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EXPANSION WITHOUT INFLATION

Excerpts from a speech by Mr. Donald M. Fleming, Minister of Finance, to the Empire Club of Canada, at the Royal York Hotel, Toronto, on Thursday, October 8, 1959

.... I have had the good fortune over the past several weeks to attend international financial gatherings of the highest importance, first the meeting of the Commonwealth Economic Consultative Council in London, and then the Annual Meetings of the Governors of the International Bank and the International Monetary Fund at Washington. These meetings have offered opportunities not only for general discussion, but for direct talks with some of the leading banking, financial and monetary authorities in the world. I return to Canada with convictions fortified by the best opinions available in the leading countries abroad. No one could participate in these valuable discussions without being profoundly impressed by the enormous recovery in Europe and the formidable contribution which hard work, self-discipline and financial statesmanship have made to the restoration of Europe's currencies to soundness and strength. The economic outlook of the Western World has improved enormously in the past two years, particularly in the industrial countries. The expansion has already gone a long distance, but the possibilities of further economic growth in the present phase are not exhausted in the world, any more than they are here in Canada.

Economic Review

During the past three years Canada has passed through a fairly complete business cycle. The period has presented almost every variety of economic and fiscal problem. It has in a sense been an economic microcosm. It has required on the part of the Government a flexible and adaptable approach to changing conditions. This is the note that I sought to sound in my Budget Speech on April 9.

The upswing which followed the recession of 1954 reached its peak in late 1956 and early 1957. Early in 1957 the economic trend was reversed and the North American Continent moved into a relatively short, but difficult, period of recession, which continued until the summer of 1958. During the next year we moved along the road to recovery, slowly at first, but since last spring with rapidly increasing momentum. The period of recovery from the recession is now past, and Canada has entered upon a period of rapid economic expansion. All signs point toward a continuation of this expansion and growth. The scale of expansion has been so great as to create financial strains, now reflected in problems of credit.

The problem which confronts us at the moment is, how may we sustain expansion without inflation? This is the question which Canadians ask, and are entitled to ask. All realize that it is not possible to ensure a completely even and unbroken course of growth. Most people recognize that in a period of such rapid economic expansion the dangers of inflation can become more threatening. It is a time for calm appraisal, careful study and analysis, constant vigilance and courage.

Let me review the steps which the Government has taken to meet the rapidly changing economic problems which have confronted Canada. We took prompt action in the summer of 1957 by such means as were within our power to offset the decline in business activity. We gave strong support to new housing construction; we increased substantially our own direct expenditures on capital projects; we reduced our own resources to increase those of the provinces and municipalities; we sustained and enlarged the general purchasing power of the Canadian public both by tax reductions and increases in pensions and other welfare payments. As the result of these and other governmental measures in the fiscal field, both the depth and the length of the recession in Canada were greatly reduced. Inevitably we incurred in the fiscal year 1958-59 a large deficit, -- not so large, however, as any of the estimates and prophecies concerning it.

By the summer of 1958 the recession had passed its low point, and the tide turned. Recovery by degrees gathered steady momentum. By the spring of 1959 the Government again adapted its fiscal policy to meet these rapidly improving conditions. It was not yet a time for a severe application of fiscal restraint, but the situation did require a reduction in the stimulus which Government fiscal policies had injected into the economic stream. We took a firm course designed to combat the perils of inflation and to preserve the purchasing power of the Canadian dollar without retarding the forces of recovery. Accordingly we raised taxes moderately and curtailed the expansion in Government expenditure. We announced a fiscal programme which would cut the cash deficit of the preceding year almost in half and would come close to producing a balanced budget as the economy regained a normal high level of employment and incomes. As I said in my Budget Speech on April 9; "There are times when a substantial deficit is clearly the right policy; there are times when the Budget should be in balance; and there are times when some provision should be made for the orderly retirement of debt." If, as all the current signs indicate, we continue to progress rapidly toward a high level of employment and income, and as capital expansion in the private sector resumes its accustomed rate of growth, we look forward to the time when the Government will cease to be a net borrower. This is a matter of deliberate aim on the part of the Government, and its achievement should materially assist the provinces, municipalities and business in meeting their borrowing problems.

I based the Budget on an estimate that our Gross National Product in 1959 would be approximately seven per cent higher than in 1958. This estimate was greeted by many with some surprise, indeed, in a few quarters, with derision. It is now evident that some of those who are responsible for directing business policies were not prepared for such a rate of growth and seriously under-estimated the demands that would be placed upon them. Indeed, it now seems clear that our 1959 GNP will exceed the estimate I made six months ago.

This growth, and the fact that it was under-estimated by not a few persons in positions of responsibility in business, have produced some stresses and strains, particularly in the demand for and the supply of credit. On January 5th of this year, speaking in this building, I expressed the hope that recovery in 1959 instead of taking the form of a sudden boom would proceed at a steady and sure pace, and thus assist the Government to curb inflationary forces in the economy. A major expansion, however, has set in with all its attendant financial strains.

Money, Credit and Interest

In some respects money and credit are like any commodity: their price responds quickly to major changes in supply and demand. The price of credit is the level of interest rates. When the supply of credit is ample or the demand is slack interest rates fall; and when this situation is reversed interest rates rise. But interest rates also reflect the quality as well as the quantity of supply and demand. If lenders or investors develop doubts about the wearing or the lasting quality of the securities they are offered they will be reluctant to buy except at a lower price, that is to say, at higher rates of interest.

It is in this respect that money and credit are so very different from commodities, in that any excessive increase in the supply is almost certain to deteriorate the quality. We have all learned in recent decades that a persistent increase in the supply of money beyond that amount necessary to finance the growth in population and production leads to inflation -- to a rise in the general level of prices, to a fall in the value of money and to a decline in the real value of securities which represent a future claim on money.

That is why, in spite of their apparent complexities, sound monetary and fiscal policies are so important to the average citizen. That is why any responsible government must do all that is within its power to defend the value of its currency, and prevent the erosion of the past and future savings of the ordinary citizen.

This leads me to review what has actually been happening in the field of money, credit and banking during the past year.

The supply of money consists of the currency in circulation plus the total volume of bank deposits on which the depositors can draw cheques. The demand for money is most readily represented by the total amount of bank loans outstanding at any time. When business is slack the demand for money also slackens since business firms do not need to carry as large inventories of raw materials, goods in process or finished products, nor do they have as large payrolls to meet each week. As business improves more money, or working capital, is needed to finance increased supplies of materials and goods, to pay weekly wages to more employees, and to buy or build additional machinery and equipment. The business man normally obtains this money, or working capital, by borrowing from his bank.

At the peak of the 1956-57 upswing the total of all business loans by the banks amounted to about $4,300 million; at the low point of the recession they were about $4,000 million, or a decline of about 8 per cent. By March of this year the volume of general business loans had again risen to the 1957 peak of $4,300 million, and continued to rise rapidly until it crossed the $5,000 million mark in July. During the past ten weeks the volume of general business loans has levelled out at a figure slightly over $5,000 million. In other words, business loans have increased by more than 25 per cent from the low point of the recession only a little over a year ago, and are now 17 per cent above the previous high record in 1957. It is thus clear that any apparent shortage of credit today is due to the extraordinary intensity of demand for commercial loans arising out of Canada's rapid economic expansion.

Let us now consider the extent to which the Bank of Canada, the chartered banks and the Government in their respective spheres may control or influence the available supply of loanable funds and their effective use. Some of the responsibilities and powers of these institutions have been defined by Parliament; others are of a more general nature.

By Act of Parliament passed in 1934, and confirmed on the several occasions since then when the Act has been before Parliament for amendment, the Bank of Canada has been given the duty "to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit, and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action." To this end the Bank of Canada has the sole right of issuing paper currency; it has the power to buy and sell broad classes of securities, to make short term loans to the chartered banks, and otherwise to establish and give effect to the appropriate monetary policy from time to time. Under this Act of Parliament the government of the day has no power or authority whatsoever to direct how the Bank of Canada shall act in these matters.

Let me emphasize that the Government of Canada has no power or control whatsoever over money supply. It cannot increase it, vary it or decrease it. I sometimes receive letters asking me why I turn the money supply on and off like a tap. The fact is that the Minister of Finance has not the slightest control over money supply.

While the Bank of Canada has a broad control over the money supply, it is the chartered banks that decide through their day to day actions how that supply of money is allocated. The overall limit of bank credit is controlled by the statutory requirement that each bank shall maintain a minimum cash reserve equal to 8 per cent of its deposit liabilities, and by an understanding between the banks and the Bank of Canada that each of the chartered banks will maintain in addition a minimum secondary reserve of highly liquid assets (i.e. day loans and Treasury Bills) equal to a further 7 per cent of its deposit liabilities. But beyond that it is for each bank to decide for itself, having regard to prudent banking practice, what proportion of its resources is put into loans, how much is invested in federal, provincial, municipal or corporate securities, or what amounts should be committed to insured mortgages under the National Housing Act. In the allocation of these resources neither the government nor the Bank of Canada has any authority to direct how the chartered banks shall act.

<u>Money Supply</u>

While the Government has no direct control over money supply and the volume of credit, nevertheless its fiscal and debt management policies unquestionably affect the total credit situation. During the period of the recession the large federal deficit that was deliberately engendered was matched by an increase in the money supply by the Bank of Canada to a degree which the Bank believed to be appropriate to the circumstances. As conditions changed from recession to recovery to expansion, the Government adapted its fiscal policy by moving in the direction of a balanced budget. Concurrently, the Bank of Canada having regard to these changed conditions, and being particularly concerned with the inflation psychosis that appeared to be spreading into Canada from the United States, took steps to stabilize the money supply.

Early in 1957 the total of currency and bank deposits in Canada was about $11.4 billion. Beginning in the summer of 1957 the Bank took steps to expand the money supply progressively to $12.3 billion in the early summer of 1958 and to $13.2 billion later in the year. In his annual report for 1958 the Governor of the Bank stated that the special circumstances of the summer of 1958 led to a somewhat greater increase in money supply than was fully warranted by strictly economic conditions, and since the first of this year the operations of the Bank of Canada have been designed to keep the money supply at a stable level.

While the total money supply has remained relatively stable over the past twelve months, except for seasonal variations, may I emphasize that there has been no freezing of the money supply. Fluctuations always occur from month to month.

It is worth recording that from the beginning of the recession to the present time the proportionate expansion of money supply in Canada has been significantly greater than in the United States. Over the past two years the United States money supply has increased 10 per cent, while ours has increased 16 per cent.

Interest Rates

The intense pressure of demand for money and credit has had its effects on the cost of borrowing, and the curve of interest yields over the past three years reflects the changing economic conditions. This curve of interest rates reached a peak in mid-1957, dropped off sharply to the mid-summer of 1958, rose sharply up to August of this year, and has been showing a mixed trend during the past six or eight weeks.

This rise in interest rates is not just a Canadian phenomenon; the same trend exists in the United States, and the spread between Canadian and American interest rates has followed a fairly consistent pattern.

The rise in interest rates and the consequential decline in bond prices has been the result of two main influences -- the large increases in net new borrowing through the sale of securities, and the heavy selling of bonds by the chartered banks in order to acquire cash for making business loans to their customers.

Net new issues of securities in Canada by the federal, provincial and municipal governments and by corporations have shown wide swings over recent years. In 1954 the total amount of net new borrowing through the securities market in Canada was just under $1 billion, in 1955 it was almost $2 billion, in 1956 it was somewhat over $1 billion, in 1957 $1,750 million, in 1958 nearly $2,700 million, and in the first six months of 1959 it was about $1,100 million. This year the federal government's share of Canada's net new borrowing requirements will be only about half of what it was last year.

The role of the chartered banks in the bond market has also been significant. In round figures the chartered banks held about $2,500 million of Government of Canada securities in August, 1957. By October, 1958, this figure had risen to almost $4,000 million, and the published figure last week showed holdings of approximately $2,800 million. In other words, between August, 1957, and October, 1958, the banks made net purchases of $1,500 million of Government of Canada securities, but during the past twelve months they have made net sales of $1,200 million, -- sales which were necessary in order to provide funds for regular business and commercial loans. The constant selling by the banks has for many months created a steady pressure on the bond market.

The encouraging corollary of these figures is that the general public in Canada, after several years of selling off their Government of Canada securities, have during the past twelve months greatly increased their holdings. In 1955 the general public's holdings of Government of Canada securities were about $9 billion; by mid-1958 they had fallen to less than $8 billion. Today the public's holdings of our bonds exceed $10 billion, an increase of $2 billion in twelve months.

In other words, in one year the public's holdings of Canada Bonds have risen by 26 per cent. This increase is in part a reflection of the more attractive interest rates prevailing, but it also demonstrates unmistakably the growing public confidence in the Government's determination to resist inflationary pressures and to defend the value of our national currency. This same confidence was further demonstrated by the striking success achieved by our Bond issue on September 14th, the result of which has helped to stabilize the bond market still further.

Moreover, besides the increase of $2 billion in its holdings of Canada Bonds the public has in the same twelve-month period increased its holdings of other Canadian securities, whether provincial, municipal or corporate, by another billion dollars.

Let me make it very clear that as Minister of Finance I dislike very much having to pay high interest rates on government borrowings. We price the securities which we issue as closely as we can in the light of rates prevailing in the market. No government, excepting one possessing complete totalitarian powers, can compel free men to lend it money. The interest rates which governments in a free society must pay depend upon the interplay of the forces of supply and demand.

Interest rates are high. Money is dear. Last week the United States Treasury issued $2 billion of bonds with a four year-ten month maturity bearing a 5 per cent coupon. It is the highest rate paid by the United States in the last twenty-nine years.

It is a fact, however, that the prevailing high interest rates have not interfered with the processes of economic growth either in Canada or elsewhere.

Let me add one final observation on the subject of interest rates. There are those who contend that a measure of inflation would today bring about a reduction in interest rates. This is a fallacy of the deepest dye. Inflation would divert savings into equities and diminish the supply of loanable funds. The result would be to force interest rates upward....

Current Credit Situation

I have already drawn attention to the extraordinary demand in 1959 for commercial credit in Canada, and to the fact that the existing shortage is the outcome of the free play of the strong forces of economic growth and is not attributable in any degree to any reduction of supply. Restrictions on credit are never popular. Refusals of credit tend to provoke strong personal resentments. We should have Utopia if every credit-worthy borrower could obtain all the money he requires at reasonable rates of interest, on other terms to his satisfaction, under conditions of full employment, a steadily expanding economy and stable prices. Unfortunately, this is a form of coexistence not yet completely attained in this imperfect world.

You would expect me to comment on the restrictions which the chartered banks have imposed on their own lending operations....

Parliament has conferred on the banks valuable charters containing many rights and privileges. I think we will all agree that these should be exercised with due regard for the national interest.

The banks are not the only source of loanable resources, but they are normally the first-line source. In times of enormous demand as throughout 1959, it is vital that the best possible use be made of the existing available lending resources, for these are not unlimited. I am particularly concerned for the legitimate credit needs of farmers and small borrowers, that their interests may not suffer in the keen competition which exists for large and very profitable accounts.

The Bank of Canada publishes quarterly a statement showing the total authorized bank credit limits for customers having lines of credit in excess of $100,000. At the end of June 1957 these lines of credit amounted to $3,864 million of which $2,130 million was outstanding. By June 1958 these lines of credit for the larger borrowers had increased to $4,321 million though only $1,964 million were outstanding. By June 1959, the latest figures available, the lines of credit had been further increased to $4,763 million of which $2,125 million were in use.

The commitments to the larger borrowers have continued greatly to exceed the actual loans, and have obliged the banks to keep available additional reserves to meet these very large lines of authorized credit. It is evident that had the banks not enlarged these lines of credit so substantially within the past year they would not have encountered such sudden and severe pressures as those which developed this spring and summer.

I also believe that large corporations should be discouraged from using bank credit as semi-permanent capital. Large corporations, unlike small businesses, can and should raise their permanent capital by issuing additional securities into the market. Let me illustrate. Corporation bond financing in Canada in 1957 totalled $1,045 million, in 1958 $769.2 million, but in 1959 up to the 24th of August only $197 million. When a corporation raises, say, $10 million in the capital market and reduces its bank loans to that extent it immediately makes available to the banks the means of making 10,000 loans of $1,000 each, or 4,000 loans of $2,500 each, or 400 loans of $25,000 each.

Attempts have been made to draw parallels between what happened in 1956 and what has happened in 1959. While there may be some points of resemblance in the background conditions the courses followed have been very different. In 1956 when it considered that some credit restraint was necessary the Bank of Canada intervened. As the result of its intervention term loans by the banks were curtailed, the liquid reserve requirements of the banks were increased and the banks found it necessary to restrict credit immediately and severely and to liquidate in a short time large holdings of Canada Bonds, resulting in very heavy losses to them. There were strong complaints by the chartered banks, and the action of the Bank of Canada was denounced as tardy, drastic and costly.

In 1959 there has been no intervention by either the Government or the Bank of Canada. In May and in August the chartered banks acting on their own initiative imposed restrictions on their lending operations. In doing so there was no need for any of the banks to blame anyone else. Certainly there was no need for indulging in recriminations. The situation was the result of unprecedented demand for credit, and the lending resources of the banks were not unlimited. I deplore the attempt made in certain quarters under these circumstances to attribute to what is vaguely and conveniently called "Ottawa" the responsibility for these restrictions.

One of the complaints which I have heard is that someone in authority should have warned the banks in advance or should have told them to do what in fact they have done. Here let me make it quite clear that I believe that the bankers best know how to operate the banking business in Canada. There are no better bankers in the world than we have in Canada. On the day I was sworn into office on June 21st, 1957, I met the Canadian Bankers Association and informed them of that belief and that bureaucratic interference with their operations did not accord with my political philosophy. The corollary of this belief is that in a free society those who discharge business functions should assume responsibility for their decisions and should not attempt to place responsibility or blame on others....

Inflation

I have reserved to this point my observations on the subject of inflation. "The choice is between the path of creeping inflation and that of a strong and stable dollar", was the warning of Dr. Wilhelm Vocke, the eminent German central banker, to the United States recently. The warning applies with equal force to Canada. We want growth. We want an expansion of our economy. We want the development of our resources. Can we have these and at the same time avoid the perils of inflation? This is a challenging question.

There is a prevalent belief that a measure of inflation called "creeping inflation" contributes to growth. Let me speak on this subject as clearly and emphatically as I can. There can be no compromise with inflation in any of its forms, including its insidious creeping form. The Canadian Government has chosen the course of maintaining a strong and stable Canadian dollar. On July 14, 1958, the Prime Minister said:- "I want to emphasize again at this time that the preservation of a sound currency and the maintenance of stability in the value of the dollar are matters to which the Government attaches the highest importance."

.... Canada enjoys no immunity from the dangers of inflation. Indeed, it has a special interest in avoiding those perils. If Canada does not maintain the stability of her currency while all of the other principal countries are doing so with theirs, we will most certainly be priced out of world markets, with results that will be a catastrophe for Canada.

We have not lightly taken up the battle against inflation. We are not unmindful of the tasks and risks involved. We do not beguile the public into thinking that the battle against inflation can be won without paying a price. We do not change our policies as have those who but a few months ago were shaking confidence by their doleful declarations on the subject of inflation and are now prepared to turn a benign eye on relaxation of effort. But having fought to this point with some success against inflation, there can be no turning back or capitulation or half-hearted struggle now....

I am asking for the support of the Canadian public, to the fullest degree that Canadians are prepared to give it to us, in our efforts to preserve the stability of the Canadian dollar. We must all recognize that there is in the world today a shortage of capital, and Canada is experiencing that shortage. I ask the Canadian people to refrain from asking for governmental expenditures which are not strictly necessary now. By preserving the value of the dollar, we shall strengthen confidence in Government credit, which will in turn arrest the upward movement in interest rates and restore bond values. This is a task in which every Canadian has a direct interest.

"The task of maintaining the soundness and stability of currency is never ended", said President Eisenhower recently. "We must be vigilant, realistic and determined in our efforts to resist the perils of inflation."

Conclusion -- Strength of the Economy

I referred in opening to the enormous recovery in the economic and financial strength of the United Kingdom and the countries of Western Europe. The expansion of the Canadian economy matches that of any other country in the world. The existence of financial strains should not be permitted to obscure in our minds the rising strength of the Canadian economy. Today the Gross National Product has reached record heights. There are more persons employed in Canada than ever before. They are earning more than ever before. They are spending more than ever before. They are saving more than ever before. Canada's exports are at a record level. Canada's imports are at a record level. Canada's total trade is at a record level. Farm cash income is at record levels. The public's holdings of government securities have reached an all-time total. Savings deposits in the Canadian banks have reached a record level. Labour income is at an all-time high. Retail sales are higher than ever before.

Liquidity in the Canadian economy is strong. Canada has recently witnessed a sudden upsurge of capital spending on new plant and equipment. These outlays, which are widely diffused throughout the economy, are rising for the first time since early 1957, and have helped to push the Gross National Product to an annual rate of $34.7 billion in the second quarter of 1959.

Canadians never had more reason to be optimistic than they have today....

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