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WHAT MAKES CANADA TICK?

An address by Mr. Donald Gordon, Deputy Governor, Bank of Canada, in Montreal, February 17, 1949, at the annual dinner of the Junior Investment Dealers' Association of Canada.

When your Secretary extended to me last November an invitation to attend the Annual dinner of the Junior Investment Dealers' Association of Canada I made some enquiries as to what the group represented because, I must confess, I had not at that time heard of its existence. I then discovered that your Association had been formed in January of 1948 and that this is, in effect, your first Annual dinner. That, of course, was sufficient reason for me to accept your kind invitation. For the truth of it is that I like innovations and the ploughing of new furrows, which probably explains why most of my adult business experience has been gained in organizations which were new at the time I became associated with them. So it is that I am glad to be with you on this your first Annual Meeting and to congratulate you on the young, healthy and, may I say, confident spirit expressed in your Secretary's letter of invitation to me in which he solemnly assured me that - and I quote - 'this group represents the future of the Investment business in Montreal'.

You will readily understand why with that confident prediction before me I have been obliged to prepare my remarks with more than usual care.

And I may as well say that I intend to touch upon one or two things which involve questions of the future rather than of the past or the present. In doing so, however, I would like to make first a short review of a more general character so that we may have before us some of the highlights of the Canadian economy, if not, indeed, the highlights of the economic system as it operates in the modern democratic state. I shall not attempt to do more than mention the main factors which affect the level of economic activity nor shall I attempt to propound economic problems and then venture solutions for them. My purpose is merely to direct the thoughts of this group of young men to the workings of the system and leave it to individuals how far each may wish to pursue particular points.

The principal subject with which I propose to deal this evening is the level of economic activity in this country and what determines it: in other words, what makes Canada tick. Now, this is obviously a broad and intricate subject and all that I can hope to do is to give you some impression of those factors which I believe to be of key importance and which I believe you will find it worthwhile to watch.

The immediate reason behind any type of economic activity is obviously, demand for the final product and I shall trace the sources of demand for some of the more important groups of things which we produce in this country. This done, it is appropriate to examine the financing of this demand and to study its variability and effect on total employment.

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The kind of things that we produce - the things that create employment - can be classified conveniently as follows:

- Consumer goods is the most important and accounts for about half of our total national output. (By 'national output' I mean our own Canadian production plus imported goods in raw or finished form.)

- Exports are next in importance and constitute about 20% of our national output with some variation reflecting the uncertainties of the world market.

- Investment goods, such as plant, equipment, housing and inventories, account for 15 - 20% of our national output, which incidentally is considerably more than it was immediately before the war and is a highly variable figure.

- Government services absorb about 10% of our national output and while this is the smallest portion they are of particular interest in the control of fluctuations in business activity.

Each of these classifications deserves examination in some detail, but first it is useful to ask: Why are these goods and services produced? Where does the demand come from? How assured and steady is the demand and consequent employment?

The sort of demand which most readily comes to mind is personal demand for those things, consumer goods, on which people choose to spend their incomes - incomes, that is, after the government has had its slice of income and other direct taxes. In 1947 the picture looked something like this:

	$ millions	%
Personal Income (salaries, interest, etc.) after deducting direct taxes of $786 millions left total disposal income of	9,493	100.0
Spent on Consumer Goods	8,888	93
Saved	605	7

The proportion of their incomes which people spend varies a good deal from time to time and has varied a great deal in recent years. During the war when consumer goods were scarce and when the patriotic pressure to save was at its height, consumers saved almost one-quarter of what they had left after paying income and other direct taxes. Since then the supply of consumer goods has increased notably, the cost of living has grown and consumers have now reverted to their pre-war habits of saving around 7% of their incomes after taxes.

The demand for investment goods comes primarily from business requiring additional plant, machinery and inventory with which to turn out finished goods. The sources from which this is financed are of particular interest. It is believed that now about two-thirds of the funds required for corporate investment come from within the corporation group itself out of sums set aside for depreciation reserves and undistributed profits. It often happens that both the saving and the investing occur within the same corporation and this goes far to explain why the new-issue market though active has not reflected the full measure of the investment boom in recent years. The balance of the savings required comes from persons either directly or through insurance companies or other savings institutions, but it is interesting to note that personal savings in 1947 totalled only about $605 mm. compared with corporation savings of $1,536 mm.

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If the mobilization of savings tends towards accumulation in corporations which have no immediate need for cash in their own businesses or through life insurance companies and similar institutions, the investment of such savings is likely to take the form of purchases of bonds rather than of equity financing. This, of course, may mean that the financing of new enterprises and those not having within themselves substantial savings power will be more difficult and, conversely, it would encourage the expansion of established and profitable companies.

At this point I should like to impose upon you a brief digression of a somewhat theoretical character but which is of central importance in understanding the role of investment and its effect on the level of employment. I have mentioned that investment is financed through savings drawn from a variety of sources. What happens is that consumers and businesses choose not to consume (i.e. choose to save) a part of their income. These savings are spent on investment goods by the businesses to whom consumers and business savers have transferred their savings. So long as business invests in capital goods on a scale equal to the amount of savings which people endeavour to make under conditions of full employment, prices and incomes (and employment) will tend to remain stable. If business endeavours to make investment expenditures in excess of the amount of saving that is being done, at a time of under-employment of labour and productive facilities, the effect will be beneficial, for the excessive investment demand will call into employment the available additional resources. But if the tendency towards greater investment expenditure develops at a time of full employment of labour and plant, then the effect cannot be to create additional employment or to produce more goods and services, -- it will merely force higher prices for the existing supply of goods and services. Conversely, if at any time business endeavours to make investment expenditures on a scale less than the amount of saving which would normally be done at the existing level of employment and income, there will be a deficiency of total purchasing power, goods will accumulate unsold, production will be reduced, and a typical depression, accompanied by falling prices and unemployment, will result.

But to return to my outline of various types of demand for our national product - Export demand, as I mentioned at the outset, absorbs about 20% of our output and looked at transaction by transaction is financed in a great variety of ways. At the moment some of our customers are assisted by funds provided through the European Recovery Program; from time to time we have assisted our overseas customers by loans, grants and export credits. These and other factors tend to complicate a picture which is fundamentally that in the long run our exports are financed by our imports. We buy from foreigners and foreigners use the proceeds of their sales to us to buy from us.

Next on my list is Government demand, and that, of course, is determined by what responsibilities the public feels the government should undertake. The financing of government demand, as we all have good reason to know, comes out of taxes or savings mobilized through the sale of securities. In using the expression 'Government demand' I am, of course, referring to all forms of Government - Federal, Provincial, Municipal, etc.

I would like to turn now to some remarks on the character and effects of the demand for each classification of goods and services into which I have grouped demands upon our national output.

The demand for consumer goods is subject to fluctuations, not only those fluctuations which I have mentioned which occur in times of war as a result of the absence of consumer commodities, but also those which develop from time to time in peace. The per capita consumption of consumer goods in quantity terms declined perhaps 25% between 1929 and 1933 and is now possibly 80% above the depression low point. This looks like a violent swing and one might be justified in assuming that fluctuations of this magnitude must have a

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corresponding effect upon the general level of prosperity and as well the rate of unemployment and living standards of the Canadian people. To form a judgment about that, however, we must also have before us the fact that wide as have been the fluctuations in the rate of domestic per capita consumer spending, even more violent swings are seen in the other demand classifications. The volume of exports has doubled since 1933 and capital investment, other than for inventories, is running at seven times its depression low. Consequently, the really significant thing about the rate of domestic consumption, particularly in times of scarcity, is that it is the residual demand. When export demand is booming and the country is in a state of full employment, then unless domestic consumption is content to adjust itself to take what is left, an inflationary rise in prices will follow. Much will depend upon the actual state of scarcity, or otherwise, of essential supplies. If there is a current scarcity of goods and services which domestic consumers regard as essential they will, in the absence of emergency governmental controls, bid up prices until labour and materials are attracted away from the export demand. On the other hand, if scarcities tend to be in things which can be done without, it is possible that domestic consumers will prefer to do without until prices look more reasonable. We have had an interesting example of this kind of psychology in the post-war years. During the war the production of many consumer goods, including semi-essentials and many conveniences, was prohibited or restricted, so that there was, of course, a large backlog of deferred consumer demand at the close of the war. Accordingly, wartime controls were lifted gradually and with an eye to the heavy competing demands for export and to some extent for domestic investment. This course of action, coupled with remarkable patience and restraint on the part of the consuming public, enabled the war-accumulated backlog of demand to be liquidated gradually without the wild upsurge in prices that the extreme and competing demands might well have brought about. While we cannot yet say that all deferred demand has been met, the post-war increase in retail sales seems to be levelling out. In due course the important thing will be whether domestic consumer demand can absorb all of the labour and resources which will be available if our current investment boom tapers off or if exports are affected by the war-created foreign exchange difficulties of so many of our traditional customers. And this takes me to my next point.

<u>Exports</u>, as I said before, constitute about one-fifth of our national output and here we have a wide and complex field with so many external and internal ramifications that it is difficult to make very useful generalizations. The question breaks generally into two parts. First, that which is termed our over-all balance of payments is the net result of our trade with the whole world. If we have an over-all surplus in our trade with the world we accumulate foreign currencies, gold or other foreign assets and thus build up our foreign exchange reserves or are able to amortize our foreign debts. If, on the other hand, we run a deficit in our trade with the world it must be paid for out of foreign exchange reserves. A trend in this direction must be watched because a continuing drain on reserves will in due course require corrective and protective action. And, of course, we must also take notice of the fact that the state of demand in foreign markets has an influence on our domestic price level.

What I have said so far deals with the generalization affecting what I have called the over-all balance of payments - that is, the net result of our trade with the world. But within that concept yet another disequilibrium can and does arise, and this particularly in the case of Canada at the present time. It is this - We may be in an over-all surplus trading position with the whole of the world and yet be in a deficit position with some parts of it. In pre-war days this did not bother us. Generally speaking, our position was that we earned a surplus of sterling and other currencies which we sold in the New York market for the U.S. dollars which in turn we used to meet our deficit in that currency arising out of the fact that we sold less to the United States than they sold to us. But when the United Kingdom, for example, because of wartime dislocations, is unable to export enough goods and services to the dollar area to earn the dollars to pay for all the imports from the dollar area

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she would like to obtain, then the United Kingdom Government had to decide either to dip into its reserves of gold and U.S. dollars or cease to take imports from the dollar area beyond what she could afford out of export earnings. The effect of this on Canada has been that the British have refrained from buying from us all the goods that we would like to sell them, and further that we have provided some of our exports to the sterling area on credit, with the result that we did not obtain the amount of U.S. funds that we needed to pay for all the goods that Canadians wanted to import from the United States. That is, of course, the genesis of our so-called dollar problem, which has forced us into a temporary programme of import restrictions and other dollar saving measures. Much could be said about the nature of the wartime dislocations in many countries of the world, the slow rate of post-war rehabilitation and so on, which has broken down multi-lateral trade and what is loosely termed the convertibility of currencies, but that is too ambitious an effort for me to attempt at this time. Moreover, many authoritative statements have been made about it by the Minister of Finance and others and these need no amplification from me.

Canada is one of the leading export countries of the world, so that it has more than a passing interest in the efforts being made to restore a war-torn and war-shattered world economy. That is why we have as a country made such a heavy investment in relief, grants, loans and other forms of assistance to those countries which are striving to repair the damage of war. It explains also why Canada has taken a very prominent part in the formation of international organizations designed to promote a high level of international trade and as well work towards lifting from the world the recurring curse of war.

Turning now to investment demand, the third largest market for our output, you will recall my earlier comment that investment for other than inventory purposes in 1948 was about seven times the 1933 volume. You will also remember that my digression on savings and investment indicated how precarious a job it is to achieve just the right level of investment - not too much - not too little. Much thought and planning has been given in all countries to influencing the level of investment in the right direction as a matter of public policy. Methods of so doing vary considerably in different countries but, under normal conditions in Canada, no direct control of capital investment by Government has been attempted apart from the influence of taxation techniques or other Budgetary influences which I shall touch upon in a moment. During the war years and in the post war emergency years there have been varying forms of direct controls affecting construction of plant and machinery. And on the financial side it will be remembered that in February 1948 the Bank of Canada took occasion to suggest to the chartered banks that under the then prevailing conditions it was undesirable for capital expenditures to be financed through expansion of bank credit. But these were special circumstances and, as I have said, under normal conditions the Canadian investment market responds to the psychology of the moment and as it is influenced by the financial and monetary policy of the Government.

One important feature of the market is the limited availability of risk capital in Canadian securities markets, which means that a great deal of the venture money going into the development of our natural resources still comes from sources outside Canada, principally the United States. The volume of such investment is evidenced by the fact that our interest and dividend payments to United States investors is running at an annual rate of some $275 million. (Remember, I am not stating these points in criticism, nor am I trying to persuade you towards any line of policy. I am merely pointing out some obvious aspects of our money market which you, as a group of young men who have chosen a career in the investment field, are bound to realize and may in due course be instrumental in changing.) It is true also that our organized investment market provides little or no help either to the establishing of new small business or to small businesses in need of capital to expand. To a limited extent this gap is now being lessened by the Industrial Development Bank.

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Recently, too, I have become impressed and interested in what appears to be the rather restricted financing facilities in Canada for large scale financing in the field of residential construction. While the question is not one in regard to which it could be said the investment industry has a primary responsibility, nevertheless it is a problem of interest to anyone in financial circles and I mention it here solely because it is another factual aspect of our money market.

Under the provisions of the Canadian Bank Act mortgage financing is not permitted, so that apart from some small working capital advances to professional builders our banking system does not appear in this field. Currently this country's housebuilding programme is at the rate of some 80,000 units per annum with a total cost of about $600,000,000. The bulk of this very large financing comes in the form of loans from private persons and from lending institutions such as life insurance companies, loan and trust companies, credit unions, pension funds and similar institutions. The residential construction industry appears to be in the process of a major change in method, because for a variety of reasons the housebuilding programme of this country is likely to require financing for projects of fifty to a hundred houses in one operation rather than in units of one, two or three as in the past. This means, of course, that there is a demand for mortgage and construction moneys in large blocks and money which formerly could be made available from individuals, estates, etc., for one or two mortgages, now needs to be mobilized so that it can form a large enough fund to meet the greatly expanded projects. Indeed, the Central Mortgage and Housing Corporation established by the Federal Government in 1946 was in part in recognition of this gap in capital investment field.

Before leaving this particular reference to Canada's housebuilding programme it may also be of interest to call attention to one more important factor. It is the fact that in most Canadian municipalities there is a definite shortage of serviced land available for residential building. By serviced land I mean land suitable for residential housing equipped with necessary services such as water, sewers, roads, sidewalks and ultimately schools and hospitals, as well as the primary services such as pumping stations, sewage disposal, incinerator, etc. The provision of such facilities is bound to be a very expensive affair and must indicate that substantial borrowing operations by municipalities are likely to be seen in the market as efforts are made to remedy the shortages.

I come now to the last major source of demand for our national output. That is, of course, the Government - and again I remind you that I refer to Federal, Provincial and local governments collectively. In 1948 Government purchases of all kinds represented about 11% of our national production; at the peak of the war it called for 40%. In fact, I think it can be said that in the modern state the extent of Government purchases of goods and services <u>and</u> the method which Government selects to raise the money needed to pay for them has a profound effect upon the level of economic activity. It is for that reason that the budget presented by the Minister of Finance of any modern democratic state and the explanations which go with it represent the most important and significant policy document placed before the public. Here one may discover the philosophy and policies of Government and may gauge the impact of such policies upon the general level of employment, income and investment - an influence which is felt in every form of activity throughout the whole country. On the financial side, the absolute level of taxes and borrowing decided upon by Government to finance its needs has a significant effect upon the general level of economic activity. But, in addition to the absolute level of taxes, the kind of taxes, that is direct or indirect, business or personal income taxes, have a direct influence upon production, depending upon whether they tend to stimulate incentive or discourage it. Other results also follow - it may be that heavy corporate profits tax will discourage equity financing in favour of

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bond issues, that tax concessions such as 'double depreciation' will stimulate expansion, and so on. There is infinite variety to the conclusions which may be drawn from a detailed examination of the Budget and the financing methods announced with it. The correct interpretation of a Government Budget is a tricky affair and one needs to be on guard not to fall into obvious errors in dealing with such things as the difference between a surplus or deficit on budgetary accounts and an over-all cash surplus or deficit. And, as well, in recent years budget policy has often been declared to be deliberately aimed at reducing the swings of the business cycle so that Government taxation and expenditure policy tends to run against current trends. To sum up, however, I repeat that an analysis of budgetary material and figures needs to be done very carefully if one is to avoid incorrect conclusions.

My last point is that the size of government borrowings will largely determine the methods used and the sources from which the funds must be obtained. Before the war, Canadian Government borrowing was on what now appears to be a small scale; there were few non-institutional lenders, and the type of loan operation resembled that of any large corporation bond issue. During the war, there was necessarily an enormous increase in the magnitude of loan operations, and we all became more aware of the far-reaching effects of Government borrowing, and of fiscal policy in general, in determining the course and nature of economic events. New methods had to be developed, suited to the conditions of the time. I do not intend to describe the work of the National War Finance Committee, as the story of their operations is conveniently brought together and summarized in a publication entitled, 'Statistics and Information on Dominion Government borrowing operations from September 1939 to December 1945', which I commend to your attention. I should, however, mention one post-war development which grew directly out of the wartime operations, namely, the creation of the Canada Savings Bond. It was during the war that Government borrowing for the first time reached out to practically all income earners. Hundreds of thousands of people who had never before purchased Government bonds or other securities became accustomed to methods of systematic saving through the payroll savings plan and instalment purchase systems, coupled with the provision of small savings instruments backed by the Dominion Government and readily cashable in case of need. It was in order to continue to provide similar facilities after the end of the war that the Canada Savings Bond was developed. During the three years it has been on sale, including the special campaigns in the autumn of each year, there have been a total of three million individual sales, amounting to $1,063 million, including 1,745,000 sales to persons who made purchases of $341 million on the payroll savings plan.

With the return of peace-time conditions, extensive shifts in holdings of wartime purchased Government bonds between different classes of investors was to be expected. As consumer goods, homes, etc., became available, individuals, as a group, tended to reduce their holdings. Life insurance companies wished to switch some of their holdings into other classes of securities for increased yield and diversification reasons as such offerings became available under long-delayed capital investment plans of industry, provincial and municipal governments. In many cases reserves created by industry for this purpose and invested temporarily in Victory Bonds were spent and the bonds sold. On the other hand, pension funds, various types of other trust funds and government accounts, such as the Unemployment Insurance Commission Fund, continued to be buyers of the highest grade securities. The banks also at times were buyers. In other words, the first few years after the war were naturally ones of adjustment in debt ownership as well as in other fields. While the Government has not found it necessary to go to the market in a major way either for cash or for refunding purposes during this adjustment period, the time is drawing near when such major refunding will have to be undertaken. The First Victory Loan 3% bonds are callable a year from next June, with final maturity date in June 1951. From then on the job to be done will grow. What methods or techniques will be used in these coming large scale pieces of financing are not yet announced but in light of the size of the operations as compared with pre-war there will be plenty of room for initiative and imagination in determining the

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best course of procedure. Indeed, this field of activity will be one in which many of this group should be active participants and it constitutes another one of the questions for the future which I leave with you.

Now, Mr. Chairman and gentlemen, that completes the review and catalogue of points I desire to place before you. As I suggested at the beginning of my address, my purpose is to provoke some serious thinking by this group, in the knowledge that I speak to many young men who will one day dominate the policies and administration of the investment industry of this country. I hope that through the years we may find similar occasions to discuss the current problems of our economy and I trust that my remarks on this occasion may have served a useful purpose.