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Recent Monetary Developments in Canada 12 pages

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In a speech to the Canadian Club of Montreal on November 16, Governor Coyne of the Bank of Canada made an unusually detailed analysis of recent monetary developments in Canada. In his speech, Governor Coyne expressed his satisfaction with the Bank's monetary management during the past 11 months as well as his general approval of the behavior of the chartered banks and the fiscal and debt-management policies of the Government during 1959. The combined actions of the central bank, the Government and the chartered banks had led, he said, to a notable improvement in the bond market's "psychological atmosphere" in September and to a much more rational view of market conditions by lenders and borrowers. Commenting on the reactions of the chartered banks to the pressures placed on them by their customers on the one hand, and the central bank (and Government through its debt-management policy) on the other, Governor Coyne declared that ". . . in the present cycle of credit expansion . . . the chartered banks have taken more effective action to prevent or restrain the potential excesses . . . than on earlier occasions."

The definite, if tempered, tone of satisfaction in the Governor's speech -- particularly his approval of the Government's willingness to price its new bond issues at competitive market rates and his approval of the Treasury's unusual rejection of a portion of the Treasury bill tender on August 20 -- may seem surprising in the light of certain recently published criticisms of Canada's monetary management. Thus, the London Economist of August 29, in an article labeled "Canada: A Financial Mess," implied that there has been continuing controversy between the Bank of Canada and the Government over appropriate financial policies, and that the Treasury's rejection of a portion of the Treasury bill issue in August was merely the latest twist in this conflict.

A more detailed and discriminating resume of financial developments in Canada is Mr. E. P. Neufeld's article, "Disowning Canada's Dear Money," in the November 1959 issue of The Banker. Neufeld approves of the Government's budgetary and debt-management policies during the recent recession and recovery. He also praises the central bank's policy of keeping the money supply virtually unchanged following its very rapid expansion in the 12 months to October 1958. But he criticizes the "authorities" management of market operations this past August, arguing that such a situation -- which "jolts the money market" -- should and could have been averted. The principal point in his article, however, is that the Diefenbaker Conservative Government -- in its statements over the past 6 months -- has publicly disclaimed any responsibility for the actions of the Bank of Canada and has thereby exposed the Bank to public attack. Neufeld argues that in the final analysis the Bank's policy must also be the Government's policy since, in any direct conflict, the Government can always impose its will on the Bank. Consequently, he avers, the Government should be courageous and publicly support the Bank's policy of limiting the quantity of money instead of denying that it has anything to do with this policy.

The differences between the Governor's speech and these two articles raise a number of interesting questions. Have, in fact, the Bank of Canada and the Popular Conservative Government been at policy loggerheads during most of the past 18 months? If they have, has the Government held back from imposing its will on the Bank simply because it did not wish to suffer the loss of prestige which an open fight with the Bank would involve? Or should the Government's determination to escape the stigma which it might acquire from open support of the Bank's "tight money" policy be interpreted merely as a practical political tactic? If this is the case, the key question is whether avoidance of responsibility for "monetary policy" by the Government has done real harm to Canada's economic welfare.

On a different and narrower plane, the question arises as to whether the Treasury bill "crisis" of August was due to mismanagement or whether it was, in the nature of things, inevitable? One might also question whether this "crisis" was as unhealthy an event as Neufeld makes out.

The answers to these questions hinge on one's interpretation of economic and financial developments in Canada during the past year or so. These developments are discussed below.

Economic activity

Whether measured by changes in Gross National Product, industrial production, or employment, the recession of 1957-58 was much milder in Canada than in the United States. On the other hand, the subsequent recovery and expansion has been much more rapid in the United States. As a result, by the second quarter of 1959, measures of Gross National Product in both countries were above their prerecession peaks in the third quarter of 1957 by roughly 8 per cent. In the third quarter of this year, economic activity in both countries flattened out; Gross National Product in the United States, influenced by the steel strike, declined about three-fourths of one per cent while the Canadian figure rose by three-tenths of one per cent (reflecting price rises rather than any output gain).

This third quarter slowdown of the rate of increase in output in Canada was not due to the United States steel strike. On the contrary, the strike, on balance, may have acted to boost activity in Canada. Canadian iron ore exports to the United States were accelerated as United States steel companies, in expectation of a high rate of production once the strike was settled, became anxious to build up their stockpiles of ore before the winter closedown of Great Lakes shipping. The strike also raised demand in Canada for Canadian produced steel to replace curtailed imports from the United States. The main factors behind the slowdown appear to have been the important strike in the West Coast lumber industry (settled September 13) and unusually early and extensive auto model changeovers. A slackening in the rate of consumer spending and a decline in the rate of inventory accumulation also contributed to the slowdown.

Economic expansion picked up again in the fourth quarter of 1959. The index of industrial production, seasonally adjusted, rose 2.4 per cent in September and another 2.4 per cent in October to reach a new record high. Canadian exports, which had been rising rather slowly and irregularly over the year, rose very sharply in November and December; the settlement of the United States steel strike promised a further growth in demand for Canadian goods by the United States, Canada's most important customer. At the close of 1959, there was widespread belief that strengthening private investment, increased exports, continued strong consumer demand, and additional inventory accumulation would as a minimum raise activity to still higher levels throughout the first half of 1960.

As in the United States, the growth in employment in Canada in the present recovery and expansion has been markedly less than the growth in production. Impressive productivity gains have left labor markets relatively free from excess demand pressures. At the same time, the large additions to industrial plant made during the 1955-57 investment boom have left a considerable margin of idle plant capacity to meet added demands. In short, current pressure on prices arising from resource shortages would not yet appear to have been a critical factor entering into policy considerations in Canada.1/

The Federal budget

The relatively much stronger counterrecession measures introduced by the Canadian Government in late 1957 and early 1958 were at least partly responsible for the more limited economic decline in Canada than in this country. Relative to Gross National Output, the Federal Government cash deficit was some 50 per cent greater than the corresponding deficit in the United States. During the first three quarters of 1958, the Government securities created to finance this deficit were absorbed entirely by the banking system; in addition, the banks also bought some $482 million of marketable Government securities sold (net) by nonbank holders during this period. The bank credit created to finance these

1/ It might be noted, however, that since late 1955 Canada's consumer price index has risen at an almost steady rate averaging 2.4 per cent a year. There has been a similar average increase in the United States index although our index has shown more cyclical sensitivity.

transactions increased the money supply1/ by 12 per cent in the year ending September 30, 1958, its most rapid increase during the postwar period.

In its budget of April 1959, faced with convincing evidence that Canada, the United States, and the world economy generally, were in the early stage of a strong economic upswing, the Government introduced a wide range of tax increases designed to cut its annual cash deficit from $1,300 million to $850 million. This budget improvement also assumed that the tax base would be enlarged by a 7 per cent rise in Gross National Product. In fact, the latest available data indicate that this projected growth figure may be slightly exceeded. Moreover, unexpectedly large corporate profits beginning in the fourth quarter of 1958 have apparently produced larger tax revenues than was expected in last April's budget, even on the basis of a 7 per cent rise in output. For the first 8 months of the current fiscal year, the Government's cash deficit (measured by the change in the net direct and guaranteed debt adjusted for changes in cash balances) was only 55 per cent of the deficit in the corresponding period of 1958; the cash deficit estimated last April for the fiscal year as a whole was 65 per cent of the deficit for the last fiscal year. There is thus a presumption that the actual deficit will be smaller than the projected deficit.

The behavior of the chartered banks

Affected by declining economic activity, chartered bank general loans (seasonally adjusted) declined by 3 per cent in the six months from September 30, 1957 until March 31, 1958. Seasonally adjusted loans then remained on a plateau until the end of October 1958 when they began to expand rapidly. During the period of slack demand for loans, lasting until October 1958, authorized lines of credit on bank accounts of $100,000 or more rose rather strongly. Business firms, evidently, were attempting to safeguard their opportunities of expansion in the event of a credit squeeze similar to that which occurred in 1956 and 1957.

Even though -- as just mentioned -- their loans first declined and then leveled off, the banks total assets rose at a fast clip from the fourth quarter of 1957 through the third quarter of 1958. In the main, this expansion represented a tremendous build-up in the banks' holdings of Government bonds, which in total amount were rapidly increasing as a result of the Government's experiment with large scale antirecession deficit financing. The Bank of Canada -- through open market purchases and purchases of new government issues -- provided adequate reserves for

1/ Total currency and chartered bank deposits, excluding Government of Canada deposits.

the chartered banks to absorb this increase in the government debt and also, as mentioned above, absorb the large volume of securities unloaded by other investors.

During and for about 6 weeks after the summer conversion loan campaign of 1958, the Bank of Canada followed a policy of supporting the price of Government bonds. This policy resulted in an accelerated monetization of debt by the public and, the authorities soon realized, could not be continued without an intolerable expansion of the money supply. Early in November 1958, the Bank ended its support purchases. Thereafter, continuing up to the present time, the Bank has followed a policy of keeping the money supply virtually unchanged and letting market interest rates rise freely under the influence of a strengthening economy and enlarged credit demands.

To meet the expanded demand for loans the chartered banks were forced to run down their bond holdings.1/ The process of loan expansion and bond liquidation proceeded even faster than it had in 1955-56; moreover it was accompanied by a further rise in outstanding lines of credit.

These developments were noted with concern in the 1958 report of the Bank of Canada (published in April 1959) and, as Governor Coyne reported in his recent speech, "were the subject of discussion at our meetings with the chartered banks in June 1959." In May 1959, with the economy definitely on the rebound and with their ratio of loans to Government bonds nearly reaching the high mark of mid-1956, the banks announced -- apparently on their own initiative -- that they intended "to exercise the utmost care in the handling of their credit facilities in order to avoid any significant increase in the overall total of bank loans."

In spite of this announced intention to restrain their further expansion, general bank loans rose at an even more rapid pace in June and July. Probably the banks really did make a more determined effort to be more selective lenders after the announcement, but failed to bring about any immediate leveling off in their loans because of the volume of firm commitments previously made.

1/ The banks' ability to run down Treasury bills instead of bonds was limited by an agreement with the Bank of Canada to hold "liquid assets," other than cash, at least equal to 7 per cent of total deposits. (For this purpose, Treasury bills constitute the lion's share of the banks' "liquid assets.") Since at the outset of their loan expansion the banks' average liquid assets ratio exceeded the minimum required ratio by only a small margin, they did not have much scope to reduce their bill holdings to meet the rising demand for loans.

The 91-day Treasury bill rate which had risen almost without pause since July 1958 leveled out in May and June at around 5.00 per cent in spite of the continued expansion of bank loans which forced the banks to continue to be net sellers of government securities on a large scale. In July, however, the 3-month bill rate began to rise very rapidly (in contrast to the roughly stable United States rate), and by mid-August it reached an all time high of 6.16 per cent. This placed the banks in a position where, apparently, they could earn a higher return on a liquid and absolutely safe government security than they could on a commercial loan since the maximum legal interest charge for loans in Canada is 6 per cent. Whether or not the rise in the bill rate above the bank's ceiling rate for loans had anything to do with it, bank loans finally did level out rather suddenly in mid-August. This peaking of bank loans came on the heels of a second announcement by the President of the Canadian Bankers Association; this time that "the chartered banks must curtail further expansion in their lending policies." The banks' loans remained stable until mid-September and then, in the period to mid-December, they fell by about 5 per cent before seasonal adjustment and by 1.8 per cent after seasonal adjustment.

While these changes in outstanding loans were taking place, the expansion in total loan authorizations on accounts with limits of $100,000 or more was finally brought to an end. As Table 1 shows, there was a large reduction in authorizations from June through September in contrast to the big expansion in such authorizations in the first two quarters of the year.

Governor Coyne has stated that most of the decline in bank loans from the August peak appears to have been in the large loan category. Moreover, in his recent speech the Governor noted that the banks expected that an increasing number of large loans would be funded on the bond market in the near future. Clearly, the Bank of Canada and the chartered banks as well have attempted to assure that a "fair share" of bank credit in the present upsurge goes -- as the Governor put it -- "to those borrowers . . . least able to find alternative sources of financing."

The sensitivity of the banking community to public opinion on this point is understandable. The charge that monetary stringency discriminates against the small borrower was one of the main political themes of the present Prime Minister when he was leader of the opposition in Parliament and when he was campaigning in the National Election of 1957 which brought him to power. The Prime Minister's attacks on the Bank of Canada's alleged prediliction for "tight money" ceased when he took office. But in the current phase of rapidly rising interest rates, he and the Finance Minister have taken pains to disassociate their Government from the policies pursued by the Bank. "The responsibility for monetary policy rests with the Bank of Canada," said Mr. Fleming, the Finance Minister, in a speech on October 8. "The fact is," Fleming said,

". . . the Minister of Finance has not the slightest control over /the/ money supply." Moreover, the Prime Minister in his last public statement on monetary affairs in a speech in October, made a veiled threat to the banks, when he said: "It is not the intention of the Federal Government to stand by and see small businessmen and farmers and home-builders and small borrowers denied, by reasons of arbitrary practices."

Table 1

Chartered Bank Business Loans

Date	$100,000 or more		Per cent of authorizations unused	Less than $100,000	
	Total amount authorized	Total amount outstanding		Total amount outstanding	Total outstanding business loans
1957					
Mar. 31	3,811	2,033	47	886	2,919
June 30	3,864	2,130	45	902	3,032
Sept. 30	4,046	2,169	46	889	3,058
Dec. 31	4,148	2,033	51	841	2,874
1958					
Mar. 31	4,226	1,991	53	862	2,853
June 30	4,321	1,964	55	914	2,878
Sept. 30	4,339	1,856	57	903	2,759
Dec. 31	4,457	1,821	59	912	2,733
1959					
Mar. 31	4,616	1,893	59	973	2,866
June 30	4,763	2,125	55	1,080	3,205
Sept. 30	4,523	2,255	50	1,034	3,289

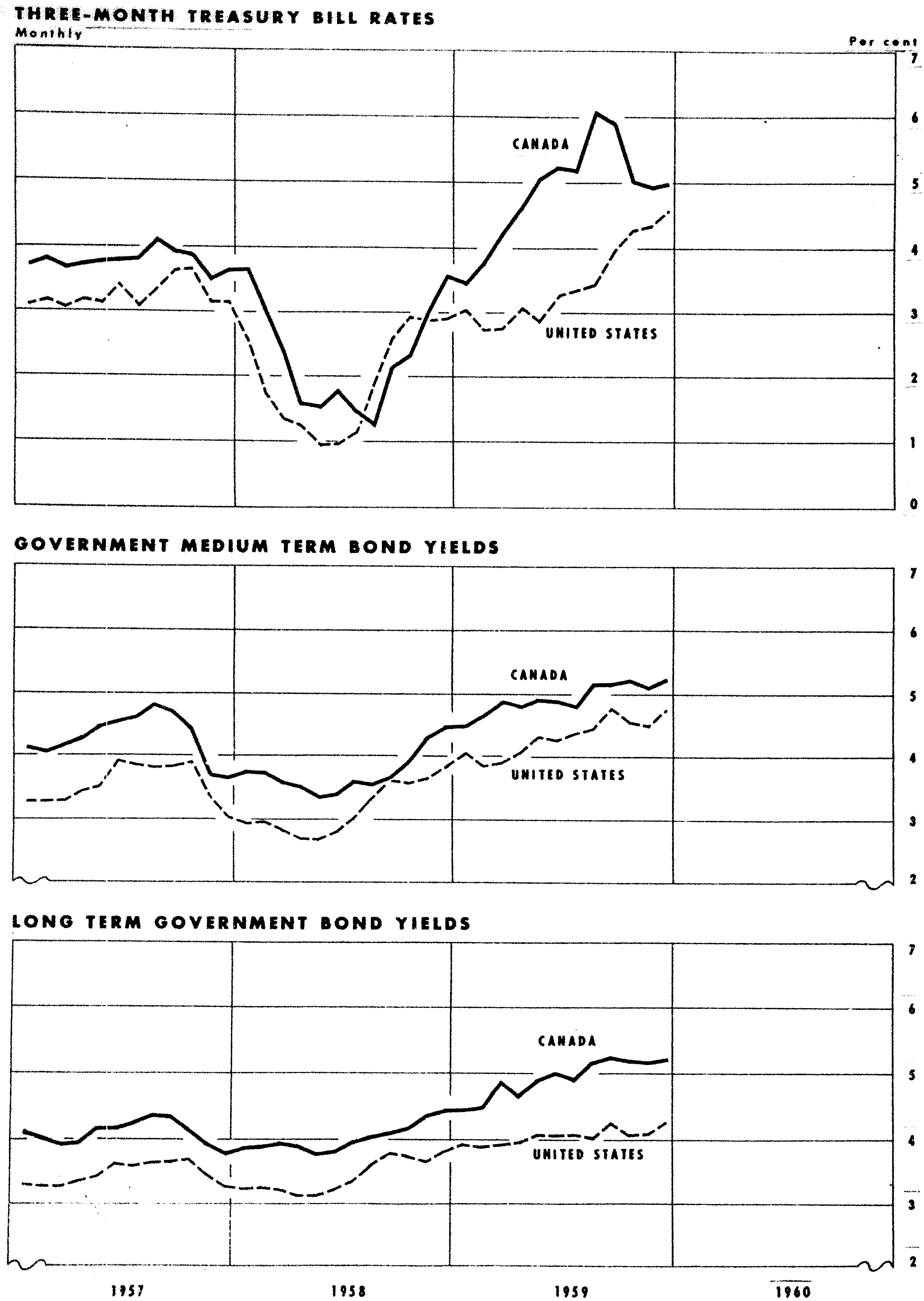
Source: Bank of Canada Statistical Summary, October 1959, page 428.

Government security yield in Canada

(a) Bill rates -- Yields on various maturities of Government of Canada securities, together with yields on comparable United States maturities, are shown in Chart I. The behavior of the 3-month Treasury bill rate in Canada up to the "crisis rate" of 6.16 per cent on August 13 has already been mentioned. In a period when the United States rate was stable or declining, the Canadian average auction rose week by week from 5.01 per cent on July 2 to 6.16 per cent on August 13. Part of this rise was probably due to an increase of $100 million in the total supply of outstanding bills in successive $20 million increments from July 16 to

CHART 1

INTEREST RATES IN CANADA AND UNITED STATES



August 13. Over these same 5 weeks, however, the Bank of Canada added $55 million to its total Treasury bill holdings, substantially reducing the market impact of this increase in the Treasury's total bill issue.

But the most important factor behind the rise in the Treasury bill rate appears to have been a miscalculation by the chartered banks on the extent to which the Bank of Canada would alleviate their tight reserve situation in this period. In the first 12 days of August, the banks' daily average ratio of cash to deposit on a statutory basis1/ was 7.9 per cent. To fulfill their reserve requirements the banks, by the end of the month, had to raise their daily average for the month to 8.0 per cent.

The banks could not, however, by their own actions raise their combined cash holdings to meet their required minimum average cash requirements for the month. Any sale of securities or runoff of Treasury bill holdings by one bank was bound to reduce the cash reserves of other banks by as much as it raised the reserves of the selling bank, so long as there were no net open market purchases by the Bank of Canada. But for the Bank of Canada to have provided the necessary reserves to the banks before they had demonstrated that they had effectively curtailed their loan expansion would have meant that it was allowing the chartered banks to determine the country's money supply -- at least in the short run. (In fact, the Bank of Canada did make the necessary open market purchases; but only after the general loans of the chartered banks dramatically leveled out in mid-August.)

Those banks whose average cash ratio early in August was running below the 8.0 per cent monthly requirement had to acquire cash through some combination of reducing loans, selling securities in the market and running off Treasury bills. In the short run, the latter was probably the most feasible method. In the week including the Treasury bill auction of August 7, when the auction rate for 91-day bills rose 26 basis points from 5.47 to 5.73 per cent, the banks reduced their net holdings of bills by $74 million, much the largest weekly reduction in their bill holdings

1/ The numerator of the required statutory cash ratio (8.0 per cent for the month as a whole) includes bank notes on hand and deposits at the Bank of Canada. The denominator includes all Canadian dollar deposits. The figures for bank notes on hand and Canadian dollar deposits are the average of these quantities on the last two Wednesdays of the previous month and the first two Wednesdays of the current month. The figure for deposits at the Bank of Canada is the daily average of deposits during the current month. Thus, after the second Wednesday of the current month, each bank knows exactly what its daily average deposit at the Bank of Canada must be in order to satisfy the legal requirement for the month.

in many months. At the next week's auction the average yield on 91-day bills climbed to 6.16 per cent. According to Neufeld, this was due to the banks' refusal to submit realistic bids in an effort to reduce their bill holdings to meet the monthly cash reserve requirement.

If some banks did, in effect, refrain from submitting realistic bids during this auction, their reduction of bills as a result was shortly balanced by purchases in the market. The banks' combined balance sheet for the Wednesday following the auction of August 13 shows that during the week they increased their bill holdings by $3 million (in contrast to a reduction in their holdings of $75 million the week before).

At the next auction, that of August 20, the Finance Minister intervened. He rejected some $31 million worth of bids, 23 per cent of the total original tender, as being "irrationally low." Bids for the remaining bills resulted in an average yield of 6.04 per cent. He also announced that the next week's offering of bills, including 6-month bills, was to be reduced to $95 million, $20 million less than the volume of maturing bills. During September and the first week in October, the Government held its new bill issues to $115 million a week, exactly equal to the volume of maturing bills.1/ The average auction rate for three-months bills on these truncated offerings dropped sharply to 5.33 per cent. Over the next three weeks, the average bid rate declined further, week by week, as the banks began to reduce their outstanding loans, -- which had finally stabilized in August -- and the whole tone of both the money market and the bond market became more relaxed.

(b) Long-term rates -- Long-term government yields in Canada, which generally move fairly closely with United States Government yields, began to rise in mid-1958. The Bank of Canada's extensive intervention during and after the conversion loan campaign halted this rise in rates in September of 1958. In November 1958, the Bank ended its support purchases and yields on Government of Canada long-term bonds rose rapidly to regain their earlier margin of from 1 to 1-1/4 per cent above yields on United States long-term bonds. Throughout 1959, yields continued to

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1/ The Government's cash balance at the Bank of Canada and the chartered banks amounted to $441 million on August 19, the day before the Finance Minister cut back the volume of the bill issue. At this level, its cash balances were $3 million greater than the average balances in mid-August for the three years previous and $21 million greater than the average balances during the previous three months.

During September and October, its cash balances declined sharply, reaching a low of $20 million the first week in November. But immediately thereafter, public subscriptions for the 1959-1960 savings bond drive began pouring in and by the end of November the Government's cash balances had risen to $664 million.

rise, climbing well above the earlier highs reached in late 1957. During June and July, a plateau appeared to have been reached; following the surge upward in the Canadian bill rate in July and a renewed increase in United States yields, however, Canadian long-term rates started to rise again in August. They continued to rise through September, in spite of a turndown in United States rates and in the short end of the market in Canada. In October the market's expectations improved markedly influenced by a strengthening belief that the Government's efforts to contain credit expansion were showing some results. Yields slipped 13 to 47 basis points below their late September highs and numerous provincial, municipal, and corporate issues, which hitherto had faced a generally unreceptive market, were successfully floated.

Financing the Government's deficit after the Conversion Loan

The Conversion loan in the autumn of 1958, the tax increases in the April 1959 budget, and the successful sale of $547 million of Canadian savings bonds (net of cash-ins) to the general public in November 1958 all materially eased the debt-management problem in Canada during 1959. Nevertheless, there still remained a considerable quantity of maturing issues to be refinanced and market conditions for new issues were almost continuously unfavorable. As already pointed out, the Bank of Canada had taken a firm stand against further additions to the money supply at a time when the chartered banks were confronted with a surging demand for loans. This meant that the Government's new issues had to compete for investor's funds against continuous sales of outstanding bonds from the chartered banks to the nonbank sector.

The Canadian Government was not prevented by any interest rate ceiling on new issues from successfully selling long-term bonds, but the condition of the market and its earlier massive funding operation made sales of shorter issues more feasible. Exceptions to this policy were two rather widely spaced Government guaranteed Canadian National Railway issues, (an issue of $150 million in 9- and 18-year bonds in May and an issue of $100 million 25-year bonds in December). Total short-term marketable issues from mid-September 1958 (after the Conversion loan) to the end of 1959 amounted to $650 million. These issues had maturities ranging from 9 months to 5 years. In addition during this period, outstanding issues of 3-month and 6-month Treasury bills were increased by $602 million. It should be noted, however, that a sizable chunk of these marketable short-term issues ($485 million) gave holders the right to convert into longer term noncallable issues with very attractive yields, at least compared to any earlier postwar levels.1/

1/ These short-term issues included a 5-year Canadian National Railway issue totaling $200 million, giving investors the right to convert any time within 4-1/2 years into a noncallable 12-year issue with a slightly lower annual yield. It also included $285 million in 1- and 3-year issues giving investors the right to convert into 16-year noncallable issues at a slightly lower annual yield.

This kind of option provides a near perfect hedge. The short maturity enables investors to take advantage of any further rise in long rates and the conversion option enables them to "scoop" the rest of the market if long rates fall.

Conclusion

The picture painted by the article in the London *Economist*, cited above, of a strong and continuing feud between the Governor of the Bank of Canada and "the Government" does not appear to be supported by the facts. When the Conservative Government came into office its leading members probably were unanimous in the belief that "Coyne must go." But whatever the initial policy frictions between the Governor and the Minister of Finance, they seem to have largely disappeared during the past year. The Governor has publicly applauded the fiscal determination of the Government to right its budget in periods of rising economic activity; while the Government, for its part, has not forced Mr. Coyne to abandon his policy of refusing to permit any further increase in the money supply following the very large increase in 1958.

Neufeld's second criticism that the Treasury bill crisis in August had a harmful effect and could have been avoided also seems questionable. Why, he asks, did the Bank of Canada "put the banks under such pressure in early August, since it had to (and did) provide the cash later in the month if it did not wish to see the banks end the month below their legal cash ratio"? This seems a somewhat misleading way to describe the situation. The initiative for the rundown of the banks' cash reserves during the first two weeks in August came from the banks themselves, through their continued loan expansion. Given the central bank's policy, which was perfectly clear to them, they placed themselves under pressure. True, the Bank of Canada did bail the banks out later in the month by conducting its open market operations so that they ended the month with a cash ratio that met the legal requirement. But it did this only after the banks had finally ended their loan expansion. If they had continued to expand their loans, the Bank of Canada might well have forced them to borrow from it at a penalty rate in order to meet their legal requirements.1/

1/ The legal penalty to which a bank is subject if it does not meet its cash requirements for the month is not specified in the Canadian Bank Act. No bank has yet violated the requirement as far as I know; presumably a bank would always prefer to borrow from the Bank of Canada at the penalty discount rate rather than fail to meet the Bank Act's requirement. A bank could also borrow the needed funds abroad.

Allowing a bill rate "crisis" to occur may have been the only way for the Bank of Canada to convince the banks that its resolve to prevent an expansion in the money supply was inflexible. The banks may well have felt that they would be rescued by the Minister of Finance who, clearly embarrassed by the sharp rise in the bill rate, would press the Bank to purchase bills on a scale sufficient to hold down the rate's rise. If so, their efforts were unsuccessful.

Looking back, it seems clear that the Canadian bill market in July and August was gripped by a wave of unrealistic speculation. Some sort of shock treatment was appropriate and the treatment administered -- the rejection of a portion of the total bill tender previously scheduled for acceptance and the announcement that the tender for the following week's auction would be reduced -- succeeded in reversing the unfounded expectations of a continued bill rise in the short run. Once investors became aware that the banks' lending expansion had finally ended, they were able to make a more realistic appraisal of fundamental market conditions, and rates fell to levels appropriate to demand and supply conditions.