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Central Banking

By Professor T. E. Gregory.

President Sifton:—Gentlemen, it is very gratifying to the executive to have you turn out in such large numbers for a meeting at this time of the year. Of course Dr. Gregory is the great drawing card. We are honored, today, in having Dr. Gregory address us again. If you will permit me I will read from the card some of the offices and posts which he has filled. Dr. Gregory, of course, is a professional man. He is a scientist and a professor. He is a Professor of Banking in London University, Governor of the London School of economics, and member of the Council of the Royal Economic Society.

Professor Gregory:—Mr. Chairman and members of the Canadian Club, this is the third year in succession that it has been my privilege to be invited to address you. On the first occasion, I had to speak on the suspension of the gold standard in Great Britain. On the second, I ventured into the highly speculative fields and discussed the subject of economic planning, but I think you will agree that there is no subject so dangerous for an economist as the subject of Central Banking, surrounded as I understand I am by the united intellect of the bankers of Toronto. May they have pity on me! The last banking story I heard before I left Great Britain was of the bankrupt Manchester merchant who went into the district bank and tried to get an overdraft. The manager simply laughed at him but the man went on pleading for his overdraft and in the end the manager said, "I cannot possibly let you have an overdraft as a business proposition but I will do it as a sporting proposition if you will tell me which of my eyes is a glass one." The man said the right one without hesitation. The

banker said, "You are right, how did you know?" Oh, said the man, "it was the kinder one of the two."

Well, I hope the bankers of Toronto will regard me with that one of their eyes which is the kinder one of the two.

Now the subject of central banking has become of world-wide significance and importance only since the war. Before the war nobody raised the problem of whether countries like Australia or New Zealand or Canada required a central bank. The credit structure of the international financial world was in those days an extremely simple one. With the exception of two or three central banks on the continent of Europe, central banking did not exist. The Federal Reserve System was in its infancy and nobody quite knew what its future scope and its future functions were going to turn out to be. The world was run, so far as international function is concerned, by the Bank of England and the Bank of England had only acquired its position and authority as a consequence of two hundred and fifty years of evolution and it was not easy to see how it could be replaced or supplanted in other countries. The supremacy of the Bank of England, I think, is to be found in the fact that London at that time was not only the great central market in which nearly all the raw materials of the world were finally financed but it was also the great market which loaned both long term money and short term money. Secondly, the turn of the screw, a rise in the bank rate in London had immediate and direct practical consequences in every other money market in the world. Under those conditions so long as the bank kept its head, the Bank of England was really the apex of a credit structure which extended over the whole commercial world. The war destroyed that position completely and the whole difficulty of central banking, since the war, on one side, has been the rise of competing central banks dominating money markets which are now at least as powerful, if not more powerful than the London money market itself. I will come back to that in a moment, because one of the questions which Canada will have to face, if and when she creates a central bank, is the question of how far any single central bank in the modern world is really master of its own house.

Why is it that since the war central banking has become so much more prominent and much more interesting a subject than it was before the war? I think for two main reasons, one fairly innocent and the other perhaps rather more sinister. The demand for central banking in all parts of the world is partly an expression of the desire of countries to run their own currency system. It is the expression, if you will, of economic nationalism. How far economic nationalism, in credit matters, is desirable or undesirable is a matter which I cannot pursue here. I regard it personally as extremely undesirable. Nevertheless the demand for central banks in part springs out of the desire for a permanent abandonment of the gold standard and for entrusting the management of local currency to a local central bank. The other reason for the emergence of the demand for central banks springs, I think, from the fact that in the last ten years monetary theory and banking theory have been making very revolutionary strides and all sorts of new and interesting ideas are being discussed in political and economic circles and most of these ideas assume that the proper vehicle for carrying these ideas out in practice is the central bank. I want to say a word about these ideas.

The central bank, so far as the business community is concerned, was popularized by the resolutions of at least three conferences since the war. The Brussels conference achieved almost as little as the World Economic Conference did a few weeks ago, but one of the things, which the Brussells conference did, was to pass a resolution that those countries which did not already possess a central bank should in future possess one. That is a resolution which was reinforced by the Genoa conference of 1922. A preparatory meeting of experts, which met before the World Economic Conference in the early part of this year and which drafted the Agenda for the World Economic Conference, again included among the suggestions the one that a central bank should be included in every country where it did not exist. And that is giving the idea of central banking a certain aroma of respectability which it might otherwise not have possessed.

I pass from these preliminary observations to ask what is a central bank expected to do and by what agencies and forces can it carry out whatever task one assigns to it. May I make it quite clear that the traditional functions assigned to a central bank, arise out of the experience particularly of the Bank of England? There is nothing *apriori* or scientific in the sense that scientists or economists invented these functions. They have been historically determined for central banks by the experiences primarily of the Bank of England. I give some of the historical experience in these matters by saying the functions of the central bank are primarily two in number. The first is to safeguard the external value of the currency, to look after the foreign exchanges. That does not necessarily mean you can only have a central bank in a country which is on the gold standard or that a country off the gold standard does not necessarily require a central bank policy. All it means is that the first historical function which a central bank is supposed to carry out, is the management of international value of a currency. The second function is to be and to act as an ultimate reservoir of credit. That is to say, to be the centre and the final centre to which a community can turn if it is looking for an expansion or a contraction of the volume of purchasing power in the country. These two functions, the management of the exchanges on the one hand and the ultimate management of the credit system on the other, are functions which every central bank has to carry out if it is to be a central bank at all. And these two functions are closely connected with each other. For many generations the Bank of England did not extend the intimate connection which exists between the management of the internal credit position and the position of foreign exchanges, but if a country desires to keep up the external value of its currency, the central bank of that country is forced to restrict credit and purchase, for expansion of credit would otherwise threaten the stability, or hoped for stability, of foreign exchanges. And therefore the two functions of the central bank, management of the foreign exchange value of the country's currency and ultimate responsibility for domestic

credit conditions are inseparable aspects of one and the same thing.

In the modern world of course, new demands are being brought forward. What those demands are I shall deal with in a moment, but one cannot understand how it is that those new requirements are being brought forward. without in the first instance understanding what central banks have done in the past. If you ask a central bank institution to do these things, what are the powers which it must possess in order that it may carry out these duties? I believe a central bank's powers must be at least three in number. In the first place the central bank must control a part or the whole of the local note issue. If it does not do that it is not in a position ultimately to expand credit. And therefore every central bank either possesses a monopoly of note issue, or at any rate, possesses a note issue of its own. You cannot have a central bank without at the same time conferring upon it a note-issuing power.

In the second place a central bank must possess the right of re-discount. The right of re-discount in the modern world does not necessarily mean simply the right to re-discount commercial bills of exchange. It is true that the majority of the central banks' constitutions of the world all include the right of re-discount in commercial bills as the head and front of a central bank action in the discounting field, but that is simply due to a historical incident and, if Canada creates a central bank, its powers of re-discount must, I think, be made wider than is apprehended in the term of re-discount purely of commercial bills of exchange, because, if I understand Canadian practice, commercial bills of exchange play a very minor role in Canadian business life. The right to manage a note issue and the right to re-discount are almost intimately associated with one another because, if a central bank expands credit, that ultimately has the effect of increasing the demand in currency. In other words it increases the demand for notes to circulate in the pockets of the commercial community. A central bank must command the respect and allegiance of the commercial and banking community and wherever you find a central bank which

does not possess moral authority in the business and financial community, that central bank is unable to carry out its functions adequately. Your great neighbors south of the line, realized the practical truth of this fact throughout 1928 and 1929. In those two years, I think it is true to say, the Federal Reserve authorities realized, much more clearly than I think anybody else did, the kind of danger which was threatening the era of prosperity; and you will remember the various exhortations that were issued by the Federal Reserve Board in the Spring of 1929. They were treated with great contempt by the Financial and Business community and the Federal Reserve System suffered a loss of moral authority in consequence which has been very serious in the subsequent. history of that great system of banks. A central bank must possess moral authority and it is not easy to create a new bank and give it moral authority. One of the advantages which the Bank of England enjoys is the fact that what the Bank of England says, goes with the London money market, without any legislation, without any rumors in the press, without any people really knowing quite how it is done, and therefore countries creating central banks ought to create a kind of central bank personnel which will inevitably command respect in the business community. If it does not, then the central bank will be unable to carry out its functions effectively as it ought to do.

Now given a central bank and given that it has got the right to re-discount and the right to issue notes, how does the central bank carry out its job? It carries out its job by one fundamental process, by ultimately expanding or ultimately contracting the volume of purchasing power. And that raises very great difficulties. It is very easy in any country and in all times to win the assent of the commercial and financial communities to an expansion of credit. Nothing is easier. Rates of interest go down, prices rise, unemployment falls. Secondly it is at all times fairly easy to expand the volume of credit. It may take a long time before the expansion of credit results in the rise of prices and the other factors but there is no opposition in the public mind to an expansion of credit. There is

occasionally very considerable opposition in the public minds and in the financial community's mind to a contraction of credit. I once said at an international gathering, at which three central bankers were present, that the ultimate duty of the government of the central bank was always so unpopular—I tried to say it picturesquely—to draw attention to the fundamental facts that, whereas it is fairly easy for central bankers to expand credit, it is sometimes exceedingly difficult for them to contract credit. But neverthelss there are times and seasons when the contraction of credit is much more fundamentally necessary in the interests of the financial community than an expansion of credit ever could be.

There is not merely a great moral difficulty, there are sometimes also very great technical difficulties standing in the way of a central bank contracting the volume of credit and, as this seems to me to be the fundamental problem of central banks in new countries, I hope you will bear with me if I mention what some of the difficulties are. The central bank can contract credit primarily in two ways. It can put up the bank rate and make it more difficult for the commercial or financial community to borrow at the central bank or the central bank can sell part or the whole of its ownership of government and other securities and deflate the open market. That is the so-called open market policy which the Federal Reserve system developed with great success in the years 1924 to 1929. Or, alternately, a central bank can attempt to contract the volume of credit by the simple device of rationing the money market and its borrowers. Now there is difficulty in applying any or all of these methods to countries in the position, let us say, of Australia or Canada. The difficulty is a two-fold one. In the first place the commercial banks may be so flushed with funds themselves even at a time when contraction of credit is necessary that the central bank has no power over them because they are not borrowing from the central bank. That is a position which occasionally happens even in the highly complex market like the London money market and it is no good putting up the bank rate if one does not contract the volume of inter-bank borrowing.

The alternative method of contracting credit, namely, selling securities in the open market, is equally difficult in certain countries because, in fact, there is no open market in which to sell securities. It is only a relatively few highly organized financial areas which possess an open market in which a central bank can sell ten to twenty millions of securities to some buyer. Canada, as far as I can discover, has not got an open market in the same sense in which the London money market has one, and under those conditions it becomes a highly important and very difficult job of deciding how best to endue the central bank with the necessary powers by means of which it can in emergency produce the necessary contraction of credit which may be required under the circumstances of time and place. I hardly dare say this to bankers but there is of course one method by which a central bank can always contract the volume of credit. It is a very simple one but it is likely to be unpopular with bankers. If you make commercial banks keep a part of their reserve with the central bank and if you give the central bank the power to ask for additional reserve of money from the commercial bank when they think they require it in the interests of the stability of the whole, you can always force the commercial bank to borrow from you and you therefore have got them more or less under your thumb. I mention this with fear and trembling, but I mention it because it is very important to realize that, if Canada does create a central bank, the method by which a central bank in this country may have to be worked may differ very considerably from the methods which are habitual in the London money market. The method which a central bank employs may be determined by the character of the community in which it exists and it is a mistake to imagine that what is suitable to Great Britain or the United States is necessarily suitable to the new central banks which are springing up in various parts of the Empire.

There is one other point which I want to refer to at this stage. A central bank must have certain positive powers. It must be able to re-discount and issue notes but the positive aspect of the duties of a central bank and its

functions have to be supplemented by certain negative understandings and I want to mention at least one of these.

If the central bank is really to carry out its task of being the ultimate guardian of financial and credit conditions in the country in which it is situated, there is one cast iron rule which has to be observed by the central bank and which must be thoroughly understood by the general public. The central bank cannot possibly carry out its function of safeguarding the general interest if it is required at the same time to be subservient to the special needs or interests of a particular industry. It is quite impossible to thrust on the central bank two antagonistic tasks, that of looking after general credit systems and at the same time that of trying to stabilize the price of a particular product or trying to safeguard the interests of a particular industry. I mention that because there are signs that in this country part of the popularity of the central bank idea is derived from the feeling that if there were a central bank in Canada it would be possible, for instance, for the central bank to do for the farming community what the commercial banks are unable to do at the present time. I think that has proven wrong in theory. I think it would lead to disastrous results in practice.

If one surveys central banking institutions one discovers that what seem in general central banks are prevented from falling too much into the grip of local ministers of finance, that central bankers have been trying to evolve a procedure which will prevent the Chancellor of the Exchequer and Finance Minister from overpowering the authority of the central bankers. That is the danger which European central banks have had to safeguard themselves against. I think it would be a thousand pities if, in the new countries of the world, the central banks had to safeguard themselves against grasping ministers of finance and also the pressure of particular commercial interests. Now a very important consequence follows from this fact, the consequence namely that the greater part of the supply of credit and purchasing power for the business and agricultural interests of any country, whether there is a central bank or not, must continue to be furnished by the commercial bank. There is

ultimately no conflict of interests or authority at all between the commercial banks and the central banks, because the sphere in which they are neutrally interested is capable of division into two parts. It is the function of the central bank to do something which the commercial bank cannot possibly do, because the commercial banker is necessarily associated with particular firms and particular districts and particular interests and a central bank carries out the task of safeguarding the general stability of the commercial and financial system. Therefore there is no real opposition between the sphere of action of a commercial bank and the sphere of action of the central bank, provided that the functions of a central bank are properly understood. Of course if you create a central bank with the idea that the central bank is to finance all those customers which the commercial bank regard as too dangerous, there will be a certain conflict of interest, but a central bank that did that consistently would not last very long. Therefore I do insist upon the very important fact that a central bank, quite apart from all other technical difficulties, can only function efficiently and properly if special interests, whatever they are, keep their hands off the machine.

That raises a problem of very great importance when it comes to the question of how the central bank personnel is to be chosen and appointed, and if and when discussions of a central bank begin in Canada, it is inevitable that there will develop two schools of thought, the thought which desires to see the bank more or less owned and controlled by the government and the school which desires to see the bank more or less owned and controlled by interests independent of the government of the day. If that view develops it is just as well to remember that this is a problem which it not unique or peculiar to Canada but is being fought out in every part of the world today and if I express here a preference for a privately owned, as distinct from a government owned bank, it it because I think that the dangers of a government ownership of a central banking institution are so obvious that they ought to be avoided. But it is perfectly legitimate to differ from me. Many

eminent colleagues of my own do differ from me. But I do beg gentlemen here, who may be engaged professionally in the business, to remember that this issue is one which does affect the fundamentals upon which central banking rests and also one by no means peculiar to Canada or North America.

May I finally say one word about the business future? The results of the very interesting condition in the last ten years in the sphere of economic thought have led many people including politicians and business men to ask for the point of view of central banks in the future, and that, instead of confining themselves to their traditional jobs of safeguarding the value of currency and looking after internal credit conditions, one should try and force upon the central bank a more definite conception of what their objective is and, as you know, many people are now saying it ought to be the duty of the central banks of the world to get us out of our difficulties by keeping the price-level stable in the future. I mention that because it is an issue which is being fought out in every part of the world and I desire to say on this subject only three things.

In the first place, even if central banks can keep the general price-level constant, that can only be achieved if there is absolute co-operation between the central banks of the world at all times and naturally at the expense of the permanent abandonment of the gold standard and I am not sure that is a wise thing. In the second place, even if a central bank could keep the price-level steady, I am not sure that keeping the general price-level steady is the most appropriate objective at which central banks can aim and I say that for one very simple reason. In the United States between 1924 and 1929 a certain approximate stability of the price-level was in fact achieved whether by good fortune or luck, or application of scientific principles, does not matter. The price-level was kept fairly steady but the stability of the price-level did not prevent at that time the engendering of a most disastrous boom. Secondly it does not seem to me that stability of prices is necessarily the aim of central banking policies. If you ask me what the central bank should do in this

twentieth century, I am inclined to think that they need do nothing, except what they have already done but they should re-define what they have already done in rather more modern terms, terms which cannot be stated with anything like pseude-scientific accuracy of stabilizing the general prices. The function of a central bank ought to be, in my opinion, to prevent the trade cycle being quite so abrupt in its fluctuations as it has been in the last four or five years. That is to say, we ought to try and keep the fluctuations of general business within narrower bounds than recently. Can that be done? I think it can, but I think it is necessary to warn you there is no scientific shortcut which economists can trace for central bankers as a kind of patent medicine which, if they swallow, will enable them to be endowed with vision much clearer than that of the ordinary man. All that you need, in order to temper down the fluctuations of the trade cycle, is to start early enough in the boom to prevent the boom from happening. If you want to avoid depression you must learn to avoid booms and, if you want to learn to avoid booms, you must have instincts and imagination to have the feel of the situation and an instinct that things are beginning to get out of hand. In other words, you want for the tasks of the twentieth century, exactly the same kind of judgment you wanted for the nineteenth.

The central banks of the world have great responsibility resting upon them but in the end central banks are composed of men and not of machines and the last thing I want to say therefore to the Canadian Club is, even if you have a central bank, do not ask for the impossible.

PRESIDENT SIFTON:—I am sure you will all permit me to express our deepest gratitude to Doctor Gregory for the great attention with which he has prepared an address on a very complicated subject and, speaking for myself, I want to say this is the first afternoon on which I have ever known anything about central banking.