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CANADA'S MONEY MUDDLE IN RETROSPECT

Questions concerning the control of money are as old as the use of money as a measure and store of value and a medium of exchange. Relevant to developments in the post-war period in Canada is the controversy of the mid-nineteenth century between the so-called Banking School and the Currency School. The Banking School maintained that control over the supply of money should be left in the hands of private commercial banks. The Currency School, on the other hand, among other things, maintained that control over the money supply should be vested directly or indirectly in the hands of government. Settlement in favour of the Currency School led to the establishment of central banks, mainly under the sponsorship of governments. These banks were to provide an umbrella over the private commercial banks.

In Canada, interference with the money supply by a central authority started with the Finance Act of 1914. This was followed by the establishment of the Bank of Canada in 1935, first with limited government participation and later with complete government control.

The degree to which the central bank should assert its influence over the economy and in particular over the private commercial banks was not questioned until the fifties. During the thirties, the war, and the immediate post-war period, the central bank, on the whole, accommodated the activities of the chartered banks without question. That is to say, the central bank, in a more or less routine fashion, assisted the chartered banks to meet the demands of business. This was done for two main reasons. First, there was a genuine conviction that economic conditions were such that this relationship was proper policy. Second, monetary policy as a means of short-run economic stabilization was out of favour and stood in the shadow of what was considered a more important central technique—fiscal policy.

With the outbreak of the Korean war, the monetary authorities were finally shaken out of their depression psychosis and began to give serious attention to the problems of inflation which had existed in varying degrees back to the end of the

Second World War. Since this meant that the central bank would have to exert a contradictory influence on the commercial banks, as well as on the spending patterns of the community at large, its motives were questioned for the first time. At first the Bank of Canada approached the problem of controlling inflation very cautiously, in order to preserve the good working relationships with the financial system. The reluctance of Mr. Towers, the Bank of Canada's first governor, to disturb this relationship is understandable. It had required careful nurturing in the years following the establishment of the Bank of Canada, since the founding of the Bank in 1935 was viewed with much suspicion by the chartered banks. Unfortunately, however, to deal with inflation in a more positive way, conflict between the Bank of Canada and the financial community was unavoidable, a risk that the Bank of Canada was not willing to undertake to the degree necessary. Thus from the end of 1949 to about 1956, monetary policy in Canada was only marginally successful in its attempts at short-run economic stabilization and in dampening the business cycle.

Throughout history, prices and general economic activity have moved in the same direction. Thus by pursuing either of its traditional objectives—price stability and high employment—the central bank pursues the other. After the mid-fifties prices continued to move up while the level of employment moved down. To Mr. Coyne, who was then governor of the Bank of Canada, the upward movement of prices was synonymous with inflation, and inflation was a sin to be eradicated at all costs. The price was high in terms of high average unemployment and lost production. In retrospect Mr. Coyne's response is understandable insofar as it has been pointed out by Professor Harry Johnson of the University of Chicago in another context that central bankers believe more in financial morality than in the economic functions of money. That Mr. Coyne did not fully appreciate the economic functions is apparent from the policies he followed and from the economic analysis contained in his frequent public speeches.

Mr. Coyne attempted to abolish a sin whose colour he thought was black when, in fact, it was only gray. He vastly exaggerated the evils of inflation. Unfortunately, except in a few instances which were generally ill-timed, he continued a policy of monetary restraint in the second half of the fifties when such a policy was no longer appropriate.

Completion of vast development projects in Canada, slower growth in the United States, and the reversal of Canada's relative competitive position with Europe created problems of economic adjustment in Canada. However, unlike the United States, Canada was not burdened with a fixed exchange rate and the maintenance of an international banking position. Canadian authorities could have pursued an

independent expansionary monetary and fiscal policy to offset the depressive influence of stronger foreign competition and slower growth in the United States.

Mr. Coyne's tight money policy worked adversely for Canada in several ways. Higher interest rates and the lack of credit availability forced Canadian corporations and governments to borrow in the United States. The increased inflow of short-term funds resulting from the sale of new issues of Canadian securities to non-residents kept the Canadian dollar at a premium *vis-à-vis* the American dollar, at a time when there was a levelling-off in the development boom and in the inflow of long-term capital. The tight-money policy which induced much of the inflow of capital kept the Canadian dollar over-valued. This had its repercussions in the balance of payments which in turn affected domestic growth, output, and employment.

Mr. Coyne defended his anti-inflationary policies and answered his critics by arguing that the stagnation the Canadian economy was experiencing was the result of excesses in the past. He maintained that the large inflow of development capital after the war had created structural disturbances in Canada's position in the world economy. Canadians had a rate of growth in excess of that which was "sustainable" or "appropriate" to the economy. The high rate of growth, which was fed by the large capital inflows, allowed Canadians to live "beyond their means"; it produced a misallocation of resources; it produced incipient problems of debt management; and it brought Canada to the stage of external bankruptcy. Mr. Coyne argued that Canada's persistent unemployment after the mid-fifties and her continuous annual balance of payments deficits could not be solved by monetary or fiscal policy. In fact, he suggested that the only way of correcting the current account deficits without incurring further inflation was by controls over imports, over foreign borrowing, over provincial, municipal, and consumer finance, and over the use of investment funds.

In the changing political environment after 1956 not only the Bank's policy but also its responsibility came under close scrutiny. It was established as a quasi-independent institution to free it from political interference. Moreover, as it grew, it became surrounded with an aura of infallibility by those who believed that the art of central banking can be understood only by a small group of experts within the sacred walls of the Bank of Canada.

During the 1957 election, and even earlier in the House of Commons, the Conservatives attempted to convince the Canadian electorate that the Liberal administration, rather than the Bank, was responsible for the tight-money policy. In Truro, N.S., on May 2, 1957, John Diefenbaker promised that "tight money will dis-

appear under the Conservative administration".[1] Indeed, after the 1957 Diefenbaker victory, interest rates did ease and the Conservative minority was quick to take credit. Soon after the election in 1958 of a majority Conservative government, however, the implementation of election promises resulted in huge government deficits which again placed upward pressure on interest rates.

Mr. Fleming, the Minister of Finance, was now quick to state that the government did not exercise any sway in the field of monetary policy and thus placed the blame for tight money squarely on the shoulders of the Bank of Canada. Mr. Coyne accepted the responsibility and defended his position in a series of speeches which began in the fall of 1959 and terminated shortly before the government sought his resignation almost two years later. Mr. Coyne's successor, Louis Rasminsky, found himself in a position similar to that of Mr. Towers, the Bank's first governor. He had to restore the favourable image of the central bank, an image which Mr. Towers had nurtured with great care. To date, Mr. Rasminsky has followed the foot-prints of the first governor.

Professor Scott Gordon, testifying before a congressional banking sub-committee in the United States, has said "The events preceding the attempted dismissal of the governor of the Bank of Canada in 1961 showed that central bank independence can degenerate into irresponsibility, and that the government itself can make use of the autonomous position of the central bank to deny its own responsibility for what it conceives to be politically unpopular policies."[2] He went on to suggest that the Bank of Canada and the U.S. Federal Reserve Board should be reconstituted as ordinary government departments. Surely this is a step in the wrong direction, since it would leave monetary policy entirely in the hands of the politician. Professor Johnson's proposals to the Royal Commission on Banking and Finance for improving the performance of the Bank of Canada are more realistic.[3] He suggested the appointment of senior economists to the Board of Directors of the Bank, a programme of exchanges between the Bank's staff of economists and economists in the universities, regular informal conferences of Bank officials and academic economists, and regular publication of the results of the Bank's own research in a journal open to contributions from outside economists.

On May 2, 1962, Canada established with the International Monetary Fund a fixed par value for the Canadian dollar of 92½ U.S. cents. This was an unfortunate move which could have been prevented if a proper monetary policy had been followed after the Canadian economy began to stagnate during the mid-fifties. The monetary authorities failed in two respects. They did not wish to admit that interest rates were relatively high and domestic credit scarce, and they appear not to have

understood the basic economic relationships between a high level of interest rates, a large capital inflow, and the over-valued dollar. The Conservative government maintained that money was scarce only insofar as the commercial banks did not allocate it equitably, and that the Canadian dollar was over-valued because junior governments and private business had borrowed too heavily in the United States. The commercial banks subsequently showed that they had catered to the small borrower, and reference to an elementary textbook in economics would have told the authorities that Canadians were driven to the U.S. financial markets not only because money was available there, but because it was cheaper. Instead of allowing lower interest rates to bring about the necessary adjustments, the government introduced measures which were nationalistic in their orientation.

It was not until after the budget speech of June, 1961, and the appointment of a new governor of the Bank of Canada that Canada returned to a semblance of monetary and fiscal orthodoxy. In his budget speech Mr. Fleming announced that the mistakes of the past were caused by the Governor of the Bank. With his removal the government could allow lower interest rates to bring about the required adjustments. Moreover, the government would use the Exchange Fund to assist in bringing the external value of the Canadian dollar to a lower level. (The past behaviour of the Exchange Fund could not be blamed on the Governor since exchange fund policy is the direct responsibility of the Minister of Finance).

The real cost of the money muddle of the previous five years was still to be assessed. The nationalist sentiments manifested in protectionist government measures, the unsettled political climate, large government deficits, slow economic growth and high employment, and contradictory statements regarding the future level of the exchange rate, had shattered foreign confidence in Canada as a place to invest. Instead of forcing the external value of the dollar down, the government actually stepped in to cushion its fall. This too was a mistake, particularly since the government was not prepared to state in one voice what level it thought was appropriate under the circumstances. On May 2, 1962, as has already been noted, the government finally established with the International Monetary Fund a fixed par value for the Canadian dollar at 92½ U.S. cents. This might have been avoided had the dollar been allowed to depreciate to a much lower level after mid-1961.

In June, the indecisive result of the federal election and further contradictory statements by members of the Conservative minority government concerning the future of the Canadian dollar added to the loss of confidence in Canadian affairs and policy. After a massive outflow of capital, on June 24 the Prime Minister issued a statement that Canada was faced with an exchange emergency, that the government

was determined to defend the exchange value of the Canadian dollar at the level established in May, and that special measures designed to deal with the situation were being implemented immediately. These measures included temporary surcharges on certain non-essential imports, a reduction in the exemptions from customs duty accorded to Canadian tourists on goods brought back to Canada, an austerity programme to reduce the government's deficit, and the mobilization of international support in the form of cash and stand-by credits amounting in total to U.S. $1050 million.

The speed with which Canada's foreign exchange reserves were built back after the crisis and the early abandonment of the emergency measures which followed are ample evidence that much of the earlier difficulty was due to the overvalued dollar and tight money. However, the strong competitive trade position which we have experienced since the dollar was depreciated does not mean that all our problems have been solved.

We will probably require an inflow of foreign capital for some time to come in order to balance our international accounts. The storm warnings are already up. If Mr. Gordon continues to tamper with the flow of foreign funds into Canada, we may experience another massive loss of foreign confidence and an exchange crisis. Professor Johnson makes a good case in his book, *The Canadian Quandary,* that there is no *substansive* evidence that foreign enterprise in Canada has acted contrary to the national interest.[4] Moreover, the cost of servicing our debt is vastly exaggerated. It amounts to less than 2 per cent of net national income at factor cost. Also, the amount of our gross national product financed by foreign funds is only about 5 per cent. There is no need for alarm. Mr. Gordon, however, thinks otherwise. In a major speech shortly before the offer by the Jos. Schlitz Brewing Company of Milwaukee to take over John Labatt Limited was made public in February, 1964, Mr. Gordon told his audience that the government believes it is "imperative to slow down the extension of non-resident ownership and control, and in time to reverse the process".[5] If we are going to see more abortive attempts to control the flow of foreign funds, foreigners are bound to become intensely apprehensive over Canada's narrow economic nationalism. Professor Slater of Queen's has said that "Nineteenth-century objects and mechanics of nationalism do not seem to provide a realistic guide to Canadian political and economic independence now or for the future".[6] Graham Towers, the first Governor of the Bank of Canada and now chairman of the Canada Life Assurance Company, told a Toronto audience in January that Canadians should not press their luck too far. He went on to say that almost all Canadians favour more ownership of their factories "just as we are all

against sin".[7] But the fact that foreign confidence in Canada has been high for most of this century does not mean that such confidence cannot be lost. Mr. R. M. Fowler, President of the Canadian Pulp and Paper Association, has described discriminatory taxes on capital flows as a "weak and inconclusive and slightly disgraceful posture" for national policy to take. Too much time is spent, he says, worrying about maintaining Canada's independence and not enough about living effectively in today's world.[8]

While it cannot be said that the present government in Ottawa, particularly Mr. Walter Gordon, has changed its mind concerning the discouragement of foreign investment in Canada, it has taken a more cautious approach. This has been the result of the public outcry following the budget proposal in March, 1963, to increase the withholding tax on dividends paid abroad by companies that failed to provide the required degree of ownership by 1965. Some of these proposals were immediately abandoned, and all of them were omitted from the following budget in January, 1964. Apart from the repercussions created by the tax proposals, the government was no doubt reminded of Canada's dependence on continued imports of American capital when the announcement of the proposed interest equalization tax in July, 1963, by the Kennedy Administration virtually halted the flow. Another foreign exchange crisis in Canada was probably averted only by our extensive wheat sales to the Soviet Union.

The new cautious approach was outlined in part by Mr. Pearson on a special CBC radio and television program in April, 1964. He said that "we will have to be very careful how we go about this [foreign investment] and perhaps we will have to take a good many years before we can work this out, but one way of modifying the danger of too much foreign control of our industry—without in any way discouraging the investment we need—is to diversify that investment".[9] One can only hope that the more reasonable and cautious approach by the Prime Minister will bring forth economic policy which will not lead us into another money muddle.

NOTES

1. Peter C. Newman, "What Was Behind The Coyne Fiasco", *Maclean's Magazine,* Oct. 19, 1963, p. 40.
2. *Globe and Mail,* Feb. 12, 1963.
3. Published as *Essays in International Finance,* No. 44, Princeton University, Department of Economics, International Finance Section, Oct., 1963.
4. See Harry G. Johnson, *The Canadian Quandary* (Toronto: McGraw-Hill Company of Canada Limited, 1963), particularly the Foreword.
5. The Kingston *Whig-Standard,* Feb. 10, 1964.
6. *The Canadian Banker,* Vol. 70, No. 4, Winter 1963, p. 14.
7. *Globe and Mail,* Jan. 31, 1964.
8. *Ibid.,* Feb. 7, 1964.
9. *Ibid.,* April 21, 1964.