. (Transcript, page 8256.) Even if the Bank actually wished to do so, the sheer physical job of vetting the millions of items passing through the clearings would preclude it, just as it presumably precludes chartered banks from detailed study of the business of other institutions which now clear through them.

the institution were also in danger of becoming insolvent because of poor investments, the authorities would, of course, also need to intervene to put its affairs on a sounder footing or to wind it up in an orderly manner. In the absence of some major crisis of this sort, however, an institution can normally count on the fact that a relatively small share of its demand obligations will be withdrawn regularly, the rate of withdrawal depending principally on the business habits of its customers and its own willingness to meet the competition from alternative investments. Large institutions operating over a wide area can usually count on a more regular pattern of settlements than smaller ones whose business can be more affected by individual transactions, while an institution with few large accounts relative to its total size is less exposed to sudden withdrawals than one having relatively more such accounts. Thus the need for liquidity in the structure of an institution's assets varies greatly with its particular circumstances.

Moreover, a given need for liquidity can be met in many different ways, for example by the regular flow of repayments from loans and investments which are not themselves marketable. Thus, if most loans are short-term, even if not callable, the institution can count on a more substantial cash flow from repayments than if the bulk of its funds is tied up in long-term loans and investments. Again, however, much depends on actual practice: loans which are nominally short-term may in practice remain on the books for long periods and provide less liquidity than long-term commitments on which there is a regular and dependable flow of repayments. Moreover, short-term investments which lack marketability are in fact less liquid than longer-term securities for which a continuing and reliable market exists.²² Because so many different factors must be taken into account, it is as difficult to prescribe how much of an institution's funds should be invested in specific liquid assets such as callable loans and marketable short-term securities as it is to pre-

scribe common capital ratios. Indeed, circumstances change over time with the development of markets: if secondary markets grow up in assets such as municipal securities and mortgages, or if new discounting facilities are introduced, the effective liquidity of whole classes of assets improves and there is less need to hold other marketable assets.

Taking account of all these considerations, and of the fact that liquid assets which must be held are not in fact a source of usable liquidity, we do not believe that statutory liquidity ratios should be imposed for purposes of public protection by the banking legislation.²³ The public interest will be adequately safeguarded if the authorities keep themselves informed of the circumstances of each institution and have the power to intervene if a particular institution is extending its asset position dangerously or not making adequate provision to meet maturing liabilities. In order to protect the institutions against unnecessary use of this power, any regulations laid down should be subject to appeal to the Treasury Board or some other appropriate body.

We would expect the institutions concerned to support wise supervision in a matter which bears so directly on their own best interests. Indeed, they might well co-operate with the Inspector General of Banks in working out appropriate guide-lines: some institutions have already taken such steps privately within their own associations. We find it difficult to offer any specific advice as to these guidelines or as to the classes of assets which would be included. However, the chartered banks have operated soundly with between 20% and 25% of their assets invested in cash, day and call loans and short-dated federal government obligations. These assets are held against liabilities which are virtually all chequable, a fact which suggests that somewhat similar ratios would be appropriate against demand and chequable liabilities—with somewhat higher ratios being held against current accounts and perhaps somewhat lower ones applying to liabilities redeemable at short notice.

²² The holders may of course consider such readily marketable long-term assets as less liquid if their price has fallen and sale would involve capital losses: the same is indeed true of marketable short-term investments.

²³ The question of giving the central bank the power to impose or alter liquidity requirements for reasons of monetary policy is discussed in Chapter 22.

The experience of institutions dealing more in genuine term deposits suggests that liquidity ratios against such liabilities might vary from as little as 10% to 20%, depending on the various factors affecting their liability and asset structure mentioned earlier. Nevertheless, the supervisory authorities and institutions are in a better position than we to work out appropriate and more precise guide-lines.

CONCLUSION

We have now completed our recommendations for amendments to the Bank Act and the related Small Loans Act. In recommending a broadening of the former's coverage to include all institutions undertaking a banking function and in proposing an increase in the powers of the Inspector General to ensure that sound practices are followed, we have been guided by the desire to establish a more flexible and equitable framework within which the main purpose of the Act—ensuring the continued soundness of the Canadian banking system—can be carried forward along proven paths and adapted to changing conditions. Our recommendation that minimum cash reserve ratios be imposed on all banking institutions, that they vary with the nature of liabilities and that they be held at the Bank of Canada should also serve to encourage sound practices and promote equity among institutions. Moreover, it will foster more contacts and consultation between the authorities and the institutions concerned—on both financial develop-

ments and policy matters—as well as adding somewhat to the predictability of institutional response to monetary measures.

As with the recommendations on the broader investment spirit and provisions of the Act set out in Chapter 18, this regulatory framework has been designed to encourage the financial system to be adaptable and creative within a competitive and non-discriminatory environment in which there will be fewer arbitrary legislative distinctions and prohibitions than are now to be found. In some cases we have suggested putting on a statutory basis effective controls which already exist, while in others our proposals are designed to fill gaps or loopholes in the regulatory framework or to make provision for future developments.

We have also tried to reconcile a broad and equitable national approach with a pattern which allows for the decentralized operation of the financial system, which encourages smaller institutions, and which enables co-operative movements like the credit unions and caisses populaires to be regulated only through their central institutions. The provisions which we have suggested may need to be altered with experience, but we would hope that any modifications would, like the proposals we have just put forward, be viewed in the perspective of the whole financial system. In the ordinary course of events the usual parliamentary review at ten year intervals would probably be often enough to keep the regulatory framework attuned to the needs of the country.

THE OBJECTIVES OF POLICY

We have thus far been primarily concerned with the financial system's role in channelling funds from lenders to borrowers. Yet the freest and most highly competitive of financial markets and the soundest of regulatory frameworks are not enough to guarantee attainment of broader economic objectives such as full employment and price stability. Measurable success in reaching these goals depends upon governments making carefully and consistently co-ordinated efforts to achieve them. We therefore turn to examine the working and effectiveness of various financial policies—with particular stress on measures designed to influence credit conditions. But monetary and debt policies—which are dealt with in Chapters 21 and 22—are only part of a wider policy structure, each component of which has important effects on the others. We have thus found it necessary to examine international financial policy and fiscal policy before we draw together our conclusions as to the factors governing the choice and combination of policies in Chapter 25. It is in this wider context that we deal with the status and organization of the Bank of Canada in Chapter 26.

THE CHARACTERISTICS OF ECONOMIC OBJECTIVES

Any analysis of broad economic objectives and financial policy quickly leads to a fundamental dilemma: society's major goals do not lend themselves to sharp definition, yet policy is likely to

be blurred and aimless if it is not sighted on a clear target. Any extended discussion of economic objectives must therefore avoid the danger of becoming either a carefully contrived model of arithmetic unreality or an eloquent exercise in generalized vagueness. Each segment of the community has its own special interests and sense of what is important and finds it difficult to agree with others on any precise policy goals for society as a whole. The list of economic objectives which emerged from our extensive exploration of the subject with domestic and foreign witnesses was consequently a long one and while there was general agreement that rising efficiency, high and stable levels of employment, price stability and a sound external position could be classed as pre-eminent objectives, there was much less agreement on their specific content or, in some cases, on their priority. Moreover, even such broad economic goals as these do not always receive continuous public support and are subservient to the constantly shifting political philosophy of society. The community may readily enough agree that all Canadians should enjoy the maximum freedom consistent with reasonable equality of opportunity and a fair sharing of national burdens and benefits, but there is no formula for translating such imprecise views into a set of workable economic objectives.

All policy must therefore be an exercise in choice, but the choices are never absolute and the circumstances in which they must be made are continually changing. Goals which may be

easily attained when the world economic environment is buoyant may be impossible to reach when the international climate is less favourable. Similarly, if the country has just gone through a prolonged period of high investment and is suffering from excess capacity, or if attitudes towards work and enterprise have become unfavourable, our economic objectives may become at least temporarily very difficult to achieve. Many factors which influence our economic performance are outside the reach of the policy-makers, particularly those responsible for financial policy—clearly, no amount of monetary ease will cure unemployment owing to a crop failure or to the existence of uncompetitive industries. One would like to have economic objectives precisely stated in order to have a yardstick against which to measure the performance of financial policy. Yet we are convinced that an attempt to establish the appropriate balance of objectives by an unchanging set of rules would lead to unreality and error, particularly in an open and constantly changing society with its many conflicting aspirations.

Having said this, we still believe it vital that the public and the authorities have their objectives clearly in mind and agreed at any point in time. These objectives may not be exactly the same from one period to another, but a consistent policy program cannot be worked out to deal with a particular situation unless it aims at some specific target and its costs and benefits are as carefully calculated as circumstance will allow. If society cannot agree to support a common objective, even temporarily, or if the policies of the authorities are inconsistent and taken with only the vaguest regard to the consequences, the results are bound to be unsatisfactory. The number of people without jobs and looking for work will obviously be higher than it otherwise might have been if the community cannot agree either on the need to combat unemployment or on well-defined measures to remedy it. Our economic performance thus depends on the public giving informed and enlightened support to the objectives of the time, on the political authorities exercising leadership to bring about agreement on major economic

goals, and on the policy-makers having a consistent and carefully-calculated program to achieve these aims.

A REVIEW OF OBJECTIVES

We believe that Canadians would now agree that the following four very broad economic objectives should be pursued by the authorities and the nation generally:

- (a) Rising productivity;
- (b) A high and stable level of employment;
- (c) Stable prices;
- (d) A sound external financial position.

Rising productivity is not, of course, an end in itself but a means of improving the economic welfare of the nation. If it is coupled with high employment, national output will grow, and the country may devote this gain in well-being to a higher standard of consumption, to increased leisure, or to expanded investment at home and more assistance to the undeveloped nations. Whether consumed or invested, enjoyed at home or given away, the rising incomes of a nation becoming steadily richer mean that its citizens have more choices open to them than one which is poor, stagnant, or declining. How wisely the fruits of this progress will be used is another question. We were urged by different witnesses to stress that increases in particular kinds of expenditures should be regarded as prime objectives of policy: some urged that more resources be devoted to schools, roads, or housing; others emphasized consumption or welfare payments; and still others private investment or the development of export and import-competing industries. Society will wish to resolve these many conflicting claims to scarce resources—for social capital, private investment, or consumption—in different ways at different times, and this will lead to policies designed to stimulate one kind of output rather than another. However, too much interference with the normal incentives which cause free markets to change their output in response to changing tastes and technology, or too much attention to highly specific subsidiary goals, is

likely to impede growth. In general, the more successful we are in achieving our broad objectives for the economy as a whole, the greater will be the opportunity to meet the special needs of individual segments of it. In particular, a satisfactory rate of overall growth stemming from rising productivity and high employment will make it easier for industries which are declining relatively or absolutely to adjust their positions, for labour and capital to find new and profitable employment, and for the nation to extend any desired support to those left behind by the forces of progress.

Growth stemming from rising efficiency must be distinguished from the once-for-all gains that can occur from drawing more people into the labour force, from reducing unemployment, or from lengthening working times. Some would add that it is a national objective to encourage national expansion through immigration, but however measured, growth, if it is to be strong and sustainable and not liable to come to an early end, cannot be based on wasteful expenditures. Rather, it must be primarily dependent on continuing adequate levels of investment—in human and social capital as well as in business and consumer assets—on advances in productive techniques which combine labour, management and capital more effectively, and on improving the quality and enterprise of the working population generally. Such increased productivity and competitiveness enable an increased output of goods and services to be realized from each unit of input.¹ If productivity is rising rapidly and if the level of employment is kept high and stable, total national output will show satisfactory gains. Since 1957, both productivity increases and the level of employment have been unsatisfactory.

Unemployment is universally recognized as an economic problem. Success in meeting the objective of promoting desirable levels of employment can therefore best be measured not by total

employment (which may vary with immigration, population trends, and the number of people wanting to work) but by the proportion of the labour force which is unemployed and genuinely seeking work.² As with the productivity objective, high and steady levels of employment are not ends in themselves but means of enhancing economic, social, and individual well-being and of offering reasonable opportunities to all who wish to take advantage of them. There is no intrinsic merit in drudgery and even less in employing half the population to dig holes and the other half to fill them in. What we seek in espousing the objective of high employment is, of course, the removal of the material and psychological distress of the unemployed and avoidance of the loss of production which unemployment involves. If sufficient productive employment opportunities are available, the country as a whole will enjoy higher real incomes per person, a larger national output and a climate more favourable to efficiency and growth.

The objective of stable prices too, while desirable for its own sake, is also important as a means to a wider end. A cumulative and pronounced rising or falling trend in the *general* level of prices can be socially and economically disrupting, although prices of individual goods and services, and financial assets should move freely because it is through such *relative* price movements that most of our resources and expenditures are allocated. While studies carried out for us confirm that the hardship wrought by inflation falls mainly on older people, those living on fixed incomes and some categories of lower income wage earners, it is clearly an important objective of policy to protect these groups against a discriminatory erosion of their living standards from which they have no adequate means of protecting themselves. Unemployment and infla-

¹ Perhaps the best indicator of the real output of the economy (the value of production corrected for price changes) is the series "gross domestic product at factor cost", while the most suitable measure of input appears to be manhours of labour, although statistics on hours worked outside the manufacturing sector are not yet adequate.

² The D.B.S. series "unemployment as a per cent of the labour force" appears to be a broadly accurate gauge of the unemployed, despite the fact that it may include a few people who have no intention of looking for jobs. Nor is there any reason to suspect that it distorts the trend of unemployment. This is especially true if the index is corrected for seasonal variations.

tion may each affect only a small part of our society—but both can destroy savings and morale in ways which the country as a whole cannot ignore. Moreover, rising prices can weaken real economic growth by undermining the system of fixed value contracts on which efficient business is founded, by generating a fear of long-term saving and lending commitments, and by diverting real resources into unproductive and inefficient channels as individuals and businesses seek to escape inflation's harmful effects. Inflation may also proceed more rapidly at home than abroad, thus discouraging both Canadians and foreigners from buying our output and frustrating efforts to maintain desirable levels of productive employment. A climate of continuous deflation is even more unlikely to lead to the realization of the goals of employment, efficiency, and a sound international economic environment.

We received a suggestion that the best measure for judging the stability of prices is the wholesale price index of commodities. Yet if prices of the goods-producing industries never fall because productivity gains are fully absorbed by increased wages and profits, the resulting pressure on wages in the service industries where productivity gains are smaller would be almost certain to lead to higher prices in this sector. The result would be a steadily rising consumer price index. Moreover, our international competitive position would be undermined if other countries kept final prices stable and allowed productivity gains to be shared between labour, management, and the community generally. Nor is the wholesale price index a particularly accurate measure of price trends in the economy as a whole. We believe that the consumer price index is a reasonably reliable indicator of final prices, although a study carried out for us showed that it had a slight tendency to overstate price increases because of the difficulties of measuring quality changes, improvements in services, and related matters. These biases are not thought to be significant for the index as a whole, but we believe D.B.S. should continue to devote more resources to improving the accuracy of this index. Although it does not measure

changes in living costs which stem from changes in tastes and patterns of consumption, the consumer price index appears to be more reliable than the price deflator for total national output which, despite improvements, still has serious upward biases, particularly in the area of investment and service prices.³

The goals of stable prices, efficiency and full employment are purely internal although their achievement can also make a worthwhile contribution to a better world economic climate. Yet we are unlikely to reach these objectives if our external financial position is unsound and our relationship with the outside world unhealthy. Canada has always been an open economy and our progress and prosperity are still inseparably linked to international economic developments, particularly those in the United States. Our extensive financial, trading, and other ties abroad, the world's increasing interdependence, and closer economic co-operation between nations all make it virtually impossible for us to insulate ourselves from events elsewhere. Indeed, it would be disastrous even to attempt to do so. Paradoxical as it may seem, the more successful we are in achieving strong and balanced external finances, the more independence we have to pursue domestic goals: full employment gets no priority in an exchange crisis, and prices cannot remain stable if the foreign exchange value of the Canadian dollar undergoes continuous deterioration.

Just as there are those who favour a particular composition of domestic output, so there are people who believe the nation's international objectives should be defined in highly specific terms. There is a view, for example that Canadian external economic policy can best serve our long-run interests by increasing foreign aid and bringing about a stronger world monetary, trade and economic system. Another strand of thought puts emphasis on replacing the current account deficit in our balance of payments by a surplus, partly to make us a net contributor to—rather than user of—the world's scarce supplies

³ See *The Reliability of Selected Price Indexes as Measures of Price Trends*, prepared for us by A. Asimakopulos.

of physical capital and other resources, and partly because it is felt that our economic independence would be enhanced. A related view is that imports of equity capital should be discouraged and that increased domestic ownership would give us more control of our economic and political destinies. Most of the witnesses before us favoured a fixed exchange rate or a relatively stable rate, but others put forward the extreme view that no concern at all should be expressed about the exchange rate and that it should be left to find any level consistent with the achievement of domestic objectives. However, these differing and sometimes conflicting viewpoints seem to us to be dealing with essentially intermediate goals. The wider objective must be an external financial position which enables us to pursue national goals—including the broad political aim of promoting a stronger world economy—with as much independence as our obligations to an interdependent world will allow.

Because it is in fact a complex of goals, there is no single measure which summarizes this objective. Stability of the spot or forward foreign exchange value of the Canadian dollar is not by itself an adequate measure of performance, particularly if it is achieved by sacrificing domestic price stability and employment or by imposing trade and exchange barriers. Wide swings in the external value of the currency are disruptive at home and abroad under any system of rates, but past experience suggests that there may be times when changes will be necessary. Nor can the only guide be the size of the nation's reserves of acceptable means of international settlement in the form of gold, U.S. dollars and other convertible currencies. Continuous and pronounced changes in the reserves (excluding borrowed reserves) may indicate unsound developments, but difficulties are not always immediately reflected in this way nor are all reserve changes necessarily symptomatic of basic problems.

The current account balance with other countries can also be a useful indicator of the external position. Yet deficits in our international accounts may reflect nothing more than vigorous growth and full utilization of domestic resources

accompanied by profitable opportunities to employ foreign funds. At other times, such deficits may indeed be an indication of fundamental competitive weakness, of unjustified foreign borrowing or of increasing vulnerability to external events.⁴ Nor do current account surpluses necessarily reflect a healthy economy, especially if they result from trade restrictions, inflation abroad, or unemployment and stagnation at home.

Yet another indicator of the soundness of Canada's external position is the composition and size of capital flows. Like those of an individual enterprise, however, a nation's outside borrowings should be viewed not in absolute terms but in relation to its income, capital program and the returns on investment. For example, inflows of a fixed-interest nature are only a potential source of trouble if repayment commitments are large in relation to domestic incomes or exports while equity flows can be considered undesirable in non-economic terms only when they represent a sizable proportion of such financing in Canada.⁵ On economic grounds, the value of direct investment must be judged by the contribution it makes to economic growth through providing Canada with real resources, extra incomes and new markets, skills and industrial techniques.

Perhaps enough has been said to indicate the complex and elusive nature of the nation's external economic objective. Like a business or individual, an economy cannot long mismanage its affairs without incurring external difficulties. If the country tries to do more than available real resources—domestic and foreign—will allow, serious consequences are bound to follow. Similarly, if inappropriately restrictive policies are pursued when there are unemployed resources in Canada, excessive inflows of capital may be attracted. Nor would the world economy benefit from such an enforced reduction in Canadian incomes and employment. Just as individual units within Canada must be vitally concerned with

⁴ Much depends on whether such deficits are the result of temporary or more permanent forces affecting the costs and markets of our export or import-competing industries.

⁵ Such equity inflows can occur even with a current account surplus if there are offsetting capital items or reserve changes.

the health of the economy as a whole, so must Canada be concerned with the well-being of the world economy and base its policies accordingly. Short-sighted steps which yield near-term gains at the expense of weakening international trade and financial arrangements are no way to achieve continuing domestic prosperity or a sound international environment. Essentially then, the external goal must be to manage Canada's international dealings with enough foresight to promote rather than sacrifice her broad, domestic political and economic aims in the long run.

The more numerous and specific these goals of the Canadian people become, the more complex becomes the task of obtaining general support for them and the greater is the possibility that they will conflict with each other. We have tried to focus attention on the major goals which we believe command the broad backing of the community, but even these few objectives are not easy to attain and have on occasion proved impossible to reconcile. Before turning to look briefly at the post-war record and the question of conflicts among objectives, however, it should be stressed again that all failures or successes are not to be laid at the door of the policy-makers, especially the monetary managers. Much depends on the world environment and other fundamental factors affecting the behaviour of the Canadian economy.

THE POST-WAR RECORD

Although short-run economic developments in Canada have to some extent a life of their own, the economy's performance can only be fully understood when viewed against the longer-term trends which influence its underlying tone and atmosphere. Some economists have disputed the existence of well-defined "long cycles" having a common cause, but whatever the merits of their case there clearly seem to be periods when a conjuncture of domestic and world events like population growth, innovations and technological progress, and the "bunching" of consumer and investment spending combine to create long waves

of vigorous growth. Conversely, there appear to be extended periods when for one reason or another resources are relatively abundant and the economy lacks the driving forces of demand which alone can spur it to top performance.⁶ Thus, although the short-run business cycle remains in many ways the most convenient method of chronicling economic events, its course must be related to the longer-run climate. These short cycles normally consist of expansions in a number of activities at about the same time, followed by comparable generalized contractions which in turn give way to the expansionary phase of the next cycle. While cycles in other countries have been as long as twelve years, the following table shows that Canadian cycles have typically averaged closer to four years in the post-war period.

TABLE 20-1
BUSINESS CYCLE REFERENCE DATES—
CANADA, POST-WAR PERIOD

Year	Quarter	Month	Turning Point	Type and Number of Phase Begun
1946.....	I	February	Trough	Expansion 1
1948.....	IV	October	Peak	Contraction 1
1949.....	III	September	Trough	Expansion 2
1953.....	II	May	Peak	Contraction 2
1954.....	II	June	Trough	Expansion 3
1957.....	II	April	Peak	Contraction 3
1958.....	II	April	Trough	Expansion 4
1960.....	I	January	Peak	Contraction 4
1961.....	I	March	Trough	Expansion 5

NOTE: Periods of contraction are indicated by shading in all charts in this chapter.

Canadian experience since 1946 can conveniently be divided into four periods. The first, from the completion of post-war reconversion and demobilization until 1949, was a time of strong demand resulting from the aftermath of war. The second, which lasted until 1953, was also one of strong demand, but was based on peacetime expansion and development as well as the special stimulus from the Korean War which broke out

⁶ See the appendix volume for a further discussion of long cycles and their history.

in June 1950. The third, which followed an inventory adjustment and curtailment of U.S. defence expenditures in late 1953 and early 1954—paralleled by a recession in Canada—was marked by a vigorous investment boom triggered in part by world-wide fears of raw material shortages. Following 1957, however, the whole climate facing Canada changed. During this fourth period, domestic spending became less vigorous as accumulated consumer demands were satisfied and spare capacity emerged in many industries, particularly in basic raw materials. This was the result both of earlier heavy investment programs and the weakened competitive position of North American producers. Reflecting the need for fundamental adjustments to these deep-seated changes in demand, the recovery phases of the business cycle tended to become shorter and less complete, although contractions did not become longer or more severe.

Chart 20-1, which shows the trends in real gross national expenditure⁷ and its year-to-year changes, illustrates the vigour with which Canadian output was growing before 1957 and the flattening out in subsequent years. Immediately after the war, the backlog of domestic demand for consumer and investment goods supported by heavy war-time accumulation of liquid assets, the need to provide assistance to the war-torn European nations and the absence of international competition combined to put heavy demands on our resources. Indeed, the expansion of Canadian output barely slackened during the mild American recession of 1949 and the demands of recovery and of the Korean War again taxed our capacity fully in the years which followed. Small absolute declines occurred in 1951 and in the 1953-54 recession, but there was vigorous expansion in the ensuing investment boom until the sharp drop in the growth rate two years later. As can also be seen from the chart, these developments closely paralleled those in the United

States, although Canadian recessions were milder and expansions more pronounced—except for the 1958-60 recovery. These developments in our growth rate are brought out even more sharply by Chart 20-2 which shows real gross national expenditure per person and year-to-year changes in this figure. If G.N.E. in constant dollars per person employed were used as an approximate measure of productivity, it would show that output per employee in all sectors (including agriculture) rose by approximately 2.7% annually from 1946 to 1956, compared to just over 1% from 1956 to 1962.

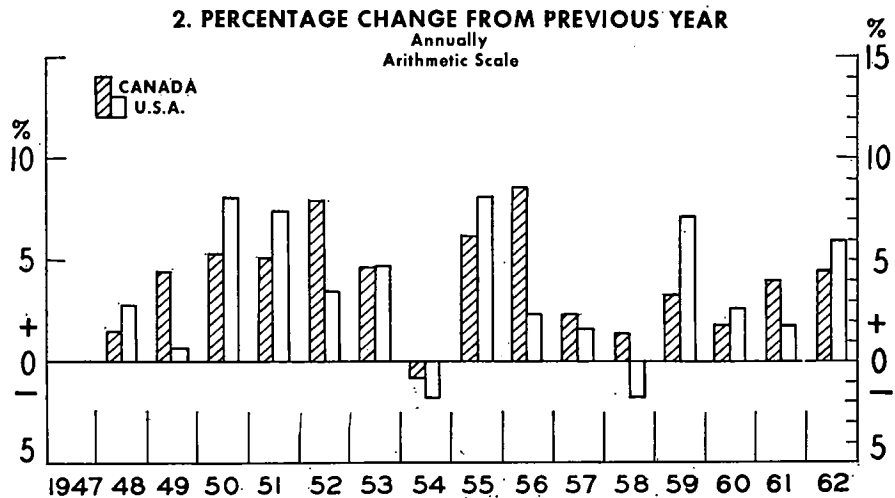
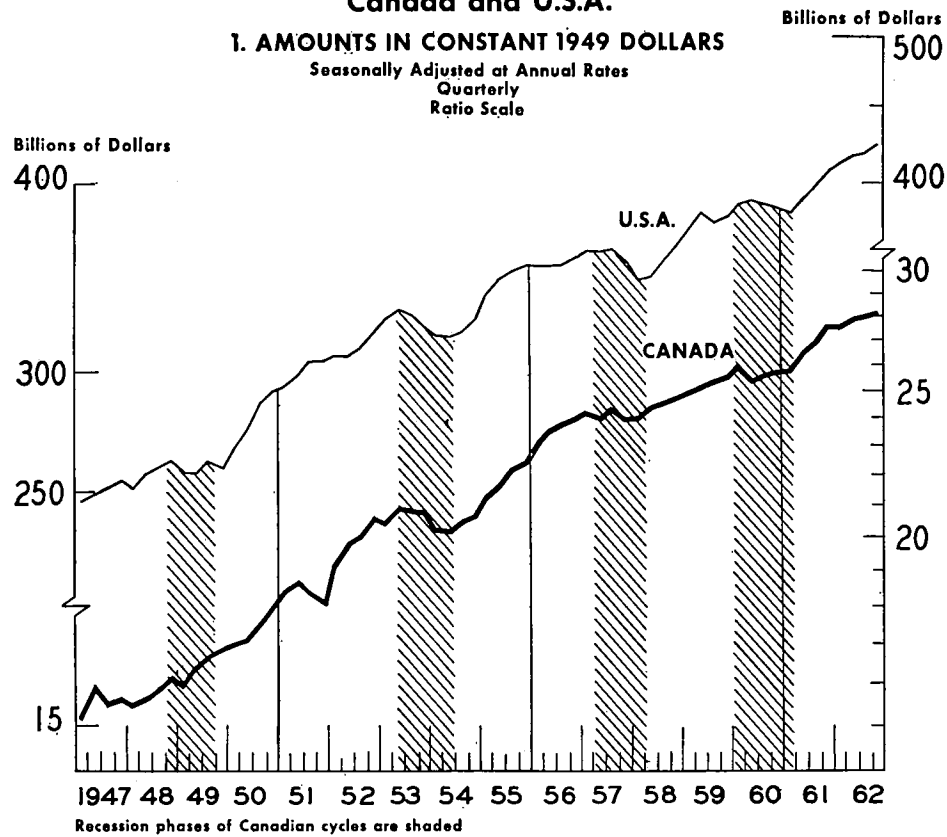
Unemployment rates reflected these developments, being very low in the early post-war period when resources were under strain, but moving up quite sharply even in the mildest recessions. However, apart from one quarter in 1950, deseasonalized unemployment did not exceed 4% of the labour force until the 1954 recession and even then did not remain long at the higher level. As chart 20-3 shows, however, the unemployment figure has not been under 5% since 1957 in either Canada or the United States. Moreover, our unemployment rates were above American rates from 1958 to 1962, partly because our higher rate of increase in the labour force had not been matched by a correspondingly higher rate of economic growth. While some of this unemployment is structural in the sense that there are job openings for which the available unemployed lack skills or training, it is worth noting that by far the largest part of the jobless total stems from generalized weakness of demand. Thus we find that all areas of the country and virtually every occupational group experienced higher unemployment rates after 1957 than they did before, although the burden continues to be heavier in some regions, occupations, and age groups than in others.⁸

While it has only been in recent years that we have failed to achieve our productivity and em-

⁷ Gross domestic product at factor cost would be a preferable measure, but for the sake of making comparisons with the United States it is not used here.

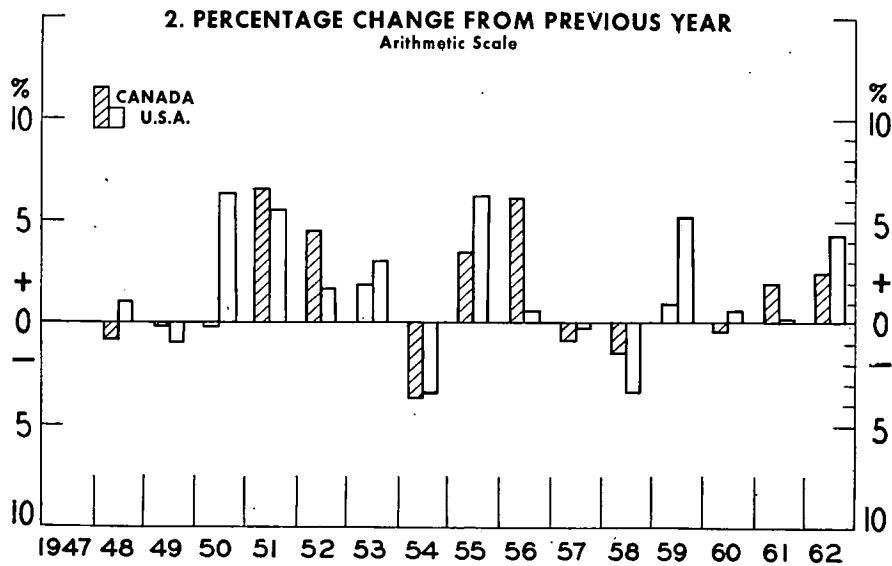
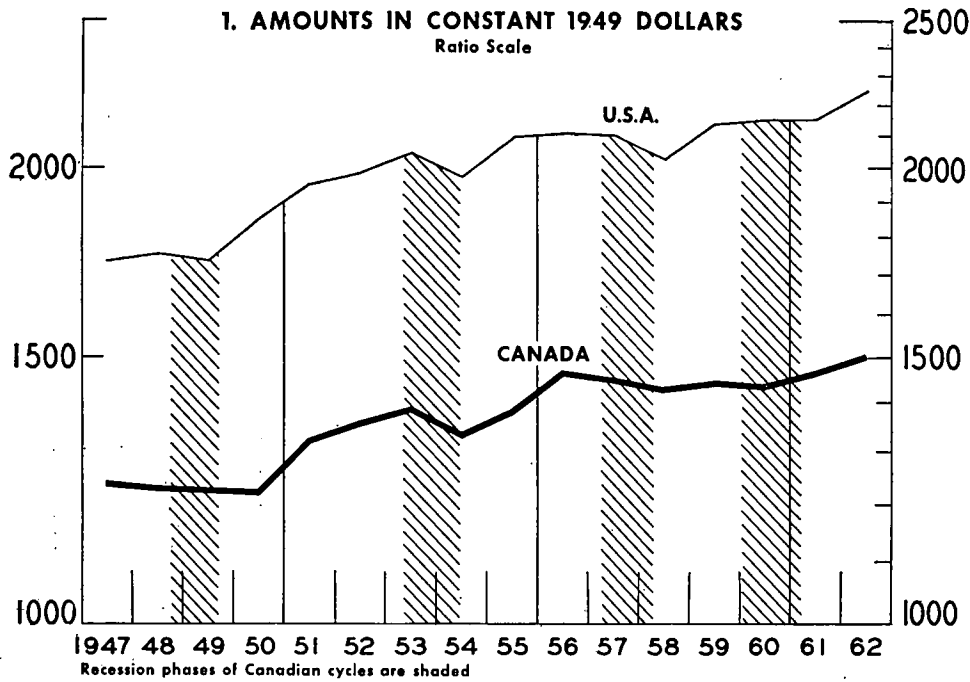
⁸ See *Report of the Special Committee of the Senate on Manpower and Employment*, Queen's Printer, 1961, which gives the detailed structure of Canadian unemployment and which brings out the heavier concentration of unemployment among men, the younger worker, the unskilled, etc.

Chart 20-1
REAL GROSS NATIONAL EXPENDITURE*
Canada and U.S.A.



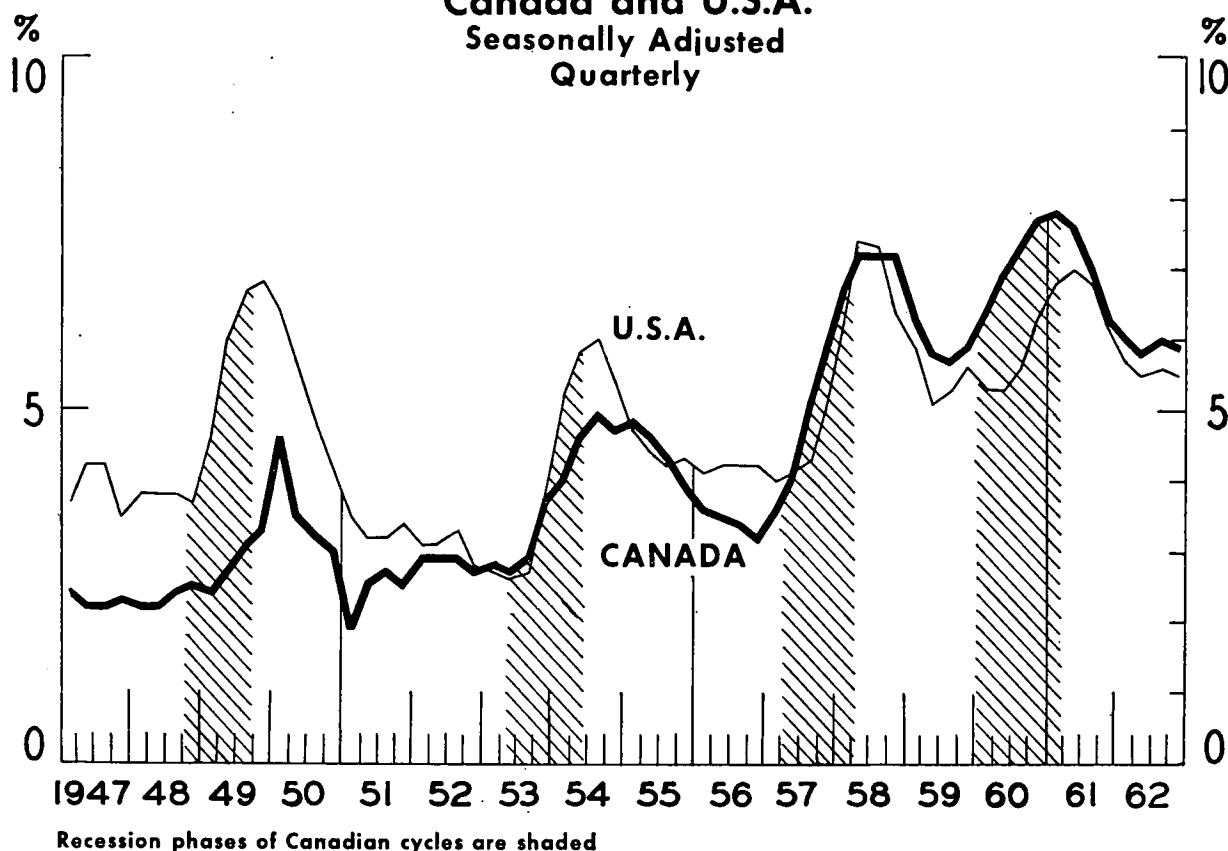
*Excludes change in farm inventories

Chart 20-2
REAL GROSS NATIONAL EXPENDITURE*
PER PERSON
Canada and U.S.A.
 Annually



*Excludes change in farm inventories

Chart 20-3
UNEMPLOYMENT
As a Percentage of Labour Force
Canada and U.S.A.
 Seasonally Adjusted
 Quarterly

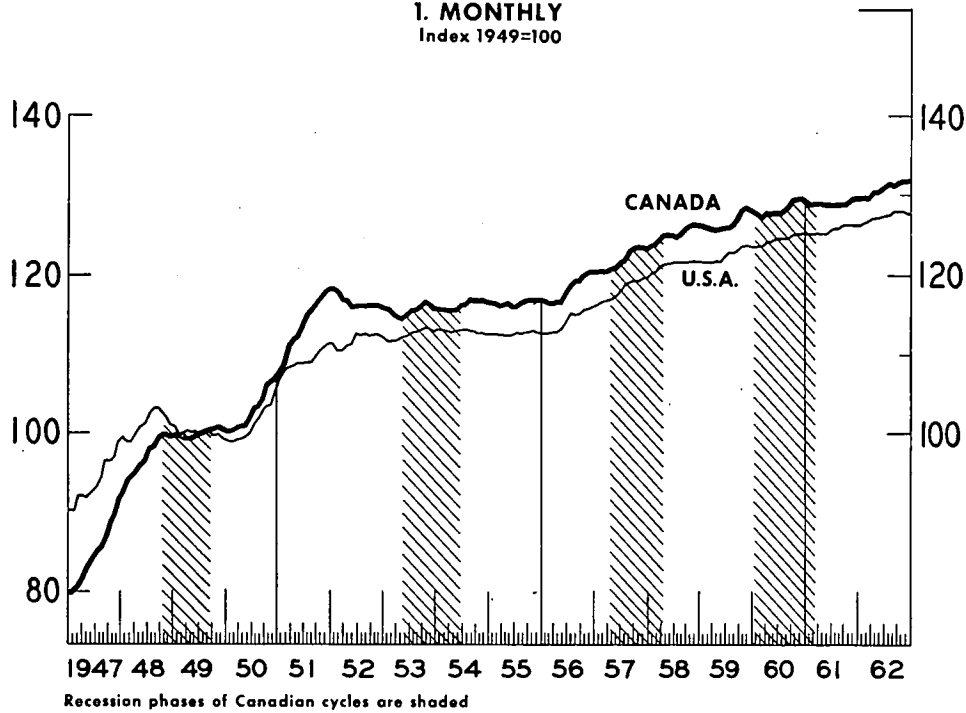


ployment objectives, the most pronounced shortfall from the target of stable prices occurred in the early post-war years. Strong demand—made effective by large public holdings of money and government bonds accumulated during the war—and wide-spread shortages led to the sharp inflation of prices shown in Chart 20-4. As can be seen from the shaded bars at the bottom of the chart, such increases reached a peak annual rate of almost 15% in 1947. By late 1948, however, these forces had spent themselves and prices became virtually stable until the Korean War triggered off world-wide fears of inflation and strong demand for goods of all kinds which led to another

sharp upsurge in prices in late 1950 and 1951. From that time until early 1956, prices were once again relatively stable because of falling agricultural prices, large productivity increases, and more competitive conditions generally. However, the pressure of the investment boom on labour rates and other costs then began to make itself felt and consumer prices rose at over 2% a year, continuing to do so even after the peak in economic activity had passed. Since 1959, however, price changes have been smaller, with increases, particularly in basic commodities, being less than normal for expansions. These trends have broadly paralleled those in the United States, providing yet

Chart 20-4
CONSUMER PRICE INDEX
 Canada and U.S.A.

1. MONTHLY
 Index 1949=100



2. PERCENTAGE CHANGE, DECEMBER TO DECEMBER

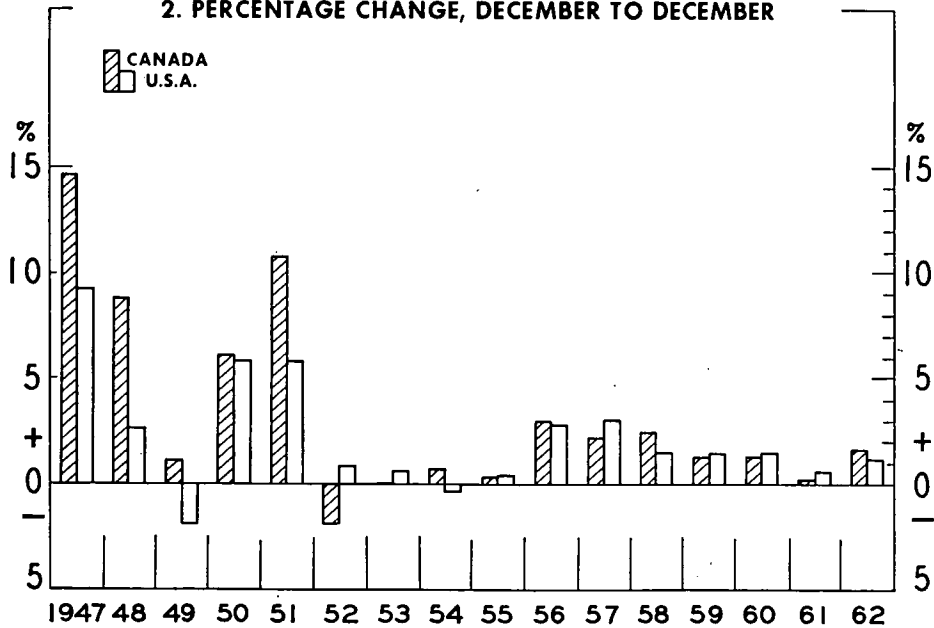
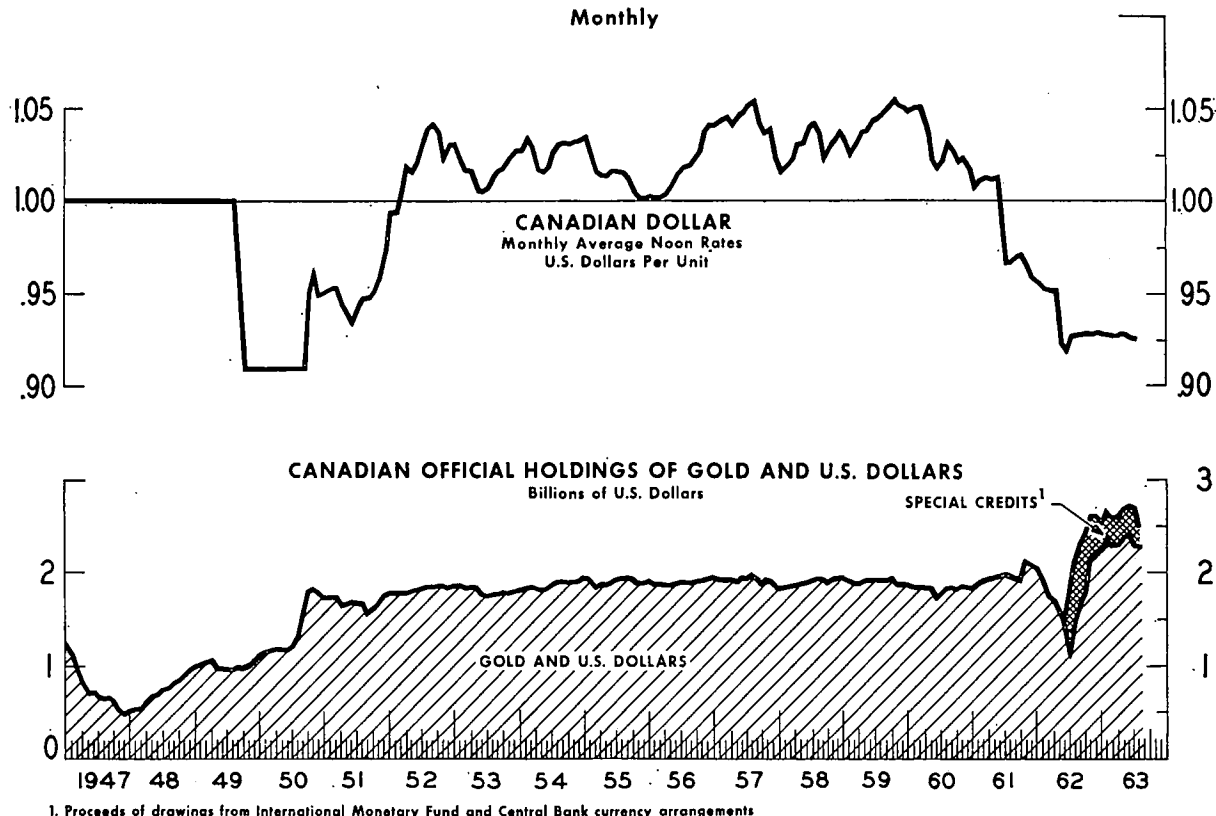


Chart 20-5
EXCHANGE RATE AND OFFICIAL FOREIGN EXCHANGE RESERVES
Monthly



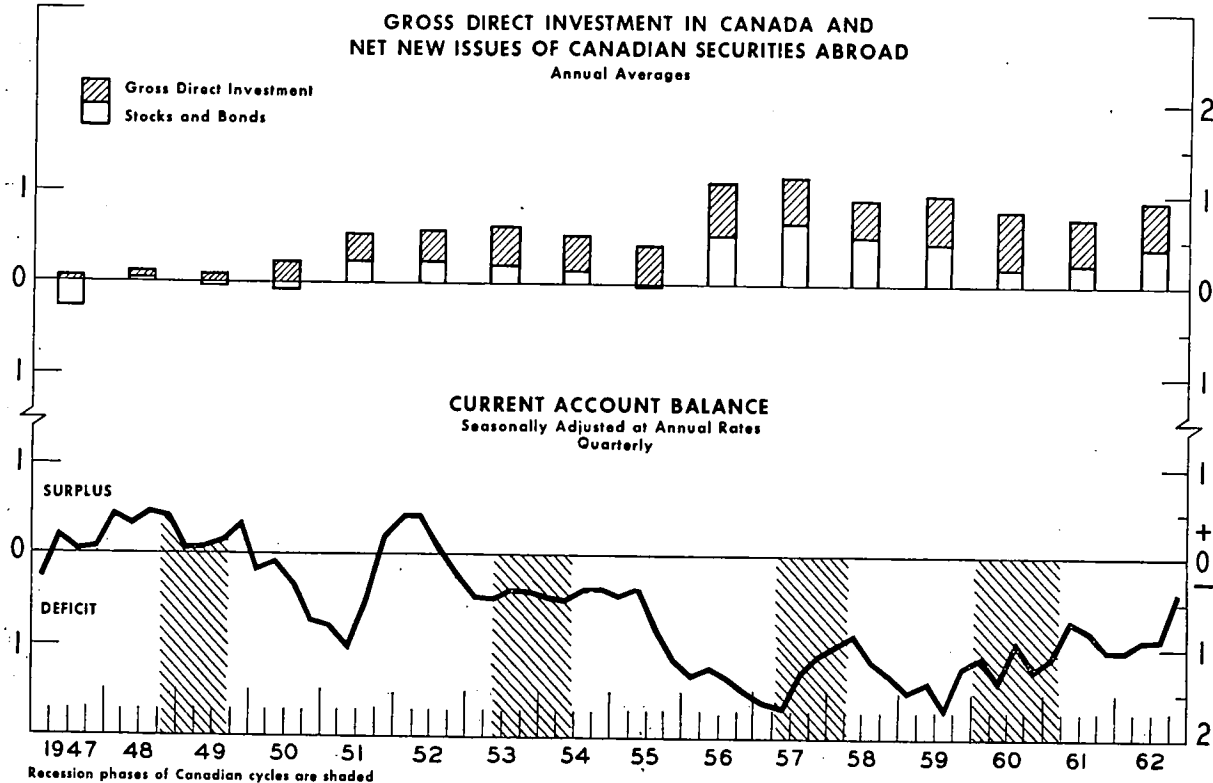
another illustration of our close economic links with that country.

Turning now to the international objective, Chart 20-5 shows the foreign exchange value of the Canadian dollar and the size of official reserves and Chart 20-6 shows the current account balance and the gross amounts of direct investment by non residents and net new securities issues abroad. The Canadian dollar was revalued from a 10% discount to parity with the American dollar in 1946, partly in the belief that our competitive position had strengthened and partly to soften inflationary pressures originating abroad. However, from mid-1946 our exchange reserves declined drastically to under \$500 million by November 1947, largely because the continuing, but reduced, surplus on current account was more than offset by the large reconstruction loans being ex-

tended to the United Kingdom and European countries. Import controls, special excise taxes and restrictions on consumer credit were then imposed by the government; together with the proceeds of government borrowing abroad and continued heavy inflation in other countries, these measures brought about a significant improvement in our current account and reserve position. When in 1949 the overseas countries underwent major devaluations to reflect the fundamental changes that had taken place in their competitive position, our dollar was devalued by 10%.

By late 1950 this rate proved untenable, despite the emergence of a current account deficit stemming from the improved position of the European economies and the strain on our domestic resources. Foreign direct investment in Canadian enterprises more than doubled as the United States

Chart 20-6
CANADIAN BALANCE OF PAYMENTS
 Billions of Dollars



became concerned about shortages of strategic materials. Growing conviction that our exchange rate could not be held led also to massive speculative inflows which—despite the attempts of the monetary authorities—could not be handled without a dangerous expansion of the money supply. Accordingly, in late 1950 the Canadian dollar was set free to find its own level and worked its way to a premium in 1952. From then until 1960, the authorities restricted their interventions to evening out erratic short-term fluctuations in the exchange rate, and official reserves remained broadly unchanged. The dollar remained at a premium throughout this whole period, despite the emergence of very large current account deficits in every year but 1952, when agricultural exports were unusually strong. In all these years direct investment remained high, with the result that even

a policy of very active monetary ease in the recession of 1954 did not bring about any absolute decline in the dollar's value. In 1955, however, the persistence of monetary ease in Canada brought about a narrower interest differential with the United States and the rate declined by about 3% in that year. As the investment boom gathered force and monetary policy shifted to restraint, the dollar strengthened sharply, partly because of heavy Canadian security issues in the New York market. Since Canadian interest rates were maintained at relatively high levels after 1957 despite the emerging weaknesses in demand, such security issues remained large and reinforced the support our dollar was receiving from direct investment inflows.

In December 1960, the government announced it believed the premium rate inappropriate

ate to the slacker conditions which had by then prevailed for some time and imposed higher withholding taxes on interest and dividends going abroad in an attempt to force the rate to a "significant discount". Also, for the first time in almost a decade the authorities began to intervene directly in the exchange market to bring down the rate; a discount of over 4% was actually reached by the end of 1961 as a result of this policy, which was announced in the 1961 budget, and of a sharp drop in foreign borrowing by Canadian residents. By early 1962, however, uncertainties over government policy and the outcome of the pending election had started a massive run on the Canadian dollar, and despite the return to a fixed rate at a value equal to 92.5¢ U.S. in May, the reserves had fallen to \$1,100 million by June. Special measures were taken to stem the tide, including the imposition of tariff surcharges, sizable borrowings from the International Monetary Fund and others, a curtailment of government expenditures, and sharp increases in interest rates. The reserves responded quickly and by early 1964 all these special measures, with the exception of reduced tourist exemptions, had been removed or relaxed and all temporary foreign borrowing—other than part of the I.M.F. credit—had been repaid.

Despite the strength of the Canadian dollar between 1950 and 1960, the international competitive position of Canadian industry deteriorated. Chart 20-7 shows Canadian labour costs per unit of output compared to those in the United States: these labour costs rise whenever productivity gains fall short of the increase in average hourly earnings. In the years when the demand for Canadian resources exceeded the available supply, this weakening competitive position did not result in serious general problems, but following 1957 it contributed to the difficulties experienced in bringing our current account into a more satisfactory position. These difficulties were made more intense by the active competition from the reconstructed and modernized economies of Europe and Japan whose position underwent dramatic improvements. However, rising inflationary pressures and the recent slow-

ing of the growth rates of those economies have eased this problem somewhat. In addition, Canadian management and labour—long accustomed to passing on higher costs to the consumer—have become more realistic and competitive in their attitudes in recent years, while the recent decline in the value of the Canadian dollar has helped their position further. There has thus been a marked improvement in our current account balance, the deficit of over \$1.4 billion in 1957 and 1959 having been reduced in 1963 to approximately \$500 million.—The improvement in the merchandise account has been even more striking, from a deficit of over \$700 million in 1956 to a sizable surplus in 1963.⁹

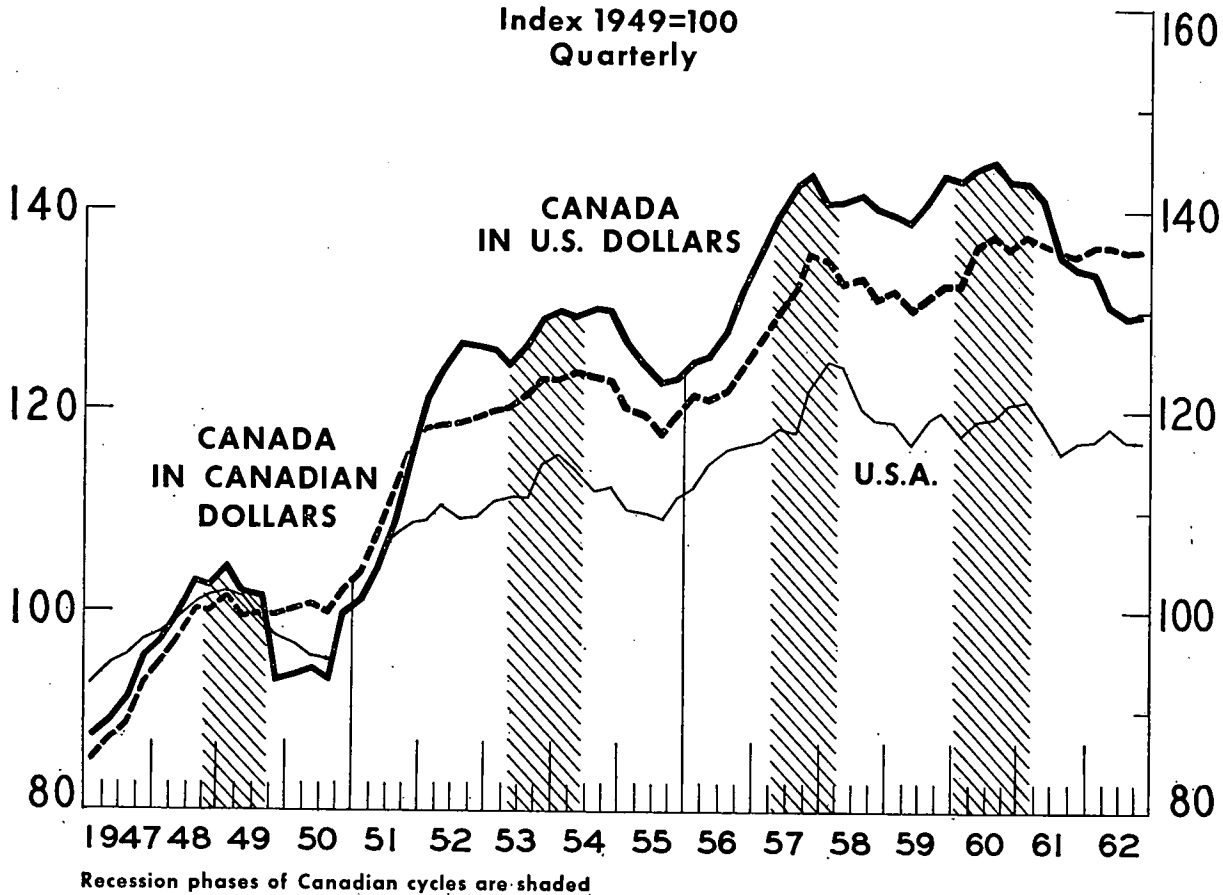
Domestic financial policies in the post-war period have also showed marked changes. In the early years after the war, monetary policy was virtually unused as a restraining influence, bank rate was set at a low level and the rate on long-term government bonds was kept between 2.60% and 3%. This reflected world-wide scepticism about the short-run effectiveness of monetary policy, a belief that a slump was not far away and that easy credit conditions would soon be appropriate in any event, and concern about the problem of managing the huge debt incurred by the government to finance the war. Thus, monetary policy played no part in combatting the post-war inflation or the exchange difficulties in 1947 and, indeed, the policy of supporting government bonds above or close to par meant that the central bank and government accounts were making it particularly easy for the public to cash in its holdings of these instruments to finance its post-war spending spree. The stock of money—already at record levels in relation to G.N.P.—was allowed to expand further from 1946 to 1948 when inflationary pressure was at its height. The resulting extra liquidity could only be worked off through additional price increases, and it was these price increases—illustrated in Chart 20-4—which brought about the decline in the ratio of money supply to G.N.P. shown in Chart 20-8.

With the outbreak of the Korean War and the limits which heavy defence expenditures put on

⁹ See also Chart 4 in Chapter 5.

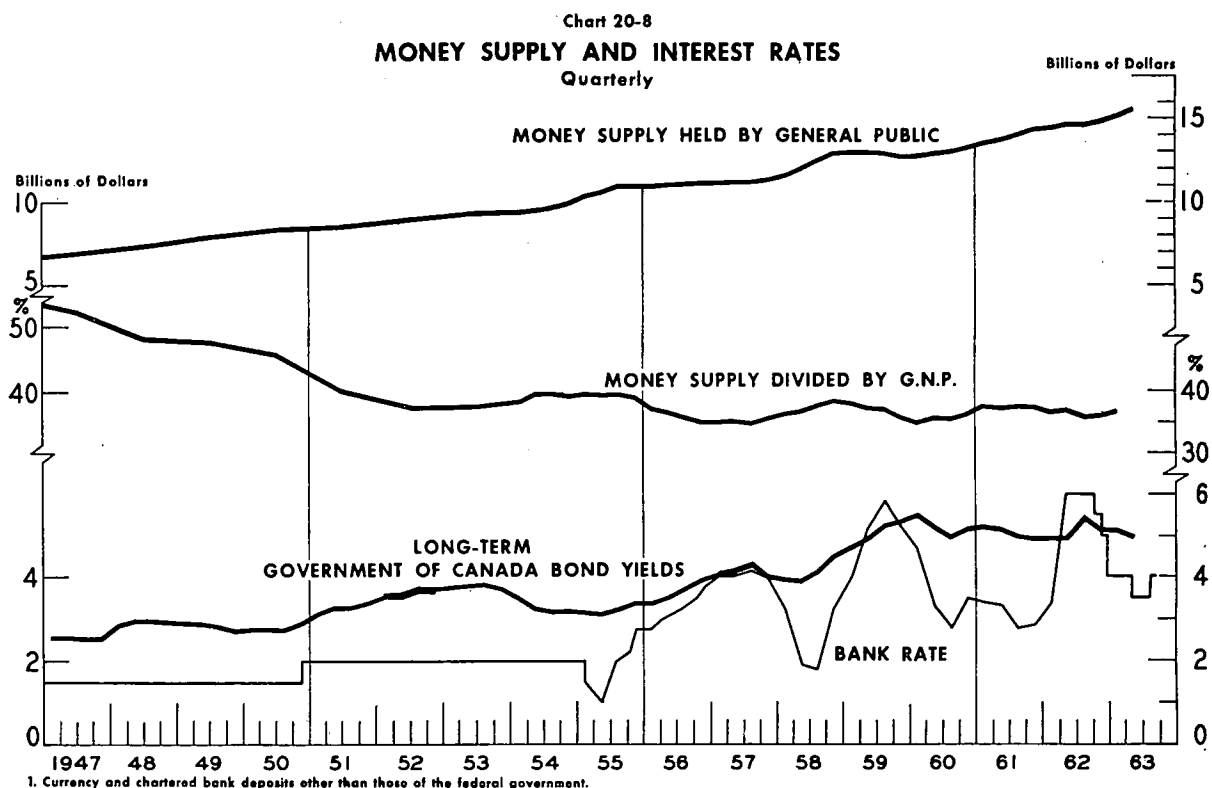
Chart 20-7
LABOUR COST PER UNIT OF OUTPUT IN MANUFACTURING
Canada and U.S.A.

Index 1949=100
 Quarterly



the possibility of using fiscal surpluses to combat inflationary pressures, monetary policy began to be used more actively around the world. In Canada, monetary restraint was applied from late 1950 onwards, bank rate was raised, and the banks were asked to curb their lending activities. Rates on 15-year Canada bonds reached a peak of 3½% in late 1953, but with the onset of the first real post-war decline in production, a very easy policy was pursued. While this recession turned out to be neither particularly severe nor especially prolonged, it raised considerable concern in the minds of the public and the monetary authorities. The latter persisted in a policy of

ease well into 1955 when the investment boom was already well under way. The money supply was increased substantially, bank rate was actually lowered in February of 1955, and rates on many short-term Canadian bonds were below those in the United States. Credit conditions were subsequently tightened to try to restrain the developing pressure on resources and bank rate was raised a number of times until in November 1956 it was set at a rate ¼ of 1% above the weekly average tender price of 91 day treasury bills. It was in this interval also that the 15% liquid asset ratio arrangement was entered into with the banks, attempts were made to curb sales



finance company activities, and the banks were urged to curtail term and other specified types of lending.

Conditions were subsequently eased in the latter part of 1957 and the money supply expanded significantly into the following year, in large part because of debt management operations to be referred to later. Mindful that they had been too easy and too late in restraining the 1955-57 boom, aware of the difficulties stemming from the high liquidity created in 1954, and influenced by continuing price increases and fears of inflation, the monetary authorities in late 1958 virtually froze the money supply despite the fact that the recovery then underway was only in its early stages and had shown few signs of strength. The resulting credit tightness, widespread fears of inflation in financial markets, and apprehension about the size of the government's deficit combined to drive interest rates to record levels. No doubt rates would have been higher than they

were in the early post-war period under virtually any policy in view of inflationary expectations and the relatively more intense world demand for capital. However, this policy of vigorous restraint contributed to the fact that the 1958-60 expansion was the weakest since the end of the war and the only one which fell short of the corresponding American recovery. The widening interest differential between Canada and the United States in 1959-60 attracted additional external capital, kept the premium on our dollar higher than it otherwise would have been, and thus contributed to the deterioration in our international current account position. Yet the authorities, apparently influenced by the failure of easier conditions to bring down the exchange rate quickly in the 1954 recession, seemed to believe at this time that their credit policy was not a significant factor in keeping the exchange rate too high.

Following rejection by the Minister of Finance of some of the tenders for treasury bills in August

1959 conditions eased, although the money supply did not begin expanding again until well into 1960, after the next recession had started. This easier trend was continued, because of the weak nature of the following recovery, until the restraint dictated by our weakening international position was imposed in the middle of 1962. As mentioned earlier, this need proved short-lived and bank rate, which had been raised to 6% in June and restored to a fixed basis, was lowered in successive stages in late 1962 and early 1963 to 3½% and subsequently raised to 4%. Meanwhile the money supply was allowed to expand further so that relatively easy credit conditions would stimulate domestic activity and avoid attracting excessive amounts of international capital and reserves.

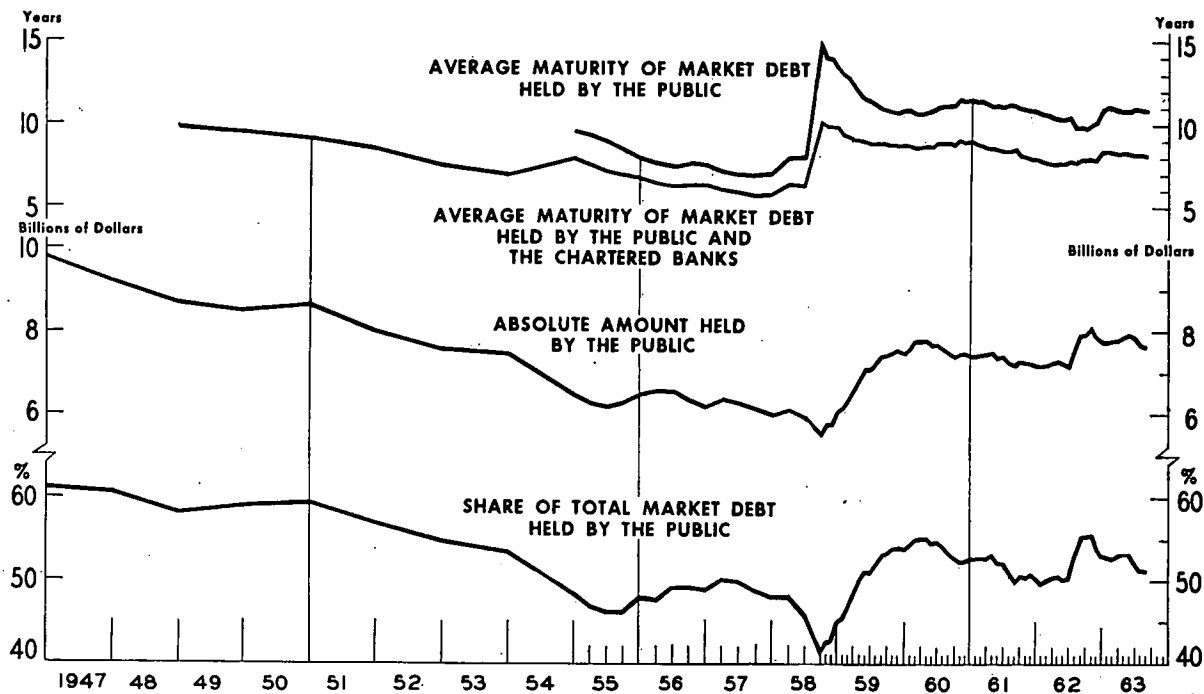
Debt management policy is closely related to monetary policy in that both influence credit conditions and thus the level of spending in the economy. If debt management policy is being used as a contra-cyclical weapon, in conjunction with

other policies, one might expect a reduction in the maturity of the debt in the hands of non-government holders when an easing in credit conditions is desired and a lengthening in opposite circumstances.¹⁰ The proportion of debt in the hands of the non-banking public—and in certain circumstances even its absolute amount—may also need to be reduced to ease credit conditions and encourage spending on real goods and services, while the reverse may be true when restraint is sought. Chart 20-9, which shows the relevant data, indicates that such a pattern has not been very closely followed in the post-war period. In the early years, the support given to government bonds encouraged their liquidation by the public, contributed to maintaining excessively easy credit conditions, and stimulated spending at a time when restraint would have been more appropriate.

¹⁰ The various principles on which the debt may be managed are discussed in Chapter 22.

Chart 20-9

AVERAGE MATURITY OF THE FEDERAL DEBT AND HOLDINGS OF THE PUBLIC¹



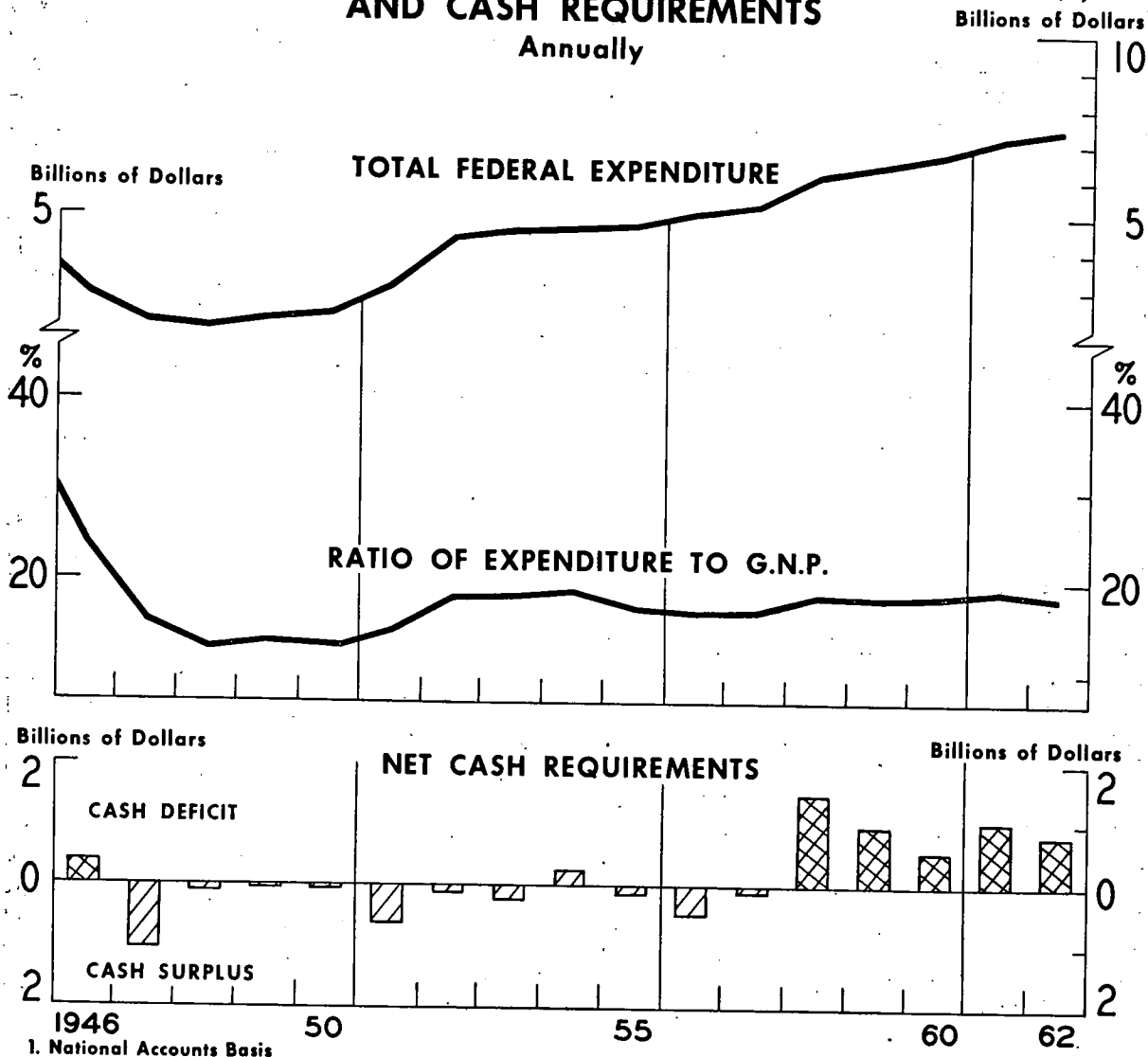
1. The "public" is used to mean all holders other than Bank of Canada, Government Accounts and the Chartered Banks.

This episode illustrates how pursuit of an inappropriate subsidiary goal, in those circumstances the maintenance of unduly low interest rates, can in fact undermine the achievement of major goals: for the sake of stabilizing the price of capital the entire economy suffered additional inflation and a further weakening in its competitive position which contributed to subsequent high levels of unemployment.

When this policy was abandoned in 1950 in order to free monetary policy to combat the renewed inflationary pressure then threatening, no real efforts were made to lengthen the term of the debt or to encourage the non-bank public even to maintain its share of the total outstanding. However, in the recession year 1954 the term was lengthened by the issue of several long maturities even though the monetary authorities were pursuing a policy of ease, while in 1955 and 1956, despite the restrictive measures being used to combat the investment boom, the term of the debt held outside the government sector shortened. This process continued well into 1957 but was reversed in the following recession by the issue of several long-term maturities. These efforts were, however, dwarfed by the huge Conversion Loan of July-September 1958 which at one step lengthened the maturity date of over 40% of the outstanding marketable debt and extended the average maturity of the public's holdings by almost 7 years to 14 years 9 months. Despite the variations in the level of economic activity since that time, the only exceptions to a process of continuous shortening of the debt in the public's hands have been 1960 (a recession year) and late 1962 and early 1963 when international considerations predominated. The amount of bonds held by the non-banking public was allowed to run down in the 1960 recession and the early part of the recovery which began in 1961 but rose sharply because of the measures taken in 1962. In general, then, debt management policy has been more oriented to the narrower, but still important, objectives of minimizing the government's costs and—to some extent—keeping security markets orderly than to broader national goals.

Fiscal policy has been used only infrequently during the post-war period as a deliberate stabilizing instrument, although a powerful stabilizing force has been provided by automatic changes in the federal surplus or deficit as underlying economic conditions have altered. We have shown federal expenditures on a national account basis on Chart 20-10, both absolutely and as a proportion of total national expenditures, while the bars at the bottom of the chart show the government's net cash requirements including those needed for loans and investments. Government expenditures were sharply reduced from their war-time level during 1946 and the proportion of national resources claimed by government fell sharply in 1947 and 1948 as was desirable during an inflationary period. Moderate cash surpluses emerged, (the large figure in 1947 was in substantial measure due to the decline in exchange reserves) although these appear to have been to some degree an accidental result of more buoyant prices and activity than had been forecast. In any event, their usefulness in drawing funds from the income stream at a time of strain on resources was undermined by monetary policies and by debt management techniques which made it particularly easy for the public to exchange its bond holdings for cash. Taxes were cut in the 1949 recession, but the government's surplus fell only moderately. However, as in all the post-war recessions, its share of national expenditures rose somewhat, thereby giving support to the level of economic activity. In late 1950 and early 1951, substantial additional taxes were imposed to finance the higher defence expenditures made necessary by the Korean War, although these expenditures did not reach a peak until 1952. A substantial surplus consequently developed in 1951 and made some contribution—along with monetary policy—to restraining demand. Other measures introduced in this period included consumer credit controls, accelerated depreciation for defence and defence-supporting investment, and the withdrawal of depreciation privileges on certain non-essential building. Price controls were

Chart 20-10
FEDERAL GOVERNMENT EXPENDITURE¹
AND CASH REQUIREMENTS
 Annually



considered following their temporary imposition in the United States but were rejected in favour of the more general instruments which were easier to administer and less damaging to efficiency. Foreign exchange controls were not needed and in any event were not favoured in view of the shelter that the earlier measures had provided to high-cost industries.

In 1953, personal income taxes were reduced to approximately their 1950 levels, but no significant deliberate measures were taken in the 1954 budget to combat the recession, and government expenditures in fact showed their smallest post-war increase. However, changes in the budgetary and cash position occurred and this, together with the introduction of the National Housing Act,

provided some support to the economy; most of the burden of stimulating the economy, nevertheless, was carried by the monetary authorities. Further modest tax reductions were made in 1955 and in spite of the fact that capital investment reached a peak of over 27% of national production two years later, no deliberate fiscal measures were taken to damp down demand in this period. Indeed, federal policy added to the strain on resources coming from the investment boom in metals, oil and gas, and manufacturing by proceeding at unreduced speed with such projects as the St. Lawrence Seaway and by financing part of the cost of a privately-owned pipeline. The automatic effect of buoyant revenues, however, turned the modest government deficit of 1954 into a surplus of about \$500 million in 1956. Monetary restraint was virtually the only discretionary policy weapon used—debt management, as we have seen, was easing credit conditions in this period. Although the next recession began in April of 1957, only minor adjustments were made to taxes, and expenditures as a proportion of national production remained well below that of 1954.

The new government took substantial steps to stimulate the economy in the latter part of 1957. Payments to pensioners and to the provinces were increased, taxes were cut, the winter works program instituted, and substantial direct mortgage lending begun. Government expenditures consequently rose sharply in the next year, both absolutely and as a percentage of national production, while the approximate cash balance of the latter part of 1957 was replaced by a net requirement of almost \$1.5 billion. On a national accounts basis, the deficit was about half as much, in part because the cash requirements included loans of over \$300 million to CMHC for mortgage lending: excluding these transactions the cash requirement was equal to a little over 3% of G.N.P. Apparently in the belief that the 1958-59 recovery was going to be vigorous and out of concern about prevailing inflationary fears, taxes were raised somewhat in 1959—a measure which, with monetary restraint, contributed to the weakness of that expansion. In 1960, some tax incentives

were given for production of new products but no major changes were made to counteract weaker economic conditions. In December, however, CMHC direct lending (which had been drastically curtailed) was expanded, the maximum mortgage loan was raised, the winter works program expanded, and measures taken to encourage small business. As a result of these expanded outlays and higher expenditures on vocational training, sewerage, and other projects, government outlays rose more sharply in 1961. This increase was curtailed somewhat in 1962 by the measures necessary to deal with the exchange crisis.

On balance, it is difficult to avoid the conclusion that financial policies in the post-war period have not made the contribution that they might to the attainment of our major economic goals. Quite apart from the inherent limitations of such policies and the difficulties of accurately predicting economic developments, there have been occasions when the instruments of policy seemed to be working against each other or when bolder measures could have been taken in the light of the evidence then in hand. Recessions in the post-war period in Canada as elsewhere have indeed been shorter and milder than those of earlier days, in part because of a lesser dependence on agricultural production but mainly because of the powerful role played by the automatic stabilizers and of more deliberate government policies. Nevertheless, as the following table shows, the performance of our economy since 1957, measured by unemployment and output gains, has been below that of most of the leading industrial countries outside North America even though prices have been more stable.

While Canada's close economic and geographic links with the United States will continue to make it difficult to outperform that economy in a significant way, and while world developments will always have a profound influence on domestic activity, there is no inherent reason why our relative economic performance cannot be improved. A decline in the relative importance of imports normally acts as a built-in cushion against recessions in the same way as their expansion

TABLE 20-2

	Unem- ployment Rates ^a	Growth of Industrial Pro- duction ^b	Price Increases ^c
	1960	1957-62	1957-62
Canada.....	7.0%	21.8%	7.1%
United States.....	5.6	18.7	7.1
Italy.....	4.3	24.7	13.0
Great Britain.....	2.4	10.9	11.2
France.....	1.9	30.2	30.4
Sweden.....	1.5	23.5	16.5
Japan.....	1.1	96.1 ^d	21.6
Germany.....	1.0	41.2	10.1

^aAdjusted to United States definitions.^b1957 Average to December 1962—I.M.F. Statistics.^cDecember to December—I.M.F. Statistics.^dManufacturing production.

provides a safety valve when resources are strained. If policies are sensible and close attention is paid to competitive factors, the record indicates that it is by no means impossible to come closer to attaining major economic objectives. To the extent that world concern over growth rates leads to improved international co-operation and co-ordination in this field, the possibilities of achieving these goals will be even greater.

CONFLICTS AMONG OBJECTIVES

If there are inherent and irreconcilable conflicts among the economic objectives of society, one or more of them must be sacrificed or modified. Indeed, even if there were only one objective of economic policy, say to bring unemployment levels below 2%, it would not necessarily follow that it could be reconciled with the facts of our economic life. While all policy measures would be directed solely to achieving this one aim, there would still be difficulties in forecasting both economic events and the effects of policy on them. Moreover, these measures might prove to be self-defeating if they led to rising prices or balance of payments difficulties which impaired domestic and international confidence and curtailed activity. The aims and administration

of policy become even more complex when more than a single goal is involved. It is a rare occurrence when the structure of our economy and the nature of policies are such that the pursuit of one objective leads automatically to the achievement of another: one policy instrument is unlikely to prove enough to ensure that we reach all our objectives, while numerous instruments are virtually never so independent in their effects that each can be operated in isolation and all can be aimed at separate objectives.

Nevertheless, there appears to be nothing in the record of Canada or other countries to support the view that the objective of rising productivity is incompatible with high levels of employment, price stability, and a sound external financial position. Although short-run gains in productivity and employment are normally greatest when the economy is recovering from a recession and its resources are being used more fully and efficiently, this is a once-for-all phenomenon and does not alter the fact that rapid and lasting long-run productivity gains have occurred at times of both low and high unemployment. While relatively slow expansions in output per worker are often accompanied by satisfactory employment levels, we see no reason why full employment and long-run productivity increases should be incompatible as long as conditions remain competitive and the general economic climate is kept favourable to work, enterprise and investment. The record also indicates that productivity and growth in Canada or elsewhere are not closely related to specific price trends: vigorous growth, measured in total as well as per employee, has occurred in times of falling, stable, and rising prices while stagnation has also been experienced in comparable circumstances. Finally, satisfactory increases in Canadian productivity do not seem to be in fundamental conflict with the objective of maintaining a healthy economic relationship to the rest of the world, provided that overall activity does not become so excessive as to strain our resources unduly, that prices and costs do not get out of line and that foreign capital is not attracted into unsound projects; external difficulties indeed seem to have occurred

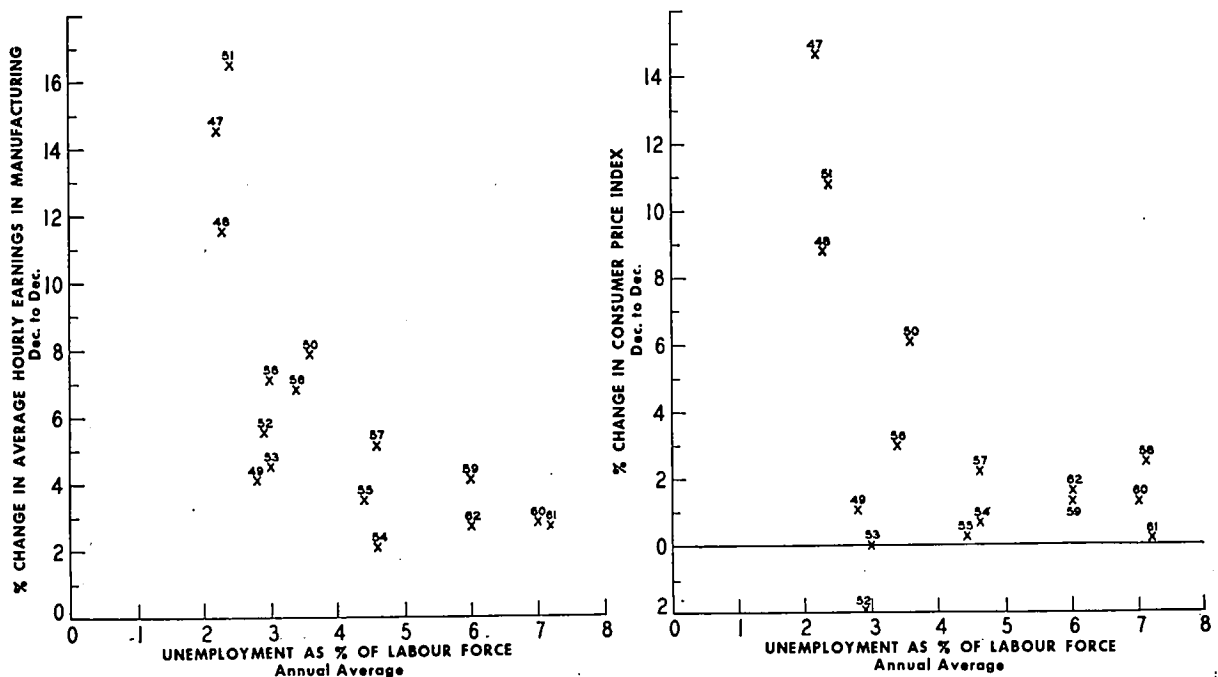
at least as often in times of slow productivity gains in Canada. There may well be times in the future, as there have in the past, when long-run measures to improve the economy's productivity must give way temporarily to considerations connected with the price, employment, or international objectives, but our main point is that there need be no lasting clash between satisfactory productivity increases and these other goals.

The evidence we have studied indicates that the likelihood of conflict between the goals of full employment and absolute price stability is much greater than that between productivity and the other goals, at least in the short run. The conflict is not necessarily severe, but wages and prices do tend to rise at a more rapid rate when demand is strong and unemployment low than when bidding for labour is less intense and competitive conditions make it more difficult to pass higher prices on to the consumer. There is, of course, always a tendency for management, labour, and other factors of production to try collectively to

take more than 100% out of the available proceeds of production: the attempt to do so, indeed, imparts much of the drive to expand production and increase efficiency. However, our staff studies did not find that this process was particularly pronounced in highly-unionized sectors of the economy or in industries where prices are dominated by relatively few companies. In fact, we are not particularly impressed with the usefulness of drawing a distinction between "cost-push" and "demand-pull" inflation: if management or labour were in reality free to push up prices and costs without regard to demand and competitive considerations, price increases in Canada would not long have remained as moderate as they have in recent years.

Chart 20-11, which compares unemployment rates with price increases in the post-war period, shows that—apart from the inflationary years immediately after the war and the abnormal increases associated with the Korean War—the conflict between the price and employment objectives

Chart 20-11
RELATIONSHIP OF UNEMPLOYMENT TO CHANGES IN LABOUR COSTS AND PRICES



has been moderate in the sense that there have been only three other years in which price increases have exceeded 2% annually. These were the boom year of 1956, when investment demand was extraordinarily high, and the two years following it: the evidence suggests that the price increases in 1957 and 1958, in addition to being influenced by fortuitous advances in food prices, were the delayed reaction at the retail level and in the service industries to earlier pressures elsewhere in the economy. Because consumer prices tend to lag behind employment and other economic trends, the absence of upward movements in the early stages of a boom does not necessarily mean that inflationary pressures are absent: conversely, increases during a recession may be nothing more than a reflection of past events and thus not a reliable guide to current policy. Nevertheless, it is quite likely to require ingenuity to reconcile the price and employment goals as unemployment falls below the range of 4% to 5%, although the record—and our staff studies—suggest that prices are not noticeably affected by unemployment rates above this range. In any event, much depends on government policies, the restraint and wisdom of labour and management, and the disciplines imposed by international competition. Although it is difficult to reconcile high employment and price stability, there is certainly no rigid and unchanging relationship between the two and no inevitability about price increases at satisfactory levels of employment. The social and economic gains to be realized from reducing unemployment justify putting heavy emphasis on this goal and on the search for solutions to the related problem of reconciling it with price stability.

We have already indicated that continuing and pronounced price increases may lead to higher unemployment, instability and an impaired rate of productivity increase by undermining business confidence, the willingness to save, and our international financial position. Although it is sometimes argued that rising prices are necessary to stimulate business enterprise and induce labour to move into more productive occupations, we see no reason why stable prices should impair incentives—particularly since rising productivity

makes such stability compatible with annual average wage increases in excess of 2%. In any event, if significant price increases come to be anticipated—and they soon would be if they continued year after year—inflation would have no stimulating effect: it would divert resources from productive uses, raise interest rates, encourage inefficiency, and might lead to severe international complications. While inflation is unlikely to accelerate markedly unless the monetary authorities permit it to do so, it is like a drug whose dose must be continually increased to get the same effect: if the authorities permitted the economy to become addicted, the inevitable return to reality would bring about very painful withdrawal adjustments.

Assuming that our domestic price, employment, and productivity objectives are being reasonably well met, there need be no continuing or complex conflicts with the international goal as long as developments in the rest of the world are not basically unfavourable. There will, however, probably be shorter-term conflicts arising from developments at home or abroad, in which domestic considerations must give way temporarily to the requirements of the international situation: the 1962 episode is a relevant example. Such conflicts are unlikely to prove lasting if the domestic economy is soundly-managed and competitive. Nevertheless, the problems of the policy-makers are likely to be proportional to the emphasis put upon more specific international aims; for example, if it is considered desirable on political grounds to take action to discourage such foreign capital as contributes to national growth and development, Canadians must be prepared not only to accept a lower rate of expansion, but also to encounter other problems with our international financial position.

The major domestic goals are most likely to come into deep-seated and more persistent conflict with the international objective if world demand or prices for Canadian exports change fundamentally, if there are continuing inflationary or deflationary developments in the main trading countries, particularly the United States, or if weaknesses in international currency arrange-

ments restrict trade and limit the scope of domestic financial policy. In extreme circumstances of this sort, it might well be necessary to alter the foreign exchange value of the currency, but this would probably shield Canada only imperfectly from unfavourable events elsewhere.¹¹ If the exchange rate were not altered in such basically-changed conditions, Canada would be unnecessarily sacrificing domestic objectives merely for the sake of stabilizing an unrealistic external value. Even with such changes in the currency, the international limitations on maintaining a satisfactory level of activity and growth when the rest of the world was failing to do so would be real and pronounced. It is therefore very much in the country's long-run interest to see that co-operative efforts are made to avoid both world stagnation and international inflation.

While we believe that the four major objectives are not fundamentally incompatible, it is only realistic to recognize that the policy-makers may be confronted with some awkward choices in the day-to-day environment in which decisions must actually be made. This is particularly the case when the goal of low levels of unemployment must be set against price stability or when shorter-term international considerations conflict with domestic goals. In such circumstances, two broad avenues are open to the authorities: to scale down or temporarily abandon one or more of the objectives—for example, by being prepared to accept higher unemployment levels or forego price stability for a limited period—or to improve or extend the policy instruments at their disposal. In the very short run, only the first course may be open, in which case the priorities assigned to the different objectives should reflect a careful consideration of the costs and benefits of abandoning or modifying each goal. These in turn will vary with what the public believes to be acceptable and desirable, with the particular circumstances of the time, and with the record of the recent past. Thus, if Canada has experienced a prolonged period of inflation more weight should be given to this objective than if prices

have been stable or falling, while if unemployment has been unduly high it should receive greater priority. The longer is the period in which results have fallen short of an objective, the greater is the failure and the more likely it is to inflict lasting damage on the structure of the economy: prolonged unemployment tends to make a worker's skills obsolete and undermine his confidence—quite apart from the hardship it inflicts—continuous price increases damage the prospects of maintaining full employment on a sustainable basis, and long periods of slow growth in productivity impair the country's international competitive position.

Since policy combinations always involve choice, virtually never are without their drawbacks and usually must be applied to a changing environment, we can offer no immutable formula by which the authorities should be guided. We do, however, wish to stress the importance of making as careful a calculation as possible of the costs and benefits of following one course rather than another, having in mind their longer-term effects. We have shown, for example, that good and freely-functioning capital markets, although not ends in themselves, can make a worthwhile contribution to efficiency and growth: it would clearly make little sense to inflict lasting damage on these markets only to achieve a short-run gain in terms of, say, exchange reserves or reduced foreign investment in Canada. The "trade-offs" between objectives—the costs and benefits of pursuing one goal at the expense of another—can never be measured only in economic terms because they involve political and social considerations as well. Studies on the economic trade-offs were carried out by our staff based on certain relationships found to exist in the 1949-61 period, but—quite apart from the difficulty of measuring underlying relationships in this way—the trade-offs are not unchanging, being affected both by the structure of the economy and by the nature of policy. The cost of maintaining a sound external position depends in large part on foreign confidence in our domestic policies and on price, employment, and productivity trends abroad in

¹¹ See Chapter 23 for a fuller discussion of this and related subjects.

relation to those in Canada. Similarly, the price paid for full employment in terms of inflationary pressures is related to the attitudes of labour and management, the competitive environment generally, the speed of reaction of those involved, the tax structure, the mix of financial and other policies being followed, and a host of other continually shifting factors. The benefits or costs of inflation in terms of productivity and growth can likewise be estimated only after taking into account an extremely wide range of considerations.

In urging the authorities to take careful account of both the immediate and more lasting consequences of their actions, we want to stress that this cannot be done wholly or even largely in quantitative terms. Some of the variables involved cannot indeed be measured in such terms and none of them can be properly understood if viewed only as rigid mathematical relationships. Yet it is worth noting that if unemployment had averaged 4½% in 1962 instead of its actual figure of 5.9%, the nation's output would have been at least \$600 million higher than it was, on the conservative assumption that the production of the additional employed would have been the same as that of those already at work; a similar calculation for 1961 yields a result of over \$1 billion. These calculations are rough and mechanical and make no allowance for the additional productivity of those already at work which would have been brought about by fuller use of capacity. Nor do they allow for any extra output that might have been realized through more buoyant conditions attracting additional immigrants and inducing those not in the labour force to become employed. It is worth noting that a 1.4% reduction in unemployment from late 1961 to early 1963, by no means a period of extreme expansion, was accompanied by a gain of about \$2 billion in real national output. Magnitudes such as this help to illustrate the gains which higher employment levels can bring, especially if they can be attained without imperilling the other objectives.

The second alternative open to the authorities when faced with conflicts between objectives is to make policy more useful by improving the

timing and effectiveness of existing instruments, by co-ordinating and balancing differing policies better, and—if necessary—by adding to the range of measures used. While we will deal with these matters in succeeding chapters, we believe that this approach offers considerable scope for improving the nation's economic performance and for reducing or eliminating the incompatibilities among our major goals. As already noted, the record indicates both that existing measures have not always been fully or wisely used and that the meshing together of fiscal, monetary and other policies in the post-war period has by no means been consistent or complete. Moreover, as many of our foreign witnesses pointed out, some of the apparent conflicts among objectives and policy failures arise from trying to solve by monetary measures problems which cannot be solved by such means. Thus, heavy responsibility for reconciling the employment and price objectives has been put on central bank policies which, while essential to help bring about the right climate of demand, are too general to attack some of the specific imperfections which give rise to much of the problem. In such cases, conflicts between objectives or failure to attain our goals, can only be remedied by using measures which go to the root of the difficulties—for example, by up-grading the skills and increasing the mobility of the labour force so that it is more responsive to changed conditions, by ironing out imperfections and competitive weaknesses in the markets for goods and services, by encouraging management to be more aggressive and efficient in export and domestic markets, and, if necessary, by ensuring that the public interest is protected in the collective bargaining process. Nevertheless, little can be accomplished by such measures if the general set of financial policy—including both monetary and fiscal policy—is not properly geared to create the right general climate and an appropriate aggregate level of demand in the economy.

The number of such policy instruments which may have to be used will depend on the nature and complexity of the problem in hand and on the influence of each instrument on the economy

at that time. Although a wide variety of measures may be required, we believe that if a co-ordinated approach is followed there is a good possibility of reconciling relatively low levels of unemployment with price stability. Similarly, the full growth potential of the economy will only be realized if appropriate monetary and fiscal policies are combined with measures to develop the economy's skills and levels of education, to encourage saving, investment and risk-taking, and to ensure that production is organized efficiently.

The entire range of society's economic goals is an elaborate and extensive one, is never static and cannot be precisely spelled out. It involves continuing compromise to blend the many special

and conflicting political, social and economic concerns of various segments of the community into a program which is generally acceptable to the nation as a whole. Unbalanced attention to one objective, or to subsidiary aims, is bound to impair performance, and we have, therefore, concentrated our attention on the possibility of attaining the four major economic objectives which we believe command general support. While luck and the world economic climate will of course continue to exercise a major influence on how successful the nation is in attaining its goals, we believe that skill, imagination and leadership will play an important role in determining the outcome.

THE EFFECT OF CREDIT CONDITIONS ON EXPENDITURE

Even if Canadians were to achieve unanimity on the ends which financial policies should serve, it would be difficult for them to agree on the means of promoting these objectives. A part of this disagreement stems from uncertainty about the effectiveness or equity of various financial measures, and we accordingly deal in this chapter with the results of the studies and surveys by which we attempted to measure the response of spending on real goods and services in the economy to changes in monetary and debt policies. Our concern is with expenditures in real terms—on consumption and physical investment—not financial transactions, since it is these expenditures that the authorities seek to influence with the aim of helping to achieve a level of economic activity compatible with our national goals.

There are a host of relationships between monetary and debt policies and spending decisions, and there are several different viewpoints from which these relationships can be examined. One such view tends to put considerable emphasis on the supply of money and stresses the broad parallelism between the stock of money and such variables as consumer spending and economic activity generally, price levels, and interest rates. A second approach lays stress on the supply of a broader range of financial assets than those which qualify as “money”, on the grounds that no sharp distinction can be drawn between chartered bank deposits and their close substitutes—the deposits of competing institutions,

savings bonds and (for large investors) money market paper. Proponents of this view thus see a powerful connection between spending decisions and the supplies of a broad range of liquid assets.

We have, however, found it more useful to think in terms of *how* operations on the part of the authorities influence spending decisions rather than in terms of a mechanical relationship between economic activity and some specified quantity of financial assets. We have therefore taken a more comprehensive approach, which seeks to explain the influence of the authorities over real expenditure in the economy in terms of “credit conditions”—i.e. the cost, terms and general availability of credit to borrowers and, consequently, the terms and yields on which savers may invest their funds. We emphasize that this is not a radical departure from the position taken in much current discussion of monetary policy and is indeed the framework developed in the Bank of Canada’s submission to us.

If credit markets were perfect, the state of credit conditions would be indicated by the level of interest rates alone. In fact, of course, there are legal, institutional and other rigidities in the system, and interest rates by themselves sometimes fail to reflect fully the ease or difficulty of obtaining credit; for example, they do not always mirror changes in the speed with which credit applications are processed, alterations in the amounts that will be lent to a given borrower, or variations in the terms and conditions demanded by lenders. Nor is there a single rate to which one can look

for indications of general credit conditions: there are many types of lender—each having slightly different investment objectives—and many classes of borrower, varying as to credit-worthiness, as to the collateral they offer and as to the amount, term and other features of their loan requirements. Thus when we talk about credit conditions generally, we are talking about the state of a variety of borrowing and lending markets rather than about a single central market in credit.

However, we have emphasized that—despite their imperfections and differences—financial markets are closely inter-related. Thus, there is a tendency for changes at the centre of the system to spread fairly quickly to the rest of it; the speed and completeness of this transmission process has indeed become greater in recent years with the development of improved markets, the increased overlapping of functions between institutions, and the heightened sophistication of participants in the capital markets generally. Changes in market rates and yields thus usually give a broadly accurate picture of the state of credit conditions, particularly in the interest-sensitive money and bond markets, although these rates may not all move together when the change in conditions is not a decisive one; short rates, for example, may lead long rates, and corporate yields may respond faster than those on government obligations. Some rates which are more rigid for legal or institutional reasons, including those on bank loans, on mortgages made by some lenders and on government lending programs, give a less accurate reflection of underlying availability since a greater or lesser degree of rationing may be occurring. Thus, one has to look at other data as well—the banks' liquid position, their lending policy and other indications—to obtain a better picture of changes in credit conditions. Although it is therefore only rarely that one can identify the exact point in time at which general credit conditions can be said to have altered, the broad changes are nevertheless clearly written on the record.

We have used the credit conditions approach in attempting to analyse the impact of monetary

and debt policies on spending because it allows one to take a comprehensive view of the financial considerations influencing spending. The links between financial conditions and spending can only be understood by looking directly at the situation facing spenders. Governments, businesses and individuals who wish to increase their spending can only do so (assuming their incomes do not rise) by reducing their rate of current saving in the form of financial assets, by borrowing, or by disposing of real or financial assets accumulated out of past income. As the Bank of Canada puts it: "Each of these methods of financing involves an impairment of the spender's position compared with what it might otherwise have been. Every spender must continually weigh the attractions and advantages of an increase in spending against the risks, difficulties and disadvantages involved in financing it . . ."¹ When credit conditions become less restrictive, funds become easier and cheaper to obtain—either by borrowing or by selling existing holdings of financial assets—and those considering new expenditures will feel less inhibited by the financial consequences of proceeding with their plans. Thus, some spending projects which were not profitable at higher levels of interest rates, or for which funds were not previously available, will be proceeded with. At the same time, those who might formerly have abstained from real spending because of the high yields obtainable on financial assets will have less incentive to do so and will tend to increase their expenditure on real goods and services. Moreover, both potential borrowers and savers may be encouraged to increase their spending by changes in their expectations about the future cost and availability of funds and in the climate of opinion generally. Incomes will rise and these higher incomes will in turn enable those receiving them to increase their spending and generate additional incomes and expenditures elsewhere in the economy. In short, it is the whole range of credit conditions—i.e. the difficulties, costs and risks of borrowing and the attractions of acquiring and holding financial assets—which

¹ Submission II, paragraph 12.

is the link between financial markets and real expenditure.

Obviously, the supply of money, and of other liquid assets, is an important factor in explaining the state of credit conditions since this will influence the terms on which the means of payment are available to spenders. However, changes in the money supply are only one of the influences bearing on credit conditions and thus on spending. They may indeed be the dominant influence at any point in time, as is true for example when massive changes in the money supply take place. Large changes in the quantity of other categories of financial assets can also influence credit conditions significantly: the huge increase in the outstanding long-term government debt at the time of the 1958 Conversion Loan for example, contributed to the subsequent sharp rise in interest rates by lowering the public's holdings of more liquid assets (short-term Victory Bonds) and causing them to require high returns for parting with investible funds. However, other influences are also important, including changes in underlying public attitudes towards spending and saving, alterations in the profitability of physical investment—whether stemming from technological change or changes in the economic climate at home and abroad—shifts in fundamental investor preferences and expectations, and many other factors.

Nevertheless, as we indicated in Chapter 6, the main technique by which the authorities have influenced credit conditions since the unpegging of the bond markets in 1950 has been through altering the cash reserves of the banking system, and hence the "money supply". Yet, as the Bank of Canada has told us, it does not conduct these operations because it has a precise view about the appropriate quantity of money at any point in time; they are carried out as a means of influencing credit conditions.²

If the authorities wish to stimulate the economy, they will induce the deposit-taking institutions to expand their assets. The initial effect will be to change the form, but not necessarily the total, of the public's financial assets;

instead of holding corporate securities or government bonds, they now hold deposits while the deposit institutions have added to their loans and bond holdings. The public's holdings are now more liquid and less risky, and this enhanced liquidity will be associated with lower interest rates, easier conditions in financial markets generally and greater inducements to spend on real goods and services.³

While we will discuss the various ways in which the authorities may influence credit conditions in the next chapter, it is worth noting here that it is difficult to draw a clear distinction between the monetary and debt authorities when discussing policies designed to influence credit conditions. Institutional arrangements vary from country to country, but the operating responsibility for Canadian monetary policy rests with the Bank of Canada, while debt management decisions are in the hands of the government and the Bank's position is that of a market agent and advisor. It is clear, however, that purchases and offsetting sales of securities by the Bank from its own portfolio without net cash reserve consequences have in themselves effects essentially similar to comparable purchases and sales by the government in the management of its debt. The distinction between monetary and debt policies is thus somewhat arbitrary, and when we speak of the authorities we shall be referring to those responsible for monetary and debt policy. This subject, and the related matter of ensuring that the two strands of policy are effectively co-ordinated to produce the desired effect on credit conditions, will be more fully dealt with later in the report.

The effect of monetary and debt policies on real economic activity of course depends on the ability of the authorities to influence credit conditions as well as on the influence of credit conditions on expenditure. While it is the latter relationship

³ This assumes that the public's preferences have not changed. If there had been a precisely equal increase in the public's desire to hold deposits and other liquid assets rather than the direct debt or other less liquid financial assets now being acquired by the institutions, credit conditions and real spending will not have been affected even though the "money supply" has altered.

² Submission II, paragraph 48.

that we will examine in this chapter, we wish to stress that the authorities must accept a major responsibility for the credit conditions prevailing at any point in time. As the late Sir Dennis Robertson put it:

"I do not think that the duty of the Central Bank in respect of interest rates, short or even long, can be properly expressed by saying that as far as possible it must leave them to be determined in a free market—it is itself inevitably too much a part of the market for that to make sense; it is its duty to influence the rates in a direction and a degree consistent with the long-term forces operating in the economy".⁴

This view is also accepted by the Bank of Canada, as the following quotation from their submission to us clearly points up:

"In summary, the job of monetary policy is to assess the nature and impact of all the factors bearing on credit conditions and to decide whether in the circumstances it should allow them to be fully reflected in credit conditions, or whether and to what extent it should try to reinforce or mitigate their effects. In any set of circumstances there are limits to the range within which it is practical for monetary policy to allow or encourage credit conditions to vary, but within the range it can influence credit conditions in the direction appropriate in the circumstances".⁵

This amounts to saying that the central bank must always have a view about the whole state of credit conditions. Moreover, it by implication says that conditions prevailing in financial markets at all times must either have been acquiesced in or encouraged by the authorities and therefore reflect its policy. As the quotation however makes clear, there are limits to the authorities' ability to influence credit conditions. These limits are imposed by the need for public acceptability of credit policies, by international considerations, by the underlying tone of domestic economic activity and by the public's attitudes to saving and investment, as

well as by the need to keep financial markets functioning effectively and many other factors. Nevertheless, there is a range—sometimes broad, sometimes narrow—over which the authorities can set the tone of financial markets in order to influence expenditure.

THE COMMISSION'S RESEARCH ON CREDIT CONDITIONS AND EXPENDITURE

From the beginning of our inquiry, we have felt that an understanding of the extent and timing of the response of the economy to changes in credit conditions was of crucial importance. In the absence of such an understanding it would be impossible to judge either the effectiveness of monetary and debt policies by themselves or the need for supporting them by other instruments of policy. We therefore made a special point of raising this issue with those testifying before us and instructed our staff to carry out a program of empirical research on the question. The facts which are available for study include statistical information on changes in economic magnitudes and the direct experience of participants. The methods which are available for studying these facts can be classified in three categories—economic arithmetic, econometrics, and surveys.

Economic arithmetic—the compilation of statistical information and its analysis by graphical and other elementary techniques—points the way for other methods. If it were not possible to array quantitative information on the level of expenditures for various purposes by various groups in the economy, it would be difficult to begin to assess the effects of policy changes. In general, however, this method has not proved particularly useful in the study of the extent and timing of expenditure changes induced by changing credit conditions. It is easy to see why this is so. If, for example, interest rates and corporate investment are charted, it is found that they often move together. Corporate investment is rising or high when the expected yields on real assets are high, but high investment in turn tends to raise incomes and interest rates, particularly if the

⁴ Submission, page 29.

⁵ Submission II, paragraph 75.

authorities seek to promote economic stability by further tightening credit conditions. This will reduce investment below what it would have been in the absence of a change in credit conditions. But since the expected yields on real productive assets are relatively high in relation to the cost of borrowing at such times, investment will still be higher than it was when profits and business activity were less buoyant. Moreover, other factors will be influencing investment decisions at the same time—changes in technology and markets are constantly occurring and attitudes and confidence frequently shift. Thus the effect of a change in credit conditions by itself will be impossible to detect by a direct study of the data. Although there may be exceptions in the case of some components of expenditure which are at times drastically affected—for example, housing—the use of nothing more than the methods of economic arithmetic often make it quite possible to argue that the effect of a change in credit conditions is zero.

The econometric method of handling the statistical data uses a quantitative analysis for discovering relationships that may be missed by merely looking at tables or charts. There are some who feel that the use of advanced statistical techniques and electronic computers to explore the relationship between one economic variable and others constitutes a "black art" likely to produce misleading results. However, the increasing use of such techniques by business firms and others has made for a wider understanding of the fact that there is no clear dividing line between elementary and advanced statistical techniques. Anyone who is prepared to draw inferences from a relationship revealed by graphical techniques or tabular presentation has no basis for rejecting a relationship revealed by an equation fitted to the same data. In many respects indeed, the econometric technique shares common difficulties with graphical analysis. If, for example, the effects of profits, credit conditions and "capacity utilization" on investment decisions are being separately evaluated, these variables must not move too closely together during the period being examined.

If they do, there may not be enough variety in the experience to permit the separate effect of credit conditions to be detected.

The econometric work of this Commission was exploratory and incomplete. We did not attempt to construct an econometric model of the Canadian economy although we did have econometric work carried out on the effects of interest rates and the money supply on the demand for consumer goods and services, for new residential buildings, new capital equipment, new non-residential structures, non-farm business inventories, exports and imports. In many cases econometric analysis failed to reveal effects of credit conditions which our other work suggested should be present in the data. But while the direct results were limited, the precision required for carrying out econometric analysis contributed in an indirect but important way to the improvement of the other empirical work carried out for us.

A third way of attacking the problem is through the direct questioning of decision-makers on the way in which they have responded to changes in credit conditions. There are several problems encountered in the use of this method. First, it may not be possible to question a sufficiently large or representative group of those making decisions. Second, those who make the decisions may not be able to disentangle the effect of credit conditions from other influences affecting their behaviour. Third, some of the indirect effects of changes in credit conditions are not recognized and therefore cannot be measured directly by this method.

The problem of adequate coverage is less serious than it might appear to be. It is true that decisions on consumption are made by literally millions of individuals, and that heavy reliance must be placed on sampling methods. Our consumer survey described in Chapter 2 attempted to shed light on the effect of credit conditions on consumers' decisions. In the case of some other categories of expenditure, however, the decisions are highly concentrated. For example, our analysis of the effects of credit conditions on the capital expenditures of business and government enter-

prises was aided by the fact that around 80 enterprises carried out over \$2 billion of the \$4 billion of corporate capital expenditures in 1959. Our staff interviewed virtually all of these firms. Of the remaining \$2 billion, capital expenditures totalling \$1.2 billion were made by 750 firms each having assets over \$5 million, 600 of whom completed mail questionnaires and many of whom were interviewed. To cover the remaining \$800 million, a mail survey was made of a sample of firms, and interviews were also carried out on a sample basis to determine how the expenditures of smaller corporations, unincorporated business, farmers, fishermen, financial and real estate corporations, builders and private institutions were affected by credit conditions. Members of our staff also interviewed officials of the provincial governments and many of the municipal governments, a number of bank managers, security underwriters and officers of other financial institutions. While the coverage was not complete, the program of interviews was large enough to provide some information on the behaviour of firms and governments in all parts of the country.

THE NATURE OF OUR FINDINGS

There has been no lack of recent experience on which to base findings on the effects of credit conditions on expenditures. In the last decade, there have been three distinct periods of credit ease (1954-55, 1957-58 and 1961-62) and three periods of credit restraint (1956-57, 1958-60 and mid-1962). There have also been other short periods when some components of credit conditions, such as short and long-term interest rates or the availability of mortgage funds, have been subject to temporary fluctuations.

The changes in credit conditions which have occurred during this period have not been small by historical standards. For example, the yields on federal treasury bills have increased from under 1% to over 6% in a period of credit restraint and declined again to just over 1½% in the ensuing period of ease, while the yields on long-term government securities have risen from under 4% to over 5½% in a period of restraint

(a swing of over 15 points in price) and declined by .8% in the subsequent period of ease. Other borrowing and lending rates have also shown significant increases and reductions, and there have been major changes in the availability of National Housing Act mortgage funds, bank loans and other forms of credit.

In addition to these short-term variations in credit conditions, there has also been a significant upward movement in interest rates over the course of the last fourteen years. During the first half of 1950, yields on long-term Government of Canada securities were below 3% and yields on provincial, municipal and corporate bonds were on the average between 3% and 3½%. In the period 1959-63, yields on long-term Government of Canada bonds were generally between 5% and 5½% and yields on provincial, municipal and corporate bonds were generally between 5½% and 6%. Other borrowing and lending rates shifted upward in a similar way. There was, in short, a major long-term change in credit conditions.

The evidence which we have examined on the effects of a change in credit conditions on expenditure derives primarily from short-term rather than long-term changes in credit conditions. Even in the case of short-term changes in credit conditions, the variety of techniques which we have used and the help we have had from all quarters do not give us certain and precise knowledge of the response of the Canadian economy. We have come to the conclusion, however, that in most instances a close study of all the circumstances can establish within useful limits the range of possible effects brought about by such short-run changes. If plans have been altered as a result of a change in credit conditions, it is possible to make a meaningful comparison between what it was intended should be done and what was in fact done. Attempts to measure the impact of a major change in the "gear" of interest rates occurring over an extended period are far less reliable. Consumers, businessmen and those responsible for provincial and municipal spending decisions are necessarily creatures of their environment. While they can indicate how a recent

change in credit conditions has altered their plans, they cannot be at all sure how their plans would have evolved had they been living in a financial climate in which the whole decision-making atmosphere had been different. Thus, for example, a policy of restraint persisted in for some years may dampen demand in ways not directly measurable because projects which might have gone forward in a different set of circumstances are not even considered. Moreover, so many other changes in basic economic forces occur over long periods that no method of analysis can distinguish the particular effects which altered conditions in financial markets might have had on expenditures.

It is true of course that Canada is in no position to pursue monetary and debt policies without regard for what is happening in the rest of the world, so that our latitude to alter the domestic financial environment is limited. Nevertheless, there have been times when the set of our policies might have been significantly different, as in the period 1958-61 when less restraint would have been appropriate.

In view of the range over which monetary and debt policies have been used in the last decade, it would be surprising if there had not been some effects on domestic expenditure. When interest rates have risen and the availability of credit has been curtailed, there has been no lack of public complaint. This suggests that these changes have been widely recognized and, given the vigour of some of the criticism, that in at least some cases credit restraint has had considerable impact. Our findings confirm this view, although the effect of restrictive policies on expenditure has been very much less than the public outcry would lead one to believe.

The relative insensitivity of much of expenditure to changes in credit conditions has not generally arisen from an unawareness of changes in credit conditions among those making decisions. For example, virtually all large non-financial corporations, and a significant proportion of smaller companies, are either borrowers or lenders in the short-term money market and

follow market trends closely, while other firms frequently have a portfolio of short-term securities to be managed. Holdings of government and other securities among manufacturing corporations in 1959 were larger than or equal to holdings of cash in all size classes above \$250,000 of assets and any change in credit conditions is immediately reflected in the market value of these holdings. Corporations without major holdings of financial assets have connections with banks and other financial institutions and are quickly made aware of any changes in lending policies. Moreover, even though a significant proportion of the funds required for capital expenditure is internally generated, firms frequently turn to outside sources of funds. Of the firms with assets over \$90 million, over 80% undertook fresh borrowing of short or long-term funds in the period 1955-62 and among the smaller firms many resorted to bank borrowing.

Our inquiries have also indicated that firms have made rapid and sometimes extensive financial adjustments because of changes in credit conditions. For example, more than 10% of the firms responding to the corporate survey indicated that their accounts receivable became noticeably slower in payment when credit conditions tightened. Similarly, during each of the periods of restraint about 5-10% of the firms surveyed were led to change their sources of finance by finding new lenders, making sale and lease-back arrangements or borrowing abroad. Some were also moved by unfavourable bond market conditions and buoyant stock markets to raise funds through equity issues. The switch to foreign sources of funds was most obvious among the largest 80 firms, 10% of whom borrowed outside Canada in 1959-60—in part because of the rise in interest rates in Canada. Less than 5% of the smaller firms borrowed abroad but these firms were rather more willing to change their sources of finance within the country. However, many small firms made increasing use of foreign trade credit.⁶

⁶ See, for example, Transcript page 5315.

Despite these extensive financial adjustments, some businesses—and consumers and governments as well—reduced their planned expenditures because it was more expensive or more difficult to borrow. Similarly, there were cases in which the higher rate of return available on financial assets led to marginal reductions in expenditure through the increased incentives to saving; even in the corporate field some of our respondents indicated that dividend policy was watched carefully in tight conditions in case the funds involved might be needed in future.⁷ In short, our findings suggest that most of the effects of credit restraint predicted by theoretical reasoning can be found in the operations of the economic system⁸. It is less easy to find reliable evidence of corresponding effects from an easing of credit conditions in recent Canadian experience, but it may well be that an equally wide assortment of such effects could be uncovered in periods of pronounced credit ease.

Thus, the issue is not whether real expenditure is affected by changes in credit conditions, especially extreme changes. The real question is how large and how rapid are the effects which result from changes in credit conditions of the kinds experienced in recent years. Our conclusion is that, aside from the substantial effects which have on occasion resulted from sharp alterations in the availability of National Housing Act mortgage funds, the domestic effects have been quite limited in the short run. Moreover, while the time taken to implement changes in policy, and for the effects of such changes to affect employment and output, does not necessarily rule out the use of monetary and debt policies to exercise a stabilizing influence over the short run, there are significant lags of this kind which mean that actions taken late in one phase of a short-

run fluctuation can easily spill over into the next phase of the cycle when the requirements of stability may call for pressure in the other direction.

Before turning to a more detailed examination of the orders of magnitude of these limited effects and the lags in them, it may be useful to consider the reasons why results of this kind have been found. Corporate investment in plant and equipment is often considered to be an item of expenditure which may be sensitive to changes in credit conditions since it fluctuates over a wide range and those making the decisions are expected to be more sensitive to costs and returns than consumers and governments. At any point of time, business firms have a number of projects involving the construction of plant or purchase of equipment for which there are various anticipated rates of return. Some projects which promise a high rate of return will have priority in the plans for investment, but there must be some projects which are regarded as marginal, and which will no longer be regarded as worthwhile investments if interest costs rise.

In some cases, investment decisions are in fact altered, but there are several reasons why increases in interest rates of the kind we have experienced affect only a strictly limited amount of business investment.⁹ First, a high proportion of business investment is financed through retained earnings and depreciation allowances. Although firms might be expected to take increased interest rates into account, and perhaps curtail some projects which fail to provide a rate of return comparable to the improved yield on financial assets, after allowing for the different risks involved, our enquiries indicate that this is very rare. The higher opportunity cost of internal funds is only taken into account in a very informal way, if at all, and the effect on expenditure through this particular channel appears to be small indeed. Perhaps more surprising is that many firms relying on external sources for some of their investment funds do not raise the gross or net rate of return which they require from particular

⁷ See also, Transcript pp. 4564-5, Canadian Metal Mining Association.

⁸ It has been suggested that an increase in interest rates might lead to a perverse reaction, namely an increase in expenditure. We have found evidence that tightening credit conditions affects the timing of financing and leads to larger-scale borrowing in anticipation of even higher rates. However, we have not found evidence that tightening credit conditions by themselves induce a rise in real expenditure, although such cases might exist.

⁹ The results of our corporate survey are set out in detail in the appendix volume.

projects when borrowing rates rise. Even in cases where changes in rates of interest are explicitly considered, the cost of only a quite limited number of projects is sufficiently affected by an increase in interest rates to lead to a decision not to proceed.

The insensitivity of many business firms to changes in interest rates thus stems in part from an unwillingness to calculate the costs and benefits of investment projects sufficiently closely. However, the widespread adoption of better techniques for the evaluation of capital expenditures has had some effect in increasing their responsiveness compared to earlier periods. Yet while the improved methods of evaluating capital projects can array existing information in a more useful form, they cannot provide certain knowledge about the future costs and benefits of these projects. Experience has taught executives that most, and sometimes all, of the quantitative data pertaining to a capital project are subject to wide margins of error. It is therefore felt that the relatively minor cost associated with an increase in the costs of internal or external funds falls well within the margin of error which must be allowed for in any project. On the other hand, if the change in credit conditions is sufficiently dramatic to alter businessmen's expectations of the economic outlook, the effect can be larger. We found very few individual instances of this effect in our examination.

Moreover, much business capital expenditure is on a "must" basis in that the firm has either to improve the quality of the product and reduce production costs or lose its position in the industry. Some of this investment is described as having no measurable rate of return and therefore as being insensitive to any change in interest rates. Even if purely "defensive", such investment is frequently judged to be of such importance to the long-run profitability of the firm that it is unaffected by the small changes in costs arising from higher borrowing rates.

It should be noted also that bond and mortgage interest paid by all non-financial corporations amounts to only about $\frac{1}{3}$ of 1% of sales and—at \$300 million in 1960—was under 10% of

pre-tax corporate profits.¹⁰ Although the figure is increased by about half if bank interest is also included, interest rates remain a relatively minor item for corporations in general. Even in the case of some of the highly capital-intensive utilities where it might have been anticipated that the effects of changing interest costs would be particularly significant, great stress was put on the need to meet the demand for services; this demand itself was only marginally affected by changes in credit conditions. In cases where the utilities had greater freedom of action to alter capital expenditures, the fact that the regulatory authorities were prepared to take the cost of funds into account in setting rates tended to reduce the degree of sensitivity.

Another factor contributing to unresponsiveness is the existence of a substantial corporate income tax. Corporate executives frequently point out that the cost of an increase in interest rates is cut in half by the existence of the corporate income tax and its effects are therefore correspondingly reduced. This view has some influence on corporate decisions, although it is sometimes suggested that if corporate after-tax profits are reduced by the full amount of the tax, the relationship between after-tax interest costs and returns is not altered. Such evidence as we have, however, indicates that a significant proportion of the corporate income tax has been passed on by corporations and that the effect of an increase in interest rates is therefore dampened by the existence of a high corporate income tax, although this effect is considerably reduced in the case of smaller firms subject to a lower rate.

These generalizations will probably come as no surprise, since virtually all the research work which has been done on the subject has tended to point in the same direction. Nevertheless, some who accept the view that the cost effect of changes in interest rates is small have held that there is a strong incentive to postpone investment if it is anticipated that interest rates will be lower in the near future. They argue that while a change in the long-term borrowing rate from 5% to 6%

¹⁰ *Taxation Statistics.*

cannot be expected to have a major effect if this higher rate is expected to continue, such a change will have an effect if it is confidently expected that the rate a year hence will again be 5%. The decision to proceed with a 20-year issue with regular repayments of principal and interest at 6% as compared with one a year later at 5% will, for example, increase annual carrying costs by almost 9%; stated another way, it implies a short-term interest cost of close to 15% for the year. We have reproduced in Chapter 24 an analysis by Professor Lundberg of a Swedish investment tax which had an effect of this order, and there seems little question that it exercised a major influence over capital expenditure.

In fact, however, an increase from 5% to 6% in long-term interest rates is most unlikely to occur if it is *generally* expected that a decline to 5% will take place within a year. Moreover, those investors who do firmly hold the view that the increase is temporary need not postpone their investment, they must merely find accommodation to tide them over until long-term interest rates have declined. If the rate they must pay for short-term accommodation is a reasonable one, then there is no reason to postpone the project, and we have found that many firms do indeed respond in this way by altering the timing of their financing in the light of their expectations of future movements in interest rates. Other firms do not attempt to forecast the market and thus implicitly treat each change in their borrowing rate as though it were a permanent change. In either case, the timing of investment spending will be largely unaffected by expectations about the future short-run changes in long-term interest rates. Nevertheless, there are some companies which are aware that they may well be borrowing at the peak of a cycle of long-term interest rates, but either do not have access to short-term finance on a sufficiently large scale or elect not to make use of it, preferring instead to cut back their spending; we found that such cases were, however, relatively rare.

If financial markets were perfect, there would be no need to go beyond an analysis of the effects of interest rates on spending. But in periods

of credit restraint, business firms with adequate access to credit in normal times cannot always obtain the funds they require at prevailing market rates. In short, limitations are imposed on the availability of credit, and the increased difficulty of obtaining funds is not fully reflected in interest rates. For a firm with alternative sources of finance at reasonable rates, limitations on the availability of credit from its usual sources may merely imply a moderate increase in the effective rate they must pay on borrowed funds. For firms without such ready access to reasonable alternatives, the effective increase in interest rates is much sharper since they must resort to lenders with significantly higher charges. For some firms, therefore, the potential effects of changes in the availability of credit from their normal sources are much greater than anything they are likely to encounter from general interest rate changes. In fact, however, changes in the availability of credit have had much the same effects as changes in interest rates. During recent periods of credit restraint, some firms have postponed or abandoned particular projects because they were unable to obtain credit or were reluctant to turn to higher-cost alternative sources. In general, however, limits on the availability of credit have not been sufficiently stringent to exercise more than a limited influence over investment in plant and equipment.

Business investment in inventories has sometimes been regarded as particularly likely to respond to credit restraint. However, we found little evidence of such responsiveness, and there appears to be little relation between non-farm inventory target levels and rates of interest. It is widely accepted by firms that desirable inventory levels are determined by technological factors, changes being largely independent of changes in the financial costs of carrying inventory. In some cases, firms reduced inventories because of suggestions made by their bankers or other lenders or because of changes in the availability of credit, but the total of such shifts appears to be small. Such evidence as we have also suggests that farm inventories and grain in commercial channels are largely unaffected by credit restraint.

Government expenditure on goods and services also tends to be relatively insensitive. In the course of our hearings, some of the provinces and municipalities drew attention to reductions in their capital expenditures in response to credit restraint. When all the evidence had been assembled and compared with total expenditures during the relevant periods, however, it became clear that provincial and municipal expenditure had been curtailed very moderately. The benefit to be derived from capital expenditure by governments can rarely be assessed in the same terms as business investment and the resulting rate of return compared with the cost of funds. Instead, governments must be influenced by their judgment of the need for particular expenditures and of the political consequences of failing to meet the continuing demand for expanded services. If these judgments suggest that expenditures be continued, governments are rarely dissuaded by an increase in interest rates of the kind we have experienced. Moreover, expecting rising prices, they may feel that the higher cost of carrying out these projects later will more than offset the extra interest payments involved. Nevertheless, interest payments constitute a tax burden, and in some cases high interest rates acted as a deterrent to capital expenditure. Similarly, limitations on the availability of credit to municipalities have had some effect on expenditure, although in other cases a decision was taken to go to the market earlier than had been planned and capital projects were not postponed.

It ought to be relatively easy to determine the effect of credit restraint on personal consumption expenditure. We are all consumers and, while we may not be fully aware of all the reasons for our decisions, ought to be able to recognize the extent to which we have altered any of our plans in response to increases in interest rates and limitations on the availability of credit. However, despite evidence that consumers are sensitive to interest rates in the sense that they alter the form of their savings, aggregate data and surveys are inconclusive as to the effects on saving in total. Despite the growth of contractual saving, in pension and other forms as well as in repayment of

outstanding debt, it is apparent that personal saving does fluctuate from year to year, but there is no available evidence showing that a firm relationship between personal saving and interest rates does, or does not, exist.¹¹

It has generally been thought that consumers who are borrowers are ordinarily quite insensitive to increases in interest rates, although they will respond in a fairly marked way to significant changes in the amount of down payment or in monthly payments resulting from a shortening in the terms of the loan. Since there is an important element of service costs in most consumer loans, the effective rates of interest are often very high and an increase of 1% or 2% in the general level of interest rates—even if reflected in a change in the rates charged on consumer loans—will have a relatively small effect on the total cost of borrowing. On the other hand, many consumers encounter difficulty in providing a larger down payment or managing the higher monthly payments which result from a shortening of the period of the loan. Thus, Canadian experience and that of other countries suggests that changes of this kind do have substantial effects on consumer expenditure financed by instalment loans.

In the case of housing, the consumer's commitment is for a larger amount outstanding over a long period and a significant increase in the mortgage rate thus leads to an increase in debt servicing costs which is substantial in relation to the consumer's income. However, the most substantial changes in expenditures on new residential construction have come in periods when there was a lack of availability of N.H.A. mortgage funds. As explained in Chapter 14, when credit conditions are relatively easy, institutional investors have found N.H.A. mortgage lending a profitable outlet for funds. If, however, long-term interest rates rise and no change is made in the N.H.A. rate, the yield differential between N.H.A. mortgages and other investments becomes unattractive and institutional investors tend to withdraw from N.H.A. lending. If the Central Mortgage and

¹¹ A rise in interest rates has opposing effects on saving—it increases the reward for saving but reduces the amount needed to achieve a given target.

Housing Corporation does not provide direct loans to overcome the resulting shortage of N.H.A. funds, builders and purchasers have the choice of financing through conventional mortgages—with their combination of higher interest rates, higher down payments and shorter term—or postponing construction.¹² This change in the terms of available mortgage funds has significantly affected the level of expenditure on housing.

Some of the domestic effects of credit ease are merely the opposite side of the coin to credit restraint. For example, the greater availability of N.H.A. loans in 1957-58 led to a significant increase in housing expenditure in 1958 because demand had been effectively restrained largely by the lack of availability of mortgage funds on favourable terms. Moreover, during this period the demand for housing remained high, and after being curtailed by credit restraint during a boom it could be encouraged by credit ease during a recession. In the case of other types of domestic expenditure neither of these conditions held. Credit restraint had had limited effects on expenditure and it could therefore be anticipated that credit ease would have limited effects. In addition, there have frequently been sharp changes in the demand for other goods and services arising from actual or anticipated changes in the level of economic activity, with demand and expenditure falling at the same time as credit conditions have eased. Thus a shift from restraint to ease could not have been expected to lead to major and observable changes in domestic expenditure.

Such evidence as we have gathered suggests that the increase in domestic expenditure, other than on housing, which has been brought forth by a decline in interest rates and an increase in the availability of credit has been very small. This is in line with the frequently expressed view that monetary policy can be effective in restraining a boom but is less effective in stimulating a recov-

ery, and reflected in statements such as "You can lead a horse to water, but you can't make him drink" or "You can't push on a string". During periods of economic weakness, attempts to stimulate investment by easing credit conditions are usually thought likely to be frustrated by a lack of incentives to invest. Indeed, if there is much excess capacity and the economic outlook is poor, the expected profitability of much investment may be negative. This is not unlike the state of affairs during the 1930's when general credit ease had less effect than many had anticipated and the notion tended to develop that monetary and debt policies were relatively ineffective in providing a stimulus to demand.

Anyone who is sceptical of the effects of credit restraint must qualify his remarks by setting a limit to the vigour with which restraint is applied. There have been many financial panics in the past when interest rates have risen to abnormal levels and lack of availability of credit has led to widespread bankruptcies. There is clearly no room for doubt that extreme financial conditions do have important effects on economic activity even if business conditions are buoyant and inflationary sentiment strong. Thus, if the normal level of short-term interest rates is 3%-4% and if international or other complications could be ignored, there will be some rate which is effective in restraining demand, even though it might be well over 6%. While theoretically there is no limit to the extent of the increase in interest rates, there is such a limit on the extent to which a decrease can be brought about by conventional monetary and debt policies. The short-term rate on treasury bills can be reduced from its norm to almost zero but cannot be made negative. There is therefore more possibility of effectiveness on the side of restraint if action is restricted to the use of conventional policies.

These differences between the effectiveness of credit restraint and credit ease were only partially significant in recent years. During recessions, there was excess capacity in many industries and the economic outlook was not favourable, but there was not any major collapse of expectations. Sim-

¹² Since an N.H.A. mortgage must be taken out as the house is being built, it is not possible for borrowers to obtain short-term finance from other sources and subsequently take out an N.H.A. mortgage when they are freely available again.

ilarly, although the over-expansion of some types of plant and equipment during the investment boom of 1955-57 removed the incentive for further investment, this was not true of all industries and firms and capital formation continued to go forward in both good years and bad. Over a wide range of investment, therefore, it was possible for credit ease to exert some influence. That such an influence is very difficult to find results in part from the nature of the changes in credit conditions during the 1950's. Throughout the decade, there was an upward trend in interest rates, each period of ease being merely a valley on the side of a hill. In most cases, changes in the direction of ease were less pronounced than changes in the direction of restraint, and thus less likely to lead to a positive response.

There are other reasons why the response to credit ease might be expected to be small as compared with that to credit restraint. We have already noted the insensitivity of firms which rely heavily on internal funds; other firms of course have less need for outside funds during a period of low investment. Moreover, firms which attempt to time their borrowing in relation to conditions in financial markets may borrow heavily during a period of credit ease, but this may have little or no effect on the timing of their capital expenditure. Finally, there can be delays in planning which impede the response to credit ease. Under conditions of credit restraint, some firms with plans all ready to proceed may decide to postpone or abandon one or more projects. While this is not an easy decision, it can readily be implemented if a start has not been made on construction or an order has not been placed for equipment. On the other hand, the framing of plans is necessarily time-consuming and if a decline in interest rates or an increase in the availability of credit leads to a decision to undertake a larger program of investment, there may be considerable delays before expenditures are actually increased. This problem will not be encountered if long-range planning is undertaken and if expenditure which has been curtailed by credit restraint is permitted to go forward in a period of ease. Despite the growth of such planning, however, conditions have fre-

quently been found to have changed enough so that a project is no longer attractive in its original form.

The identification of such response to credit ease as does exist is made more difficult because when credit is readily available and interest rates are lower than they have been in the past, credit conditions may not be accorded a great deal of importance. A decision to proceed with a particular expenditure might not have been taken if conditions had been tighter, but it is particularly difficult to separate this effect from the many other factors influencing the decision. Thus, the very limited reaction to credit ease revealed by questionnaires and interviews probably understates the effect on domestic expenditure. For example, the proportion of respondents to our consumer survey who indicated that they would step up their purchases of houses and cars under significantly easier credit conditions was only a fraction that of those who indicated they would curb their purchases under comparable conditions of restraint. Yet we have no doubt that the greater availability and more favourable terms of consumer credit in the post-war period has had a considerable impact on the buying of consumer goods.

THE INTERNATIONAL EFFECTS OF CHANGES IN CREDIT CONDITIONS

The discussion above has been limited to the direct response of domestic expenditure to variations in credit conditions. This is the relationship which is important for countries operating under a fixed exchange rate system. If capital flows freely in response to interest differentials under such a system, a change in capital movements will have its major effect on the exchange reserves rather than on the exchange rate. However, under a flexible exchange rate system with large-scale capital flows—the system under which Canada operated during the 1950's—changes in credit conditions can also have an important indirect effect on expenditure through the exchange rate.

Under the flexible rate system, a change in credit conditions in Canada which raised interest

rates relative to those in other capital markets tended to reduce domestic expenditure directly and thus reduce imports to some extent.¹³ The initial improvement in our international current account—which under a fixed rate system leads to gains in exchange reserves—tended under a flexible system to increase the international value of the Canadian dollar. If there were no capital movements or changes in official reserves, this change in the exchange rate would have had to be such as to lead to other changes in international trade to restore the original current account position—i.e. other imports would have had to increase or exports decline, a process which would further curtail spending in Canada. Since the original domestic effects of credit restraint are not large, the adjustment in the exchange rate under these conditions would not normally need to be very large either. However, during this period capital was flowing freely into Canada and credit restraint which widened the differential between our interest rates and those elsewhere encouraged greater capital inflows and pushed the international value of the Canadian dollar still higher. The resulting additional encouragement to imports and discouragement to exports thus exercised a significant dampening effect on economic activity not found under a fixed exchange rate system.

The importance of this effect on domestic expenditure turns, among other things, on the extent to which capital movements respond to interest rate differentials and to which trade responds to changes in the exchange rate. Our evidence suggests that while some capital flows are immediately responsive to changes in credit conditions, small and temporary fluctuations in the exchange rate are unlikely to have a major effect on trade. As we shall indicate below, there are other sources of balance over the short run, including stabilizing speculative capital movements. However, exchange rate movements which are larger and expected to persist will exercise a major effect over trade. Thus, under a flexible

exchange rate system, the international effects of changes in credit conditions which alter the interest differential between Canada and other countries have important repercussions on our foreign trade and therefore on domestic economic activity, provided they extend beyond a short period.

THE LAGS IN THE RESPONSE OF EXPENDITURE TO CREDIT CONDITIONS

In any assessment of the potential usefulness of monetary and debt policies, it is important to know the timing as well as the size of their effects on expenditure and output, particularly when credit conditions are varied frequently. It has long been recognized that the tardy response of the economy to policy changes poses a problem, but for the two decades prior to 1950 this was not a major issue. Many leading countries maintained easy credit conditions throughout the 1930's and 1940's and with the policy instruments set in one direction the timing of their effects did not greatly matter. Thus, the high unemployment existing in the Canadian economy in the late 1930's could hardly be imputed to lags in monetary policy's effectiveness. Indeed, it was not until a flexible monetary policy was restored in the 1950's, and reversals of policy began taking place every two or three years, that timing became a matter of major importance. We are concerned here with the time between a change in credit conditions and the resulting changes in output and employment, because without some knowledge of the delays involved one cannot be sure whether even the promptest action by the authorities will have an effect soon enough to stabilize, rather than de-stabilize, the economy.

There appears to be little delay in the recognition of a significant change in credit conditions by the financial officers of governments and corporations. They may not all dissect the weekly report of the Bank of Canada, but they do deal in financial markets on a regular basis. They are thus quickly made aware of any major change in market rates of interest and the availability of funds. This is not to say that there is much re-

¹³ The supply of exports might also be increased in conditions such that high levels of domestic demand had previously diverted production to the home market.

sponse of expenditures to the early stages of a policy of restraint or ease. In some past periods, short and long rates of interest have risen for many months before there has been any significant response from those making capital expenditure decisions. Indeed, our enquiries have pointed up the fact that the first few months of a gradual change in credit conditions have usually been taken up in bringing the financial system to the point where it begins to exert a restraining influence over expenditure. An exception to this general tendency occurred in 1962, when the change in credit conditions was dramatic. The fact that there were other uncertainties present—including a foreign exchange crisis—and that the change came after a long period of bank loan expansion makes this rather a special case. It does nonetheless indicate that a decisive change in interest rates and bank lending policies can have a rapid impact on capital expenditure decisions.

A change in the decision to undertake or not to undertake a capital project will naturally not have an immediate effect on employment and output. Most capital expenditures in the current period are for projects started in previous periods, while most decisions made currently involve expenditures in subsequent periods. The extent of the lag depends upon the nature of the project. This can be illustrated by a series of examples drawn from the period of credit restraint in mid-1962. An oil company which decided to reduce its service station program for 1962 would have carried the program to completion in the summer and fall of that year. The construction of a ship which was postponed in 1962 was scheduled for completion in the spring of 1963 so that any direct employment effects would have been felt during the period mid-1962 to early 1963. Some warehouse construction which was postponed because of the unavailability of bank credit would have been undertaken in the summer and fall. Replacement expenditure of \$600,000 which was planned by an engineering contractor would have been made by the fall. A construction materials firm which postponed the purchase of cars and trucks reduced the sales of

motor vehicles in 1962. A small building products firm which was negotiating with a lending institution when credit was tightened was unable to obtain funds for expansion and postponed expenditures which would have been mainly made the same year. A small, but rapidly growing, industrial products firm was planning to modernize equipment but was discouraged by "tight money talk" and did not make its purchase in 1962. A medium-sized oil company postponed a pipe line project from the 1962 construction season to the next construction season.

Some of the direct and indirect effects of the postponements or abandonments listed above—which, though numerous, did not involve a high proportion of business capital expenditures—would have spilled over into 1963 and beyond, but it is evident that much of the effect would have been felt fairly quickly. We found other cases where the lags were much longer. A paper manufacturer who did not purchase a paper machine estimated that the employment effects of this would extend over a period of two and a half years. Part of the work on the new buildings required to house the machine would have been carried out in 1962, but the construction of the machine itself would have been spread over a much longer period and might well have taken place in another country. An oil company which responded to the 1962 change in credit conditions reported that it was planning to restrict expenditure in the next year as well. A power company which postponed the start of a project was able to provide fairly precise information indicating that the result would be a fall in expenditure in 1962 and 1963 and a subsequent rise in 1964 and 1965, with the bulk of the restraining effect coming in 1963.

The lags in residential construction are much less complex than those found in government expenditure and corporate investment. It has sometimes taken a considerable interval for the yield differential between N.H.A. mortgage loans and other investments to alter and therefore for institutional lending to be affected significantly, but once this has occurred—or a decision has

been taken to alter CMHC direct lending—housing starts can be affected very quickly. Our econometric work suggests an average lag of about three months, with the lag on occasion being as short as a few weeks. The submission of the Central Mortgage and Housing Corporation suggests that peaks in residential construction activity are likely to lag peaks in starts by as much as four months, reflecting the length of the construction period and the timing of work done within that period.

We have already indicated that the major effects of changes in credit conditions which have come through changes in the exchange rate are felt with a considerable lag. Some international capital flows respond quickly, but there may be compensating movements which reduce the immediate effect on the exchange rate; moreover, long-term capital flows respond more slowly. However, even if the rate responds in a matter of months, it takes time for adjustments to be made by producers, and these will be limited if the change is in any event expected to be temporary.

In summary, there is considerable variation in the lags between the time when credit conditions are brought to the point where they exert an influence over different categories of expenditure and the time when those effects are felt in the economy. For some categories of expenditure such as residential construction, the lags are variable but fairly short and fairly easy to predict. In other sectors of the economy, the lags depend upon the nature of the expenditure, but a major proportion of the direct effects on employment and output may come within a period ranging from a few weeks to 6-9 months, although other effects—both direct and indirect—will extend into later periods. Our evidence suggests, moreover, that these lags can be shortened considerably by fairly dramatic changes in credit conditions, especially if the climate of business opinion and expectations is significantly affected by the policy measures themselves or by other events in the economy. Finally, the evidence seems to indicate that for all but the very shortest of cyclical fluctuations,

the actions of the authorities can play a useful stabilizing role, although the variable nature of some of the lags means that there is a risk that the effects of previous policies may exert some restraining influence after conditions have changed and ease is called for. These effects are most likely to be seriously harmful when inappropriately restrictive policies are persisted in.

A CASE STUDY OF CREDIT RESTRAINT IN 1958-60

The complex nature of the problem of estimating the extent and timing of the short-run response of the economy to changes in credit conditions can be illustrated by considering the period of credit restraint 1958-60. The seasonally adjusted annual rates of gross national expenditure in the fourth quarter of 1959 and the first and second quarters of 1960 (the peak of the expansion) were \$35.4 billion, \$36.0 billion and \$35.6 billion respectively. As things turned out, the level of economic activity during these three quarters was well below the capacity of the economy, but the appropriateness of policy is not the issue here. We can observe what in fact happened, but we must infer what would have happened under alternative credit conditions if we are to assess the effects of the changes in credit conditions which took place during this period.

It would be misleading to suggest that the techniques of measurement used permit precise definition of the alternative credit conditions assumed. We have, however, used as a benchmark the credit conditions which might have resulted from a decision to operate as far in the direction of ease as was consistent with the avoidance of a large-scale depreciation of the exchange rate. We assume this would have entailed credit conditions characterized by a very moderate rise in interest rates and little restraint on bank lending. Using this set of credit conditions as a reference point, estimates have been made of the effect on expenditure of the variation of credit conditions which actually occurred, i.e. an increase in treasury bill rates from around 1% in mid-1958

to over 6% in August, 1959, a rise in yields on long-term government securities from around 4% to 5.6% and significant restraint on bank lending.

We have not been able to make an estimate of the direct effect on consumption of the change in credit conditions which occurred in 1958-60. Consumption is a very large component of expenditure and even a moderate response to increased interest rates or limitations on the availability of credit would be quantitatively significant. Consumer credit outstanding increased from around \$3.2 billion at the end of 1958 to \$3.6 billion at the end of 1959, although personal loans by the chartered banks against marketable securities fell from \$287 million in 1958 to \$282 million in 1959—presumably because of the curb on lending for speculative purposes. Other bank personal loans stopped rising for some months during 1959. Some individuals were refused loans during the period and some of them in fact curtailed their expenditure on durable goods, but our impression—supported by the results of our consumer survey—is that this was not a common occurrence.¹⁴

In an attempt to obtain added information on consumer responsiveness to changes in credit conditions, some hypothetical questions were asked in our consumer survey. The results suggested a much higher responsiveness than previous evidence and the data on aggregate consumption expenditure would support, but there is reason to believe that the information obtained is misleading. For example, of the 388 respondents who had purchased automobiles on credit in the period 1957-62 and who were asked what they would have done if higher finance charges had required them to pay 5% more per month—i.e. \$3 to \$4 more per month on a new automobile contract—no less than 48% replied that they would have deferred or downgraded purchases. Moreover, 41% replied in a similar vein when asked for their probable response to a shorter-term loan

with monthly payments 10% higher.¹⁵ For housing, the responses of 543 households were just as extreme, 46% indicating that they would have postponed or made cheaper purchases if monthly mortgage payments had been 10% higher owing to higher interest rates and 37% making the same comment about a similar increase stemming from a shorter-term loan. Interestingly, however, only 2% to 8% of respondents replied that they would make a more expensive purchase in the reverse circumstances.¹⁶

We are sceptical about these results for a number of reasons. First, hypothetical questions are always hazardous and the responses are much less reliable than those based on decisions which have actually been taken; this is especially the case when it is not possible to follow up subsequently and verify the answers against actual behaviour. Secondly, the questions were difficult and it is evident from the comments of respondents and of the interviewers that they were not always fully understood. Thirdly, there were numerous replies which indicated that respondents objected strongly to the level of interest charges that they had in fact paid and as a matter of principle felt bound to indicate that they would postpone purchases if they were any higher.

Our scepticism is supported by the evidence which the survey obtained on actual spending decisions. All respondents were asked if they had deferred purchases of houses or cars in the five years 1957-1962 after seriously considering them (to the point of checking prices, credit terms and other details). For houses and cars, 10% and 8% of respondents respectively reported deferrals, but the dominant reason was that they were too expensive. Only one-tenth of these deferrals were attributed to financing difficulties of any kind; of these a part stemmed from apparent unwillingness to pay any rate of interest within the range

¹⁴ A 5% increase in monthly payments involves an increase in effective interest rates of from 18% to 24% over a two-year contract: if monthly payments are 10% higher, all other factors unchanged, the term of the loan is shortened by 2½ months.

¹⁵ The questions and the replies are tabulated in the appendix volume.

¹⁶ 4% of households reported being refused a bank loan in the period 1957-62, but only one-quarter of the respondents were given tight credit conditions as the reason and not all of these occurred in 1959-60.

charged in recent years.¹⁷ Respondents who had not deferred purchases commonly commented that changes in interest rates or financing terms were not a factor in their decisions or—when they were—that other considerations of a special kind over-rode them.

The modest response of actual spending decisions on housing and cars to changes in credit conditions in the period is broadly consistent with aggregate data and other evidence. At the same time, the hypothetical results are not completely irrelevant for assessing consumer behaviour in the case of more drastic changes in credit conditions. For example, the changes suggested in the questions on housing were equivalent to a rise of 1½% in the interest rate on a 20-year 6½% mortgage or to a shortening in term of about 3½ years. The proportion of respondents—about 25%¹⁸—who stated that they would postpone purchase of a house in such conditions, can be compared to the 20%-25% reduction in planned housing outlays that occurred in 1956-57 when N.H.A. funds were less freely available. (Allowance must be made for the fact that some of these reductions in consumer spending on houses would have fallen on existing houses and thus not have directly affected gross national expenditure and that the results of the survey apply only to those who used credit to finance their purchases.)

The hypothetical response for automobiles seems to have less relevance for the future, although it may be indicative of the effect of direct controls. While the stringent consumer controls in the Korean War period did not appear to have effects as dramatic as those indicated by the survey, it may be the case that the disappearance of demand backlogs, the spreading use of consumer credit, the importance of debt repayment in many budgets, and the lack of inflationary fears have increased consumer sensitivity to such controls. In short, while we have every reason to be-

lieve that the answers to the hypothetical questions in the consumer survey overstate the responsiveness of consumers to even dramatic changes in credit conditions, we believe that they are not entirely irrelevant. Further research into consumer behaviour might yield fruitful results on the effectiveness of monetary and debt policies.

Returning to the actual response of consumer spending to the changes in credit conditions which took place in 1959-60, it appears unlikely that the direct effect on consumption of the increase in interest rates or reductions in the availability of credit was of major importance during the period, particularly since only a small proportion of total consumption (excluding housing) is financed on credit. As noted earlier, we have no direct information on the response of personal saving to changes in credit conditions. Net personal saving declined in 1959, but this is a residual item in the national accounts and it is dangerous to infer anything from it. However, it is important to note that even if the short-run *direct* effect on consumption of a change in credit conditions is small, any decline in income arising from a fall in expenditure elsewhere in the economy will lead *indirectly* to some decline in consumption.

Government expenditures on goods and services (excluding expenditures of publicly owned enterprises whose principal sources of revenues are derived from the provision of goods and services to the public) amounted to \$6.5 billion in 1959. Of this, \$2.85 billion was spent directly by the federal government on goods and services, while expenditures by provinces and municipalities—and the school boards and hospital districts within their jurisdiction—totalled \$3.65 billion. We have already referred to the testimony received from the provinces and the municipalities and the general conclusion we reached after examining all the evidence. In the case of the provinces, this finding was further tested by correspondence relating particularly to capital expenditures during the period 1958-60. It was found that to the extent that any reliable judgment could be made there had been little response to credit restraint in provincial capital

¹⁷ However, a significant number of house buyers indicated that they found the term of mortgage loans too long, or the loans too large, for their needs.

¹⁸ 9% of survey respondents indicated that they would postpone housing purchases if the down payment were 10% higher.

expenditure. It was almost as difficult to find much evidence of significant responsiveness on the part of municipalities, school districts and hospital boards. Some municipalities which found bank financing difficult in the latter half of 1959 went to the market rather earlier than planned but did not postpone capital projects. Putting together the evidence derived from interviews with representatives of the provinces and municipalities with a direct analysis of provincial and municipal expenditure during the period, we would conclude that the amount of expenditure postponed was in the range of \$10-25 million. A portion of this expenditure would have been carried out during the peak quarters, but it is not possible to date the impact on expenditure with any accuracy.

Despite the sensitivity of new residential construction to changing credit conditions, outlays on new housing were not greatly affected in this particular period. Loans by approved lenders fell off sharply during the latter half of 1959, and for the year as a whole were down to \$280 million from \$510 million in 1958. However, Central Mortgage and Housing Corporation acted as the residual lender for home owner applicants through most of the year.¹⁹ Over \$340 million was committed in the first ten months of 1959, and by November the Corporation had exhausted its available funds. However, the decline in lending came too late to reduce the level of economic activity until the second quarter of 1960. In short, the substantial effect of credit conditions on private N.H.A. lending, and thus on housing construction, was almost entirely offset by direct public lending. The net effect on residential construction was therefore minor in the first two peak quarters, almost certainly not exceeding \$50 million at annual rates, compared to recorded housing expenditures of about \$1,675 million annually in the same period.

Expenditures on new non-residential construction and new machinery and equipment ran at levels of from \$5 billion to \$5.4 billion in the three peak quarters. In 1959 as a whole, the capi-

tal expenditure of private and public non-financial corporations totalled \$4 billion, while those of the 80 largest private and public corporations totalled \$2 billion. It has been estimated from the results of the corporate survey that the capital expenditures of the latter firms in the last quarter of 1959 and the first two quarters of 1960 would have been \$20-25 million higher if credit conditions had been significantly easier.²⁰ For the firms of smaller size, the estimate is based on less adequate information but it appears that the effects of changes in credit conditions were of the order of \$30-40 million in the three peak quarters. The latter estimate includes an allowance for changes in the expenditure of proprietorships and partnerships operating in the fields of manufacturing, commercial services and trade.

The effects estimated above, while surprisingly small, were distributed through all the size classes of firms. When large firms postponed expenditure, they generally did so because they were unwilling to borrow at current rates. A few large firms postponed expenditures because of doubts about the advisability of expansion during a period of credit restriction, while an occasional large firm encountered difficulty in obtaining the funds it needed. Almost without exception, however, their adjustments to planned capital expenditures were marginal in nature. Among the smaller firms, there was generally little reaction to the change in interest rates; it was rather the case that they found themselves unable to obtain increased credit from their usual sources. In some instances, these limitations were sufficient to cause expenditures to be postponed but in others the firms found alternative sources, frequently at higher cost. The proportion of smaller firms which did change their capital expenditure was no greater than that of larger firms, but they did so to a greater degree; the differential effects were not large.

The small number of firms which indicated a response to credit conditions makes it difficult to say much that is meaningful about regional or

²⁰ This, like our other estimates, is the estimated direct effect of easier credit conditions. There is no reliable way of measuring the indirect effects on individual expenditure components.

¹⁹ Loans to builders were not available for part of the year.

industrial distribution. It can be said, however, that the effects have not been concentrated in particular regions or particular industries, a finding which confirms that of other studies.²¹

There are other components of gross business fixed capital formation which were not covered by the corporate survey. These included agriculture and fishing with capital expenditures in 1959 of over \$500 million; finance, insurance and real estate with capital expenditures of over \$250 million; and hospitals, private schools, churches and universities with capital expenditures of \$200 million. Staff studies and interviews have thrown some light on the degree of responsiveness to credit conditions of these sectors of expenditure.

Capital expenditures in agriculture and fishing appear to be, if anything, less affected by changes in credit conditions than are non-farm corporate capital expenditures. Capital expenditures in finance, insurance and real estate include the building and equipping of offices for financial institutions and the construction of non-residential buildings by firms whose object is to lease or sell the premises rather than use them for their own operations. Expenditures of the latter type are the major part of these expenditures and are affected considerably both by the availability of mortgage funds and of interim construction credit from the chartered banks. Expenditures in this category might have altered by up to 5% in late 1959 and early 1960, although most of the expenditure consequences of decisions made at that time would appear in a later period. The evidence on the third category, including hospitals, private schools, churches and universities, is very limited. While some financing difficulties were encountered as a consequence of credit restraint, there is little indication that any significant amount of construction was postponed.

Non-farm inventories increased by \$300 million, \$700 million and \$400 million in the three peak quarters. Interest rates are only one element in the total carrying cost of inventories and even those firms which have recently introduced new

techniques for controlling inventories do not generally take into account changes in market rates of interest in establishing inventory levels. There were, however, some firms which responded to credit restraint in 1959 by reducing their inventories below the level which would have existed under easier credit conditions. In some cases this was the result of limited availability of funds, and in one important case it was a response to the anticipated effect of credit restraint on sales. It is estimated that expenditure in the three peak quarters may have fallen by something of the order of \$10-25 million.

As indicated in our earlier discussion, the effect of credit conditions on the exports and imports of goods and services under the flexible exchange rate system is a very complex one. During this period, the interest rate differential between Canada and the United States widened significantly and exercised an influence over capital flows which added to the exchange rate effects resulting from the reduction in import expenditures. The average value of the Canadian dollar rose by approximately 2½ cents from U.S. \$1.025 to U.S. \$1.05 from February to November 1959. Under the alternative credit conditions we have assumed, we visualize that the Canadian dollar by the fall of 1959 might have been worth only U.S. \$1.00. If this is a plausible guess, and it is little more than a guess, all the evidence which we have available—derived from economic arithmetic, econometric analysis and the surveys—seems to suggest that this rate change would have had limited effects on the flow of trade; these effects might have been of the order of \$150-\$250 million in the three quarters. At the same time, the volume of imports would have tended to increase because of the direct effects of higher levels of domestic expenditure resulting from easier credit conditions. This estimate of the overall effect of credit restraint on our trade balance is necessarily a very broad one, and since the possibilities of error are compounded by the several steps in the process of estimation the results should be regarded as of limited reliability.

The total of all these effects of changed credit conditions on expenditures will be greater than the

²¹ See, for example, Report of Professor A. K. Cairncross to the Atlantic Provinces, Atlantic Provinces Research Board, 1961.

sum of the component parts. Any decline in public and private investment, in consumption or production for export, or in domestic production because of replacement by imports, tends to reduce incomes and hence to have further effects on consumption and investment. Some people who would have been at work in the fall of 1959 and the early months of 1960 did not have jobs as a result of the direct and indirect effects of credit restraint. Unemployment insurance and dissaving could provide some support for their expenditure but some decline in consumption would result. Similarly, capital expenditures that might have been made in the period if demand had been stronger never took place. To put all these effects together in a satisfactory manner would require more information than we have available, or indeed is ever likely to be available.

Within the inherent limitations of any attempt to measure the impact of credit conditions on expenditure, however, we can attempt to summarize our findings of the combined effect of changed credit conditions in 1958-60. Our survey of firms identified effects on capital investment of from \$50 to \$65 million in the three peak quarters, a figure which is probably an understatement because of the impossibility of identifying the subconscious effects which tight credit conditions may have had on spending decisions; the original replies indicated a higher responsiveness, but follow-up interviews enabled us to determine that some of the reasons for postponements were not primarily connected to changes in credit conditions. Institutional, financial and real estate enterprises combined, principally the latter, appear to have curtailed investment by from \$10 million to \$20 million in the three peak quarters, while the impact on the spending of agricultural and fishing enterprises, which we surveyed less completely than the other categories mentioned, clearly did not exceed \$10 million and may well have been virtually nil. We estimate that housing expenditures fell by \$30 million to \$50 million in the period, with much of the effect falling in the latter part of it; the effects would, of course, have been bigger but

for the direct lending of CMHC. If we add to these figures our survey and other results for the change in non-farm inventories resulting from changed credit conditions, we obtain measurable effects in the range of \$110 million to \$195 million. Converting these three-quarter data into annual rates, we obtain a range of \$150 million to \$250 million, figures which may be compared with an average annual rate of G.N.P. of \$35½ billion in the period.

To these figures must be added some allowance for the effects of changed credit conditions on consumption, on which our data are admittedly sketchy. However, the behaviour of the aggregate figures suggests that consumer expenditures on new automobiles and other durables, which averaged under \$2.7 billion at annual rates in the period, could scarcely have been affected by more than 2% to 3%.

Finally, there would have been secondary repercussions on incomes from this deferred spending. While we have no evidence as to their magnitude, the behaviour of the economy and other indications do not suggest that they are likely to be so large as to alter the totals dramatically. Within the period mentioned, for example, it would not be possible to conceive of these effects trebling—or even doubling—the direct impact of credit conditions on expenditures. If we take a figure of under 50% as being more representative of the order of magnitude likely to be involved, the total direct and indirect effects would range from \$275 million to \$450 million. To measure the results on Canadian economic activity, a deduction must be made for the proportion of this expenditure which would have fallen on imports. Thus corrected, the indicated direct and indirect effects of credit restraint on domestic expenditures would be of the order of \$200 million to something over \$300 million at annual rates, i.e. from just over ¼ of 1% to just under 1% of G.N.P. Under a floating exchange rate system, \$150 to \$250 million would be added to these totals.

We wish to emphasize again the difficulty of measuring the economy's responsiveness to

changed credit conditions—especially in the consumer sector—and draw attention to the hazards involved in estimating its indirect effects. Nevertheless, we believe that our estimates give a reliable indication of the orders of magnitude and confirm that the effects are significant enough to be worth striving to achieve at the right time. This was especially the case under a flexible exchange system, since the effectiveness of credit policy was much greater under such a system. Although attempts were made to assess the significance of the subtle and elusive influence of changes in credit conditions on the general business climate, this proved more difficult to evaluate. For example, certain new projects—especially of a promotional kind—may never have been seriously considered because of the tightness of credit conditions. To the extent that we have failed to take this effect fully into account, our results err on the low side and underestimate the short-run contribution which monetary and debt policies can make to stabilizing the economy.

THE IMPLICATIONS OF THE 1958-60 EXPERIENCE AND OTHER EVIDENCE

The experience of 1958-60 can be compared with that of other recent periods of credit tightness. In 1956-57—the first occasion in the post-war period when major use was made of interest rates to impose restraint—there was an understandable reluctance to push the use of conventional monetary and debt policies too far. Partly because of this, partly because business conditions and expectations were unusually buoyant, and partly perhaps because the period is well in the past, the effects we were able to discover in the corporate sector were smaller than in 1958-60 and in mid-1962. On the other hand, the effects of credit conditions on residential construction were much higher, perhaps of the order of \$200-\$300 million, because the Central Mortgage and Housing Corporation did not offset them with direct lending.²² The international effects were

also significant, although it is not easy to estimate what would have happened to the exchange rate in the absence of credit restraint; in fact the Canadian dollar appreciated by over four cents from March 1956 to March 1957. Given that the effect of credit restraint on residential construction in 1956-57 was about equal to all domestic effects on the rest of the economy found for 1958-60 and that the international effects were probably no less, the total impact of credit restraint in 1956-57 exceeded that of 1958-60.

The sharp increase in interest rates brought about by the authorities in mid-1962 was designed to deal with a loss of exchange reserves rather than to contain an excessive boom. The action taken was, however, very vigorous, and the effects on corporate investment which we have been able to identify are of the same order of magnitude as in 1958-60. The effects on residential construction were small since the Central Mortgage and Housing Corporation continued acting as a residual lender for home owner applicants and conventional lending rates hardly changed. The measures of 1962 were effective in influencing the flow of capital, but we were by then operating under a fixed exchange rate and the large scale capital inflow was felt primarily on official reserves; the effect on the exchange rate, and thus on the flow of goods and services, was minor. The absence of any significant international effects on expenditure, and the modest impact on residential construction, reduced the total impact of the mid-1962 credit restraint substantially below that of the two preceding periods.

The results of our inquiry may also be compared with those of our counterparts in the United States and the United Kingdom. The Commission on Money and Credit (C.M.C.) did not attempt any aggregate estimates, although they did discuss the quantitative consequences of changes in credit conditions in a few selected areas. They pointed out that "estimates of the percentage of state and local expenditures shifted from the late phases of a boom to the following

²² The Corporation did not become a major direct lender until September, 1957.

recession range from 2 to 5 per cent".²³ Our estimates are at the lower end of that range. They also found effects on residential construction in both 1955-57 and 1959, which they suggested ran to declines of roughly 15% to 20%; this is comparable to the case in Canada when residential construction bore the full brunt of the decline in N.H.A. lending in 1956-57. For the rest, their analysis was cast in very general terms. It was pointed out that high-leverage speculative investments such as real estate would be sensitive to monetary policy—of which we, too, found evidence—and that investment in long-lived assets and investment for mechanization and cost reduction would also be affected. They also argued that in the absence of anticipated price increases, investment in inventories "seems likely to be somewhat sensitive to interest rates and credit terms".²⁴ Their evidence indicated that changes in credit terms had "some, but only a slight, direct effect on consumer expenditures for other than residential construction".²⁴ The general impression we derive from reading their report as a whole is that they expected larger domestic effects from changes in credit conditions, except for housing, than our evidence suggests are likely to occur in Canada.

The Committee on the Working of the Monetary System in the United Kingdom (the Radcliffe Committee) did not attempt any total quantitative assessment of the effect of monetary policy, although their report brought together a considerable amount of evidence on the subject. They thought it unlikely that the "quick" effects of interest rates on personal savings would be sufficient to "justify consideration when a rapid adjustment of the level of demand is needed". They also concluded that there "was no sign that consumer spending was forced down" by restraint on bank lending and that "stocks of commodities are extremely insensitive to interest rates". In general, their evidence on the lack of responsiveness of corporate investment was

broadly similar to ours. In assessing the effectiveness of particular monetary measures, they took the view that a minimum effect of £100 million in a year provided a rough test of whether a measure altered expenditure in a significant way and remarked:

"... we find it difficult, on such evidence as we have received, to believe that any of the changes in interest rates have by themselves had an impact of this order of magnitude. The squeeze on bank advances in 1955-56 perhaps would, if the impact could be measured, qualify by this criterion. Almost certainly the change in hire purchase control, when at all substantial, did have effects of this order."²⁵

Given the size of the Canadian gross national product in recent years, an effect of \$150-\$200 million in a year is the rough equivalent of an effect of £100 million in the British economy in the nineteen-fifties. Thus, while the C.M.C. concluded that monetary policy was "a valuable and effective instrument of economic policy", the Radcliffe Committee concluded that monetary measures "are incapable by themselves of having an effect sufficiently prompt and far-reaching for their purposes, unless applied with a vigour that itself creates a major emergency".

Both groups, however, had doubts about the effectiveness of credit ease in stimulating expenditure. The C.M.C. argued that "while the processes and channels through which monetary measures operate are the same for a policy of ease as for a policy of restraint, an expansionary policy may be less effective than a restrictive policy."²⁶ The Radcliffe Committee had little to say about the effects of credit ease during periods of mild recession, but in their discussion of a catastrophic slump it was suggested that "it follows from what has already been said of the effects of monetary measures that they cannot be expected to act quickly enough or alone to bring about even a slow complete recovery."²⁷

²³ *Money and Credit*—The Report of the Commission on Money and Credit, 1961, Prentice-Hall Inc., page 51.

²⁴ *Ibid.*, page 52.

²⁵ *Report of the Committee on the Working of the Monetary System*, H.M.S.O. Cmd. 827, paragraph 471.

²⁶ *Op. cit.*, page 54.

²⁷ *Op. cit.*, paragraph 521.

The estimates summarized above and compared with the findings of similar bodies in other countries apply primarily to the effects of short-term variations in credit conditions over the range experienced in Canada. As suggested earlier, these are the most relevant magnitudes for most purposes, given the close relationship between Canada's capital market and that of the United States. A vastly different set of credit conditions could only exist if somewhat similar changes were occurring in the United States, although this does not necessarily mean that Canada will have no freedom of action to vary credit conditions in the future. Be that as it may, a persistently different state of credit conditions from mid-1958 onwards would probably have had substantial effects on employment and output. A lower international value of the Canadian dollar might have been expected to emerge from easier credit conditions. If maintained over an extended period, it would have had a significant effect on the flow of international trade in goods and services and thus significant direct and indirect effects on economic activity. Moreover, the existence of lower short and long-term interest rates over an extended period would have created a more certain climate which would have encouraged new projects to go forward and would have given individuals, corporations and governments time to adjust their other plans to a different set of credit conditions. There would of course have been domestic and international reasons for not allowing the exchange rate to depreciate drastically, and thus there would have been limits to the extent to which credit conditions in Canada could have been allowed to diverge from those existing abroad. Even within these limitations, however, the domestic effects would have been significant.

Our analysis so far has looked to the past, but our results are primarily of interest because of the light they may throw on the future effectiveness of changes in monetary and debt policies. The effects of changes in credit conditions on housing expenditure are likely to be reduced by the relative weakening in the demand for housing

and by the improvements in the conventional mortgage market: the impact of reduced availability of mortgage funds on residential construction will be still further softened if our proposals on N.H.A. and conventional lending are adopted. On the other hand, the effects could still be larger than those of 1958-60 and 1962 if the government does not offset them by increased direct lending. Borrowing costs will remain an important consideration for provincial and municipal governments, but there is little reason to suppose that these governments will respond to changed credit conditions in a significantly different way in the future as long as their financial position remains strong.

There is similarly little indication that those making business capital and inventory decisions will become more responsive to variations in credit conditions over the range we have experienced in recent years, although more modest profit margins and the growing importance of capital in their total costs may have slight effects in this direction. Their insensitivity in the past has not arisen from an unawareness of changes in credit conditions, firms often adjusting their financial arrangements to them. However, the effects on their decisions to purchase goods and services can probably be expected to remain limited in view of the substantial use made of internal funds, the need for firms to make investments to protect their competitive position and the relatively unimportant role of interest costs in affecting their return from new projects. Wider changes in credit conditions might be expected to have significantly greater effects, but in the absence of such changes it seems unlikely that there will be any significantly greater response from consumers, governments or corporations than we have already experienced. Finally, the effects of changing credit conditions on expenditure through exchange rate variations are not likely to be present.

CONCLUSION

No one seriously engaged in trying to determine the effectiveness of monetary and debt poli-

cies can expect to obtain a simple "yes" or "no" answer. We have found that monetary and debt policies are indeed effective in influencing expenditure, but we have also found that if variations in credit conditions do not exceed those experienced in recent years—when changes have been by no means insignificant—these effects are limited. In the absence of the special factors causing changing credit conditions to have a particular impact on housing outlays and on international trade, the potential effect of monetary and debt policies on expenditure will be reduced. This is as true for the longer term as it is for the short: with the exchange rate fixed, a long-term change in credit conditions can have neither as helpful—nor as harmful—an effect on spending as was the case in the past.

It does not follow, however, that monetary and debt policies are worthless or dispensable. The effects which we have found, while perhaps smaller than many people would expect, are still significant when compared with the fluctuations of expenditure which public policy attempts to mitigate. It should also be recognized that the impact of changed credit conditions on spending is not independent of the prevailing environment or the wisdom of the policies being pursued: a movement of short-term rates from 2% to 6%, for example, will have a greater effect on spending in conditions of relatively modest expansion than in boom periods, especially if persisted in. In such circumstances, many of the decisions to expand plant which might otherwise have been taken may simply not be considered at all because of the unfavourable financial environment. Similarly, the maintenance of conditions of extreme credit ease in boom periods is very likely to lead to excesses which will have serious effects on real economic activity, even though such a policy would have very much more limited effects in stimulating economic activity in contractionary periods.

Whatever doubts there may be about the size of the effects of significant changes in credit conditions on domestic spending in differing circumstances, there is no doubt that the prompt and immediate reactions in financial markets

have a strong influence over flows of international financial capital. Under a flexible exchange rate system, this influence will lead to exchange rate effects which have an additional impact on domestic expenditure, but even though this effect is missing under a fixed-rate system, monetary and debt policies still play an important part in dealing with problems arising out of international capital movements which affect our exchange reserves. The prompt effect of such policies on international capital flows—while sometimes limiting the use of credit policies for purely domestic aims—at least gives the authorities an instrument which allows them reasonable freedom to use other policy weapons for domestic purposes. In short, monetary and debt policies can play a useful role in maintaining a balanced international financial position and averting crises which might otherwise arise because of undesirable developments in the flow of capital between Canada and other countries.

Finally, monetary and debt policies have an important part to play in stabilizing the economy because money will not manage itself: not the least contribution which sensible monetary and debt policies make to the attainment of economic goals is in preventing extreme variations in credit conditions with all their accompanying disturbances and crises. The absence of such monetary disturbances, which used to be a prominent feature of financial events and an important cause of "booms and busts" in the economy, is now so much a part of the background of expectations and the business climate that it tends to be taken for granted. But in any assessment of the importance of monetary and debt policies, it is well to recognize that the avoidance of major catastrophes—and their attendant excesses of optimism and pessimism which so dramatically affected spending decisions—and the creation of a stable underlying environment are extremely helpful in promoting national economic objectives.

Thus we are convinced that "money does matter", although the direct domestic effects of changes in credit conditions—especially minor changes—are not as great as some recent discus-

sion would suggest. Moreover, failure to ensure that monetary and debt policies are at least broadly appropriate to the circumstances can have harmful effects on the economy's performance. While we wish we had been able to find greater stabilizing effects from the variation of credit conditions, we believe that our findings do suggest that monetary and debt policies have a constructive role to play in stabilizing the economy. We hope that these findings will encourage others to search for further evidence on the size and timing of expenditure changes induced by changing credit conditions, for we are the first to recognize that our own results should not be accepted uncritically and that future conditions will in any event lead to differing degrees of responsiveness.

Assuming that we can count on the authorities to aid in avoiding any major financial crises and to prevent the economy from being affected unnecessarily by other disturbances, we are still left with the problem of how monetary and debt policy can exert enough influence over spending to mitigate significantly the fluctuations in expenditure which are bound to occur from time to time. While there is scope for widening the range of variation of general credit conditions beyond the boundaries of the recent past without unduly disrupting either financial markets or domestic business activity, international considerations are

likely to rule out this alternative if similar changes are not taking place in other countries, particularly the United States. The consequences on our official reserves would then be serious and the policy would sooner or later have to be modified. There may be occasions when selective credit measures and the creation or retention of imperfections in the financial markets will help to minimize these international complications or otherwise enhance the effectiveness of policy—as we shall indicate in the next chapter—but in normal circumstances we are opposed to such measures because of their adverse effects on efficiency and on the development of competitive and adaptable financial markets. Yet even if future circumstances allow more variation in domestic credit conditions, monetary and debt policies will have weaker effects on domestic expenditure under a fixed exchange rate.

Our findings thus lead us to the conclusion that monetary and debt policies must be teamed up with others if the economy is to achieve its full potential. Seriously-wrong monetary and debt policies can have disastrous effects, but the positive contribution which appropriate credit conditions can make to economic goals is such that monetary and debt policies cannot be expected to play an unsupported role in stabilizing the economy: they must be strongly supported by fiscal and other policies.

THE TECHNIQUES OF MONETARY POLICY AND DEBT MANAGEMENT

We have concluded that the influence of short-run changes in credit conditions on real spending is likely to be relatively small and in some cases considerably delayed. We now turn to examine the techniques employed by the monetary and debt authorities to alter credit conditions; the limitations on the range of variation of credit conditions in the long run as well as the short (bearing in mind the view that a more persistent change in such conditions may have a significant influence on expenditure); and finally the measures which may be taken to overcome these limitations.

We discuss the techniques of monetary policy and debt management in a single chapter because these instruments work together to bring about changes in economic activity through their combined influence on the terms and conditions prevailing in financial markets. While in Canada there is a formal division of authority within government as to the responsibility for monetary and debt management operations, with the Bank of Canada having immediate responsibility for conducting monetary operations and the Minister of Finance exercising responsibility for the government in matters of debt management and foreign exchange policy, it nevertheless remains true that attempts to draw clear distinctions between monetary and debt policies are of limited usefulness.¹ The authorities cannot view policies affecting the supply of money and the structure of the federal debt as being unrelated: they each

have influences on credit conditions and spending and must be harmoniously combined.

Indeed, all instruments of financial policy and their combined effect on financial conditions and spending must be viewed as a coherent whole. For example, if it has been decided that economic conditions call for expansionary measures which result in a government deficit, this will need to be financed. The way in which it is financed will have an influence on credit conditions and the need for these operations must be taken into account when decisions are being made on the steps required to influence credit conditions in the direction and to the extent that the circumstances appear to justify. The other steps required may be limited to operations on the cash reserves of the banking system, but they may also include operations in the market by the Bank of Canada or the government's own accounts which alter the maturity structure of the debt in the hands of the public without any net influence over cash reserves. These techniques are all serving a common end. The more they are viewed as a co-ordinated whole the more likely it is that the use of different techniques can be varied to suit the particular circumstances of the time; the greater also will be the possibility that the authorities will be able to influence credit conditions with a minimum of difficulty and disruption.

The essential unity of monetary and debt management operations was strongly emphasized in the Report of the Committee on the Working of the Monetary System submitted in the United Kingdom in 1959. The Radcliffe Committee

¹ The position of the Bank of Canada within government is fully discussed in Chapter 26.

defined the public debt as the net liability of the government sector as a whole; this includes the note and deposit liabilities of the central bank as well as interest-bearing government debt but excludes securities and cash held in government accounts or the central bank. This approach emphasizes that all government actions which influence the size and structure of public holdings of cash and interest-bearing government debt are similar in their effects. Although agreeing with the point made by the Radcliffe Committee, we have found it convenient in the somewhat different Canadian institutional circumstances to follow the usual practice of defining the federal debt as including all outstanding securities, wherever held, in order to simplify the exposition. We therefore will deal separately with the techniques of debt management within the context of all financial policy. However, changes in the state of the debt held by the public may result from sales and purchases of securities by the Bank of Canada as well as debt issue, retirement or market transactions carried out for the government: such central bank operations are treated as an integral part of debt management and discussed in the following section.

A great variety of operating procedures may be used by both the monetary and the debt authorities to influence financial markets and spending decisions. The use of one technique rather than another is of secondary importance compared to the adoption of a correct balance of policy, but the particular choice may still have important implications for the economy or financial markets. Some of the measures discussed in this chapter, such as alterations in the supply of cash reserves or in the structure of the public debt, operate in a general way by affecting the cost and availability of credit. Although some sectors of the economy will be affected more severely than others as a result of market imperfections, differing reliance on borrowed funds or their own sensitivity to financial considerations, these measures operate indirectly through their effects on financial markets generally. They thus differ in principle from measures which are designed to strike directly at the amounts and

terms of particular types of credit by using or creating market imperfections.

Extensive use of the direct measures may create distortions in the financial system, lower its efficiency, and indeed lead to widespread practices designed to evade their impact. The immediate usefulness of such techniques must be carefully weighed against the inequities and lasting harm they may cause. The general instruments do not present these problems, but they also must be used skillfully if government action is to be effective. Ill-chosen and badly-managed operations will disrupt financial markets unnecessarily and the resulting uncertainty may limit the authorities' freedom of action and the effectiveness of their attempts to influence economic activity. Moreover, if conflicting actions are taken the impact of all government measures on credit conditions and expenditure may be reduced.

THE MANAGEMENT OF THE FEDERAL DEBT

(i) *Principles of debt management*

Because of its size, the important role it plays in portfolios and the central position of the markets where it is traded, the federal government's debt is a major factor affecting financial conditions. Despite the much more rapid growth of other forms of debt since the war, the federal debt was still the largest category of primary debt outstanding in 1962, representing almost 27% of the total. Trends in the total, maturity structure, and composition of the federal debt are shown in Table 22-1. Changes in the amount, type and distribution of the federal debt interact with other forces at work in financial markets to affect flows of funds and the state of credit conditions. The principles on which the debt is managed over the cycles of economic activity therefore have important implications for monetary and financial policies generally.

Those who take a doctrinaire view on this question divide into two main camps—those favouring counter-cyclical management of the debt and those favouring a policy of minimizing at all times the interest and other costs of government borrowing. Given the type of marketable debt

TABLE 22-1
DIRECT AND GUARANTEED FEDERAL DEBT OUTSTANDING
(as at December 31)

—	Treasury bills, notes and deposit certifi- cates ^a	Other Market Securities				Total Market Debt	Non Market Debt ^d	Total	Average Maturity of market debt			
		2 years & under ^b	2 to 5 years	5 to 10 years	Over 10 years ^c				Total		Public ^e	
									years	mos.	years	mos.
(millions of dollars)												
1940	785	484	642	468	2,834	5,213	26	5,239	10	5	—	—
1945	1,796	1,049	1,676	2,200	10,071	16,792	692	17,484	10	6	—	—
1950	1,500	1,300	1,498	4,983	5,393	14,674	1,218	15,892	8	1	—	—
1952	1,400	2,109	2,548	3,894	3,985	13,936	1,250	15,186	6	9	—	—
1954	1,530	1,749	2,302	4,292	3,503	13,376	2,090	15,466	7	2	9	6
1956	1,575	2,197	2,150	4,800	1,971	12,693	2,541	15,234	6	7	7	6
1958	1,495	2,334	2,006	1,947	5,739	13,521	2,895	16,416	10	4	13	4
1960	1,985	2,251	2,806	1,160	5,950	14,153	3,594	17,747	9	5	11	6
1962	2,165	2,545	2,443	2,472	5,103	14,729	4,719	19,448	8	5	10	9
(Percent)												
1940	15.0	9.2	12.3	8.9	54.1	99.5	0.5	100.0	—	—	—	—
1945	10.3	6.0	9.6	12.6	57.6	96.0	4.0	100.0	—	—	—	—
1950	9.4	8.2	9.4	31.4	33.9	92.3	7.7	100.0	—	—	—	—
1952	9.2	13.9	16.8	25.6	26.2	91.8	8.2	100.0	—	—	—	—
1954	9.9	11.3	14.9	27.8	22.7	86.5	13.5	100.0	—	—	—	—
1956	10.3	14.4	14.1	31.5	12.9	83.3	16.7	100.0	—	—	—	—
1958	9.1	14.2	12.2	11.9	35.0	82.4	17.6	100.0	—	—	—	—
1960	11.2	12.7	15.8	6.5	33.5	79.7	20.3	100.0	—	—	—	—
1962	11.1	13.1	12.6	12.7	26.2	75.7	24.3	100.0	—	—	—	—

^a The Government retired the final \$200 million of deposit certificates in 1952 and the final \$500 million of treasury notes in 1956.

^b Includes matured issues still outstanding.

^c Includes undated issues ('perpetuals').

^d Includes Refundable Tax and War Savings Certificates in earlier years: since 1954 Canada Savings Bonds only, except in 1962 when \$100 million of non-marketable debt held by the Unemployment Insurance Fund is included.

^e The "Public" is defined as all holders other than government accounts, the Bank of Canada and the chartered banks.

issued by the government, its average term to maturity declines continuously and steps must be taken from time to time to issue new longer-term securities. The proponents of a counter-cyclical debt policy argue that the public's debt holdings should be lengthened in periods of credit restraint by the issue of new long-term securities and sales of existing long-term debt from official accounts—including the central bank's—in exchange for shorter maturities. These operations will tend to raise the whole level of interest rates and put particular upward pressure on long-term rates, to which expenditures are thought to be especially sensitive. Debt operations would thus reinforce the effects of monetary policy working

through cash management and the banking institutions. During periods of credit ease, on the other hand, proponents of this view argue that the government's requirements should be more than met by new issues of short-term debt while longer issues are bought in by the authorities. These operations would shorten the public's debt holdings and thus assist in easing credit conditions.

Opponents of counter-cyclical debt management have argued that the cyclical timing of long-term issues should be precisely the opposite of this. They argue that the issuance of long-term securities during periods of credit restraint is unnecessary. Cash reserve management is adequate to raise or lower interest rates over as wide a range

as overriding limitations on the freedom of policy will permit and major changes in the average maturity of the debt in the hands of the public are not required. Moreover, by forcing the government to borrow long-term funds at high interest rates, counter-cyclical debt management will significantly raise the cost of servicing the debt. Thus it is held that the debt manager should seek to minimize the cost of the debt by issuing long-term securities during the recession periods when long-term interest rates are near their cyclical lows, and refrain from offering long-term securities when rates are near their cyclical peaks. The principles of portfolio management which this approach would suggest for the Bank of Canada and the government accounts is to seek to maximize profits by selling long bonds when prices are high and buying them in again when prices are low.²

These are not the only rules according to which the debt might be managed. Some would argue that since government debt operations are necessarily very large relative to the size of our financial markets they can cause serious disturbances whose harmful consequences more than offset any advantage. Since they also argue that debt management cannot itself have important effects on the level and structure of rates, they recommend that the authorities should follow a regular pattern of debt issue and management, placing and refunding issues at regular intervals in order to maintain a uniform maturity structure of the debt. This policy would serve to average the cost of the debt over cycles in interest rates, but its proponents have also argued that since investors could take account of future government issues—whether to raise new funds or refund maturing debt—certainty and stability in markets

might well serve to lower the government's average borrowing costs.³

The policies followed in Canada since the war do not fall clearly into any one of these categories. However, they come closer to the interest minimization pattern than the counter-cyclical techniques for most of the period. During the early post-war years, the practice of maintaining fixed bond prices and repaying debt from cash surpluses implied an unwillingness to use debt operations (or, for that matter, cash management operations) as a stabilizing technique. When this policy was abandoned, only limited efforts were made to offset the shortening of the debt until the recession year 1954.⁴ The debt in the hands of the public was allowed to shorten again in 1955 and 1956, with purchases of long-term securities by the Bank of Canada and government accounts doing much to moderate the rise in their yields at a time when a restrictive monetary policy was being followed. One long issue, the 3½'s of 1996-98, was offered in September 1956 but this was the only attempt during the period of restraint 1955-57 to lengthen the publicly-held debt. The issue was priced too high for successful distribution and the authorities were obliged to take up a substantial part of it. During this period, an apparent unwillingness to allow long rates to rise above 4% nullified the attempt to lengthen the debt, and the net effect was that the restrictive monetary policy being followed was less effective than it might have been.

The debt continued to shorten during most of 1957. However, in early 1958, when an expansionary monetary policy was being followed to combat a recession, this process was reversed. The limited efforts to lengthen the debt in early 1958 were dwarfed by the huge Conversion Loan in the period July-September which at one step increased the average term to maturity of the publicly held debt from 96 months on June 30, 1958 to 178 months on September 30, 1958. In the years since the Conversion Loan, which in-

² The view that government should pay no interest on its debt, financing its needs solely by the issue of currency, is the *reductio ad absurdum* of a cost minimization approach. Such a policy in conjunction with deficits in the government's accounts would lead inevitably to extreme credit ease throughout the system, an exchange crisis and finally uncontrollable inflation. Many of those who propose this view ignore the physical limitations on economic output, assuming that what can be paid for can be produced at current market prices.

³ A forceful presentation of this approach may be found in *Techniques of Treasury Debt Management* by Tilford C. Gaines, Free Press of Glencoe, 1962.

⁴ See Chart 9 in Chapter 20 showing changes in the average maturity of the debt.

clude two periods of credit restraint and two periods of relative credit ease, the publicly held debt has shortened continuously, the only exception being the fourth quarter of 1962. Thus there is little in the record to suggest that during much of the post-war period monetary and debt policies were harnessed for the achievement of common objectives—or indeed that any consistent debt policy was being followed. In the past few years, however, considerable experimentation with new techniques and more careful co-ordination of monetary and debt policies have reduced the disruptions resulting from debt management and increased its usefulness as an instrument of policy.

The choice among the various principles on which the debt may be managed depends on the balance of advantage and disadvantage of each when viewed in the full context of government economic policy. Taking first the cost minimization policy, the advantage sought is a reduction in the charge on the government to meet interest on the debt, matched either by reduced taxation or increased government expenditure in more useful directions. Despite a recent revival in a subtle form of the "burden of the debt" controversy,⁵ it is generally accepted that domestic interest payments are best thought of as part of a transfer process which has effects on the distribution of incomes and wealth and involves some administrative costs but does not impose other real burdens on the community as a whole. Since virtually all of the federal government's debt is held within Canada, the transfer argument applies in our case. Thus the real effects of any reduction in the present level of net interest payments on the federal debt—which amount to some \$750 million—would depend on the differing spending and saving habits of taxpayers and investors in government securities (if taxes are reduced by the full amount) or upon the differing spending patterns of investors and governments (if other government expenditures are raised). Whatever the outcome, it is safe to assume that the effect on the economy would be

much less than the change in the government's interest payments.

It must also be recognized that there is no precise indicator of the best time to issue longer-term debt. The authorities can never be sure when rates are low that they will not go even lower. Nor can they be certain that it will in fact be more advantageous to issue a one-year bond which must be refunded each year for five years at unknown rates than to issue a five-year maturity at prevailing rates. Moreover, if repeated attempts are made to sell long bonds at the low point in the interest cycle, investors will become disillusioned and demand higher returns on such bonds, thereby offsetting much of the interest-cost benefits of attempting to pursue the cost minimization objective to an extreme point.

However, the principal objection to following this policy at all times is not that its real effects are small or that it is difficult to know what measures will in fact minimize costs, but that such a rigid rule would complicate the authorities' task of establishing suitable credit conditions by precluding the use of the debt as an aid to other arms of stabilization policy.⁶

We discussed the strengths and weaknesses of counter-cyclical management of the debt with many of the witnesses who appeared before us. Some argued that alterations of the debt structure can have powerful effects on the level and structure of interest rates and should be vigorously used to achieve them.⁷ A more common view was that debt management can have only limited independent effects on interest rates. With some variations of emphasis, this judgment was expressed by Sir Dennis Robertson from his study of developments in the United Kingdom,⁸ by Mr. Bernstein on the basis of U. S. experience⁹ and by other

⁵ Sales of long-term securities at the low point in the interest rate cycle (the peak in bond prices) may aid the authorities during a succeeding period of higher rates by "locking in" investors—i.e. making them unwilling to sell their bonds at less than they paid for them—and thus perhaps reducing their spending from what it might otherwise have been. The same effect can be achieved—perhaps more appropriately—by selling long debt in the early part of a restrictive period.

⁷ See, for instance, Submission of Professor Clarence Barber and his evidence, Transcript, pages 880 to 896.

⁸ Transcript, page 5132.

⁹ Transcript, page 4487.

⁶ See, for example, "Is the National Debt a Burden?", by E. J. Mishan, *The Banker*, September, 1963.

witnesses. The consensus appeared to be that although management of the debt can nudge the rate structure usefully, powerful effects are not to be expected.

Differences in the views expressed reflect both experience in the countries concerned and the magnitude of debt operations envisaged. Thus, comments on the United States must reflect the rather limited changes in the debt structure associated with the recent Treasury and Federal Reserve policy known as "operation nudge". Beginning in 1961 the U.S. authorities took steps to alter the maturity structure of the debt in public hands in order to maintain short-term interest rates at a higher than normal level relative to long-term rates for international reasons.¹⁰ This was done by raising new funds with increases in the treasury bill issue and by the practice adopted by the Federal Reserve System of adding to bank reserves by purchasing longer-term securities. So far as the United Kingdom is concerned, Lord Cobbold in his evidence before us stressed the pressing need during his tenure as Governor of the Bank of England to lengthen the debt whenever possible and laid correspondingly less emphasis on counter-cyclical policies.¹¹

Judgments about Canadian experience are to a degree dominated by the dramatic lengthening of the debt in 1958 through the Conversion Loan. In the first half of 1958, considerable uncertainty had developed in securities markets following extensive speculation in an apparently successful long-term CNR issue early in the year. This culminated in the failure of two long issues delivered on May 1.¹² It was decided that in order to

¹⁰ The absolute level of long-term rates was nevertheless higher than that which would have obtained had international considerations allowed the U.S. authorities to pursue a policy of ease throughout the yield structure.

¹¹ Transcript, pages 4045-49.

¹² It might be noted that some of the speculative pressures which contributed to the disruption of markets in early 1958 could have been avoided if government financial policy had been clearer and if the Bank of Canada had been following the technique of more recent years of making additional amounts of new issues available to markets when strong demand develops. This technique tends to curb any sharp rise in prices and to dampen excesses of speculative enthusiasm by dealers and their customers. However, it should be pointed out that speculative pressures were widespread in North American bond markets at that time, as the collapse of the U.S. bond market in mid-1958 showed very clearly.

clear away the substantial blocks of Victory Bonds which were approaching maturity (\$947 million were to mature in January 1959, and a further \$1,165 million in June 1960, with the remaining three Victory issues totalling \$4,304 million maturing in 1962, 1963 and 1966) and to restore confidence in Government bonds, all the Victory issues should be converted into longer-term securities. During a two-month campaign from mid-July to mid-September reminiscent of the war bond drives, \$5,806 million of the four Conversion issues, representing 45% of the outstanding market debt, were issued in exchange for the Victory Bonds. There can be little doubt that the substitution of long for short bonds to an extent that raised the average maturity of public holdings from 8 years to almost 15 years contributed significantly to the upward adjustment in rates at that time and to the maintenance of relatively high rates thereafter.

However, it is now generally accepted that this massive operation created considerable difficulty and complicated the authorities' task subsequently. The major difficulty was that the liquidity of the economy was substantially reduced at a time when, despite some evidence of an economic upturn, the underlying economic situation was weak. Moreover, a debt management exercise of this magnitude was almost certain to cause some disruption of markets. The declared objective was conversion of all Victory Bonds, including the issue with final maturity in 1966 which was not callable before 1961, and to achieve this end the terms were made extremely attractive and the operation was presented as a patriotic endeavour which deserved unanimous support. Moreover, the prices of the Victory Bond issues were raised and fixed at very attractive levels¹³ so that throughout the operation and for some weeks thereafter the Bank of Canada had to support bond prices in the face of a rapid upward adjustment of interest rates in the United States. Thus partly for technical reasons that might have been avoided, debt management inter-

¹³ Because there was a set structure of margins between the Victory Bonds and the new conversion issues, prices of the latter were also effectively fixed.

ferred with monetary policy at a crucial time. When market support was withdrawn and market prices fell away, investors felt themselves deceived.

Even without these complications, a funding operation of this size was bound to create conditions in which it would be difficult to reduce interest rates if that should prove desirable. Having been severely shaken, the market would not soon have been prepared to carry government securities at much lower rates, even if a major attempt had been made to reverse the exercise by substituting short for long bonds in private portfolios. In effect the authorities committed themselves to relatively high rates for a considerable time, a step which was to prove unfortunate in the light of subsequent events. A smaller operation, more flexibly managed and offered as an option rather than a duty would not have brought all these difficulties in its train.

It should be noted that the Conversion Loan in 1958 revealed fundamental conflicts in policy. The budget brought down on June 17 emphasized the need for expansionary measures and forecast a record peacetime cash deficit of \$1.4 billion. Sales of long-term securities could not be regarded as an expansionary move, although it was claimed that the Conversion would make it easier for other borrowers to obtain long-term finance. In the event, credit conditions tightened markedly despite the considerable monetary expansion which took place, and corporations, provinces and municipalities turned to the U.S. capital market for their funds. This led to upward pressure on the value of the Canadian dollar that was to say the least no positive stimulus to domestic expansion. If rapid adjustments of rates are desirable for domestic or international reasons they can be achieved through monetary policy acting on the system's cash reserves. Massive support from debt management is not essential. In view of this fact and of the disturbances which can result from overly ambitious debt operations, such extreme ventures in debt management should be avoided.

This, however, leaves open the question of whether more limited counter-cyclical debt poli-

cies should be followed. The Conversion Loan may not have been undertaken for counter-cyclical purposes, but it had major effects on interest rates. It is reasonable to conclude that more limited operations would have smaller but nonetheless significant effects and there is some supporting evidence in Canadian experience. For instance, the official purchases of long-term debt in 1956 undoubtedly served to lessen the increase in long-term rates, misguided though the policy may have been. A happier instance came with the steps taken following the June 1961 budget when establishment of the Purchase Fund to support long-term issues, switching operations by the Bank of Canada and the announced temporary suspension of new long issues all served to take pressure off prices in that part of the market. The cancellation of all market securities held by the Unemployment Insurance Fund, a high proportion of them long-term issues, also assisted in reassuring the market by removing the threat of sizable sales. These debt operations—or announcements of operations which would not be undertaken—provided useful support in promoting easier conditions in financial markets.

Again in 1962, imaginative public debt transactions assisted in bringing about the rapid market changes necessitated by the foreign exchange crisis. The instrument chiefly relied on was monetary policy: because of rapid loan increases and pressure on their cash positions, the banks made heavy sales of securities in June, July and August which resulted in the sharp upward adjustment of rates needed to check the losses of foreign exchange. However, in the course of reducing cash reserves the Bank of Canada operated in all maturity classes, selling first treasury bills in order to drive short rates up particularly quickly but soon shifting the weight to the long end of the market. In August, a \$120 million loan maturing in 1980 was issued, increasing the pressure on long rates, and in August and September the Bank sold \$140 million of long-term issues. The cash effect of Bank transactions was reduced by temporary transfers of government cash balances and

transactions with the government's Securities Investment Account.¹⁴ The entire operation, which also involved sizable switches from the Bank's portfolio, demonstrated the manner in which co-ordinated monetary and debt operations can bring about rapid, smooth adjustments of credit conditions. It can be argued nevertheless that a greater reliance on debt management might have been useful. More substantial official sales of medium and long-term debt (matched by offsetting purchases of short bonds in the case of Bank of Canada sales) might have driven rates up with less need for the banks to sell bonds. Thus, the banks' ability to follow the relatively free lending policies which were appropriate domestically throughout the external crisis would have been less impaired by pressure on their liquidity. However, this is a gloss on a successful operation carried out in circumstances that left no room for delay.

These few incidents have exemplified both the harm and the help that debt management can bring to government financial policy. If they demonstrate anything, it is that flexibility is of the essence. It is our view that an attempt to follow any rigid program of debt management would be undesirable. Strict adherence to cost minimization objectives or to the "neutral" objective of maintaining a uniform debt structure through a regular pattern of issue and retirement would sacrifice the help in adjusting credit conditions which careful management of the debt can provide for the sake of achieving subsidiary goals. Moreover, the neutral procedure could not easily be adjusted to the government's changing needs for finance and might lead to positively undesirable interest rate consequences as investor preferences shift for cyclical or other reasons. On the other hand, a counter-cyclical policy pressed in season and out might also involve the au-

thorities in operations which would disrupt markets. For instance, it is difficult to sell long-term issues when bond prices are falling and failure to price an issue sufficiently attractively may lead to highly disorderly market conditions. In any case, investors must be paid returns attractive enough to persuade them to hold government bonds in the long run—and over a period of years these costs might not be widely different under either policy. Similarly, even if a policy of cost-minimization is not being followed, the government must offer issues designed to minimize interest costs within the context of the policy being followed—an under-priced issue which leads to subsequent speculation can be as disrupting to markets and the government credit in the long run as one which fails to attract buyers because it is over-priced.

The monetary and debt authorities are responsible for financing the government. Given the other policies being pursued, they are at the same time responsible for attempting to achieve a state of credit conditions which will be conducive to the achievement of the broad objectives of economic policy. If they succeed in influencing credit conditions in the direction and to the extent required, they will have achieved their major objectives. At some times, as in the summer of 1962, it might be desirable to make considerable use of debt operations to raise interest rates in order to lessen the need for bank sales of securities to drive rates up: such sales may lead to an undesirable restriction of bank lending. In another conjuncture of domestic and international circumstances a different mix of policy measures might be used to achieve a somewhat different pattern of credit conditions.

An additional device which has been proposed as part of counter-cyclical debt policy and to aid in varying the pattern of credit conditions is variation in the size of government cash balances held in the chartered banks. It has been suggested to us that during periods of economic buoyancy when the government is running a cash surplus, the funds should not be used to repay debt but rather be held in the form of cash balances in the chartered banks. These cash balances could

¹⁴ See *Bank of Canada Report for 1962*, pp. 52-53. It is not possible to trace the official transactions in published figures for the details of the portfolios of the Bank and government accounts are not revealed: changes in the maturity classes published reflect the passage of time as well as actual transactions. We think detailed publication with a reasonable delay, as in the United States, would contribute much to informed discussion without endangering the authorities' position in any way.

then be called upon during an ensuing recession to finance cash deficits. The objection to the cyclical use of cash balances on a large scale is essentially political. In periods of excess demand, the Minister of Finance might find it extremely difficult to persuade his cabinet colleagues and Parliament that the funds sitting in his accounts should not be used for increased expenditures. However, if there were good reason for supposing that the authorities were unable to vary credit conditions over a sufficiently wide range without the support of this technique, the merits of the proposal would justify the Minister in accepting that risk.¹⁵ On occasion in the past, the gingerly way in which the authorities have exercised their influence over credit conditions has suggested that a supplement of this kind would have been valuable. It is not clear that this is the case today. If a combination of cash surpluses, debt repayment and credit restraint is required, this combination can be achieved through the use of existing techniques without reliance on major changes in government cash balances.¹⁶ While there is no reason to rule out use of this technique, we do not believe it need be a necessary or frequent instrument of policy.

While following a flexible approach to their job, the authorities cannot afford to neglect the continual shortening of the debt as time passes. To do so would be to invite situations in which the immediate needs of debt management seriously limit their freedom of action. There are no precise guide lines to the extent to which the debt can be allowed to shorten before remedial action is

taken, but an excessive reliance on short financing will lead finally to problems of continuous refinancing. This will inevitably give rise to almost continuous disruptions in financial markets associated with the sale and delivery of new issues and may seriously inhibit efforts to influence credit conditions. The problem would become even more severe if government should show itself unwilling to pay the price needed to place the issues satisfactorily—that is, if it disagreed with the monetary policy being pursued. If, therefore, opportunities present themselves for debt lengthening which do not interfere with the achievement of the desired state of credit conditions, there is good reason for taking advantage of these possibilities in order to avoid future conflicts of objectives. If the authorities find themselves unable to sell long-term debt over an extended period, this is an indication that the average level of long-term rates is too low.

The practice developed in recent years of gradually retiring parts of approaching issues in exchange for longer-term securities—either at the time of new issues or through gradual “advance refunding” operations by the Bank of Canada or government accounts—has enabled the authorities to look after this problem in an orderly way. This technique, a variant of the “tap” system of continuous issue used in the United Kingdom, permits the authorities to feed long-term issues out without running the risk of unsettling markets with sizable blocks of new long debt. However, there are times, as in 1962, when sale of a new long issue can influence markets usefully and occasions also arise when announcement of a larger issue will serve to attract more buyers.

The merits of different debt issue techniques were discussed in Chapter 16 where we concluded that the methods which have evolved appear to be working well. In this matter, as with the underlying principles of debt management, we believe that the authorities should not be bound by any rigid rules or conventions. They have evolved new techniques, and no doubt as markets develop further and circumstances change will continue to adapt their methods in order to achieve smooth

¹⁵ In the exchange crisis of 1962, for example, the Minister announced that the Canadian dollar proceeds of sales of official reserves would be earmarked and not used for domestic expenditures. In late 1963 and early 1964, the government again accumulated substantial cash balances, perhaps in anticipation of future accumulation of exchange reserves.

¹⁶ If the accumulation of government balances were used to achieve a given state of credit conditions, the initial effect would be to leave bonds rather than bank deposits in the hands of the public. Interest rates would thus be higher than if securities were retired. Less pressure would thus have to be applied directly to the banks, which would therefore be somewhat freer to lend than if the desired level of interest rates were achieved by restricting the cash reserves of the system and obliging the banks and other institutions to sell securities.

and efficient delivery of new issues. In doing so, they should avoid the temptation to experiment needlessly: there is considerable advantage in maintaining continuity in the government's method of approaching the market. If the merchandise is properly priced and designed for the intended buyers, it will sell: if not, the most imaginative technical innovations will not bring in the customers.

This is not to deny that issues may be designed specifically to attract certain types of buyer, as with discount bonds, or to meet particular market situations, as in 1959 and 1960 when five short-term issues convertible into long-term securities were sold in order to tempt long-term funds out of a reluctant market.¹⁷ Features designed to suit market preferences—of which no-call provisions are another example—result in increasing the availability of funds though their ultimate effects on the gross interest costs of the government's debt are more difficult to assess.¹⁸ Sales of issues abroad can also be useful, particularly as a means of obtaining foreign exchange when the rate or reserves are under pressure.

There are, however, limits to our eclecticism. Although the thought has perhaps not been seriously entertained in this country, we think it worthwhile recording our opposition to the sale of securities whose value is linked in some way to changes in the prices of goods and services—so-called 'index' bonds. Such bonds are in reality an admission of the government's failure to achieve one of its main economic goals, and their sale can only complicate the task of achieving it. In inflationary circumstances they are likely to provoke other major adjustments in the system

¹⁷ Any future convertible issues might, however, have some reasonable call feature at the government's option. Outstanding issues are not normally converted before the last available date even when it would be advantageous to the holder to do so: the premium on the long-term issue into which it is convertible will be reflected in its price in any event. If subsequently the conversion becomes unattractive, however, all the bonds will be presented for redemption at the end of their life as short-term maturities.

¹⁸ At the end of 1962, \$1,631 million of Canadian National Railway debt guaranteed by the federal government was outstanding. These securities have normally sold and traded at slightly higher yields than comparable direct government issues. The government should weigh the advantages of separate financing for this Crown Corporation.

and impair the position of other borrowers who are unable to offer similar terms to obtain needed funds. In addition, this may reduce the public's willingness to accept restrictive measures and merely shift more of the burden of inflation onto other groups in the economy. A lesser disadvantage is that such bonds would compete unnecessarily with equities and reduce the flow of needed risk capital.

As we noted in Chapter 4, the federal government has relied heavily on the sale of Canada Savings Bonds to meet its need for funds. They now represent 37% of the federal debt held outside official accounts and the chartered banks and 50% of the holdings of individuals and non-financial companies. Although in some years they have been made available for much of the year, it has been the practice to concentrate the sales effort during a relatively short period in the fall, and a high proportion of sales occur during this annual campaign. The bonds, which may be redeemed at face value plus accrued interest at any time, have carried attractive interest rates¹⁹ and have competed very successfully with institutional liabilities and other instruments for a place in personal portfolios. As shown in Table 2 of Chapter 7, the \$4,620 million of C.S.B.'s outstanding at the end of 1962 accounted for more than one quarter of the main types of fixed-value liquid claims held by individuals, and the share continues to rise.

Although these bonds compete with the federal government's other debt as well as with other savings instruments, it is undoubtedly true that they enable the government to draw funds from a market which could not be tapped on the same scale with conventional market securities. Information prepared for us by the Department of Finance indicates that the average cost of funds, including the administrative and other costs of managing the annual campaign as well as interest payments, has been somewhat higher than for

¹⁹ Since 1956, the coupon yield of each issue has risen over the life of the bonds, encouraging purchasers to hold them until final maturity. C.S.B.'s may be cashed on demand, but the redemption experience between the annual campaigns has been moderate although large amounts may be exchanged for new bonds if the new rate is substantially higher.

other government borrowings. However, costs have not been excessive, and it is in any case impossible to estimate how much higher the yields on other debt would have been if the authorities had attempted to raise larger amounts in the securities markets without making other adjustments in credit policy. It is argued, moreover, that it is desirable for the government to encourage individual thrift by making C.S.B.'s available through payroll deduction or by instalment purchase.

It is our view nevertheless that the government has placed exaggerated emphasis on Canada Savings Bonds. So long as sales are vigorously pressed and attractive yields are offered, substantial amounts will be raised. Once this cycle is established, it is deceptively easy to argue that the government would have great difficulty in meeting its requirements in any other way. It must be remembered, however, that reduced competition from C.S.B.'s would increase the flows of funds into other investments, including not only other federal securities but also the deposits and other liabilities of private financial institutions. The institutions would no doubt invest a part of their increased funds in government debt: more importantly, perhaps, they would be in a position to increase the flow of private funds into mortgage and other private debt instruments. As we noted in Chapter 14, an increased supply of private mortgage funds would enable the government to withdraw gradually from the direct CMHC lending to home-owners which has in recent years been a sizable charge on its resources. These two important offsets to reduced sales of C.S.B.'s—increased purchases of other federal debt and a substantial net reduction in the government's need for funds to finance N.H.A. mortgages—must be taken into account in considering the possible advantages of some withdrawal from the savings bond market.

A move in this direction would also check the tendency for an increasing share of private holdings of government debt to be in fixed-value form and hence immune to the market consequences of changes in security prices and yields. (We would not press this argument far because it is unlikely

that changes in the value of their securities contribute much to the impact of financial policy on individuals' spending decisions. Moreover, in the absence of C.S.B.'s, a part of the public would undoubtedly choose to hold equally-liquid deposits in financial institutions.) Finally, there are now a great many savings alternatives open to individuals, and it is increasingly difficult to argue that the somewhat higher costs to the government of C.S.B. borrowing are justified by the social desirability of encouraging thrift in this particular form. We recommend, therefore, that the government consider the possibility of pressing the sales of C.S.B.'s less vigorously. It might be desirable to reduce the maximum permitted purchase below the present \$10,000 in order to lessen the element of competition with other government debt.²⁰ In addition, the rates might be made somewhat less attractive.

(ii) *Organization for Debt Management*

Given the close connection between monetary and debt policy, it is vital that a close working relationship be maintained between the Bank of Canada and the Department of Finance. Information and opinion must flow freely between them for in the absence of frank dealings between the two, neither can do its job well.

Since we take the view that debt management should be an integral part of a co-ordinated program of government policy, we see no advantage in setting up a separate debt management commission within the government organization. In fact it might be a dangerous move, raising the possibility of quite unnecessary conflicts in the government sector's operations in financial markets. Nor do we think it would be desirable to establish a formal committee of investment dealers or others in financial markets to advise the government on the timing and pricing of its new issues.²¹ Officials in the Bank of Canada and the Department of Finance must

²⁰ It will be recalled from Chapter 2 that our consumer survey showed that 56% of C.S.B.'s were concentrated in relatively few households with holdings of \$10,000 or more.

²¹ Arrangements of this sort exist in the United States: see the Transcript, page 3811 ff; for 'Mr. Thomas' description of the manner in which these committees operate.

of course keep in close touch with the markets in the course of their daily work. There is nothing to prevent dealers and others from giving opinions and suggestions, whether or not their views are specifically solicited, and formal committees would not in our view significantly improve the information relevant to new issue decisions.

TECHNIQUES OF MONETARY POLICY

Debt management has a place—sometimes an important place—as a supplementary instrument to vary credit conditions. However, the credit instrument on which reliance must mainly rest is monetary policy—the operations of the central bank affecting the amount of its liabilities outstanding, in particular the cash reserves of the banking system.

The techniques used by the Bank of Canada to control the amount of ultimate cash in the system are described in some detail in the Bank's submission to us. Chartered bank reserves consist of Bank of Canada deposits and part of the outstanding note issue. Changes in these reserves result from changes in any other Bank of Canada asset or liability, and can only come about as a result of such changes. Thus if the Bank of Canada alters its total assets, reserves will be affected if there is no offsetting change in some other liability. Taking account of fluctuations in items over which it does not have daily control, such as the note circulation²² and the ebb and flow of payments through the government's account, the Bank acts on the items which it does control from day to day in order to set the level of bank reserves. By varying its buying and selling prices for government securities, the central bank can increase or reduce its portfolio with conse-

²² The amount of notes in active circulation is determined by the preferences of the public. Under the present cash reserve formula the amount of till money included in legal reserves each month is fixed on the basis of average recent holdings. For this reason, changes in public holdings of notes do not alter legal reserves during a month except to the extent that the banks draw down their deposits to meet the drain of notes or redeposit excess notes with the Bank of Canada for credit to their deposit accounts. The Bank of Canada does not normally allow changes in the note circulation to affect credit conditions, and accordingly takes the necessary offsetting actions.

BANK OF CANADA BALANCE SHEET
Dec. 31, 1962—millions of dollars

ASSETS		LIABILITIES	
Treasury bills.....	455	Held by chartered banks:	
Other Govt. securities.....	2,427	Notes.....	417
		Deposits.....	746
Bankers' acceptances.....	3	Held by others:	
Investment in I.D.B.	158	Notes.....	1,817
		Govt. of Canada deposits.....	43
Foreign currency items.....	73	Other Canadian deposits.....	38
		Foreign currency items.....	61
All other assets*.....	114	All other liabilities*.....	110
	3,231		3,231

*The principal variable components of these categories are items in the process of settlement—including the float in the government's account—and the Bank of Canada's profit liability to the Minister of Finance.

quent effects on cash reserves. These open market operations, and changes in treasury bill holdings at the weekly auction, are the principal techniques of cash management.²³

Cash may also be affected by moving government balances between the government's accounts at the central bank and at the chartered banks—a reduction in the Bank of Canada account increases the banks' cash reserves and vice versa—and such transfers are used each day as the final balancing item to set the desired level of cash for the following day. The central bank makes recommendations about the amounts to be drawn down or re-deposited as part of its cash management function, but transfers are carried out under the Minister of Finance's responsibility and with his concurrence. In practice, the government account is normally used only to smooth out day

²³ It has been suggested that the Bank should be 'neutral' at the bill auctions, simply replacing its maturing bills with new ones at the average price and altering its bill holdings exclusively by market transactions before or after the auction. In view of the convenience for cash management of changes at the auction and the market disturbance which can sometimes be avoided in this way, we see no advantage in adopting such a rule.

to day cash fluctuations and most transfers are made to prevent the deposit at the Bank of Canada from altering substantially; thus they serve to offset the disturbing effect which swings in the government's receipts and payments would otherwise have on bank reserves. Operations carried out for the government, whether for domestic securities accounts or for the Exchange Fund Account, do not affect cash reserves so long as the government's deposit account at the central bank is held steady by appropriate transfers of funds to or from its accounts with the chartered banks. Similarly, the Bank of Canada normally maintains a steady net position in foreign currency assets and liabilities and thus its transactions in foreign items seldom affect reserves.

The Bank of Canada acts as agent for the Minister of Finance in all transactions for the government's securities accounts or the Exchange Fund. It also has the power to act as fiscal agent for any provincial government and is permitted to invest in provincial government securities, but these powers have not been exercised. In practice the Bank would find it extremely difficult to act for provincial governments and deal in their securities because of the virtually insoluble problems of equity among different governments that would inevitably arise. (In view of the relatively small annual increase in the Bank's security portfolio, it could make only a limited contribution to provincial financing in any case.) We do not see the same political objection to including provincial securities among those eligible for discount at the Bank of Canada but there would be little advantage in doing so: as a practical matter this would reduce the borrowing costs of provincial governments little if at all.

There are two ways in which the system can obtain cash temporarily from the Bank of Canada. Each chartered bank has a line of credit against which it may borrow for a minimum of one week if it finds itself short of the cash necessary to meet its requirement. The first loan to a bank is made at Bank Rate but at the discretion of the Bank of Canada a higher rate may be charged on an extension or a second loan in the same month.

Banks borrow relatively infrequently since neither they nor the central bank regard this as an acceptable means of obtaining cash except in emergencies. Banks more frequently draw extra cash into the system by calling their loans to money market dealers and obliging them to turn to the central bank. As noted in Chapter 16, the recognized money market dealers are entitled to obtain funds (which enter bank cash reserves) by selling securities to the Bank of Canada under an agreement to re-purchase them within 30 days.²⁴ Transactions are carried out at prices which result in the dealer paying about $\frac{1}{4}$ of 1% more than the rate on treasury bills²⁵ for the accommodation, and since this is a relatively costly source of funds they have a strong inducement to find financing elsewhere or to reduce their inventories. Thus the system is not encouraged to borrow continuously from the Bank of Canada. Dealer lines of credit are reviewed from time to time to ensure that they are adequate, but it appears that bank lines are deliberately kept low to discourage direct bank borrowing.²⁶

It is important that the central bank be able to bring about rapid and smooth changes in the financial system, and it is frequently argued that delays in response to central bank action result partly from weaknesses in the apparatus of control. Two of these supposed weaknesses are the fact that cash reserve ratios have applied only to the chartered banks and that the requirement relates to their liabilities in a previous period. The first point has been fully discussed in earlier chapters: we agree with the Bank of Canada that the absence of specified reserve requirements applying to other banking institutions has had little effect on the pattern of their response to central bank action. The recommendation made in Chapter 19 for the application of common reserve requirements was based primarily on other considerations.

²⁴ At the end of 1963, 15 dealers were entitled to use this facility.

²⁵ The present dual Bank Rate system is discussed below.

²⁶ See Bank of Canada Submission III, paragraph 54; see also Transcript, pp. 7615-23, in which the Bank of Canada made it clear that any bank's access to central bank credit in unusual circumstances would not be dependent on the size of these lines.

The Bank Act now fixes the base for calculation of reserve requirements each month as the average of each bank's deposit liabilities on the four Wednesdays ending with the second last Wednesday of the preceding month, and the holdings of till money which may be included in required reserves for the current month are fixed in the same way. Thus, the banks know at the beginning of each month the amount of Bank of Canada deposits they must hold on average during the month. Changes in their liabilities do not alter the required amount of reserves until they enter the formula in the following month. Moreover, the fact that they are only required to observe the minimum on the average of business days means that they may allow their cash to run low on some days and recoup by holding higher reserves on other days during the month. To quote from the central bank's submission: "The present view of the Bank of Canada is that the existing formula permits unduly slow responses and results in unduly large discontinuities in reserve requirements".²⁷

Taking first the principle of a lagged calculation, it is in general true that no matter how one arrives at the figure for minimum required reserves the central bank is able to vary actual reserves in relation to the requirement at any time. If banks' assets and liabilities rise during a month, the requirement does not rise in step, but the Bank of Canada is nevertheless able to lower reserves relative to the requirement if it wishes to restrain or reverse the expansion. Whether the requirements rise automatically and reserves are held constant or the minimum is constant while actual cash is reduced, the reserve ratio falls at once and banks are brought under reserve pressure. They cannot delay their response because they must meet the requirement in the current month, and it is not obvious that they would respond more quickly under one system than the other.

Provided that it has up to date information on the banks' activities, the central bank can influence them in the direction it considers ap-

propriate.²⁸ If chartered banks acquire bonds more rapidly than is considered desirable and the Bank of Canada hesitates to restrain the increase or reverse it, this really reflects a problem of conflict between the Bank's possible short-run objectives of stabilizing market yields or stabilizing particular quantities in the system: no cash reserve system can overcome such a conflict. Under a lagged or a current cash requirement, the crucial factors are the view of the banking institutions as to how difficult or easy the central bank will make it for them to meet the cash requirement currently and in the future and the central bank's willingness to accept the interest rate consequences of bringing quantitative pressure to bear on the system.

Thus we would argue that the use of a lagged requirement does not itself allow banks to escape the central bank's control. In view of the great difficulty banking institutions would have in compiling current deposit figures and the advantages of certainty about the requirement (since changes in cash occur in relation to a known minimum at all times), we believe that a lagged requirement should be maintained. As mentioned in Chapter 19, the minimum should be set above the level dictated by the banking institutions' business needs in order to ensure that they have a strong incentive to work close to the minimum and thus respond quickly to changes in the availability of reserves. At the same time it should not exceed this prudent minimum by too much for there is no point in calling for unnecessary amounts of non-earning assets.²⁹ We believe that the requirements recommended in Chapter 19 strike an appropriate balance.

The Bank of Canada has argued that response would be more precise if the averaging period were shorter because the banks would have less opportunity to offset low cash on some days with higher levels on others. They would therefore tend to work more closely to the requirement on

²⁸ The fact that the Bank of Canada does not have current information on banks' participation in new issues does create problems, but it is the delay in receiving information rather than a lagged cash base that is at the root of the difficulty. See Transcript, page 7604.

²⁹ The power to vary the ratio is discussed later in this chapter.

²⁷ Bank of Canada Submission III, paragraph 46.

each day than they do at present.³⁰ On the other hand, the chartered banks expressed the view that if the averaging period were shorter they would in practice have to work further above it than at present because they would have less time to achieve the required average level. The result might be that their responses would be less predictable than at present. It is also relevant that there is a monthly payments cycle for a great many transactions so that each bank has a pattern of cash flows which is completed within each month. If the reserve period were shorter, the discontinuities between one reserve period and another might well be greater.³¹

Changes from month to month in the deposits required at the central bank have ranged from \$1 million to \$45 million in recent years, with the largest ones normally occurring in February and March as a result of the regular seasonal movement in the note circulation over the Christmas shopping period. The Bank has entered into one month sale and repurchase agreements with the government in order to handle these predictable large changes in requirements. This technique, temporary shifts of government deposits between the chartered banks and the Bank of Canada, and changes in treasury bill holdings at the regular weekly auctions can all be used to alter the level of cash so that any necessary market transactions can be carried out over a number of days. Thus the central bank has the means of ensuring that even quite large changes in the monthly requirement are accommodated without disrupting securities markets. Since the Bank of Canada agrees that any problems with the time period of the present formula are not serious,³² and since shortening the reserve period might lead to additional complications, we are not inclined to recommend any change in it.

The cash reserve requirements we recommended earlier should apply as at present to combined holdings of till money and deposits at the Bank of Canada. The chartered banks tend to hold about two-thirds of their reserves in deposits

and one-third in currency, but we do not have comparable information for the other institutions. If the requirement applied only to central bank deposits, the change in the cash requirement each month would be somewhat less than under the present system. However, in the absence of information on which to base rough estimates of an equitable level of requirements excluding till money, and in view of the fact that the monthly changes under the present system are not so large as to be a nuisance, we have preferred to recommend inclusion of both till money and deposits in the minimum reserves. Moreover, inability to include till money in eligible reserves might discriminate against smaller or more remote institutions by forcing them to hold larger amounts of non-earning assets than larger institutions or those in major centres.³³

We conclude, therefore, that the Bank of Canada's ability to bring about prompt and pervasive changes in financial conditions has not been weakened to any significant degree by inadequacies in the apparatus of cash control. Our view of the matter might be different if we felt it vitally important for the central bank to have precise day-to-day control over such quantities as the amounts of liquid assets held by banking institutions or the total of their deposit liabilities. However, we are persuaded that in working day by day to influence credit conditions the central bank should be more concerned to influence the movement of interest rates in the appropriate direction and prevent sudden random gyrations in the rate structure than to impose a particular short-run pattern of change in the amounts of particular assets and liabilities outstanding.

Needless to say, prices and quantities go hand in hand and the distinction between one immediate target of policy and the other cannot be rigidly drawn. Nonetheless, important consequences can follow from the choice between the two approaches. The financial system must be able to absorb sudden changes in market expectations, and if the adjustment were invariably taken up

³⁰ Transcript pages 7597-7599.

³¹ Transcript, page 8065.

³² Transcript, page 7958.

³³ It might also have the effect of encouraging institutions to economize excessively on till money, with possible adverse results, although this is rather unlikely.

by swings in interest rates, this would lead to confusion and uncertainty in domestic financial markets and to serious disturbance of international financial flows. For instance, in October 1960, the central bank reacted to the apparent failure of a long-term issue by putting sharp pressure on the system in an attempt to restrict the expansion of bank assets. As a result, interest rates rose very sharply at an inappropriate time and did not return to September 1960 levels for about a year. Even then, the apparent object of the policy adopted in October 1960 was not achieved for bank assets continued to rise. In October 1962, different circumstances faced the authorities with a similar choice between immediate price and quantity objectives. On this occasion the central bank supported the market with security purchases of some \$111 million during three days and this action prevented the sudden eruption of the Cuban crisis from precipitating a similar distortion of credit conditions. Substantial excess cash reserves flowed into the banks temporarily but the central bank was able to reverse this gyration of the most crucial quantity in the system by reselling securities almost immediately. A week or two after the crisis hardly a trace of its passing remained.

These were both dramatic occurrences, but it is equally true that in more normal circumstances the central bank can facilitate its daily task and avoid creating unnecessary confusion by focusing its attention mainly on market prices. This involves watching to see what quantities emerge as a result of its own action impinging on all the other forces at work rather than attempting to lay emphasis on quantities and see what interest rates develop in consequence.

The management of the rates at which the central bank is prepared to act as lender of last resort to banks and money market dealers can assist in the task of maintaining stable market conditions or moving them smoothly and decisively as the occasion demands. Since June of 1962, the Bank of Canada has operated a dual Bank Rate system. The "official" Bank Rate at which it lends to banks is fixed by the Bank from time to time,

while money market dealers may obtain funds under repurchase agreements at the lower of this rate and the "Money Market Rate" which is set $\frac{1}{4}$ of 1% above the average successful bid at the most recent treasury bill auction. Prior to 1956 there was only an administered Bank Rate, while from 1956 to 1962 the single Bank Rate "floated" $\frac{1}{4}$ of 1% above the treasury bill rate. The practical differences between these various techniques should not be exaggerated because the central bank has very close control over treasury bill rates: they do not move significantly unless the authorities initiate or acquiesce in the change. Changes in a floating Bank Rate thus provide an indication of the central bank's policy just as do adjustments of a fixed rate.³⁴ On the other hand, neither one can invariably be taken as an unambiguous signal of coming monetary policy.

In describing its use of the fixed rate during the past eighteen months, the Bank of Canada made a distinction between the occasions when a change in Bank Rate can be taken as a clear signal of intent—as when the rate was originally set at 6% during the 1962 exchange crisis—and the more normal circumstances in which Bank Rate changes reflect "gradual and tentative adjustments in the emphasis of policy rather than any major turning points in policy with unambiguous implications for the future".³⁵ Such gradual adjustments may be little more powerful as a signal than the changes in treasury bill and other short term rates which will already have occurred as a result of central bank action. However, the Bank went on to argue that the use of a fixed rate can assist in stabilizing and controlling market developments by setting a "tentative ceiling" on short-term rates.³⁶ Taken with its occasional use as a dramatic signal of changed policy, this seems to us a useful way of viewing the role of Bank Rate. It recognizes the useful function which occasional dramatic alterations can have in jolting

³⁴ In the extreme circumstances of August 1959, the control of the authorities over the bill rate was dramatically demonstrated by the decision not to accept tenders for all the bills offered. The result was an immediate adjustment of market expectations and interest rates.

³⁵ Transcript, pages 7475-76.

³⁶ Transcript, page 7656.

market psychology. At the same time, it recognizes that too frequent changes in Bank Rate can weaken its effectiveness and lead to confusion, or indifference, in financial markets.

However they are made, changes in the Bank Rate should be accompanied by as clear a statement as possible of the reasoning behind them. As several of our witnesses, including the Governor, pointed out, there is no virtue in the central bank confining its communications to a "curious system of flashes"³⁷ when more direct and understandable means are available. This is particularly the case because there are not the same formalized or conventional public reactions to Bank Rate changes in Canada as are found in the United Kingdom.³⁸

In emphasizing the importance of focusing attention on interest rate developments, we are not suggesting that quantities can be disregarded: the two interact and combine to influence credit conditions and spending. Nor are we arguing that the maintenance of orderly markets calls for the central bank to set the entire pattern of rates by its operations in the market, although there is no reason to preclude the Bank from operating in any part of the market from time to time in order to help along the adjustments it wishes to achieve. This point has been sufficiently discussed in relation to debt management to make clear the reasons for our opposition to a "bills only" approach to open market operations. However, excessive central bank intervention throughout the market can be harmful. The markets in medium and longer-term issues are not as active as the short market: this can be an advantage when the authorities wish to move the entire structure of interest rates rapidly, but it also means that continual dealings in these thinner

markets would be more disturbing than similar transactions in bills or short bonds.³⁹

If the central bank were buying and selling longer issues every day, dealers would be less likely to make effective markets themselves and more likely to spend their time trying to anticipate the Bank's next move. In these circumstances, the market's usefulness in channelling funds efficiently from lenders to borrowers would be impaired and the authorities would to a degree be deprived of the reflection of underlying pressures and of information drawn from reaction to their own moves which a good securities market can provide. The point should not be over-emphasized, because however it operates the central bank is the main participant in the market and others are bound to be influenced by their view of the direction of its policy. Nevertheless, we believe that the central bank can normally carry out its function effectively by operating in the short market, and that it should enter the long market forcefully only when there are strong reasons for doing so.

We conclude that technical considerations such as the details of cash reserve arrangements or the manner of setting Bank Rate have not stood in the way of carrying out an effective monetary policy.

THE POLICY PROBLEM

There are more basic difficulties facing the authorities. Their first task, on which all else depends, is of course to determine what action is appropriate for the circumstances. To do this, they must analyse the current economic situation, understand the nature and strength of the forces at work and forecast with reasonable accuracy the strength and duration of future changes in the level of economic activity. Even the analysis of current events is difficult enough because the essential statistical information is available only after some delay. Thus, the results of labour force surveys are not available to the authorities until almost a month after the event, and there

³⁷ We are indebted to the late Sir Dennis Robertson for this phrase. He went on to say "this system does not work unless there is somebody to tell you what the flashes mean". Transcript, pages 5164-65.

³⁸ Many institutional lending and borrowing rates are linked to Bank Rate in that country. Conventions of this sort can be useful but they can also create undesirable rigidities in the rate structure and lead to inappropriate rate adjustments if the authorities wish to limit the impact of temporary measures to the short end of the market. On balance we think them undesirable.

³⁹ See for instance Mr. Thomas' remarks, Transcript, page 3786.

is a similar delay in preparation of the Consumer Price Index. Approximately twice this period elapses before information is available on such important elements in the emerging situation as industrial production, new orders and inventories and foreign trade, despite the fact that the authorities have access to some of these data shortly before they are published. We do not wish these comments to reflect on the excellent work of the Dominion Bureau of Statistics staff, who are well aware that the rapid production of less accurate statistics would serve no good purpose. Although any shortening of the time taken to prepare reliable data would be helpful, the fact remains that today's decisions must always be taken on the basis of information about the past behaviour of the economy.

If known changes in past economic conditions were an infallible guide to the duration and strength of an expansion or contraction, the authorities' job would still be comparatively simple in spite of the delays in obtaining current information. Unfortunately, the world is less certain than this and the authorities may fail to take action not because they are unaware of the current change in economic conditions, nor because of any administrative delays such as those typified by the widely spaced budgets of the fiscal authority, but rather because it is difficult to forecast economic conditions with sufficient accuracy to permit clear-cut judgments on the actions needed. Indeed, this is the only reason for delay because a change in the direction of market operations can be initiated immediately a decision has been taken. Whether one should describe such delays in establishing policy as lags in the response of the authorities or as an inevitable result of uncertainty about unfolding events, it is clear that they will always exist in some degree. Despite great improvements in statistical information and methods of analysis, forecasting is still an art in which informed judgment plays a major part. Forecasts need not be precise but they must give a correct view of the direction and underlying strength of economic developments if the authorities are to succeed

in their main job of establishing the correct general set of policy.

In the absence of certainty, the authorities must decide in which direction they are prepared to err, given the general background against which they are operating. Thus, if the climate is generally buoyant and inflationary, they may decide it best to err on the side of restraint for a few months even though it may subsequently become clear that conditions are weaker than had been thought. Conversely, if there is a general climate of demand weakness and excess capacity, they may lean on the side of ease until events become clearer, but with the full knowledge that there is a fairly substantial risk of being wrong. These are not situations in which the choice is between extremes of policy, but rather between shades of emphasis designed to establish the appropriate policy climate.

Given the best economic analysis available to them, the authorities can only meet events with an appropriate policy if they have an informed view of the effects their action can be expected to have. This means that the central bank must have some notion of the magnitude and timing of the effects which changed credit conditions and the set of other policy instruments will have on real economic activity, a subject we discussed in the previous chapter. They must also know the effects which their own actions will have on credit conditions.

The authorities can of course observe directly many of the key components of credit conditions. Firstly, they have virtually complete current information on the level and structure of interest rates. In addition, each Thursday the Bank has up to date reports on the chartered bank's holdings of government securities and other liquid assets and full information on their assets and liabilities a week after the event. These main items of statistical information, which are published immediately, are supplemented by others, equally current, such as reports on "country bank" loans to the dealer market.⁴⁰ At the

⁴⁰ As mentioned in chapter 16, the "country bank" figures should be published each week.

same time, its continuing contacts with investment dealers bring the Bank of Canada a good deal of additional information on the behaviour of the central markets and the views of participants. All of this allows the Bank to see and to sense the response of the money market, the bond markets and the chartered banks to its own actions in the context of the other forces influencing them. Responses are quick and the immediate feed-back of information enables the authorities to take further action promptly in order to achieve their aims.

The description of central banking technique as a matter of "successive approximation"⁴¹ or—as officials of the Federal Reserve phrase it—as a process of "probing" financial markets,⁴² applies best to the behaviour of these central markets. This is the part of the system which is most immediately sensitive to official operations and for which the most complete information is currently available. Trials can be taken without delay and errors recognized while time remains to try again.

However, the links between central bank action and developments in other parts of the financial system are a good deal more tenuous, both because information on changes in other important components of credit conditions is much less complete and because the response to central bank action is slower and more diffuse. Despite excellent statistical reporting, the authorities' knowledge of chartered bank lending cannot be complete and up to date because so much depends on the policies adopted by head offices and the manner in which local managers and credit officers execute them. In view of the continuing close contact between the central bank and chartered banks, the problem is much less serious here than in other areas, although we were told for instance that the Bank of Canada sometimes finds that even the short delays before it has reports of chartered bank purchases of new issues complicate its task of assessing financial develop-

ments. Current statistical information on the activities of other financial institutions is much less adequate: monthly data on the receivables of sales finance and small loan companies and on the investment activity of large life insurance companies have for some years been compiled reasonably quickly, but it is only recently that quarterly balance sheets of the trust and loan companies have been available, while it is still the case that only annual data is available for the caisses populaires and credit unions, and that with a considerable delay.

In the securities markets, coverage of new bond and stock issues is generally good, but there has been no complete information on the important and rapidly growing commercial paper market. Our own survey makes a contribution to filling this gap and should be kept up to date and made more useful by collecting current information on a monthly basis. Similarly, the work now underway at the Dominion Bureau of Statistics towards preparation of quarterly balance sheet coverage of financial and non-financial companies will greatly improve the knowledge of developments in financial markets.⁴³

In the absence of adequate statistics and close contacts beyond the chartered banks and main investment dealers, the central bank is not as fully informed on developments throughout the financial system as it ideally needs to be. Even with much fuller information, it would still face problems in deciding what its own action should be. Quite apart from the delays and uncertainty of real responses to changed credit conditions, the response of the financial system itself to central bank action is really a complex of reactions working itself out over time. For some crucial components of credit conditions, the delays are uncertain and can be quite long. "Successive approximation" thus has a quite different meaning when applied to the entire set of domestic credit conditions than it does in the close and sensitive

⁴¹ See for instance Bank of Canada Submission II, paragraph 49, Submission III, paragraph 36 and Transcript page 7564 ff.

⁴² Submission of Mr. Allan Sproul, page 4 and Transcript page 5633 ff.

⁴³ The preparation of statistical reports for government is already a costly burden on all the financial and non-financial enterprises which must provide the essential raw material for analysis. Every effort should be made to avoid unnecessary requests and duplication of reporting to different parts of government.

money and bond markets for which information is good and where responses are relatively quick. In the narrower context, the authorities can observe the response to their actions and, taking account of it, can press or relax their action in order to achieve the results they have in mind. This process is far from precise in a mechanical sense, but the authorities' influence is even less precise when it comes to the "set" of bank lending policies, the availability and cost of mortgage funds, the state of markets for provincial, municipal and corporate securities, the ease and terms on which consumers may finance expenditures and the many other channels through which financial conditions can influence economic activity. Current conditions are largely the result of past actions and in many respects cannot be altered rapidly, let alone set with any precision. The following review of recent changes in monetary policy and credit conditions illustrates the complex and variable patterns that unfold.

THE PATTERN OF CHANGE IN CREDIT CONDITIONS

One can go back and identify the intervals which have elapsed from the beginning of periods of restraint to the time when different components of credit conditions altered. If one takes the 1955-57 period as an example, the rate on treasury bills began to rise in February 1955, although it did not exceed 2% until the latter part of the year despite the rapidly-accelerating pace of business activity. Medium and long-term rates began to rise during the second quarter, the rate of increase of the seasonally adjusted money supply declined in August and the Bank of Canada report appearing some months later dated the adoption of a restrictive monetary policy at about that time. The Bank of Canada discussed the situation with the chartered banks in November 1955 and the banks then took serious steps towards a more restrictive loan policy. Despite continued pressure on the banks (including imposition of the 15% liquid asset ratio) and the adoption of more restrictive lending policies during the spring, seasonally adjusted bank loans

continued to rise rapidly until mid-1956 and did not stop rising until 1957 when the economy reached its peak.

Meanwhile the N.H.A. rate, which had been reduced from 5½% to 5¼% in February 1955, was raised to 5½% in March 1956 and finally to 6% almost a year later, and rates on prime conventional mortgage loans edged up gradually from about 5¼% in the summer of 1955 to a high of 7% at the end of 1957. The relatively unattractive N.H.A. rate and cessation of bank mortgage lending led to a sharp reduction in the private flow of funds for new housing during 1956. In other parts of the capital market, similar changes were going forward throughout this rather extended period during which a restrictive policy was gradually imposed.

In the next period of restriction, increasing demands for funds began to move interest rates upward in May and June 1958. The rate of increase of the seasonally adjusted money supply dropped in October at the end of the Conversion Loan support period. Chartered banks began to run off their bond and other liquid asset holdings rapidly when the increase in their resources was brought to an end, and in the spring and summer of 1959 they adopted restrictive loan policies which contributed much to bringing the increase in their loans to an end in September. Once again the shifts to higher levels of interest rates and more restrictive credit policies elsewhere in the financial system occurred throughout this period of some 15 months.

Despite the fact that bond rates moved steadily upward from mid-1958 until October 1959, the prime rate on conventional mortgages held steady at about 6¼% until mid-1959 and then moved quickly up to 7¼% or slightly more by September: the N.H.A. rate was unchanged at 6% until December 1959 when it was raised to 6¼%. The private supply of new housing funds fell sharply in 1959 and again in 1960, although CMHC continued to lend generously until towards the end of 1959: its approvals remained low for about a year, despite the hesitant shift back to an easier monetary policy in 1960.

In the special circumstances of 1962, action was more decisive and events followed more quickly upon each other. The chartered banks' liquid assets did not rise after the end of 1961, in March they began liquidating treasury bills, and in early May 1962 interest rates began to rise. After the beginning of June, the banks sold very substantial amounts of bonds in addition to further liquidation of treasury bills, driving the entire structure of rates rapidly upwards. In late June, a fixed Bank Rate of 6% was announced. The external difficulties which led to this dramatic shift in policy eased quickly with the re-establishment of capital inflows, and the authorities were able—beginning in August—to move interest rates downward and ease the pressure on chartered bank resources. Because cash restraint and high interest rates lasted only for a short time, some of the components of credit conditions which are relatively slow to adjust were not significantly affected by events in 1962 as they had been in the protracted, although more gradual, earlier periods of restriction. Thus, a number of types of bank lending were little affected and there was no significant change in the cost or supply of mortgage funds. In the opposite circumstances of a short period of credit ease, one would also find that some components of credit conditions would be affected little if at all.

The pattern of change towards easier credit was not uniform on the two earlier occasions when restriction had lasted longer and pervaded the financial system. In late 1957 and early 1958, interest rates declined rapidly from the August 1957 peak, CMHC made loans of over \$160 million in the last quarter of 1957 and the relaxation of restraint on bank lending appears to have begun early in 1958 under the stimulus of rising bank liquidity. A rapid change in credit conditions thus occurred in the last four months of 1957 as a result of a lowering in demands for funds and expansionary action by the authorities. In 1959 and 1960, the movement towards credit ease was much slower and less clear cut. Treasury bill yields declined from the peak of over 6% in August 1959 but

were still over 5% at year-end and did not decline sharply until March 1960. Long-term yields levelled off in the latter part of 1959 but did not decline until early 1960. Meanwhile, the banks' liquidity ratios, which had reached their post-war low in the preceding period of loan growth, built up less rapidly than they had two years earlier and total assets did not begin to rise markedly until after the middle of the year. In these circumstances, the shift to an easier lending policy was more cautious than in 1958.

The authorities' hesitant monetary action contributed to uncertainty in securities markets which culminated with the failure of a long-term CNR issue delivered in October, 1960. Some speculative rise in bond prices preceded the unfortunate attempt to sell this issue, and subsequent lack of official support when the market weakened contributed to the sharp upward adjustment of rates in the securities markets referred to earlier. Conventional mortgage rates declined moderately from April to October, but the N.H.A. rate was held firm at 6½% until late in 1961. Finally, as already noted, the supply of new residential funds actually fell in 1960 as a result of the cut in direct government lending at the end of the previous boom. Thus in this period, the change towards easier credit conditions came slowly and indistinctly, reflecting the mixed character of the actions taken by the authorities.

It is clear from this summary of recent developments that the speed and extent of changes in credit conditions depend in part on the decisiveness with which the authorities are prepared to act and the nature of the situation facing them. The decisiveness of policy changes in turn is strongly influenced by the authorities' view of the economic prospects. When all other considerations are overwhelmed by the pressing need for action to meet a serious problem, such as the exchange crisis in 1962, firm action can be taken. Experience in that episode has demonstrated that the necessary changes in interest rates and financial flows can be brought about very quickly indeed, especially if the banking system is fairly taut when vigorous restraint is first applied. On the other hand, if crisis does not stalk the land and policy

is directed more to affecting domestic rates of spending, and if the strength and probable duration of the expansion or contraction is not clear to the authorities, they may choose to act more gradually, following the situation as it develops and pressing their policy more vigorously or relaxing it as the prospects become clearer. This is the approach normally adopted by central banks: "if one knew in advance . . . what the situation was going to be six months from now, then some other method might be possible, but one doesn't know that: one has to be influenced by the development of the situation".⁴⁴

However, the uncertainty of economic forecasts does not mean that the authorities should have no view of the underlying economic climate and of the appropriate direction of policy. They must make a choice as to the side on which it is better for them to be subsequently proved wrong, making gradual adjustments to this policy as events unfold. The response of the financial system will be correspondingly gradual, posing the danger that the full effects on spending will be felt only after the economic situation has altered. The authorities thus have the exceedingly difficult task of choosing between firm action based on forecasts that may well prove incorrect and gradual action whose cumulative effects may be strongest too late to assist in meeting the economic situation originally in prospect. Some have argued that the difficulties are such that discretionary monetary policy is more likely to contribute to short-run instability than to lessen it. While recognizing the problem and accepting the proposition that the monetary authorities cannot succeed in timing their policy to counteract every minor fluctuation in demand and output, we believe that discretionary policy can be helpful in preventing such cycles from becoming excessive.

The discussion of lags in this and the previous chapter can be summed up in the following terms. With some exceptions, the major sectors of the economy are sufficiently insensitive to minor changes in credit conditions that few changes in the decisions to spend occur before credit con-

ditions have altered significantly. If—as in 1955-57 and in 1958-60—the authorities follow a policy of gradually imposing increasing restraint, they can probably expect six to nine months to elapse before the change in credit conditions has important effects on the decisions to spend of governments and corporations. The effects on economic activity in turn will be distributed through time; some being felt within a few weeks and others extending over a period of years. Our knowledge of the distribution of these effects is limited, but at least a further six to nine months is probably required to encompass a major proportion of the effects on employment and output. This means that if the authorities take the view that credit conditions ought not to be changed quickly in the direction of restraint, they must probably be prepared to wait for a period of a year to eighteen months before a major proportion of the effects on employment and output arising from changes in the decisions of governments and corporations have been realized. Some of the direct and indirect effects will be felt much later.

A period of a year to eighteen months, which it should be emphasized is a very rough estimate, is long relative to some of the periods of expansion we have experienced in recent years. But periods of expansion which are short and weak do not in any event call for significant restraint. The boom of 1954-57, with a duration of just under three years, is perhaps more typical of the type of expansion which will call for policies of restraint in the future. The lags in the system are not so long as to rule out a useful though limited contribution from a change in monetary and debt policies if the nature of this type of expansion is recognized in time.

While response to the 1955-57 and 1958-60 experiences of domestic credit restraint and ease was neither rapid nor decisive, the delays in adjusting financial conditions are not irreducible. The events of 1962 were admittedly unusual but they have shown that adjustments in interest rates and the structure of bank assets can be brought about very rapidly—perhaps more rapidly than was earlier thought possible. If circumstances had called for continued restraint, other components

⁴⁴ Transcript, page 7569—evidence of the Governor of the Bank of Canada.

of credit conditions would undoubtedly have been affected by central bank pressure on the system with considerably less delay than during the previous restrictive periods. It is reasonable, therefore, to expect well-executed financial policy to assist in stabilizing the economy. However its potential effectiveness may be reduced not only by the delays before spending responds to policy measures but also by limitations on the range through which credit conditions can in fact be varied.

LIMITATIONS ON THE AUTHORITIES' FREEDOM TO VARY CREDIT CONDITIONS

Only part of the difficulty confronting the monetary and debt authorities in exercising a stabilizing influence over the economy derives from lags in the flow of information, inability to forecast accurately and lags in the response of the financial system and the economy to changes in policy. Even if information were available earlier and if sufficiently accurate forecasts could be made of the strength and duration of fluctuations, it appears that the effects of monetary and debt instruments will be limited in the short run if confined to the range over which they varied in recent years. One obvious answer to this problem is that the short-run variation of credit conditions should take place over a wider range. Similarly, if longer-term developments can be foreseen accurately, significant changes should take place in the whole level of interest rates and the availability of credit to meet the new circumstances.

It bears repeating that an important part of the central bank's job is to prevent the development of financial crises: it must try to keep credit conditions within the range where markets can operate effectively if the economy is not to suffer the disruptions of financial panic. This is best seen not as a limitation on its freedom but as a positive objective of policy. Bearing this point in mind, what are the limitations which prevent the use of the instruments of policy over a wider range than we have experienced?

One limitation is the difficulty of altering market expectations in the absence of a major change

in economic circumstances. Borrowers' and lenders' views about the level and structure of rates are based on their assessment of the basic forces at work in the economy as well as their judgment of the authorities' probable course of action. It is by no means easy to shift credit conditions in a direction or to a degree which markets do not feel to be in accordance with their view of the economic outlook. In most circumstances this does not pose an insuperable problem because the authorities will in fact not be trying to lower interest rates when the economy is under pressure or vice versa. Thus most of the time it is appropriate for the authorities to "reinforce or mitigate" the impact of underlying forces on interest rates (the Bank of Canada's phrase already cited).

In another passage cited in Chapter 21, Sir Dennis Robertson went somewhat further in saying that the central bank should "influence the rates . . . in a direction and a degree consistent with the long-term forces operating in the economy". If the long-term forces call for a policy not obviously in line with immediate economic circumstances, problems can arise. Efforts by the authorities to take account of lags in the impact of their measures and to move credit conditions in anticipation of the future economic situation are likely to have quite limited success. If all the current indicators of economic activity are still rising, it may be difficult to persuade markets that the time has come to shift to an easier policy to meet a coming recessionary phase. Even when the changed economic situation is generally evident, resistance to attempts to lower rates may persist.

The conventional instruments of policy have traditionally been capable of bringing about sharp reductions in short-term rates of interest, but major downward shifts in long-term rates over a short period are virtually unknown in most countries in the absence of a basic change in underlying conditions such as the great depression of the nineteen thirties. For instance, holders of long-term securities will not normally assume that long-term interest rates can or will change from over 5% to under 3% and remain at the new

low level. If rates begin to move downwards towards 4%, holders of long-term securities will begin to realize on their assets on the assumption that such securities will likely be available in the near future at yields close to 5%. If the authorities wish to achieve a major downward movement of interest rates, they will ordinarily have to follow a policy of persistent ease over a considerable period. The extent of a reduction of long-term interest rates which can be quickly achieved is thus fairly limited unless the authorities are prepared to take the risks of wholesale liquidation which might be associated with an attempt to peg bond prices at a level regarded as completely inappropriate by the market.

The Bank of Canada drew attention to one of the dangers of such a policy: "The central bank will be very conscious of the limitations which it will face in attempting to keep the more liquid situation under control later on. This may be particularly true if it feels that the possibility of the reappearance of inflationary pressures is not too remote, and if it is not confident that adequate support from other public policies will be forthcoming at a later stage".⁴⁵ On the first point, it must of course be said that if the recession is expected to give way shortly to renewed excess pressure on the economy, a policy of extreme ease would in any case be inappropriate. While recognizing the practical difficulties of bringing all government policies to bear quickly on the ensuing inflationary situation, we can only urge that as far as possible they be continuously coordinated in support of each other.

Attempts to bring about wide fluctuations in interest rates and credit conditions may run into other domestic limitations. There may be hesitation to alter security prices so drastically that dealers and financial institutions are disrupted. An excessive concern for the stability of asset values need not stand in the way of vigorous policy: experience has shown that institutions and markets are well able to withstand very substantial shocks, although this is not to say that policy should ever deliberately court the danger of provoking crises.

Lack of public acceptability of tight money is more likely to inhibit the government, and even the central bank itself. The problem is a real one, particularly since some borrowers are affected more severely than others. Much can nonetheless be done to obtain support for policy, and to overcome the resistance to changes in interest rate levels caused by market expectations, if the authorities take pains to inform the public of their view of the economic situation and the reasons for the policy being followed. We do not envisage the central bank or others in government always being in a position to give clear and unambiguous 'signals' of each change in policy—or always finding it desirable to do so. However, a continuous effort should be made to keep the country informed of their assessment of the underlying economic situation so that adjustments in the set of monetary policy will be more readily accepted.

Despite the authorities' best efforts, these domestic limitations on changes in interest rates and in other components of credit conditions will persist to some degree. However, they are less important than the constraint of our international position which, under present arrangements, is very likely to impose even narrower limitations on interest rate changes than the other factors would allow.

Canada is more than most countries closely integrated into capital markets abroad. There can be, and have been, short periods in which the short and long-term yield differentials between Canada and the United States have increased or decreased without consequential short-term effects on the exchange rate and on exchange reserves. However, attempts to widen the range of variation of interest rates far outside the range of variation prevailing in other capital markets, particularly in the United States, are likely to promote large-scale movements of capital. The authorities in this country can attempt to raise the interest rates to be paid by provinces, large municipalities and large corporations, but if rates in the United States and other external capital markets are significantly lower, they cannot succeed in making most major borrowers pay the Canadian rates. In the absence

⁴⁵ Bank of Canada Submission II, paragraph 73.

of other measures, very high rates will likely lead to a massive resort to external borrowing and, depending upon the exchange rate system in use, either to an appreciation of the exchange rate or the large-scale accumulation of exchange reserves.⁴⁶ Any attempt to achieve very low rates will tend to lead to the opposite result—exchange rate depreciation or loss of reserves. On occasion, these may be precisely the results which are desired; but it is clear that domestic changes in credit conditions can never be considered in isolation from their likely effects on international capital movements. It follows that if there are limits to the changes in the exchange rate or to the gains or losses of international reserves which are regarded as acceptable, then these limits also apply to the range of variation of domestic credit conditions.

WIDENING THE RANGE OF VARIATION OF CREDIT CONDITIONS

Our analysis in this and the previous chapter points up the difficulties in using conventional monetary and debt policies to make a major contribution to the domestic stabilization of the economy, particularly over short periods. The conventional instruments of policy, even if appropriately used, have limited effects on expenditure within the range experienced in the post-war period. If used over a much wider range, either in the short or longer run, they would have larger effects. However, there are limits to the possibility of extending the range of variation of credit conditions, particularly because of international considerations. Thus, if interest rates are raised or lowered substantially within Canada in relation to the rates prevailing in external capital markets, the effect will be largely to redirect borrowing rather than to curtail or increase it. If a change in reserves or an alteration of the exchange rate is desired, then clearly this redirection is a desir-

able by-product of the action. If, however, a substantial change in domestic credit conditions is urgently required, devices which widen the range of variation without at the same time leading to excessively large swings in interest rates and the exchange rate or reserves might be brought into play.

If the availability or cost of some types of credit can be directly influenced, and markets are somewhat imperfect so that the borrowers affected are in practice not able to find funds elsewhere by bidding up interest rates, direct action on some credit channels can strike quickly at vulnerable sectors of the economy. To take an example, a variety of measures discussed below may be used to induce the banks to restrict their lending. If the rates charged on bank loans rise rapidly in response to the use of devices of this kind, the customers who decide to forego bank borrowing may be largely those with other alternatives. Their demand will merely be redirected and interest rates will rise throughout the system. Under these circumstances, the results are essentially similar to those which would have occurred if the banks had been left free to adjust the structure of their assets as they wished. If the rates charged on bank loans do not respond to direct controls because of legal or other constraints, the rationing of bank loans will be done by non-price measures, and again if the bank customers who are refused loans can turn to other parts of the capital market and obtain finance by bidding up interest rates elsewhere their spending will not be curbed by much more than would have been the case if the direct measures had not been applied. If, however, some bank customers who are refused loans in either instance do not seek, or cannot find, accommodation elsewhere at acceptable rates, credit flows and expenditures will both be reduced without the full effect of the restraint being reflected in interest rates.

To the extent, therefore, that these direct devices reduce availability of credit with a dampened effect on interest rates, they permit a widening of the range of credit conditions while imposing a burden on particular institutions and

⁴⁶ The existence of such measures as the proposed U.S. interest-equalization tax may moderate Canadian external borrowing in such circumstances, although this would not be true if the interest differential exceeded the tax by a wide margin. Moral suasion by the Canadian authorities may also check such borrowing.

particular borrowers.⁴⁷ The more perfectly the financial system functions, that is the more changes in the availability of credit anywhere are reflected in interest rates everywhere, the less opportunity there is for reducing credit availability to some borrowers without this being fully reflected in interest rates. In short, devices of the kind discussed below can be viewed as techniques which use or create market imperfections for the purpose of achieving significant effects on expenditure through reduced availability of funds rather than higher interest rates.⁴⁸

Before discussing a few of the direct measures, we should state our view that they should not become a regular part of the apparatus of control but be reserved for extreme situations. The general credit instruments used intelligently can contribute usefully to stabilizing the economy and at most times they and other general policies can bring us as close to achieving our economic objectives as it seems reasonable to expect. Direct intervention in financial markets can disrupt them unnecessarily and may in the long run inhibit the best development of the financial system. Moreover, such measures can be very difficult to administer and, if used regularly, are likely to become less and less effective as borrowers find ways to circumvent them. As the Governor of the Bank of Canada said to us "Markets will not accept the imperfections".⁴⁹ The financial system will adapt, ways will be found to make funds available when the normal channels are stopped and the authorities will then be endlessly building new dams where the new flows have appeared. As an example, the large sales finance companies were little affected by restriction of their bank loans for they were

able to turn increasingly to the money market for funds.

However, occasions will doubtless arise when as a result of errors of forecasting, inadequate use of the general instruments or sudden, unpredictable occurrences the authorities are faced with a pressing need to restrain credit flows decisively. Since a general increase in the cost of credit does not have a sufficiently strong and rapid effect on spending, the authorities will be faced with a dilemma: either they must interfere with free markets which allocate resources equitably and efficiently or they must sacrifice in part the objective of stabilizing the economy. It may then be better to accept the costs and inequities of direct measures than to allow excess demand pressures to run unchecked.

(i) *Administrative Control of Institutional Lending*

The devices which lie closest to our own experience are controls over the banking system. These may be written into the legislation to give the central bank standby powers to be used only with government approval. Alternatively, effective control over the institutions may be based on agreements with them when need arises, rather than on any formal powers. Provision is already made in existing legislation for variation of the banks' cash reserves from 8% to 12%, subject to a month's notice for each change and a limit of 1% a month on increases in the ratio. In other words, the Bank of Canada can raise the requirement from 8% to 12% over a period of four months.

This technique may be used to freeze increases in reserves when the authorities cannot accept the interest rate consequences of putting selling pressure on the securities markets, for instance when the problem at hand is one of financing excessive inflows of capital from abroad. Whether used in these circumstances, or as a device for controlling loans by reducing bank liquidity, the effect is to impound a higher share of assets in a particular form. We do not believe it a particularly useful instrument for either purpose. If speculative

⁴⁷ The main impact is likely to fall on medium-sized and small borrowers with few alternative sources of finance. We noted in the previous chapter that the effect of such measures will be blunted to the extent that the authorities urge the banks to discriminate less severely against these borrowers: those with ready access to alternative sources of finance, such as the money and securities markets, will not be seriously affected by curbs on bank loans to them.

⁴⁸ Professor Erik Lundberg discussed general and direct monetary measures in these terms in his article "Economic Stability and Monetary Policy", *Skandinaviska Banken Quarterly Review*, No. 1, 1962.

⁴⁹ Transcript, page 7553.

capital inflows must be financed and ultimately checked, the power to force banks to raise their lending to government by some \$600 million gradually over four months may not prove prompt or decisive enough to meet the situation. If the object is to check bank lending in extreme circumstances, the instrument—although sizable in relation to the banks' cyclical portfolio adjustments—is unnecessarily cumbersome.

Essentially similar results could be achieved by variations in bank liquid asset ratios with the difference that the banks would earn a return on the assets impounded. Since 1956, the chartered banks have agreed to maintain a minimum liquid asset ratio of 15% of deposit liabilities on a monthly average basis. This is made up of at least 8% in notes of and deposits at the Bank of Canada and the remainder in additional cash and in day-to-day loans and treasury bills. As with the cash ratio, there has been no variation in this ratio since it was first introduced. In the chapter on chartered banks we expressed the view that this agreement with the Bank of Canada is of limited use as an instrument to control bank lending and does not contribute significantly to a more orderly adjustment to cash reserve pressure.

If the authorities do urgently need to restrict bank lending through direct control of bank liquidity, they must reach further into the portfolios of liquid assets. The Bank of Canada has indeed suggested that a variable liquid asset ratio would be a useful supplement to its ordinary techniques of control.⁵⁰ If it were to be useful, however, the authorities would also have to be given the power to vary it more widely than the present cash ratio, although presumably within specified limits, and to impose the changes more quickly.

The system of "special deposits" used in some countries is essentially the same as the use of a variable cash reserve requirement. The banks can be required to deposit funds with the central bank over and above normal requirements and these special deposits can be released to them

when economic conditions alter. If a similar control is exercised by requiring the banking institutions to invest in non-marketable government securities, the special issue is similar in effect to raising the liquid asset ratio of the banks.

These devices are designed to limit the adjustment of bank portfolios by increasing the minimum amounts of particular assets which must be held. Another device for limiting this adjustment is the imposition of a ceiling on the increase of other assets, in particular bank loans and non-government securities. A step of this kind was taken in Canada in February 1951 when the banks agreed that "further expansion in total bank credit was undesirable". There was no net increase in bank loans and investments other than Government of Canada securities in the last nine months of 1951. Considerable use is made of direct bank loan restrictions in Holland, where the central bank is unable to engage in extensive open market operations.⁵¹

These last practices are examples of the use of "moral suasion", to which all central banks resort from time to time. In circumstances when the national interest is clearly involved, the authorities can request financial institutions or other private interests to adopt particular policies. Their success depends on the clarity and force of the case presented by the authorities: with rare exceptions Canadian experience has been that the banks and others will co-operate in the national interest if reasonable arguments are advanced. However, knowledge that the authorities have the power to enforce their wishes doubtless strengthens the appeal, and it can be argued that the main purpose of legislating the power to impose a liquid asset ratio would be to provide a sanction behind the authorities' less formal attempts to elicit co-operation.

There is a danger, however, that the power itself or persuasion by the authorities will be used unnecessarily to impose a particular pattern of investment on private institutions or as a means of providing a captive source of finance for the government at the expense of other bor-

⁵⁰ Transcript, pages 7608-7615.

⁵¹ Submission of Dr. Marius W. Holtrop, President of De Nederlandsche Bank N.V., and Transcript, page 4137 ff.

rowers. Quite apart from this sort of abuse, there is likely to be less meaningful discussion with the private institutions and less pressure on the authorities to formulate and defend sound policies if they have the power to impose their will without the private debate which must accompany less formal moral suasion. Moreover, emergency devices such as a variable liquid asset ratio may become a permanent part of the machinery, with the authorities relying increasingly on their ability to control what may not be the crucial credit flows in the system and being the less careful and adept in using the general instruments.

Moral suasion may be directed to purposes other than the restriction of bank lending, although this has been its most common use in Canada. For instance, the Bank of Canada has held discussions with insurance companies, sales finance companies, department stores, stockbrokers and investment dealers with a view to obtaining agreement on policies to be followed. Agreement has not always been achieved, sometimes because the need was not evident to the institutions concerned, sometimes because the channels of discussion had not been well established.

Agreements are more likely to be reached if the central bank keeps in regular contact with the institutions concerned: those who hear from the central bank only when it wants them to do something against their own interests are unlikely to understand the authorities' problems or to feel that their own are appreciated. Even if there is close contact, moral suasion cannot be relied on to carry much of the weight of policy in normal situations because market participants cannot be expected to act against their own interests except temporarily and in exceptional circumstances. As Mr. Towers put it: "In the final analysis, over-all monetary and fiscal policy must do the job. But I believe there can usefully be some rare, temporary and prudent exceptions to this rule".⁵² When exceptions are made, they should carry the approval of the Minister and the terms of agreement reached should be made public unless there are overwhelming arguments in the

public interest for keeping them secret, as might, for example, be the case during an exchange crisis.

We are not persuaded by the evidence before us that any legislative power to direct the allocation of the institutions' funds is necessary. These are in the main emergency measures, and if the authorities' case is well founded, co-operation will be forthcoming. If the authorities, however, find themselves handicapped in operating by the lack of specific legal powers, we would have no particular preference between a variable liquid asset ratio and some statutory authority to control loan increases. However, we do recommend that if any such power is written into law its use should require the specific approval of government. The Bank of Canada might impose a restriction but it should lapse in perhaps a month unless endorsed by government and tabled in Parliament.

(ii) *Selective Credit Controls*

Another set of devices which can be used to widen the range of variation of credit conditions with dampened effects on interest rates are selective credit controls. These controls are directed to types of lending rather than to the lending of particular institutions. For example, our existing arrangements for housing finance have frequently had effects essentially similar to those resulting from selective credit controls. The government provides relatively favourable terms for purchasers and builders of new housing by guaranteeing mortgages. If this N.H.A. lending is curbed—either in the automatic way described in the previous chapter or more consciously by raising down payments and shortening the term of the loan—it imposes a sharp change in the terms and conditions of borrowing facing builders and purchasers of new housing. A major increase in the down payment requirement and a shortening of the term of repayment are precisely the changes which are thought to be of particular use in affecting the expenditure of consumers on housing and durable goods. In this sense the existing arrangements for financing housing expenditure, which lead to sharp reductions in pri-

⁵² Submission, p. 9.

vate N.H.A. lending in periods of restraint if the N.H.A. rate is not raised, and which thus force borrowers into the less favourable conventional market, have a built-in tendency to operate in the same way as consumer credit controls. While believing that there are compelling grounds for allowing the N.H.A. rate to be set free to vary with market rates, we have also suggested that the down payment requirements and maximum term of loans could be altered from time to time in line with the needs of stabilization policy. In extreme circumstances the authorities may also wish to fix the rate for short periods in order to reinforce their policy: thus the possibility of using selective controls on housing will not be lost to the authorities, but they will be required to use them as a matter of conscious policy rather than relying on the fortuitous effects of present institutional arrangements.

Consumer credit controls also depend for their effectiveness on the inability or unwillingness of consumers to find alternative sources of finance to provide the higher down payments and the shorter terms of repayment which would be required under such controls. If alternative sources can be readily found by consumers, the attempt to block up one channel of lending will merely encourage the widening of another channel and the effect will be felt quite fully on interest rates. Similarly, to the extent that controls over instalment finance lead to the development of organizations which purchase and lease durable goods, demand has not been curtailed but merely re-directed. There is also a danger that lenders will evade the restrictions by writing inflated cash values for trade-ins into their contracts and employing other stratagems with the collusion of their customers. As we have mentioned earlier, this is a problem likely to arise from repetitive use of the instrument. Whether used periodically or infrequently, control over consumer instalment finance poses severe problems of adequate administration. In this country there is also some doubt as to the federal government's authority to impose them. In any event the imposition of special excise taxes on consumer durables (which strike at all consumers,

not just those who borrow) may be just as effective in curbing consumer spending, especially if they are thought likely to be withdrawn in the fairly near future.

Direct credit measures can also be used to exert a stronger influence on business spending, and it can be argued that they are more appropriate than attempts to control consumer spending because of the wider cyclical swings in business investment. Going beyond control of bank loans, the authorities may ration the flow of funds from securities markets by imposing control over new capital issues. This is a drastic measure and experience in other countries has shown that it cannot be administered easily. Priorities must be established, account must be taken of alternative sources of funds, including foreign markets, of flows among associated companies and of the fact that a great many companies draw most of the funds they need for capital expenditure from internal sources rather than from the capital markets. In view of all the difficulties and disadvantages of the direct intervention by government in the process of allocating funds among individual companies, we find it difficult to imagine circumstances which would justify capital issues control.

Techniques of varying the effective cost of funds to firms by the use of various fiscal measures will be described in a later chapter. Less dramatic effects may be achieved by altering the taxation rules regarding the deductibility of interest on borrowed funds, but this has not proved either equitable or workable in countries such as Australia where the technique has been used: many companies were not affected at all, while others were so seriously harmed that wide-scale exemptions had to be made.

CONCLUSION

These direct measures should be called into play only when all else has failed and an emergency justifies the disruption and costs of drastic action. Even the general instruments are bound to affect some people more than others, but the authorities must not be restrained by excessive

tenderness; if any type of stabilization policy is to be effective, someone must be affected. So long as markets are reasonably good, it is probable that the marginal, less credit-worthy, less productive types of expenditure will be affected more severely than others by a restrictive policy applied to the system as a whole. In any case, there is no assurance that those administering direct measures would be better able to select the expenditures which should go forward and reject those to be deferred or cancelled. Yet it should be recognized that there is a conflict between the long-run objective of developing sensitive and flexible financial markets that will allocate resources well among competing uses and the need to stabilize economic activity with measures that work fairly quickly. The more adept the markets become at moving funds with comparatively little change in interest rates to those wishing to use them, the less one can count on imperfections and the additional cost and inconvenience of borrowing standing in the way of real expenditures.

Whatever techniques are used, there is no way of making the job of the monetary and debt managers an easy one. They must always operate with limited information against a continually changing series of financial and economic events, and it will remain a matter of judgment as to how far they can or should try to moderate or reinforce these unfolding trends with their own actions. The underlying realities and public attitudes shaping credit conditions will impose limitations on their freedom, and the international environment may further inhibit their ability to vary policy over a wide range. Even

with prompt information and excellent forecasting, the delays in making their actions effective on credit conditions and the lag between this point and the impact on real spending will limit the contribution which any policies—conventional or unconventional—can make to stabilization in the short run. This contribution will be greater if the authorities take account of the longer-run forces influencing the economy in the broad set of their policy approach to more immediate events.

Despite the limitations of monetary policies, the emergencies justifying direct intervention in market flows should be rare, if the other arms of policy are properly used, and debt management is well co-ordinated with monetary measures. The limits of what can be expected from the general instruments of credit policy alone must nevertheless be recognized. Their impact can be hastened by concerted official action, and the range of variation can be widened somewhat by appropriate combined use of monetary and debt measures, but it remains true that at the best one cannot expect credit policy alone to stabilize the economy. This is not primarily a matter of the techniques used. Rather it results from the comparatively limited effect of any reasonable or feasible change in credit conditions on real expenditure. While such changes in credit conditions can make a worthwhile contribution to stabilization, it is clear that even the most imaginative and appropriately executed monetary and debt policies will not allow the country to achieve, or even approach, its economic goals unless other instruments of government policy are also brought into play.

INTERNATIONAL FINANCIAL POLICY

There are few countries of the world today in which international considerations do not play an important part in domestic economic policy decisions. Over the post-war period many of the barriers to the flow of trade and capital have been removed or lowered and the international connections among domestic financial systems have been strengthened. Changes in financial policies can now have rapid effects on international flows of funds and recognition of this exercises an influence over the policies of countries large and small.

Moreover, all countries which buy and sell in markets abroad must ensure that policy is aimed at keeping their costs competitive if they are to earn the internationally-acceptable money needed to pay for imports. In this respect, countries are like individuals, being able to spend only what they earn or are able to borrow from others; (both can, of course, in the short run, also run down their external financial assets to the extent that they have them). Similarly, a nation's capacity to earn income or to borrow, like those of an individual, depend upon its skills, willingness to work and the efficiency with which it uses its resources. International lending and borrowing can be just as productive and useful as domestic lending and borrowing, but if carried on over a long period on a major scale relative to income can also create concern about the difficulties which may be associated with servicing a large external debt.

The fewer and lower the barriers and restrictions to the free flow of trade, capital and labour, and the more closely a nation is integrated into the international economy, the more necessary it is that international considerations play a part in all policy decisions. While membership in the international community sets some limits to the policies which can be pursued by individual countries, the net advantages derived from international specialization are very great. As with individuals, reductions in the degree of economic interdependence could lead only to higher production costs and a drastic reduction in the attainable standard of living.

Canada is *par excellence* an example of a country which is closely tied in a variety of ways to the rest of the world, and its financial, trade and other links with the United States in particular make for a uniquely close relationship between the two countries. This close relationship is on balance of great advantage to Canada, but it does mean that changes in U.S. policies or investment attitudes which may not be of major importance in the huge framework of the U.S. economy can on occasion have very big effects on Canada and pose substantial difficulties for Canadian economic policy.

Given this high degree of economic interdependence, there is a sense in which all financial policy in Canada is to a greater or lesser extent international financial policy. There are, however, a narrower range of international issues including exchange rate policy, other policies to influence

the balance of payments and policies connected with world payments arrangements, on which we shall focus our attention in the present chapter.

In the course of our discussion we shall be comparing the present exchange rate system with the flexible exchange rate which Canada has had in the past. The purpose of this analysis is to isolate fundamental factors influencing Canada's international financial policy and to assess the implications for general economic policy of the adoption of a fixed exchange rate. We wish to make it clear at the outset that we do not advocate any change in the existing exchange rate system: the fixed rate is at a level that seems appropriate and the system is working well.

THE CANADIAN EXCHANGE RATE BEFORE 1950

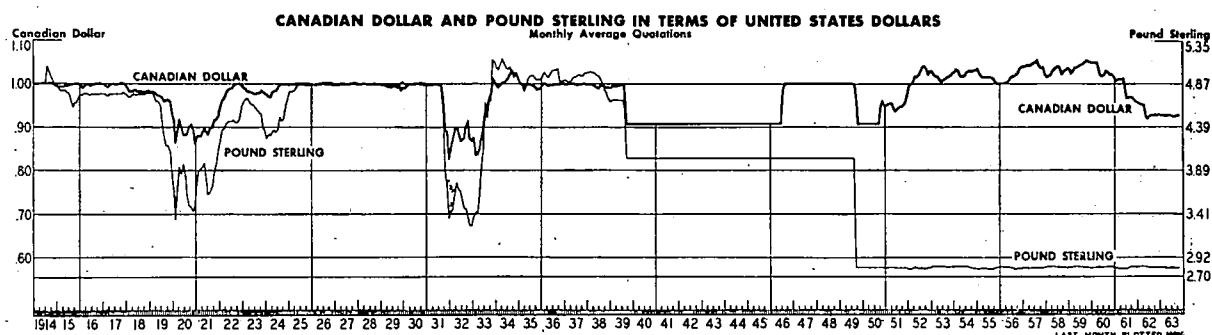
Over the decades, Canada has had considerable experience with both a fixed and fluctuating exchange rate. Prior to 1914, the Canadian dollar was fixed in terms of gold and, therefore, fixed in terms of all other major currencies. The international gold standard, which because of the then dominant position of Britain might more accurately be called the international sterling standard, was a workable arrangement, and the Canadian economy adapted to some very substantial changes in capital flows and trade within its framework. While in some respects it was like present exchange rate arrangements, the problems we confront and the means of dealing with them

have changed, not least because of the increased responsibility for economic management which has been assumed by national governments. It was easier for governments to accept a fixed relation between gold and national currencies as the principal (and sometimes the only) objective of monetary policy when they were not expected to assume a major responsibility for national employment, productivity and prices.

For most of the period 1914-39, Canada had a fluctuating exchange rate. Canada went off the gold standard in 1914 and did not return to it until July, 1926: even then we remained on it only until January, 1929. As indicated in Chart 23-1, the fluctuation of the Canadian dollar was kept within narrow limits throughout most of the inter-war years, except during the periods 1919-20 and 1930-33. The fact that Canada was only on a fixed rate for two and a half out of twenty-five years could be taken as strong evidence of the difficulty of maintaining such a system in this country, but although this experience is by no means irrelevant, it is noteworthy that most other major currencies were also flexible for much of the period. Severe economic fluctuations and the inadequacies of the international payments system made the maintenance of fixed rates a world rather than simply a Canadian problem.

During the war years the value of the Canadian dollar was fixed at a 10% discount relative to the United States dollar and there was a comprehensive system of exchange control. In July, 1946 the Canadian dollar was revalued to parity with

Chart 23-1



the American dollar, in part to insulate the Canadian economy from the rapid price increases following the removal of controls in the United States. This exchange rate was maintained for over three years in spite of serious balance of payments difficulties in 1947 and early 1948. Though the rate was appropriate in terms of price and cost relationships, the unexpectedly heavy drawings of the United Kingdom and European countries on Canadian reconstruction loans and other demands put upon an overburdened Canadian economy led to a decline in the Exchange Fund's holdings of gold and U.S. dollars from \$1,667 million at the end of May, 1946 to \$480 million at the end of November, 1947.¹ Emergency assistance was obtained from the United States Export-Import Bank and import controls and special excise taxes imposed. The reserves recovered fairly quickly and by the end of 1948 totalled just under \$1 billion. In September, 1949 there was a 30.5% devaluation of sterling in terms of the United States dollar accompanied by devaluations on the part of many other countries. A decision was taken to devalue the Canadian dollar by 9% in order to protect Canada's competitive position and balance of payments. Following this devaluation, little change took place in the reserves for some months, but in the middle of 1950 a substantial speculative inflow of capital developed which added just under \$500 million to the reserves in August and September. With two attempts at setting the exchange rate having yielded little success, the decision to free the exchange rate was announced on September 30, 1950.

THE FLEXIBLE EXCHANGE RATE 1950-1960

Immediately after the withdrawal of the official buying and selling rates, the Canadian dollar appreciated sharply. Following some weakness in the first half of 1951 it resumed this movement in the latter half of 1951 and broke through parity with the U.S. dollar in March, 1952 to a premium of 4% in August. The total appreciation from Sep-

tember, 1950 was 14 cents but from mid-1952 to the end of 1960 the exchange rate stayed within fairly narrow limits—the total range of fluctuation amounting to about five and a half cents. Although the rate was flexible, it could not be described as unstable.

If there had been no major changes in the Canadian balance of payments during this period, the simplest explanation of this stability would be found in the economic conditions of the period. There were recessions in a number of major countries during these years, but they were much less severe than the pre-war contractions, and not completely in phase. Thus, when cyclical declines occurred in the United States, the continued advance of the Western European economies, our second major market, provided a partial cushion for Canadian exports. The maintenance of favourable world economic conditions, and some fortuitously anti-cyclical movements in agricultural exports, is reflected in the basic stability of all exports shown in Chart 23-2. During these years also, as in others, the Canadian and American economies tended to move together and there was a similar parallellism in the economic policies followed by the governments of the two countries.

Under these conditions it could be argued that there were unlikely to be major stresses and strains on Canada's balance of international payments and that stability of the exchange rate was precisely what might have been expected. This reasoning, however, assumes that no major shifts occurred in the Canadian balance of payments, and this was clearly not the case. Between 1953 and 1957, the Canadian current account deficit increased by over a billion dollars from \$440 million to \$1,455 million, declined by over \$300 million in 1958, increased by \$370 million in 1959 and fell again by \$260 million in 1960. These are large changes, and broad economic stability obviously is not the full explanation for the exchange rate stability of this period. To understand the forces at work some reference is required to the mechanism of adjustment under a flexible exchange rate.

¹ Had the exchange rate been flexible, it would undoubtedly have fallen sharply in 1947 and recovered in 1948.

Under balance of payments accounting, deficits on current account are necessarily matched by surpluses on capital account and vice versa. The question then arises as to how, with such limited adjustments in the international value of the Canadian dollar, the current and capital accounts were kept in balance. There are three possible explanations—first, that this was achieved through changes in the official reserves; second, that the factors determining the size of the current deficit and the capital surplus were such as to induce offsetting changes in these accounts without ex-

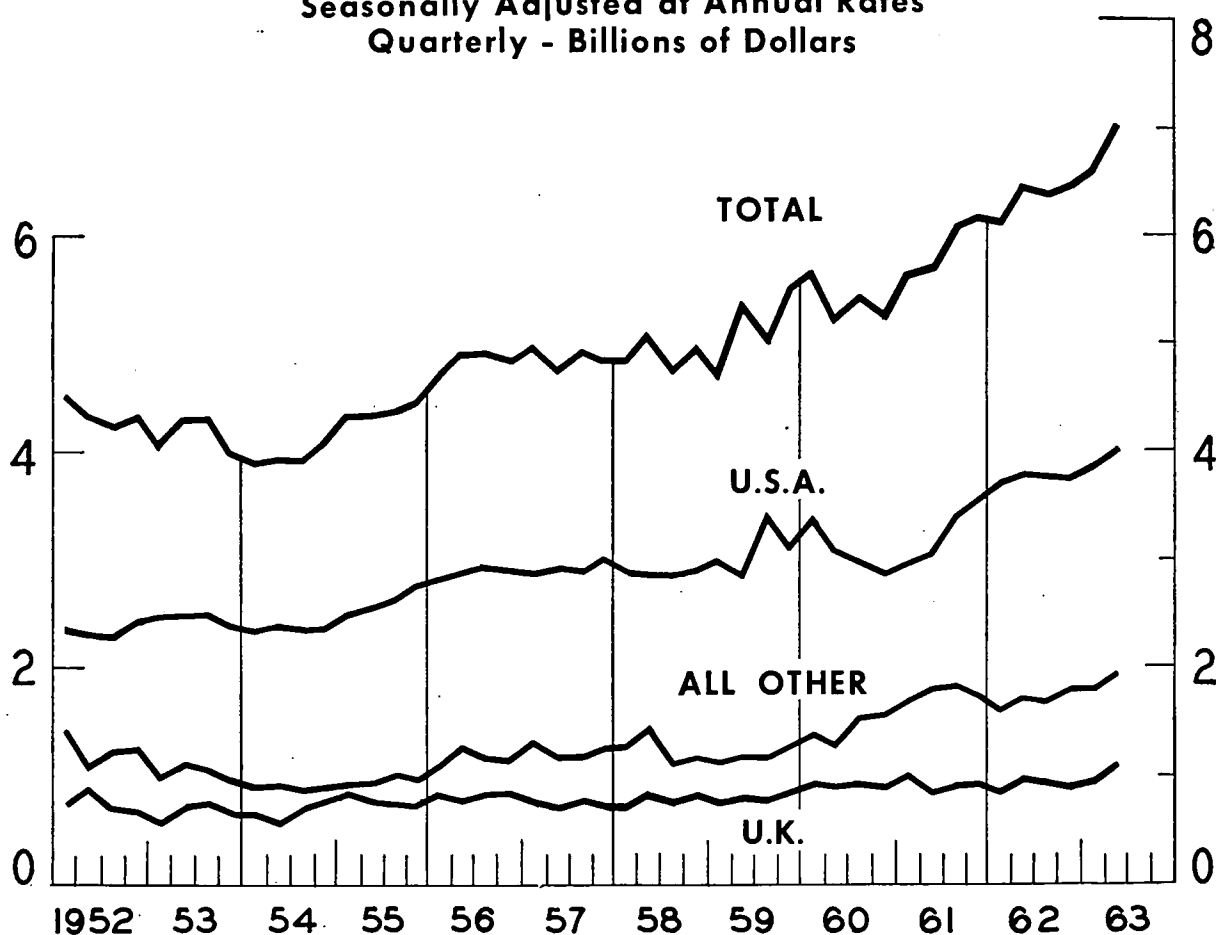
change rate movements; and third, that limited changes in the exchange rate affected the current or capital accounts or both in ways that quickly brought them into balance.

The official reserves were not used during the period 1953-60 to prevent persistent movements in the exchange rate. The policy of the Exchange Fund was one of correcting or preventing disorderly conditions rather than interfering with basic trends, and it intervened in the market only to prevent substantial movements in the exchange rate within any given

Chart 23-2

CANADIAN MERCHANDISE EXPORTS

Seasonally Adjusted at Annual Rates
Quarterly - Billions of Dollars



trading day or from one day to another. There were, of course, occasions when this policy required the Exchange Fund to be a net buyer or seller continuously for several months. When a movement in the exchange rate became pronounced, however, there is no evidence that the Fund attempted to stop it. The limited part played by the Exchange Fund in the period 1953-60 is indicated by the fact that changes in the official reserves from month to month from December 1952 to 1960 were below \$20 million in 59 of the 96 months, from \$20 million to \$50 million in 31, from \$50 million to \$100 million in five, and only exceeded \$100 million in one of the months during the period. Over the period as a whole, the highest month-end reserve figure was only \$233 million above the lowest holding recorded.

If official reserve operations did not play a major part, the second possibility is that changes in the capital account and the current account were related in such a way that a balance was achieved without the necessity of major movements in the exchange rate. Changes in these accounts do not just happen; they arise out of a set of economic conditions, and if these conditions were to produce capital account surpluses and current account deficits simultaneously they clearly provide part of the explanation.

An economy is ordinarily not the recipient of substantial foreign direct and equity investment unless economic prospects are favourable and long-term profit expectations high in relation to alternatives in other parts of the world. Similarly, the flow of long-term debt capital will be towards the country in which interest rates are high in relation to those offered elsewhere for securities of comparable quality. Profit expectations and interest rates are likely to move together since the rise in economic activity resulting from favourable economic prospects brings pressure to bear on financial markets and influences interest rates in an upward direction. An economy in which investment is particularly attractive in relation to other economies, therefore, will tend to have domestic interest rates higher than comparable rates abroad. Of course,

the level of interest rates or, more generally, the state of credit conditions, will be influenced by the actions taken by the monetary and debt authorities, but it may be assumed that the authorities will broadly acquiesce in the tightening of credit conditions which occurs in a buoyant economy. Yet this very buoyancy is also likely to lead to a current account deficit. If the Canadian economy is expanding at a rapid rate, especially if it is growing faster than the economies of the United States and other countries and is at or approaching full employment, there will be a tendency for imports of goods and services to rise relative to exports and for a current account deficit to develop to balance the capital inflow, even without exchange rate changes.

The experience of the years 1953-60 tends to support these generalizations. This is a short period and as always there were random occurrences which tended to blur the outline. Nevertheless, it is clear that with the exception of 1960—when there were large capital inflows connected with take-over bids—direct investment tended to be higher during periods of expansion and lower during recessions.² Portfolio investment also responded significantly to economic and credit conditions in Canada. Simultaneously, the current account was affected in the opposite direction, with imports rising rapidly during periods of expansion and declining in periods of recession. Three main categories of imports show a strong cyclical movement; machinery and equipment, industrial materials and consumer durables. Fluctuations in the imports of machinery and equipment tended to reflect changes in domestic capital expenditure on these items, which have a high average import content. Imports of industrial materials reflected, with a slightly greater amplitude, corresponding swings in industrial production, while consumer durables imports appeared to be largely determined by cyclical movements in domestic expenditure on durable goods. Thus, over the period, capital account surpluses and

² Retained earnings of foreign-owned enterprises in Canada also tend to grow in periods of economic expansion, with higher dividend payout ratios occurring in recession years.

current account deficits tended to be higher during periods of prosperity and lower during periods of recession.

If there were a perfect offsetting of long-term capital flows and the current account balance, one would expect a virtually stable exchange rate over the course of the economic fluctuations experienced in the period. In years of prosperity and restrictive monetary policy in Canada, however, the interaction of heavy capital inflows and the current account deficit produced an appreciation of the Canadian dollar, while in periods of lower levels of activity our dollar tended to weaken. It is natural, therefore, to look to the exchange rate itself for part of the explanation of the balancing process. Indeed, this is precisely what a flexible exchange rate is supposed to do. If there is a tendency for the capital inflow to run ahead of the current account deficit, then pressure on the exchange market will lead to an appreciation of the Canadian dollar. An appreciation of the Canadian dollar will discourage exports and encourage imports of goods and thus increase the current account deficit. The opposite will occur if the capital inflow shows a tendency to fall short of the current account deficit.

We have already referred to this effect in our discussion of credit conditions and expenditure. Our inquiries suggest that the short-term effects of small changes in the exchange rate are likely to be fairly limited. Major changes in the exchange rate which are not quickly reversed are another matter. Canadian experience with such changes is not extensive, the most relevant experience being that resulting from the depreciation of the exchange rate in 1961 and 1962. The effects of this depreciation have been obscured by the imposition and removal of the import surcharges, the reduction in the tourist allowance and other factors which were already at work to improve our international competitive position. Early indications suggest that the effects are significant but that changes in the exchange rate take a considerable time to work their way through the economic system. During the period 1953-60 the exchange rate moved within fairly narrow limits and

changes in one direction were reversed before the effects were fully realized. Moreover, changes were often regarded as temporary and therefore as not justifying new production arrangements in Canada. We conclude, therefore, that the limited fluctuations of the flexible rate in the period 1953-60 did not have effects on the current account which were large enough to provide more than part of the explanation of the short-term balancing process. On the other hand, there is little doubt that the average level of the rate did have significant effects on the current account balance in the longer term.

The final possibility is that changes in the exchange rate had effects on the capital account and particularly on short-term capital movements. As we have pointed out elsewhere, small changes in the exchange rate may not have major effects on long-term capital movements. If the interest rate advantage which has been obtained by a Canadian borrower is sufficiently great to offset a change in the exchange rate of 10-15% over the term of the borrowing, short-term fluctuations in the value of the Canadian dollar will be of limited importance. On the other hand, small changes in the exchange rate can have a very considerable effect on the profitability of short-term capital transactions. For example, if under a flexible rate an investor anticipates correctly that the value of the Canadian dollar will decline by 1% in the course of the next thirty days, a purchase and resale of an American dollar asset would yield a normal interest return plus a profit at an annual rate of 12% on the investment. Such speculative flows serve to check the movement of the exchange rate.

As we indicated in Chapter 15, a speculator need not go through these steps, but can instead enter into a forward contract with a bank to buy U.S. dollars. This does not involve a credit-worthy customer in putting up any capital, but allows him to sell the U.S. currency at a profit if the price rise materializes.³ The transaction will nonetheless have effects on the balance of payments. If the bank cannot find a seller of forward

³ It may, of course, involve him in a loss if the dollar moves the other way.

U.S. dollars, it will cover its forward commitment by an equivalent purchase of spot U.S. dollars. As explained earlier, this is only an intermediate step; the bank will then seek someone in the market who is prepared to swap spot Canadian dollars and a contract to buy forward Canadian dollars for the bank's offering of spot U.S. dollars and a contract to buy forward U.S. dollars. In short, the bank must find someone who is prepared to hold U.S. dollars for the life of the contract—that is, someone who is prepared to move short-term capital to the United States. If the spot-forward differential is not sufficiently attractive to bring forth investors of this kind, then outright purchasers of forward U.S. dollars will have to be charged a price which will make short-term capital movements to the United States profitable. In either case, the upward movement in the exchange rate will be moderated by the consequences of the speculator's action.⁴

An outright purchase of forward U.S. dollars or forward Sterling is only one of the ways in which participants in the exchange market may react to a developing expectation that the Canadian dollar is likely to depreciate. Exporters receiving payments of U.S. dollars currently or in the future may decide to delay conversion in the spot or forward markets in expectation of receiving a higher price in the future. Similarly, those who have payments to make in the United States may choose to make these payments while the Canadian dollar is at a high level. Borrowers of long-term foreign capital may likewise decide to postpone their issues for the time being or defer bringing the proceeds back to Canada. If, therefore, under the influence of large-scale long-term capital movements the Canadian dollar appreciates for a period, the expectation may develop that the appreciation will be reversed. There will then be a tendency for an outward flow of short-term capital to develop and this will tend to inhibit further appreciation of the Canadian dollar.

This is not to suggest that all short-term capital flows in the period tended to moderate swings in the exchange rate. Tightening credit conditions in Canada were often associated with increased flows of unhedged short capital, particularly in the form of trade credit or other intercorporate indebtedness, which tended to lead to further strengthening of the rate in such circumstances.

Nevertheless, stabilizing speculation of the kind described above appears to have contributed to the moderation of exchange rate movements during the period 1953-60. We found little evidence of what might be called "pure" speculation, that is, speculation which was unconnected with any other trade or capital transactions. We did find, however, that some of those who were participants in the exchange market in the ordinary course of business tended to take a view of the future movement of the exchange rate and act accordingly. It probably puts the point too crudely to say that many of these speculators were characterized by a "parity psychology" but the evidence suggests that when the Canadian dollar went to a significant premium in relation to the U.S. dollar, some participants in the market did not expect this rate to persist.

The explanation of the relative stability of the exchange rate during the period 1953-60 can therefore be summarized in the following terms. There were no depressions during the period in either Canada or the rest of the world. The major shifts which occurred in the Canadian balance of payments derived from favourable economic prospects in Canada which encouraged a flow of capital and at the same time led to a period of economic expansion which encouraged a sharp rise in imports. To a considerable extent, then, there were forces at work promoting a balance without the need for exchange rate changes. The average level of the exchange rate throughout the period exercised a significant influence on the current account, but the temporary fluctuations which occurred around this

⁴ The process described is reversed if speculation favours the Canadian dollar.

level appear to have had a limited short-term effect on trade in goods and services. Changes in the exchange rate did, however, bring forth stabilizing capital movements.

THE FIXED EXCHANGE RATE

While the foreign exchange rate was not formally fixed until May 2, 1962, there were fundamental changes in the flexible rate system a good deal earlier. In the budget of December 20, 1960, the Minister of Finance expressed concern over the impact which the inflow of foreign capital was having on the foreign exchange rate and announced a generalization of the 15% withholding tax on interest and dividend payments to non-residents. This was generally considered to be a measure to restrict the inflow of capital and to reduce the price of the Canadian dollar in the foreign exchange market. It is also worthy of note that in each of the following six months official holdings of gold and foreign exchange showed successive increases; the additions from December 31, 1960 to June 30, 1961, totalled \$256 million. In the budget speech of June 20, 1961 the Minister of Finance noted that the Government considered the existing international value of the Canadian dollar (monthly average in May just over U.S. \$1.01) to be "unduly high" in the light of general economic conditions in Canada and expressed the following view on the appropriate level of the exchange rate:

"No one can say today what the appropriate level of our exchange rate would be when our balance of payments is in a position better suited to our present economic circumstances. But the rate will certainly be lower than it has been of late, and it may well be appropriate for it to move to a significant discount. It will be government policy to facilitate such a movement".

In addition to the use of debt policies, this was to be done through direct intervention of the Exchange Fund in the foreign exchange market. The immediate effect of this announcement was a sharp depreciation of the Canadian dollar to just

below 97¢ U.S. or a drop of about 3 cents. During the autumn the Canadian dollar showed renewed strength but in November and December it weakened again and from the end of October 1961 to June 22, 1962 the resources of the Exchange Fund were used to resist the decline in the value of the Canadian dollar.

In the early stages of the reserve drain, the authorities made concessions to the speculative pressure by allowing the value of the Canadian dollar to decline. As the loss of reserves accelerated in January and February a further adjustment of the rate was permitted, followed by an attempt to hold the Canadian dollar at around 95¢ U.S.

The behaviour of the rate in late February and March, and the decline in the reserve loss in March, suggest that this measure did lead to some abatement of the speculative pressures. In April, however, pressures were renewed and in addition to losses of \$114.6 million from official holdings, the Exchange Fund entered into commitments to sell U.S. dollars forward amounting to \$13 million. On May 2nd the Government announced a devaluation to 92.5¢ U.S., formal abandonment of the flexible exchange rate system and adherence to the International Monetary Fund system of maintaining the external value of the Canadian dollar within 1 per cent on either side of the newly established par value of \$1.081 Canadian for the United States dollar, with ultimate support points at \$1.070 and \$1.092.

The devaluation and adoption of a fixed rate was supported by a moderate upward adjustment of the yield on treasury bills. These measures were not sufficient to allay the speculative pressures. During May official holdings declined by a further \$102 million and forward sale commitments rose by \$72.6 million. The same pattern continued through the first three weeks of June. If we disregard the addition of \$650 million of special international financial assistance, official holdings fell by an additional \$334.1 million during June and through June 22 additional commitments were made to supply forward U.S. dollars to the extent of \$154.4 million.

The measures announced on June 24, 1962, which successfully overcame the crisis, fell into two parts; a domestic "austerity" program and massive international support for the Canadian dollar. Import surcharges and a reduction in the duty-free allowance to returning tourists presented tangible evidence of direct action to reduce the current account deficit. A restriction on government spending, including a civil service wage freeze, gave evidence of direct action to limit the government deficit. A sharp increase in both short and long-term interest rates imposed additional restraint on the domestic economy and served to attract an inflow of capital. This was later supplemented by a long-term government issue of U.S. \$250 million sold in the New York market. The international assistance took the form of drawings on the International Monetary Fund equivalent to U.S. \$300 million and reciprocal currency swaps with the Federal Reserve System and the Bank of England totalling U.S. \$350 million. In addition, a stand-by credit was arranged with the United States Export-Import Bank of U.S. \$400 million. In the annual report of the Bank of Canada for 1962, the Governor pointed out that certain central banks in Western Europe had intimated that they were ready, if this were desired, to place additional funds at the disposal of the Bank of Canada. The magnitude of the international support provided and the rapidity with which it was arranged contributed to the restoration of confidence in the Canadian dollar and played an important part in reducing the burden of adjustment on Canada.

The measures initiated on June 24th had a rapid effect on the official reserve position. As pointed out in the budget papers of 1962, on June 24, 1962 the "spot" position of the official reserves had fallen to about \$1,100 million and there were in addition substantial forward sales commitments outstanding. At the end of the year, the official holdings, excluding the remaining special international financial assistance of \$300 million, had reached \$2,239 million. As the reserve position improved through late 1962 and early 1963, most of the steps taken in June were

reversed. The import surcharges were removed, and long-term interest rates—which had begun to decline in the late summer of 1962—were in the latter part of the year kept at levels only marginally higher than in the early months of 1962.

The Budget Speech of June 13, 1963 contained a number of tax and other proposals which could be expected to have an effect on the balance of payments. These included a 30% tax on the sale to non-residents of corporations listed on Canadian stock exchanges and a similar tax on the sale of stock in such companies in amounts exceeding \$50,000 a day by a single seller. In addition, special incentives were offered to the non-resident shareholders of companies beneficially owned by Canadians to the extent of 25% or more. These shareholders were given a reduction of withholding tax from 15% to 10% while non-resident shareholders in companies with less than 25% Canadian ownership were to have their withholding taxes increased from 15% to 20%. Manufacturing and processing companies with a minimum of 25% Canadian ownership were given the opportunity of writing off new machinery and equipment for tax purposes in two years, while companies with a lesser degree of Canadian ownership were not given this privilege. Subsequently, the 30% "takeover" tax was withdrawn, and the proposed changes in the withholding tax on dividends modified to entitle non-resident shareholders to a 10% rate if at least 25% of the outstanding voting stock was available for purchase by Canadians.⁵ In addition, reference was made to proposed tariff changes—since implemented—with the objective of reducing "very greatly" net imports of automobiles and parts.

On July 18th, just over a month after the Budget, the United States Administration proposed an "interest equalization tax" designed to raise the cost to foreigners of borrowing or selling equities in the United States without the necessity of a general increase in long-term

⁵ These changes may lead to higher U.S. and other withholding taxes on Canada's growing equity investments abroad, although this will depend on the outcome of negotiations on internationally-agreed tax conventions.

interest rates in the United States.⁶ Representations by the Canadian Government led to an exemption for new issues of Canadian securities apparently on the understanding that such issues would not be used to build up Canada's foreign exchange reserves.⁷ Canadian official holdings of gold and foreign exchange, which had remained at a high level during the first six months of 1963, fell in July by U.S. \$110.9 millions (excluding a repayment of I.M.F. borrowings of \$79.7 million) and declined by a further \$31 million in August. On August 12 bank rate was increased to 4% from 3½% but the reserves increased again thereafter and interest rates declined.

THE IMPLICATIONS FOR POLICY OF A FIXED EXCHANGE RATE

In thinking about Canadian economic policy for the future it is important to be clear on the way in which the adoption of a fixed exchange rate affects the choice of policies. There are some who feel that the system we had in the 1950's permitted the pursuit of domestic objectives without the need for serious concern over the movements of the exchange rate: they thus expect the fixed rate to lead to a fundamental change in the orientation of economic policy, with international considerations receiving greater emphasis than domestic needs. There are others who feel that our room for manoeuvre under the flexible rate was not significantly greater than it is under a fixed rate and who therefore tend to argue that the two systems are in effect very similar. In fact, the truth of the matter seems to be some-

where in between: under no system is Canada free to ignore international considerations, but under a fixed rate system there is a more immediate and direct link with the international financial environment, a fact which is by no means always a disadvantage to Canada.

It is easy to see how even well-informed people can differ on these issues. There are many apparent paradoxes in the history of the Canadian flexible exchange rate. It was a flexible rate without explicit outer limits on its fluctuations, yet it was very stable after the initial adjustments of 1950-52. In part, this reflected the economic policies followed in Canada. This was also an apparent paradox since a flexible rate is supposed to tempt national financial authorities into policies which are excessively expansionist, but in Canada during 1958-60 restraining credit policies were maintained during a period in which unemployment averaged 6.7%. There was a third apparent paradox in the last phase of the flexible exchange rate experiment. When a decision was taken to use the resources of the government to force down the international value of the Canadian dollar it might have been expected that the government would be a large seller of Canadian dollars. Within a matter of months after this decision, however, the government in fact had to support the Canadian dollar by being a large seller of American dollars—indeed a seller on such a scale that the rate had to be fixed and emergency measures later implemented to maintain it.

Enough has been said earlier to indicate that these paradoxes are more apparent than real. The Canadian exchange rate did not need to be flexible over a wide range in order to perform its functions. Indeed, it is unlikely that a flexible rate which had fluctuated over a wide range would have achieved the degree of international acceptability which was accorded the Canadian rate and is vital to the workability of any exchange rate system. Moreover, wide swings in a fluctuating rate might have been difficult to contain. If the policies followed in Canada had led to the view that there was no reasonable limit to the likely moves in the exchange rate, speculative

⁶ The proposed tax, when enacted into law, is to apply until the end of 1965 and date retroactively to the summer of 1963. It will not apply to foreign direct investment by U.S. residents or to the purchase by them of listed shares in foreign companies in which a majority interest is held in the U.S. and which trade mainly in the U.S. Nor will it apply to bank loans or borrowings of under 3-year terms. On borrowings longer than this, the tax scales up from 2.75% for under 3½-year issues to 15% on issues with a term longer than 28½ years. A number of technical exemptions are also proposed which relate to dealer inventories of foreign bonds resold to foreigners in 90 days, labour union investments, and insurance company foreign investments in connection with policy reserves in foreign countries.

⁷ See, p. 14, House Ways and Means Committee Report, No. 1036, December 1963, U.S. Govt. Printing Office.

capital movements might have become violently destabilizing. If, for example, during a period when the United States authorities were imposing monetary and fiscal restraint, Canada had adopted a policy of extreme credit ease and very large government deficits, this might have set off a speculative outflow which would have carried the exchange rate below any level experienced in recent years. This might not have happened on the first occasion. A long record of prudent economic management is not dissipated overnight and a set of policies which diverged from this pattern might well have been regarded as a temporary aberration. If, however, it had become clear from repeated examples that prudence was not to be expected in the future, the reactions might well have become more violent—just as they would under a fixed rate system when the consequences fall on the reserves. The widespread and often vigorous opposition to flexible exchange rates voiced by experts outside this country is based on the disruptive effects of exchange rate changes of this kind. This, however, was not the kind of flexible exchange rate system we had in this country.

Indeed, the charge which reasonably can be brought against the flexible exchange rate is that the international value of the Canadian dollar was too stable in the face of a major change in the economic environment. A substantial premium on the Canadian dollar and large capital inflows were appropriate during the investment boom of 1955-57 but when economic conditions changed it was desirable that economic policy should be so ordered that there would be a fall in the international value of the Canadian dollar, the current account deficit and the capital inflow. Had credit conditions been easier, some of the capital inflow would not have occurred and the value of the Canadian dollar would have been lower: while the consequences would not have been immediate, the lower exchange rate would have stimulated employment, incomes and domestic savings. The policies in fact pursued were thus very different from those which might have been expected to result from the freedom sometimes thought implicit in a flexible exchange rate. Far from beg-

garing her neighbours Canada followed policies which in time led to such dissatisfaction with the level of the rate that an escape was sought through direct intervention in the exchange market.

The consequences of direct intervention were also less paradoxical than appears on the surface. If the government is known to be operating in the market with the express purpose of lowering the value of the Canadian dollar, this is likely to lead to considerable uncertainty among other participants in the market. Once expectations developed that a fall in the value of the Canadian dollar was likely to occur then, in the circumstances of the time, these expectations were very difficult to reverse and in fact were not reversed until emergency measures had been introduced.

The difference between the flexible and fixed rate systems is a matter of degree and not of kind. Under a flexible exchange rate, any country which is a responsible member of the international community and which is concerned with domestic price stability will find that there are implicit, if not explicit, limits to the variation of the exchange rate which is acceptable; movements in the exchange rate which result from policy changes therefore cannot be ignored. Under a fixed rate, attention first focusses on the reserves rather than the rate, but in both cases international limitations on domestic policy are effectively present.

Under a fixed exchange rate, monetary and debt policies have effects on domestic expenditure and on international capital flows, but since the exchange rate is fixed they do not at the same time have an influence over international trade through the channel provided by the exchange rate. The influence of monetary and debt policies on expenditure is correspondingly reduced. This has led to suggestions that under a fixed rate system the primary role of monetary and debt policies should be to influence the balance of payments, leaving to fiscal and other policies the primary responsibility for domestic stabilization. We have already had two examples, in the summers of 1962 and 1963, of increases in interest rates which were inappropriate from the point of view of the domestic economy

but which were regarded as necessary in the light of the international payments position. This suggests that the choice of exchange rate systems may influence the "mix" of policies, although it does not mean that monetary policy must always be geared only to international considerations or that when it is, it is necessarily inappropriate from a purely domestic point of view.

The effects of a given mix of policies will also be different under a fixed-rate system, with fiscal policy having stronger effects. Fiscal deficits and surpluses affect the financing requirements of the government and thus influence credit conditions. Other things equal, fiscal deficits tend to raise interest rates and fiscal surpluses to lower them, and it is the task of the monetary and debt authorities to take these effects into consideration in achieving the credit conditions required in the circumstances. If this kind of accommodating action is not taken under a flexible exchange rate system, fiscal policy changes will encounter dampening effects. Thus the expansionary effects of a federal deficit will be reduced since if the federal deficit increases interest rates will rise, international capital inflows will increase and the resulting upward pressure on the Canadian dollar⁸ will lead to adverse effects on our international trade in goods and services. A fiscal surplus, on the other hand, tends to lower interest rates, discourage the inward flows of capital and encourage a depreciation of the Canadian dollar; as a result, the contractionary impact of a Government surplus will be partly offset by effects on the current account of the balance of payments. Under a fixed rate system, effects of this kind influence the level of reserves rather than the exchange rate, and fiscal policy does not encounter offsetting effects working through the exchange rate and the current account of the balance of payments.

⁸ There will also be some effects working in the opposite direction. Expansionary fiscal policy increases the demand for imports, thus increasing the demand for foreign currency. Moreover, the existence of a deficit may weaken confidence in the future value of the Canadian dollar with effects on the exchange market.

One would normally expect fiscal and other policies to be pulling in the same direction unless international or other considerations dictated otherwise. However, the example given above is not too far removed from what actually happened in some of the years following 1957, and helps to explain why the relatively large federal deficits in this period, without the support of appropriate monetary and debt policies, did not produce the desired effect on domestic economic conditions. In any event, the reduced effectiveness of monetary policy under a fixed rate system and the enhanced power of fiscal policy under such a system means that the latter must be used more actively to achieve domestic objectives.

While the existence of a fixed exchange rate does have effects on the relative strength of the various instruments of Canadian policy, and can well influence the decisions on the "mix" of policies, it would be wrong to exaggerate the differences. As we have already pointed out, our enquiries indicate that the short-run effects on the flow of goods and services of moderate and temporary fluctuations in the exchange rate are quite limited, i.e. if policy changes are moderate and generally reversed within the period of a short-run cyclical fluctuation, the effects on trade will be relatively small. This in turn means that for policy changes of this kind, the difference between the relative capacity of the various instruments of policy is not greatly different under a fixed than under a flexible exchange rate system.

The issue, however, is not the relative effectiveness of the individual instruments of policy but the general question of the freedom of action of the financial authorities. The central question is not usually whether fiscal ease and monetary tightness is to be preferred to fiscal tightness and monetary ease, but rather whether a policy of general expansion combining fiscal deficits and monetary ease is consistent with the maintenance of a sound external financial position. If the exchange rate is fixed and if changes in exchange and import restrictions are ruled out, the authorities' freedom of action depends on holdings of

official exchange reserves and the acceptable size of changes in them. If the exchange rate is at a level which leads to a continuous addition to the reserves and this is acceptable both domestically and internationally, the authorities will not feel unduly inhibited by balance of payments considerations. Similarly, if reserves are very high the authorities may be prepared to accept considerable losses before permitting balance of payments factors to weigh heavily in the determination of domestic policies.

Normally, the reserves will not be undergoing changes of a disruptive kind, and the authorities should have considerable freedom to pursue domestic economic objectives. If the domestic economy is soundly managed, it should be possible to handle even quite large swings in the reserve position, although such swings are not without their difficulties. If massive additions to reserves occur during a period of buoyancy, it is inappropriate to finance them through the banking system since this will add to the banks' liquidity, bring about an inappropriate easing of credit conditions and intensify inflationary pressure.⁹ On the other hand, while an increase in interest rates might be appropriate domestically in such circumstances, it might merely add to the capital inflows. If these flows are expected to be temporary, there are a variety of devices—such as temporary liquid asset agreements with the banks, or sales of non-market securities to them—which can be employed to handle the domestic financing of the reserve changes.

If it becomes evident that the inflow reflects longer-term forces, the authorities will find it necessary to alter the "mix" of economic policies. Larger fiscal surpluses would be needed to provide the necessary domestic financing of reserves and to dampen business activity, since interest rates would have to be maintained at relatively lower levels to avoid adding to the capital in-

flow.¹⁰ This assumes that the Canadian authorities are able to convince other governments that the reserve accumulations are not harming their international position and to persuade the Canadian public of the need to add to holdings of gold and U.S. dollars with a low rate of return.

Appropriate fiscal policies take on added importance under a fixed rate system, since if they are not used additional pressure will be put on domestic prices. Because price and cost increases are not readily reversible, increases will limit the authorities' ability to combat a subsequent recession because of a weakened international competitive position. Under a flexible rate system these adjustments can come about through upward movements in the rate which are subsequently reversed, although under either system the authorities must be concerned with containing domestic prices and costs to ensure that they do not necessitate continuous and cumulative depreciation of the currency, both internally and externally.

In the different circumstances of major reserve drains in periods of slack activity in Canada, the authorities may need to call on international assistance and bring about some increase in domestic interest rates. If the drain persists and interest rates must be maintained at higher levels than purely domestic considerations would call for, increased reliance must be put on fiscal measures to stimulate the economy and on other policies designed to bring about fundamental improvements in our relative costs of production.

It is sometimes argued that the difficulties with which a fixed rate system may occasionally confront the authorities can be overcome by making it an "adjustable peg" which alters fairly frequently. Both economic logic and the existing international payments arrangements clearly indicate that a change in a fixed rate should be

⁹ Such inflows do not present a comparable problem in periods of economic slack because an easing of credit conditions is then appropriate to both the domestic and international situation.

¹⁰ If the present proposal to remove Canada's exemption from the U.S. interest-equalization tax if our reserves become excessive is enacted into law, it might reduce foreign borrowing by Canadians in times of buoyant domestic conditions. It would thus reduce the capital inflows with which the Canadian authorities would normally have to cope when domestic credit conditions are restrictive. This temporary measure, however, is objectionable on other grounds, not least in that it may prevent Canada from accumulating sufficient reserves in such periods to defend the fixed rate in less favourable times.

made if the disequilibrium is fundamental in nature. For example, a rate adjustment would be permissible and necessary if basic demand conditions for exports or imports were to alter in a major way, if the structure of Canadian relative costs and prices were to change substantially or if the character and amount of capital flows were to undergo massive and lasting shifts of a destabilizing nature. However, frequent changes in the fixed value of a major currency such as that of Canada cannot be made without creating serious uncertainties in domestic production, trade and capital flows. If it came to be believed that changes were likely to occur, then at the first hint of difficulties in either direction there would be widespread speculation on the Canadian dollar similar to that which took place in 1962.

If frequent changes in the exchange rate are ruled out, then there will be times when the rate is undervalued relative to existing conditions and other times when it is overvalued. Substantial changes in reserves will often provide the adjustment mechanism in such circumstances, but there is no denying that persistent gains or losses in reserves will limit the extent to which the authorities can follow policies to achieve their domestic objectives. Given the sensitivity of international capital flows, it may be possible to minimize these limitations by gearing monetary and debt policies to international considerations and by placing more reliance on fiscal and other policies to achieve purely domestic aims. Nevertheless, there are limits to this process and it is only realistic to recognize that international considerations will at times in the future, as they have in the past, exercise a decisive influence on the choice of policy at home.

While a flexible rate would appear to have some advantages in Canada's circumstances in that it provides for somewhat greater freedom and effectiveness of domestic monetary policy, its advantages should not be overstressed. The flexible exchange rate was too high after 1957, in part because of domestic credit policies, but there is no certainty that more appropriate measures would have resulted in an exchange rate wholly suited to the structure of our relative costs and

prices. If the view had been that the flexible exchange rate had not declined sufficiently, it might have been desirable to fix a lower rate, at least by 1960 when the disequilibrium in our international competitive position was generally evident. This would have made for greater certainty and facilitated the production adjustments in the export and import-competing industries that are necessary if the economy is to come closer to full employment levels.

The authorities cannot escape the consequences of their domestic policy actions on the international financial position under either exchange rate system, although a fixed rate system may bring the consequences of ill-advised steps more quickly and dramatically to public attention. However, when a low value is established under a fixed rate system so that the international consequences of domestic inflation are not immediately felt, poor performance at home will not immediately be reflected in exchange reserves; moreover, a fortuitous change in the current or capital accounts may temporarily mask the international consequences of domestic policy actions. What does remain beyond dispute is that under either exchange system the authorities can mismanage our affairs. Similarly, good economic results can be achieved under either system, although Canada's special position is likely to limit the domestic freedom of the authorities and may necessitate more exchange rate changes in the long run than would be needed by some other industrial countries. In the final analysis, it is not the exchange rate system in use but domestic policy designed to keep the economy efficient and adaptable which is the essential condition of achieving a sound and viable external financial position.

THE EXCHANGE FUND AND SHORT-TERM CAPITAL MOVEMENTS

The role of the Exchange Fund under the flexible exchange rate system was a strictly limited one, but when the decision was taken to intervene in the exchange market in late 1960 the tactics to be followed became a matter of considerable importance. The Exchange Fund oper-

ated extensively in both the spot and forward markets, but in the situation which then existed other steps were required to restore confidence. The question is still open, however, whether under more favourable conditions with more limited speculative pressure, a combination of domestic credit policies and forward operations of the Exchange Fund could be used as a device for overcoming temporary difficulties which otherwise might prove to be too large to be conveniently handled by changes in the official reserves of foreign exchange.

In earlier chapters we have shown how international capital movements respond to interest rate and availability differentials and noted that much of the capital flow has been on an unhedged basis. When, for example, a Canadian issuer sells long-term securities to investors in the United States in American currency, he must assume the risk that the exchange rate over the period up to the maturity of the issue will not change sufficiently to offset the gain in lower interest costs from borrowing abroad. If forward contracts were available so that he could ensure in advance that U.S. dollars five, ten or fifteen years hence could be purchased at a given price, such transactions could be carried out on a hedged basis. Forward contracts of this kind, however, are not normally available and either the borrower—or the lender if the issue is in Canadian currency—must assume an exchange risk. There are also shorter-term capital flows responsive to interest and availability differentials which are frequently not hedged. From the evidence we have examined, and from an analysis of movements in the components of the capital account of the balance of payments, it would appear that an important part of this type of flow can be ascribed to changes in accounts payable and receivable. For example, when credit tightens in Canada, Canadian subsidiaries of foreign firms appear to rely somewhat more heavily on advances from their parent firms through the medium of inter-company accounts while importers generally rely more on foreign trade credit.

Even though some short-term capital movements are unhedged this is not the general rule,

since the profit to be gained by the movement of short-term capital in response to interest differentials can easily be converted into a loss by a minor movement in the exchange rate. Such capital movements therefore tend to be made on a covered basis, i.e. they involve a spot purchase and forward sale of the relevant currency. There is clearly a significant difference in the effect on the reserves if short-term capital movements are made on a hedged rather than an unhedged basis. If unhedged movements were the rule, a relative increase in short-term interest rates in Canada would lead to a large inward flow of capital which would persist as long as the relevant interest differentials were kept sufficiently large. If the movements are on a covered basis, however, things are very different. Relatively high short-term interest rates in Canada will attract foreign investors but they will wish to sell Canadian dollars forward to insure against the exchange risk. As a result, the price of forward Canadian dollars will quickly fall to the point where net inward movements are no longer attractive. To the extent that the premium on forward U.S. dollars leads, for example, to an increase in sales of forward foreign currency by exporters and a decrease in purchases of such currency by importers, there will be a current addition to exchange reserves at the expense of additions to reserves in the future.

While the net movement of short-term capital may terminate quickly, there may continue to be large flows in both directions. As pointed out in Chapter 15, covered short-term capital movements in one direction make possible and frequently lead to short-term capital movements in the other direction. If a private purchase of spot and a sale of forward Canadian dollars are matched by offsetting private transactions the other way, there will be no effect on official holdings of gold and U.S. dollars. A corporate treasurer in Canada may find that the rate on "swap" deposits offered by a Canadian chartered bank is attractive and invest surplus funds in a U.S. dollar deposit with the U.S. dollars sold forward. These funds might well be invested in

loans to investment dealers in New York and sold forward. The offsetting spot and forward transaction in the other direction may arise from an American investor buying Canadian finance paper and selling forward the Canadian dollar proceeds at maturity. Clearly, if the Canadian corporate treasurer had invested in the Canadian finance paper directly and the American investor had made a direct loan to an investment dealer in New York, the flows in both directions would have been eliminated. There would have been no difference in the flow of funds between final borrowers and lenders and no transactions in the exchange market. The financial intermediaries have provided services to clients with particular preferences as to the kind of assets they want and the kind of liabilities they wish to assume, and as long as such transactions are offsetting they have no net effect on the reserve position.

If, however, a covered short-term capital movement into Canada occurs in circumstances which lead to an increase in the price of forward U.S. dollars, and this in turn leads to an increase in outright sales of forward U.S. dollars, there will be an addition to the reserves. What in effect happens—through the intermediation of a bank—is that the Exchange Fund obtains the spot U.S. dollars supplied by the foreign investor, and the exporter who has been brought into the market by the favourable forward rate supplies the forward U.S. dollars. Thus current reserves are increased at the expense of future additions to the reserves. Similarly, if the Exchange Fund is prepared to carry out “swaps” by selling forward U.S. dollars directly and purchasing spot U.S. dollars, then again the reserves will increase as a result of a covered short-term capital movement into Canada.

The use of the forward market by the exchange authorities has often been suggested as a major means of preventing a reduction in exchange reserves. For example, if concern over the future value of the Canadian dollar leads to large scale purchases by the public of forward U.S. dollars, the price of the latter will rise. Other things equal, this will make the movements of short-term capital to the United States more prof-

itable and bring pressure to bear on official exchange reserves. If, however, the exchange authorities are prepared to undertake commitments to supply forward U.S. dollars, they can prevent their price from rising and so prevent the movement of short-term capital. If the loss of confidence in the future value of the Canadian dollar is a temporary one, those who have purchased forward U.S. dollars beyond their needs will reverse their transactions and a difficult situation will have been averted.

Some have gone so far as to argue that if the exchange authorities are sufficiently bold in their use of the forward market, the use of this technique alone will be enough to stem a major run on a currency. Their contention is that if the authorities are confident that the disequilibrium is not fundamental and that no change is required in the value of the currency, they can safely undertake virtually unlimited commitments to supply foreign currency. This process can be made painful for the speculator: official operations can be conducted in such a way that, even though he establishes his original forward position at less cost than he could have done without the Fund's intervention, he must pay an even higher price to close out his position. One conclusive limit on the use of this technique is the willingness of speculators to accept without question a commitment to supply foreign currency in the future. Moreover, if the underlying situation calls for a devaluation, the authorities will be involved in substantial losses if they have heavy commitments to deliver forward foreign exchange.

In 1950, when the Exchange Fund bought forward U.S. dollars on a large scale, it could well be argued that there was a fundamental disequilibrium and that such action could therefore not succeed. In 1962, the Exchange Fund undertook to supply forward U.S. dollars to the extent of \$239 million. It is difficult to know how large these commitments might have become if the authorities had been willing to continue this policy, although in one week between June 15 and June 22 they increased by no less than \$119 million. There is evidence, moreover, that

market participants were concerned over the dangers posed by the possible introduction of exchange controls, and as Exchange Fund commitments became larger and larger these fears might well have been magnified.

This is not to say that official operations in the forward market cannot fulfill a useful function. In our view, there is considerable scope for such operations, either on a unilateral basis or in co-operation with other governments and central banks.¹¹ Such co-operation is now especially vital in view of the widespread convertibility of currencies and the ease with which international speculative pressures can be triggered off. We would hope that in the development of supplementary defences against such speculative attacks on currencies, Canada will play a useful part. This is particularly important under a fixed rate system since—as already indicated—such a system will occasionally involve major changes, often within brief time periods, in the size of official holdings of foreign exchange.

It is not possible to specify what level of reserves should be held to enable Canada to adjust smoothly and with a maximum of independence to changing domestic and international conditions. Obviously, however, the reserves must be larger than under a flexible system, and the public should learn not to read undue significance into changes which, while large in absolute amount, are not symptomatic of major difficulties. Nor will the desirable level of reserves be an unchanging one: it will depend on such factors as the size and trend of our imports, exports and current account position and on the type and amount of our international indebtedness and capital flows. It will also depend on the speed and completeness with which deficits in our overall balance of payments correct themselves and—very importantly—on the accessibility of temporary international financial assistance.

Similarly, it would be impossible and undesirable to specify any rigid or mechanical rules for official intervention in the spot or forward exchange markets. These must depend on the cir-

cumstances of the time, but will certainly involve the authorities in active and continuous market operations under a fixed-rate system. We have heard favourable comments about the decisiveness and skill with which the authorities have operated in the exchange market, and have no reason to propose any changes in the arrangements under which the Bank of Canada manages the Exchange Fund as agent for the Minister of Finance. To return the exchange reserves to the Bank of Canada, where they were located until the war, would serve little purpose, might cause some confusion of responsibility and would involve the central bank in additional open market or other operations to offset the cash reserve effects of changes in exchange holdings.

OTHER POLICIES TO INFLUENCE THE BALANCE OF PAYMENTS

Our primary concern above has been with the way in which the general instruments of policy influence the balance of payments. Most of our illustrations have been drawn from the period 1953-63, a period during which the current account of the Canadian balance of payments was in continual deficit. There have been sharp differences of view on both the deficit itself and equally on some of the policies which have been proposed for reducing it. Some have held the view almost from the beginning that the deficit was undesirable, that it reflected the unwillingness of Canadians to provide for their own economic development, and that it contributed to the increase in foreign ownership discussed in Chapter 5. Those taking this view were critical of the deficit even in years such as 1955-57 when foreign resources were required to satisfy the demands of the investment boom of that period. When economic slack developed after 1957, they were able to point to the depressing effect of the current account deficit, but the essence of their position was that a sizable deficit was undesirable under any set of economic conditions.

¹¹ We believe that official forward commitments should normally be disclosed, but not without a reasonable delay.

A more balanced view has been put forward by others who have not been greatly concerned about foreign ownership and control and have felt that in periods of rapid growth there is no reason why foreign capital should not be used to supplement domestic savings. In their view, the crucial question concerns the state of economic conditions in Canada. If there is excess demand for output then foreign resources are required. If there is economic slack, no net foreign resources in the physical sense are required; nevertheless, gross flows in both directions may still be needed to realize our full potential, especially since foreign direct investment in new plant and equipment is frequently an addition to total investment rather than a substitute for part of it. The same cannot always be said of takeovers of existing Canadian companies, although there were often benefits in the accompanying flow of technical knowledge, skilled management and established market connections. This body of opinion, therefore, was not critical of the deficit in the years of economic buoyancy and only became concerned when it appeared that some of the capital flow under the flexible exchange rate system was having a depressing effect on the Canadian economy.

There was a similar diversity of views on the steps which should be taken to reduce the deficit in the years after 1957. Some favoured striking directly at the flow of capital or the flow of commodities or both. Many, however, were unprepared to advocate policies which discriminated against foreign investors or foreign trade and argued that much of the excess capital flow after 1957 was a symptom of inappropriate monetary and debt policies.

The direct measures which have been proposed fall into two groups—those designed to affect the current account directly and those aimed at capital transactions. These two types of measures have different effects under a fixed than under a flexible exchange rate. Under a flexible exchange rate system, direct action to restrict the entry of goods and services on current account will tend to lead to an appreciation of the exchange

rate. This in turn will reduce exports and increase imports of other goods and services and thus lead to offsetting changes elsewhere in the current account. On the other hand, direct restrictions on capital imports will reduce the demand for Canadian dollars, lead to a depreciation of the exchange rate and set in motion forces which in time will lead to a decline in the current account deficit. In the latter case there could be some offsetting effects within the capital account as a result of the reduction in capital flows tightening domestic credit conditions. In the first case also there may be indirect effects, particularly if resulting higher costs or adverse reaction to the measures at home or abroad impair our economic growth and reduce investment.

Under a fixed exchange rate, in contrast, restrictions on current account transactions will not be offset by exchange rate movements. Similarly, the application of direct restrictions to capital movements will not trip off a mechanism for adjusting the current account through the exchange rate. Instead, the main impact will fall on the official reserves, reducing them if capital imports are limited and raising them if imports of goods are restricted.

Many supporters of direct measures, however, have advocated measures on both sides of the accounts simultaneously. Under a flexible exchange rate, capital account restrictions alone would lead to a depreciation of the international value of the Canadian dollar, but this will not occur if at the same time offsetting direct restrictions on the movement of goods and services are introduced. Under a fixed rate with anything less than high and growing reserves, action taken to discourage capital flows can lead to balance of payments difficulties unless matched by direct restrictions on current account transactions. Alternatively, restriction on current account transactions might so improve the potential reserve position that action would need to be taken to curb the capital flow.

As our earlier discussion makes clear, there has been no lack of examples of direct balance of payments measures affecting Canada in recent

years. However, we have not felt it desirable to analyse these measures in any detailed way, although it is evident that there is almost no limit to the variety of devices which can be and have been used to discourage the flow of commodities and capital. Yet the central question is not how this might be done but whether it should be done. It should be remembered first that all economic policies are interrelated. Thus, for example, the discouragement of non-resident investment which contributes to our economic growth involves paying a price in terms of slower national development, a change in credit policies relative to those in other countries will have inevitable effects on international capital flows, and higher tariffs or other policies which raise Canadian production costs are bound to affect our industry's ability to export.¹²

Second, many international economic policies once established tend to have lasting consequences; it is always dangerous in dealing with a temporary problem to initiate measures the effects of which will be experienced over many years, even when basic conditions have changed. In Canada's circumstances one cannot, for example, sensibly contemplate the imposition of exchange controls to meet short-run peace-time emergencies. Quite apart from the likelihood that their use will be a substitute for the more fundamental measures which would probably be needed in such circumstances, they would have lasting effects on the long-term flow of capital and increase speculative pressures against the Canadian dollar at any sign of the slightest weakness in our external position. Much the same is true of short-run changes in withholding taxes. It is true, nonetheless, that a number of industrial countries have permanently established controls on certain types of capital movements, some of which are now being relaxed, and some also have rules relating to the incorporation or acquisition of domestic com-

panies by non-residents; these rules usually relate to domestic participation in the equity, subject to certain conditions. These, however, are not subject to short-run variation and are not used to discriminate against existing investments. This serves to emphasize that countries adopting such policies must be prepared to accept their consequences on a long-run basis.

A third point to remember in attempting to influence international arrangements is that the nationals of one country are not the only participants in the process. Actions which damage the interests of other countries invite retaliation. The ultimate consequences, both economic and political, of a particular action are therefore always uncertain. Since our international economic actions can lead to serious damage to our own interests they must be carefully considered in the light of their probable impact on our domestic goals of efficiency, employment and price stability.

A fourth consideration which is important in Canada is the division of powers between the federal and provincial governments. Since natural resources are under the control of the provinces, there are both legal and political limits to the extent to which the federal government can expect to exercise an influence over foreign investment.

Finally it must be remembered that in international, as in domestic, financial policy an array of minor measures aimed at subsidiary objectives is no substitute for getting the broad, general posture of policy set in the right direction. If we wish to attain a sound and viable international financial position and not be excessively dependent on foreign capital at times when we have available resources in Canada, the real solution lies in having an efficient, competitive and adaptable economy. Similarly, if we wish to achieve greater Canadian ownership of industry, the solution must lie primarily in increasing Canadian incomes, enhancing the incentives to equity investment and ensuring that our financial institutions and framework do not impede such ownership.

¹² Many branch plants were set up in Canada to take advantage of the tariff, which thus contributed both to higher non-resident ownership and the competitive inability of some firms to serve export markets.

INTERNATIONAL CO-OPERATION AND THE WORLD PAYMENTS SYSTEM

With an economy particularly oriented towards world trade and closely connected to other capital markets, Canada has a special interest in ensuring that the international financial system works smoothly and that there is a maximum of co-operation between countries to achieve the objectives of high employment, rising productivity and stability of prices. Constructive international arrangements enhance Canada's ability to pursue appropriate domestic policies in the long run by reducing the chances that other countries will pursue inappropriately restrictive trade or credit policies. Moreover, they can greatly reduce the need to undergo excessively painful domestic adjustments to meet short-run international crises; the massive international financial aid received in June of 1962 is a striking example of the usefulness of such arrangements.

Despite the importance of the international payments system for Canada, the subject did not attract much attention in this country during the period of the flexible exchange system. For a decade we had not found it necessary to pay any serious attention to the level of official reserves since adjustments were carried out through exchange rate changes. Moreover, because the reserves changed little, other countries had no direct concern about the effects of our actions on their reserves. Although the Canadian experiment with a flexible exchange rate attracted a good deal of attention abroad, there is little evidence that this experience had much impact on the discussion of possible alternative world payments arrangements. In part this was because our closest associates, the United Kingdom and the United States, are the two reserve countries of the international community, and the Canadian experience was not directly relevant for countries which acted as bankers to the world.

In the last year or two, however, there has been a sharp rise in the attention paid to the international payments system in Canada. The

exchange crisis, and the assistance from abroad which helped to combat it, drew attention to the institutions and arrangements designed to deal with such problems. Moreover, the adoption of a fixed rate system meant that changes in Canada's exchange reserves were watched more closely. It is natural therefore that concern for our own reserve position quickly led to an interest in this country in the question of the adequacy of reserves for the system as a whole.

As already indicated, there has been a major change since the days of the gold standard in the economic and political environment within which the international payments system must work. Governments have accepted responsibility for the maintenance of high employment and this implies a willingness to use the general instruments of economic policy to influence expenditure. Unless all major countries are following such policies, the efforts of any one of them to follow expansionary policies can have effects on its balance of payments. Even if all are striving to minimize unemployment, there can be significant differences—for policy, structural, or technological reasons—in the extent to which prices in some countries increase relative to prices in others. Thus, if one country's costs and prices increase more rapidly than those of its trading partners, it will only be a matter of time until its weakened competitive position leads to balance of payments difficulties. In addition, changes in world demand and technology can affect different countries in different ways and may force them to choose between altering their exchange rate or national employment and productivity goals.

The most obvious way of reconciling domestic objectives and international balance is through unilateral decisions to change the international value of the country's currency or the level of exchange controls and other barriers to trade. These techniques were used extensively in the inter-war period, but devaluation on the part of one country usually led quickly to devaluation by other countries; the original depreciation was thus offset, or more than offset, but trade and

capital movements suffered in the meantime from the uncertainties created. In short, it became apparent that one country could only succeed in changing the international value of its currency if other countries did not resort to competitive exchange depreciation. A similar conclusion emerged from the experience with the use of exchange, tariff and other restrictions on trade and capital movements. Any one country acting alone can alter its balance of payments in this way, but if other countries are not prepared to accept the balance of payments consequences, they can offset these effects by imposing similar restrictions. An increase in exchange controls and barriers to trade by all countries may leave the original disequilibrium problem unsolved but will reduce the flow of goods and capital and impose losses on all countries.

The arrangements for the post-war payments system made when the International Monetary Fund (I.M.F.) was established at Bretton Woods in 1944 were a natural response to the inter-war difficulties. Since devaluations, at least by important countries, could not in fact be effective unless other countries were prepared to tolerate them, an agreement was reached on the conditions under which a change in a par value was acceptable. Any proposed change in par value, which together with all previous changes exceeded 10% of the initial par value, required Fund approval. Similarly, restrictions on current payments, other than those used during the post-war transitional period under Article XIV of the I.M.F. Agreement, required the approval of the Fund. Thus two of the most obvious ways of avoiding the restraints imposed by the world economy were made subject to international approval.

Although a number of countries took advantage of Article XIV, on February 15, 1961 all of the major continental European countries and the United Kingdom agreed to accept the obligations of convertibility of their currencies as set forth in Article VIII. Under this Article, they agreed to avoid exchange restrictions, multiple currency practices and discriminatory currency

arrangements. If in future any of these countries wish to make use of such measures, they will have to obtain the prior approval of the Fund. Thus, in general, it can be said that any resort to exchange controls by a major country must be accepted internationally if it is not to carry the sanction of denial of access to the resources of the Fund.

While many countries have shown a lingering attachment for exchange restrictions, the same cannot be said for currency depreciation. In part, this may result from special circumstances. The major devaluations of 1949 brought most currencies into a favourable competitive relationship with the U.S. dollar. In recent years, the countries which have faced some continuing difficulties, the United Kingdom and the United States, have been influenced in their thinking by their special position as international bankers. It may be that if the payments position of industrial countries other than the United States worsened, there would be more willingness than in the past for devaluation to be looked upon as a remedy. There has, however, been a considerable reluctance to alter par values—except for a number of less developed countries—and this may well continue into the future.

This places a considerable strain on the international payments system and reserves. If changes in exchange restrictions are virtually ruled out and there is a great reluctance to alter par values, the conflict between domestic objectives and international balance can become very sharp. This conflict lies at the heart of the controversy over international liquidity. Under fixed exchange rates, any divergence from an existing equilibrium can only persist if countries are prepared and able to permit major changes in their international reserves. This, of course, does not mean that countries may keep their economy out of step with their major trading partners; under any arrangements they must sooner or later adjust to the world around them.

Those who think that domestic adjustments should come sooner rather than later feel that international reserves (or access to such reserves)

need only be adequate to tide over temporary situations, i.e. short-run crises in which a limited period is necessary for emergency domestic policies to be introduced and take effect. These people would argue that business, labour and government would in time recognize that international considerations severely restrict their freedom of action and would adjust their attitudes and policies towards prices, wages and other factors affecting the country's international competitive position. Others feel that reserves should be adequate to cope with the large and persistent one-way movements of exchange reserves which may be entailed if countries attempt to deal with a problem of international imbalance by adopting fundamental measures involving a minimum sacrifice of domestic policy objectives.

The extent to which countries should have time and freedom to adjust their domestic policies thus underlies the argument about international liquidity. It is recognized that there can be no ultimate escape from the limitations imposed by membership in the international economy and that international credit, like its domestic counterpart, should be used only for constructive purposes and not to permit irresponsible borrowers to escape the consequences of their actions. Nevertheless, there is an important difference between a system which requires an almost immediate adjustment of domestic policies to international requirements and one which permits greater freedom in the time taken and measures chosen to reconcile the two.

Major developments have occurred in international payment arrangements in recent years and further changes are now under consideration. Indeed, some years hence those with an interest in international finance may describe the current period as one in which fundamental alterations were made to the system. The resources available to the International Monetary Fund have been substantially increased, first by a 50% increase in quotas to a total of about \$15.3

billion,¹³ and second, by the General Arrangements to Borrow under which ten countries including Canada, the United States, the United Kingdom, Japan and the major continental European countries agreed conditionally to lend to the Fund amounts which total \$6 billion. Together with world gold reserves of some \$39.2 billion and foreign exchange holdings of \$23.3 billion—mainly in the form of U.S. dollars and sterling—these international reserves are equivalent to about 60% of annual world imports of \$140 billion. The ratio of reserves to trade is, however, lower than it was in 1953, when it stood at about 80%, and, of course, below that in 1937 when world reserves were equal to 100% of the then much lower value of trade.

There is no simple relationship between the appropriate level of international reserves and world trade. The size of reserves needed depends on their distribution between countries, the severity and length of international imbalances, access to other forms of international assistance, and the willingness of countries to avoid measures which impair world prosperity. Nevertheless, there is a widespread belief that international reserves must be increased if future problems are to be avoided. In particular, there is a danger that the leading countries may pursue inappropriately restrictive trade and credit policies in an unsuccessful attempt to compete with each other for the same limited stock of reserves, and that they will be forced to sacrifice domestic employment and productivity objectives in doing so.

There are many who feel that the I.M.F. or some other broadly-based international institution should be the main channel through which changes in the system are brought about. This

¹³ Canada's quota is \$550 million (U.S.). Details of drawing rights from the fund are complex (see p. 7, *International Financial Statistics*, Sept. 1963, published by the I.M.F.); but in general a country may more or less automatically borrow up to one quarter of its quota and may borrow up to 100% of its quota subject to conditions about pursuing appropriate policies. It must obtain a waiver from the Fund if it wishes to borrow more than this. The fund is now also prepared to enter into standby agreements; this assures the borrowing country of automatic access to assistance within the agreed limits.

may be the way in which developments finally go, but there are several reasons why much of the initiative is likely to come from other sources. At present the staff of the Fund contains a limited number of international central bankers, while national central banks and treasuries have a good deal of strength in this area. This itself reflects the unwillingness of governments to act to a greater extent through the Fund framework, partly because of the large size and heterogeneous nature of the Fund's membership. A high proportion of the routine lending and day-to-day activity of the Fund arises from its relationships with under-developed countries whose problems are very different from those of the industrial countries. There is thus an understandable tendency for the industrial countries to prefer to discuss their problems bilaterally, or in a forum such as the Organization for Economic Cooperation and Development or the Bank for International Settlements where the membership is almost exclusively drawn from countries with similar interests and problems. Thus, many of the recent developments in international financial arrangements have taken place outside the I.M.F., particularly through bilateral arrangements negotiated by the United States.

The widespread international banking responsibilities of the United States provide a favourable setting for such arrangements, which have received added impetus from the payments difficulties which the Americans have encountered. Deficit countries are usually more inventive in developing techniques for meeting payments problems than surplus countries. The United States has been running a substantial current account surplus and is a large creditor on international account, but her long-term investments abroad and her foreign aid programs have involved an increase in her short-term liabilities. Moreover, her gold stock—which reached a peak of over \$24.5 billion in 1949—had declined to \$15.6 billion at the end of 1963. Losses of gold were regarded as desirable in much of the post-war period since the U.S. had too large a

proportion of the world's monetary gold until the latter part of the 1950's. However, U.S. gold holdings have now reached the point at which the Americans have felt it essential to prevent the conversion of short claims from leading to further excessive declines. They have therefore developed techniques for economizing gold and forestalling the conversion of dollar holdings of foreign governments and central banks into gold.

In some cases, this problem has been a temporary one and has been met by the use of currency "swaps". If a foreign central bank acquires dollars on a temporary basis which it ordinarily would convert into gold, the Federal Reserve System initiates a drawing against a previously arranged credit with that bank and buys the dollars for the period of the swap. The process can be reversed at the end of the period and a temporary gold movement avoided, the transaction in effect having provided an exchange guarantee to the foreign central bank and thereby having dissuaded it from making a gold purchase. If the additions to dollar holdings of foreign governments or central banks are not expected to be temporary, another technique is used. The United States Treasury sells special bonds denominated in the currency of various European countries—including Italy, Germany, Switzerland, Belgium, and Austria—to foreign central banks and treasuries, and uses the proceeds to purchase holdings of dollars. This again provides an exchange guarantee to foreign governments and central banks on part of their dollar holdings¹⁴

These swaps have also been used, together with credits obtained by the U.S. Treasury, for extensive operations in forward and spot exchange markets when temporary, but strong, destabilizing speculation has occurred; these transactions are subsequently liquidated when

¹⁴ Total swap lines with 10 central banks and the Bank for International Settlements amounted to \$1,550 million at the end of August 1963, while U.S. Treasury foreign currency bonds outstanding at the same date amounted to the equivalent of \$705 million U.S.; five central banks and one government were involved. The actual net debtor position of the Federal Reserve under the swap lines was \$73 million in early September.

conditions become more favourable, or are funded into foreign currency bond issues. For example, operations in forward German marks reached a peak outstanding of some \$340 million U.S. equivalent in June 1961; similarly, a total swing of some \$175 million in the Belgian payments position in the year ending October 1963 was financed through the swap facility and Treasury issues with that country, thus economizing on the use of gold reserves.¹⁵ In effect, additional international reserves are created by these techniques, which the authorities can use to prevent runs on existing reserves. In addition, countries in need of temporary extra reserves have drawn on these swap facilities or on *ad hoc* credits from the world's central banks—for example, Canada in 1962 and the United Kingdom to the extent of \$900 million in early 1961. Finally co-operative operations by central banks have been undertaken in the London gold market to prevent speculative disturbances from leading to currency flights.

These are now temporary expedients, but if the "temporary" period is long enough, and if the facilities are put on a regular basis and the amounts involved are large enough, a considerable step has been taken to provide time for more fundamental adjustments to take place. The announced willingness of the United States to acquire foreign currencies might well involve large amounts over an extended period. If this were to occur during years in which the United States payments position was again strong, countries which have acquired reserves of U.S. dollars and gold in recent years will not have to draw down their holdings; instead, their currencies will be used to add to the reserves being accumulated by the United States against future eventualities.

The recent experience has been a useful one and has contributed to a realistic appraisal of the problem and of the possible solutions to it by governments, central banks and international institutions. At the same time, the various pro-

posals which have been made for major reforms of the international financial system have attracted a good deal of attention and alerted legislatures and financial communities to the need for serious thinking about these issues. At the 1963 meeting of the International Monetary Fund, it was decided that two studies should be made of the problem of international liquidity, one by the I.M.F. and the other by representatives of the ten countries which had participated in the General Arrangements to Borrow.

It is our view that it is in the interests of this country that, with appropriate safeguards against irresponsible borrowing, international reserves should be gradually increased so that time will be available to national financial authorities to make adjustments to their international positions while at the same time retaining some freedom of action to pursue domestic objectives of policy.

One possible answer to this problem, but one which we do not support, would be an increase in the price of gold. This would require action by the United States, and Canadian governments in the past have wisely refrained from making pronouncements on this subject. A writing-up of the gold price would naturally benefit Canada as a gold-producing country—particularly in a period when we had unemployed labour—and would make a contribution to increasing international liquidity. However, except for relatively minor effects on the annual production of gold it would be a once-over, large and abrupt change which would not deal with the problem in a continuing way. (We rule out small changes since they would merely trigger speculation on further changes). Quite apart from the inequity of the relief it would provide (the main beneficiaries would be gold-producing countries and those which held large gold reserves, while those which had played a constructive part in improving international liquidity by minimizing gold holdings would be penalized), the solution lacks the elements of discretion and gradualness which are essential if a lasting answer to the international liquidity

¹⁵ For a full discussion, see the excellent and informative articles in the *Monthly Review of the Federal Reserve Bank of New York*, October 1962, March 1963, and October 1963.

problem is to be found.¹⁶ As with the domestic financial system, which we no longer leave to the uncertainties of gold production, the answer to the international financial system's problems lies in the intelligent management of an expanded stock of credit rather than in adjusting the price of gold.

Wherever the ultimate solution to the world's future liquidity needs is found, however, it is worth noting that Canada found its own answer to this problem in the 1950's through the use of a flexible exchange rate which moved within narrow limits. This may be a solution which has some application for other non-reserve countries since to the extent that it is used the need of such countries for additional reserves would be strictly limited and pressure on the existing stock of international liquidity correspondingly reduced. The solution more likely to emerge, however, is a system in which countries are able to avoid conflicts between the domestic and international objectives of policy through access to additional international reserves. In any event, there is no doubt that recent thinking and market experience will lead to constructive proposals which will contribute to the further development of the international payments system.

We would like to stress in conclusion that the soundest of international payments arrangements, while essential if the world economy is to perform satisfactorily, is no guarantee that national objectives will in fact be achieved. Much depends upon how wisely individual countries, particularly the major trading nations, manage their affairs. Yet the higher the degree of co-operation among national governments and the greater their willingness to co-ordinate their efforts to achieve sustainable economic progress and high employment, the more likely we are to establish the sound international environment necessary to accomplish our aims.

¹⁶ Any inflationary potential stemming from the monetary consequences of a rise in the gold price could presumably be neutralized by the world's central banks, although such an increase might induce some countries to adopt unsound policies.

CONCLUSION

In our view the existing parity of 92½¢ U.S. is a good exchange rate for Canada and one which we hope can be maintained for a long time to come. Whether or not changes in the exchange value of the currency will be necessary in the more distant future will depend upon future developments, including changes which may be made in the world payments system. Under any financial arrangements, however, the Canadian economy will be subject to pressures arising from world trade and investment trends which will limit our independence of action. Our financial policies, particularly our monetary and debt policies, should never be carried out without regard to their international consequences and a fixed exchange rate will help to ensure that this is the case. Operation of the present system will involve substantial swings in our international reserves, and from time to time will require active foreign exchange market operations to counter speculative pressures. At the same time, it will mean that monetary and debt policies designed to achieve domestic objectives will have to be reasonably consistent with our short-run international economic position.

The best way for us to maintain a sound external financial position will still be to have a soundly-managed economy at home. While we indicated in Chapter 5 that the burden of our external indebtedness is not excessive, we have pointed out that inappropriate financial policies can lead to the attraction of more foreign capital than is necessary or desirable in periods of slack in the economy. No doubt there will continue to be gross flows of capital in both directions and net drawings on foreign resources to supplement Canadian savings in boom periods, but we do not believe that the country needs to be heavily dependent on foreign financing at all times, especially when there are unused resources available in Canada. As in other aspects of policy, we are more likely to be successful in this aim if we take fundamental measures designed to improve the competitiveness and adaptability of

the economy than if we deal only with the symptoms of the problem. In this task, constructive international co-operation to achieve high employment and price stability can play an important

role, and Canada should take an active part in bringing about needed improvements to world payments and other facilities designed to achieve these goals.