

THE STABILITY ASPECTS OF CANADIAN NEAR-BANKS

THE STABILITY ASPECTS OF NEAR-BANKING
FINANCIAL INTERMEDIARIES IN THE
CANADIAN POST-WAR ECONOMY

by

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Scope and Contents:

The following is a study of the operations of various near-banks during the period 1954 to 1964, including; the caisses populaires and credit unions, the trust and mortgage loan companies, and the sales finance and consumer loan companies. It entails an examination of the contribution to the stock of money and near-money by these near-banks and other financial intermediaries, as well as their role in facilitating the flow of loanable funds from saving to investment. It is our intention to determine the stability implications of these activities through their influence upon; a) the money supply, b) the demand for money, c) the income velocity of money.

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INTRODUCTION

In its submission to the Royal Commission on Banking and Finance, the central bank includes as basic economic objectives; a) a high and stable level of employment, b) price stability, c) sustained economic growth, d) an equitable sharing of economic benefits and burdens and e) the maintenance of a high degree of economic freedom. Except for the last two objectives, which are really ends in themselves, the first three are more accurately described as means to a more basic and, i.e., the attainment of a rising general standard of living. The distinction between whether these objectives are means or ends is not so important as recognition of the fact that within the context of immediate goals certain conflicts may arise. For example, in an attempt to promote a high level of employment, critical pressure may be brought to bear upon the general level of prices. In Canada's experience, conflicts have also arisen between external and internal policies. For example, during 1962, when domestic policy was still one of monetary ease, priority was given to external policy resulting in higher interest rates to

ensure an adequate flow of foreign capital into the country. Also, during the immediate post-war years, conflicts were evident between Canada's debt management policy, which kept interest rates low to minimize debt costs, and appropriate monetary policy which should have pressed for higher interest rates in view of rapidly rising prices. These conflicts are difficult to assess and perhaps can only be justified in terms of certain priorities that are inevitable during a time of crisis. In the following study we are principally concerned with the impact of financial intermediaries upon the economy and the stability implications arising out of their activities. Because our interests are addressed to the stability of "near-bank" operations, we therefore concentrate our attention upon the first two objectives; not because of priority considerations, but because they have come to be regarded as economic stability objectives.

An economic policy aimed at stability is one which attempts to mitigate fluctuations in the level of economic activity. Two principal indicators of economic activity are the price level and the level of employment. As the economy moves from recession to boom, these indicators tend to fluctuate widely. During the upswing, increased capital and consumption expenditure produce inflationary pressures as the supply of goods and services tries to keep pace with

growing demand. As the surplus in available resources is eliminated, production costs increase with competitive bidding up of factor prices. Rising costs put additional pressure on final prices so that without some let up in demand the economy is subjected to a price-cost spiral that tends to offset the process of growth in the economy's national product. In addition, this undesirable expansion will create excesses and distortions, overcapacity in some fields and deficiencies in others, and lead to a recession or depression which brings expansion, for a time, to an end. Clearly, the stabilizing role of economic policy is to initiate, through the proper "mix" of fiscal, monetary, debt management, and other public policies, an influence over economic activity such as to prevent the above consequences.

To the extent that these controls succeed in dampening rising demand, inflation; leading to recession and unemployment, may be curtailed. The difficulty facing the authorities cannot be too strongly emphasized, for their task is to achieve the twin objective mentioned above. Coupled with the desire to maintain price stability is the equally important, although not always compatible, goal of achieving a high and stable level of employment.

In the following study, it is the intention to examine the influence upon stability of financial intermediaries, notably those intermediaries which have come to be

called "near-banks". These institutions, together with the chartered banks, comprise the heart of the financial market in Canada. The institutional arrangements which make up the market provide a network of channels through which lenders and borrowers of loanable funds are brought together. The influence of the above intermediaries upon the economy derives from their activities in this market which entails the creation and exchange of financial assets and liabilities. These activities, which are distinct from other enterprises dealing in physical goods and non-financial services, characterizes the function of financial intermediation. The part played by financial intermediaries in facilitating the flow of loanable funds from lender to borrower is so vital to the economy that any alteration in their operations is bound to have important stability implications. In the absence of this intermediate stage, the saving-to-investment flow of funds would be slowed down and significantly reduced as well as made more costly. Also, without the corresponding contribution to the stock of assets held by economic units, portfolios would tend to be much less diversified.

x Dur to their key position in determining interest rates and over-all liquidity in the economy, financial intermediaries are necessarily the focal point of central bank monetary policy. Effective stabilization policy must

touch all the important channels through which credit is created.

CHAPTER I

THE CONTRIBUTION TO THE STOCK OF MONEY BY THE NEAR BANKS AND OTHER FINANCIAL INTERMEDIARIES PLUS A GENERAL ACCOUNT OF THEIR OPERATIONS

- a) Criteria for measuring the banking function of various financial intermediaries
- b) Chartered Banks
- c) Caisses Populaires and Credit Unions
- d) Trust and Mortgage Loan Companies
- e) Sales Finance and Consumer Loan Companies
- f) Mutual Funds and Pension Funds
- g) Insurance Companies
- h) Summary

Note: The above sections are purposely arranged to present the contributions of the relevant financial institutions in a descending order of liquidity.

a) Criteria for measuring the banking function of various financial intermediaries

Due to their relative size and importance as key lenders, the chartered banks are the most prominent intermediaries in our financial system. Traditionally, however, banks have been recognized mainly because they create liabilities officially defined as money and it is largely for this reason that monetary policy has been directed toward the banking system. There are, nevertheless, many other institutions in the business of creating credit which do not come under the direct control of the monetary authority. This fact has, in recent years, raised considerable controversy over the effectiveness of monetary policy and its inability to influence those financial institutions outside the banking system.

It is recognized that in addition to demand deposits, created by the chartered banks and officially defined as money, there are a number of highly liquid assets created by other intermediaries which have come to be accepted as very good substitutes for money. An increase in money substitutes, or so-called "near-money", tends to cause a surplus in the existing stock of money created by the chartered banks. This is the same thing as saying that economic units have shown a preference toward holding near-money assets as opposed to money assets and thus the demand for money in the economy has

declined. Theoretical analysis has demonstrated that this can have substantial effects upon the level of liquidity and interest rates and hence upon economic activity. It is argued that to the extent that near-money serves as a substitute for money, that is, fulfills the store of value and medium of exchange functions, it should be controlled in the same manner that the central bank now controls money created by the banking system. This controversy turns on a question of terminology. If it is agreed that those institutions creating money substitutes are, in fact, performing a banking function, then it is perhaps reasonable to classify them as banks and as such, expect them to come under the central controls as outlined in the Bank of Canada Act. However, there is no apparent agreement as to what is the definition of banking. In an attempt to clarify this issue we will review a number of opinions that have been recently expressed. It will be our purpose to determine what constitutes a banking business with a view to establishing a rough criteria that will serve to identify a number of financial intermediaries.

If we begin by examining the Bank Act it is apparent that there is nowhere included a clear statement on the description of the type of institution to which its terms apply. The closest the Act comes to a definition is where it defines a bank as "a bank to which this Act applies"

(sec. 2), i.e. "each bank enumerated in schedule A" (sec. 4), which lists the ten chartered banks incorporated at the time the Act was established. The Act really sidesteps any detailed description of what is to be understood by the term "bank."

Many descriptions of banking include lists of various activities thought most characteristic of a banking business. Thus one observer recently provided the following:¹

- 1) making short-term loans on promissory notes
- 2) discounting trade paper
- 3) advancing to governments and municipalities large sums under their statutory borrowing powers
- 4) dealing in foreign exchange

The Canadian Bankers' Association, in its submission to the Porter Commission, expands upon the above list. They submit that among the essential features of a bank are:

that it accepts deposits repayable on demand or short notice, some or all of which are normally transferable by cheque, and lends or invests the funds deposited with it.²

The C.B.A., in addition, includes a number of activities which

¹J.E. Rutledge, as quoted by The Financial Post, May 29, 1965, p. 47. Mr. Rutledge is president of Nova Scotia Trust Company.

²The Canadian Banker's Association, Submission to the Canadian Royal Commission on Banking and Finance (Supplement to the Canadian Banker, Spring 1963), Paragraph 29.

they regard as typical banking functions:

foreign exchange transactions, buying and selling domestic or foreign bills of exchange, the collection of clean or documentary bills, remittances, cheque clearing, issuing letters of credit, giving financial guarantees, safekeeping of securities or other valuables, rental of safety deposit boxes.³

These attempts to describe a bank or banking function are really inadequate because there is hardly one of the services mentioned that is not offered by some financial institution other than a chartered bank.

Another approach that has been used is to define a bank as an institution having liabilities that are generally acceptable for making and receiving payments, such as bank notes or chequing deposits. The Porter Commission adopted this approach.

Whatever else it may embrace, the banking function is generally taken to include the issuing of claims which serve as means of payment or as close substitutes for such money claims.⁴

The Commission believes that all private financial institutions issuing banking liabilities should come under the federal banking legislation. It includes in its definition of banking liabilities:

³Ibid.

⁴Report of the Royal Commission on Banking and Finance, Ottawa: Queen's Printer, 1964, p. 377.

all term deposits, whatever their formal name, and other claims on institutions maturing, or redeemable at a fixed price, within 100 days of the time of original issue or of the time at which notice of withdrawal is given by the customer.⁵

+ This definition of banking is qualified to exclude non-financial firms, provincial government agencies, those dealing with less than 50 people, those issuing short-term liabilities not redeemable on demand or short-notice and issued through independent agents or dealers under a prospectus, investment dealers and stock brokers, caisses populaires and credit unions. In addition the Treasury Board would be given authority to exempt others. The principal institutions included would be; the chartered banks, Quebec savings banks, many trust companies and mortgage loan companies, centrals of caisses populaires and credit unions, and perhaps some sales finance companies. This recommendation is made on the grounds that for purposes of classification, and also control, the significant characteristic is the maturity of the liabilities issued by relevant financial institutions. Thus, all financial institutions are to be regarded as banks so long as they issue liabilities of under 100 days to maturity.

E.P. Neufeld, along with others, has pointed out

⁵ Ibid., p. 378.

that the practical application of the above institutional classification is really not satisfactory since it is unconstitutional. It is necessary to recognize that certain financial intermediaries referred to by the Commission, trust companies for example, come under provincial legislation on matters of property. To follow the recommendations of the Royal Commission would be to suggest that the federal government override the constitutionally established powers of institutional regulation and control granted to the provinces.

A second criticism by Neufeld entails the distinction between money and near-money on the basis of the medium of exchange function:

It seems logical that the distinguishing characteristic of banking in Canada should be thought of in terms of medium of exchange liabilities, and not the maturity of liabilities; a deposit which is not transferred to third persons is not a medium of exchange, while one that is transferred is a medium of exchange.⁶

Neufeld stresses the medium of exchange function of money and adds that what is important is not whether a deposit can be transferred, but rather, whether in fact, it is. Thus the question of whether an institution should require a banking charter, using this criteria, might best be determined if its chequing deposits play a significant part

⁶E.P. Neufeld, "The Report of the Royal Commission Banking and Finance: A General View," Canadian Banker (Summer, 1964), LXXI, 31.

in the economy's payments mechanism:- we assume, of course, that a deposit will qualify for this distinction when it attains a certain average rate of turnover and reaches a certain volume.

+ The Royal Commission, on the other hand, tend^s to
+ stress the store of value function of money and notes that there is a variety of liabilities, issued by various institutions, which are generally accepted by ultimate lenders as good substitutes for money. That is, not only do these liabilities serve as a store of value but they also have sufficient liquidity (some are perfectly liquid) to leave those giving up money balances with a substantially unchanged liquidity position. Thus the act of drawing savings from one economic section (ultimate lenders) and loaning out these savings to another economic sector (ultimate borrowers) serves to increase over-all liquidity in the economy and raises the velocity of turnover of money. It is the ability to perform this function that brings the Commission to include a number of financial intermediaries under the title of banks.

Continuing to stress the function of creating liquid liabilities, Dr. Holtrop, President of the Netherlands Bank, told the Porter Commission that in the Netherlands, all institutions that receive deposits and make loans are classified as banks. He went on to explain that there were certain qualifications. For example, if the amount on

deposit was less than a certain minimum, or if the lending activity was small relative to other activities the same institution was engaged in, then it was not considered a banking business. Dr. Holtrop noted further that if deposits turn over more than 1% per annum, according to his criteria this was pretty clearly a banking business.

It seems apparent that the most useful approach towards defining a bank is through its liabilities. It is this approach that we adopt for our criteria because it fits in with the theoretical distinction between money and near-money. In the following study we will attempt to classify a number of financial intermediaries according to their banking functions. Some of the liabilities created by these institutions, which are assets in the hands of the public, may be regarded as the ultimate form of liquidity. That is, such liabilities will serve as a store of value and be regarded as "an undisputed (even if not legally enforceable) means of final discharge of debt."⁷ These liabilities will be easily recognized as money and will include Bank of Canada notes as well as demand deposits created by the chartered banks. Also in this category of money, we will include liabilities issued by other financial institutions which are characterized by a high degree of acceptability as means of payment. In addition, a second category will be

⁷Dennis Robertson, "A Memorandum Submitted to the Canadian Royal Commission on Banking and Finance", Essays in International Finance (May, 1963) p. 21.

identified. This will include a variety of highly liquid liabilities, not immediately serviceable as a means of payment but nevertheless recognized as a good substitute for money; this will be referred to as near-money. In order to assess the relative importance of each liability as means of payment, its volume and rate of turnover will be noted.

Thus it is our purpose to analyze the operation of various financial intermediaries by reference to their balance sheets. This will enable us to categorize these institutions according to the type of claim they issue in exchange for savings which they are successful in attracting. Those institutions that perform a relatively large deposit business and that issue claims of first order liquidity will be regarded as banks. Those institutions that similarly conduct a large deposit business, but issue claims that are less liquid, yet still accepted substitutes for money, will be classified as near-banks. In the third category will be a number of intermediaries, far divorced from this banking function, that issue claims of a long-term illiquid nature; they will be generally referred to as non-banking financial intermediaries.

b) Chartered banks

The chartered banks are the most important intermediary in the capital market. This is attributed, primarily, to their size and to the fact that they serve so wide a range

of customers, including other financial institutions. Bank deposits are recognized as the preferred form of cash holdings due to a variety of reasons among which must be included; the convenience of the branch system, the fact that the banks operate the clearing system, and the importance associated with "a good bank connection". In their day-to-day operations the banks have a close working relationship with other financial institutions including investment dealers and finance companies who rely upon the banks for lines of credit. In short, the chartered banks are the biggest short-term lenders and borrowers, plus the principal administrators of the payments mechanism. Because their financial activities both directly and indirectly cover such a wide range, they maintain a powerful position in the financial system.

The asset portfolio of a chartered bank reflects both tradition and law in its relatively strong liquid position. The banks have, over the years, shown the influence of the "commercial loan" theory of banking by absorbing large quantities of short-term assets. Contributing to this liquidity position in recent years however, has been the required cash reserve stipulated by the Bank Act and amended to 8% of deposit liabilities in 1954, as well as the non-statutory secondary reserve introduced by the central bank in 1956, requiring 7% of deposit liabilities to be held in

day loans and treasury bills.⁸ Liquidity is further expanded by bank purchases of call loans and government of Canada bonds. These "more liquid" assets have continued to remain above 30% of total chartered bank assets, only dropping below this level once in the last four years.

Since the last world war the distribution of chartered bank assets has shown some important changes. While during the war years purchases of liquid instruments were as high as 69.5% of total assets, they have since continued to decline reflecting mainly an increase in personal loans. Since 1945, personal loans and mortgages have increased from 15% of total loans to 29% recorded in 1962. This expansion is attributed to the increased competition launched against the installment finance companies, credit unions and small loan companies. It is believed that further increases in this business will be forthcoming if present restrictions on mortgage lending are lifted and other impediments to competition such as the 6% interest ceiling on loans are eliminated or revised.⁹ Other assets of lesser liquidity held,

⁸Both these reserve requirements have been revised by the recent Bank Act amendments. The cash reserve is to be reduced to roughly 7% while the present liquid asset ratio is being eliminated. The central bank will retain the power to raise the liquid asset ratio at its discretion; it may request a 6% liquid reserve at any time with calls to increase this rate by 1% per month up to 12%.

⁹The present revision of the Bank Act allows the banks to enter conventional mortgage lending on a competitive footing and also clears the way for the eventual elimination of the interest ceiling on loans.

include loans to business and government (provincial and municipal) as well as security purchases from these economic units. Loans to businesses, farmers, and municipalities have increased slowly relative to personal loans during the post-war period, with business loans making up close to half of all loans granted. Purchases of securities from the above units have declined, however, with business between banks and provincial government showing a marked decrease.¹⁰

The liability side of the chartered bank's balance sheet explains, in part, the liquidity position taken in their asset portfolio. In addition to holding liquid assets in order to meet requests for short-term credit, particularly during periods of tight money, the banks must protect themselves against changes in their reserve position. This position is affected by both day-to-day and long-term fluctuations in demand deposits and thus necessitates some adjustment of assets to compensate for the change. The method of compensation requires adequate liquid reserves and draws the banks into close contact with the money market.

The current account¹¹ is the most important banking

¹⁰The chartered banks continue to show a preference toward short-term loans. For example, only approximately 13% of business loans outstanding have an original term of more than one year.

¹¹Includes deposits of governments and other banks as well as public demand deposits and personal chequing accounts.

liability in the economy's payments mechanism. This demand deposit account is designed mainly for businesses and is used for all their normal payment needs and, to a limited extent, as a cash reserve. The government and other financial institutions also use current accounts as cash reserves and working balances. In 1945 current accounts comprised 49.4% of total Canadian dollar deposits but have since declined to 34.8% in 1962. In 1961 current accounts turned over 68 times during the year.¹²

The largest deposit account category carried by the chartered banks is their personal savings deposit which has continued to grow since the war and reached 57.9% of Canadian dollar deposits in 1962. These accounts are used by individuals, both as a savings instrument and as a means of payment, although the rate of turnover at $1\frac{1}{2}$ times per year is much less than the current account. Over one-half of these accounts are used for chequing purposes and show an average balance of less than \$100. The bulk of the funds are held in a relatively small proportion of accounts whose owners regard them as a more permanent, yet conveniently accessible form, of interest-bearing investment.¹³

¹²The Royal Commission, pp. 117-119.

¹³A standardized rate of interest is paid on savings deposits. In mid-1960 it was $2\frac{3}{4}\%$ and by 1965 it had increased to 3%. With the advent of the new Bank Act there are signs of these rates becoming much more competitive.

In 1957 the banks introduced non-interest bearing "personal chequing accounts" to accommodate those making active use of their savings. These accounts have not proven successful owing both, to their heavy cost of servicing, and to public preference for interest-bearing savings accounts. The rate of turnover of chequing accounts is approximately 15 times per year.

Increased competition from other intermediaries offering short-term investments has forced the banks to improve the attractiveness of their non-chequable term liabilities. Since 1950 these liabilities, including deposit receipts, have expanded from \$300 million to \$400 million to \$1.2 billion in 1963. The 1955 to 1960 term rates on balances of \$100,000 or more were fixed just below the current rates on treasury bills. Since early 1961 term rates have frequently exceeded the treasury bill rate with deposit instruments varying from 30 days to a year in maturity; also, the minimum acceptable balance has been revised down to 25,000. Steps have recently been taken to expand this term business into the personal savings field and one chartered bank now offers a term instrument, convertible on demand, over a wide range of maturities for amounts as small as \$1,000. This latter investment is clearly intended as one defense against the "guaranteed investment certificate" sold by the trust companies.

TABLE I¹⁴Selected Liquid Financial Assets Held Mainly By Individuals

	<u>1945</u>		<u>1950</u>		<u>1955</u>		<u>1958</u>		<u>1962</u>	
	\$mn.	%	\$mn.	%	\$mn.	%	\$mn.	%	\$mn.	%
Chartered Bank Personal Savings Deposits	2,635	73.3	4,176	63.8	5,633	55.5	6,844	54.5	7,932	45.8
Quebec Savings Bank Deposits	130	3.6	190	2.9	247	2.4	274	2.2	324	1.9
Caisses Populaires and Credit Union Shares and Deposits	135	3.8	288	4.4	598	5.9	919	2.3	1,516	8.7
Trust Company Deposits and Certificates	181	5.0	343	5.2	597	5.9	825	6.6	1,682	9.7
Mortgage Loan Company Deposits and Debentures	156	4.3	278	4.3	469	4.6	602	4.8	1,055	6.1
Deposits in Government Savings Institutions	110	3.1	162	2.5	180	1.8	195	1.6	206	1.2
Canada Savings Bonds	248	6.9	1,104	16.9	2,433	24.0	2,895	23.1	4,620	26.7
Total	3,595	100.0	6,541	100.0	10,156	100.0	12,554	100.0	17,335	100.0

¹⁴The Royal Commission, p. 120.

Since the war the chartered banks have encountered strong competition from a number of financial intermediaries. These intermediaries have shown a particularly rapid growth relative to the chartered banks, both in the savings they are successful in attracting, and in the assets they purchase. In an effort to maintain their share of cash flows the banks have introduced such innovations as term deposit certificates, special savings plans, and personal chequing accounts. Nevertheless, although savings deposits have grown more rapidly than current accounts, the banks have lost ground, in recent years, in the competition for funds. (see Table I, p. 20). The Porter Commission has noted a number of factors which influence this trend.

The nature of the asset offered - whether money or a less liquid instrument - the ease or difficulty with which customers may invest and withdraw their funds, the location of offices and hours of business, the risk of loss, and the other facilities available to the customer such as safe keeping and the possibility of borrowing when occasion arises, all enter as elements in the competition for funds.¹⁵

The chartered banks have generally relied upon their widespread branch system and operation of the cheque clearing system to mop up most of the available savings in the country. Rather than competing through appropriate office hours in local competitive situations (experiments in some branches are

¹⁵The Royal Commission, pp. 119-120.

being conducted), or varying their prices, the banks have maintained a uniform service across the country and have concentrated their efforts upon extending their branches and enhancing the quality of their services. As a result, the banking field has become over populated at the expense of efficiency. Two other factors noted by the Commission that have contributed to the bank's loss of position are; 1) their slowness in the savings field to offer more than one type of interest-bearing deposit to individuals with balances of less than \$25,000 coupled with their inflexibility in extending free chequing privileges and 2) their inability to compete effectively for funds where interest rates are high, due to the 6% ceiling placed on loans by the Bank Act. This second factor has been a significant restraint on the bank's competitive position since it limits the prices banks may offer to attract savings.

c) Caisses Populaires and Credit Unions

The caisses populaires and credit unions are cooperative organizations designed to hold the savings of their members and to pay interest which reflects the yields from such investments as security holdings and personal loans. The caisses populaires concentrate their business in rural Quebec; while the credit unions, although mainly in Ontario, British Columbia, and Saskatchewan, have spread from their origin in Nova Scotia to most of the other provinces. The

majority of the 4,700 caisses and credit unions are federated in 18 distinct, and sometimes rival, leagues. They have established 27 central credit societies in which reserves are pooled and other financial operations managed. Since the war, the proportion of personal savings attracted by these institutions, relative to other deposit taking institutions, has more than doubled. (see Table I, p. 20). Total asset holdings have increased by 211% during the period 1955 to 1965 reflecting the fourth largest growth rate among Canadian financial intermediaries.¹⁶ The asset portfolio of the caisses populaires, compared with that of the credit unions, tends to be more liquid. At the end of 1961 cash reserves were just over 8.0% while 38% of total assets were securities and 50% were loans and mortgages to members.¹⁷ In contrast, the credit unions loaned out 81% of their funds to members (mainly personal loans) while holding investments of 12% and cash reserves of 4%. The credit unions operate with relatively low cash reserves and security holdings, whereas the caisses populaires reflect a much more conservative policy. One reason for this is that while the credit unions concentrate their business on personal loans which have a rapid turnover, the caisses

¹⁶The Financial Post, May 29, 1965.

¹⁷The Royal Commission, p. 166. Personal loans are minor comprising approximately 8% to 9% of total assets.

populaires are active mainly in mortgage lending which turns over only once in 5 to 7 years. It is therefore not so surprising that the liquidity needs of the caisses tend to be greater.

TABLE II

Combined Liabilities of Locals¹⁸

(December 31, 1961)

	Caisses Populaires		Credit Unions	
	\$Mn.	%	\$Mn.	%
Borrowings and other liabilities	2.7	0.3	29.7	4.5
Deposits	734.8	87.5	78.9	12.0
Shares	56.7	6.8	499.8	76.1
Reserves	38.1	4.5	25.4	3.9
Undivided savings	7.6	0.9	23.0	3.5

The asset side of the balance sheet is readily explained when we examine the liabilities listed for the two organizations. The immediate distinction is that credit unions mainly issue shares, while caisses populaires concentrate upon deposits (see Table II). Share business by the caisses and deposit claims against the credit unions are relatively minor

¹⁸The Royal Commission, p. 158.

and therefore we will first turn to discuss these liabilities.

The deposits of credit unions are regarded as similar to the current accounts (or personal chequing accounts) of the chartered banks. In 1961 they totalled \$79 million showing a continuous declining growth rate relative to other liabilities. The rate of turnover of deposits is estimated at between 20 and 40 times per year.

Distribution of shares by the caisses populaires has been restricted in order to prevent dilution and the lowering of the established rate of dividend; they are equal to only 7.7% of deposits. Shares are thought to be similar to such instruments as term deposits of trust companies and offer a return on investment ranging between 5% and 7% per year. Demand for shares is strong resulting in an annual growth rate of 10%. However, distribution policy has resulted in some 80% of all members holding only one qualifying share, and others holding varying amounts up to the maximum permitted.

Deposit claims are the most important liability of the caisses populaires and amount to 87.5% of total liabilities. These deposit claims are recognized as being close substitutes for chartered bank savings deposits in as much as they are chequable and widely used as a means of payment. The rate of turnover is approximately 2.7 times a year and has steadily increased since 1950 when it was 2.5.

The caisses attract 25% of all savings deposits in Quebec. Since these deposits are chequable, it makes the

caisses an important link in the payments mechanism. Indeed, in one year it is estimated that over \$1 billion is drawn against local caisses.¹⁹ Cheque clearing arrangements are handled by the caisses centrals and are comparable to those of the banks. For bank-to-caisses clearings a somewhat longer process is involved. For example, a caisses cheque cashed at a bank is first directed to the bank's clearing center in Montreal or Quebec City. Next, it is delivered to the Provincial Bank of Canada from which it is cleared to the Quebec or Montreal caisses central. In the next two steps the cheque is sent to the proper central and finally to the local caisses on which it is drawn.

The caisses populaires have proven effective competitors of the chartered banks offering similar services as well as frequently higher rates of interest. They also have been competitive in terms of office location, hours of business and in providing additional services.

The credit unions draw the bulk of their funds from the sale of shares which amount to 76.1% of their total liabilities. These shares have been compared to the non-chequable savings deposits of U.S. financial institutions such as the mutual savings banks and the savings and loan

¹⁹In Quebec \$87 billion is annually drawn against the chartered banks.

associations. Similar to these institutions, the shares drawn on the credit unions turn over at the approximate rate of 0.5 times per year. This velocity could increase in future with the extension of chequing services offered by most of the large institutions.²⁰ According to the Porter Commission credit union shares seem to be part of the union member's long-term rather than short-term savings program. If this is true, then along with their non-chequable characteristics, shares would not appear to be close substitutes for money. However, it is apparent from the evidence in the working paper presented by Gilles Mercure, that there is no fine line of distinction between shares of the credit unions and deposits of the caisses populaires. In his conclusion the author suggests:

that shares and deposits combined of both credit unions and caisses populaires have a velocity roughly comparable to that of banks savings deposits, except for a small number of accounts of current nature.²¹

In his final analysis of the credit unions and

²⁰ It is estimated that five years ago there were only 50 credit unions with chequing facilities compared with the present number of 350. Of the 3,418 societies it is believed that between 600 and 700 are currently in a position to give "reasonably good" chequing services, assuming this requires \$200,000 assets and a full time staff. See Gilles Mercure "Credit Unions and Caisses Populaires". Working Paper prepared for the Royal Commission on Banking and Finance, (November, 1962), p. 109.

²¹ Gilles Mercure, p. 83.

caisses populaires Mercure states that

they issue liabilities that are all redeemable on demand in practice and fulfill one of the two functions of money, that is to serve as a store of value in liquid form. In all caisses populaires, and in most credit unions of some size, these are chequable liabilities and fulfill the second of the functions of money, that is to serve as a means of payment. The essence of banking is to extend credit while at the same time to retain for the benefit of the ultimate lender the very utility of the money transferred to the ultimate borrower. Caisses populaires and credit unions are, or soon tend to become, banks.²²

We must concur with Mercure since the liquid liabilities issued by these institutions achieve a high degree of acceptability as means of payment and also achieve a sizeable volume. In accordance with our criteria both the credit union and caisses populaires must be classified as banks.

d) Trust and Mortgage Loan Companies

During the ten years from 1955 to 1965 the trust and mortgage loan companies have shown the second and third largest growth rates among the important Canadian financial intermediaries.²³ Throughout this period trust company asset

²² Ibid., p. 180.

²³ It should be noted that these growth rates are based on the percentage change in total asset holdings over a decade and are related to the asset holdings of other intermediaries such as banks, finance companies, mutual funds, and credit unions. A problem encountered in measuring the relative size of trust companies is that their asset structure reflects book value rather than market value and therefore tends to be undervalued. It has been observed that a large portion of their assets, mainly in E.T. & A., have been carried on their books for long periods of time without being revalued to properly reflect current market rates.

holdings increased 291% while for the mortgage companies it was 235%. Market shares have also expanded as indicated in Table I, page 20. Individual holdings of trust company deposits and certificates have nearly tripled over the past decade, while holdings of mortgage company deposits and debentures increased over 100%.

For the trust companies the "non-intermediary" function,^{involving} the administration of a great many trust and agency accounts, comprises the largest part of their operation. In 1958, funds designated "Estates, Trusts and Agency Funds" made up 85% of total liabilities. This figure, as high as 91.4% in 1946, has during the last four years, continued to reflect this downward trend.

Since 1961, 25 of the present total of 55 trust companies were formed with company offices doubling in number to a total of 400. Many of these new companies are concerned mainly with savings and loan operations indicating that it is in this area that they must first establish themselves before moving into the more sophisticated and less accessible business of E.T. and A.²⁴ This development has contributed to the diversified nature of trust company operations which is characterized by a wide range of investments; some leaning toward mortgages and long-term bonds,

²⁴The Financial Post, May 29, 1965.

others retaining a close contact with the money market. The mortgage loan companies, on the other hand, tend to be more highly concentrated and to confine their operations almost exclusively to mortgage investment.

TABLE III

Mortgage Loan Companies²⁵

(end 1964)

<u>Assets</u>	<u>\$ mn.</u>	<u>%</u>
Cash	64	3.4
Short-term Securities	10	0.5
Bonds	196	10.5
Mortgages	1469	77.0
Cd'n. Preferred and Common Stock	56	2.9
Foreign Securities	4	0.2
Other Assets	109	5.7
	<hr/>	<hr/>
Total Assets	1908	100.0
 <u>Liabilities</u>		
Demand Deposits chequable	154	8.1
non-chequable	166	8.7
Term Deposits (debentures, etc.)	980	51.4
Other Liabilities	361	18.9
Shareholders Equity	247	12.9
	<hr/>	<hr/>
Total Liabilities	1908	100.0

²⁵ Bank of Canada Statistical Summary (April, 1965),
p. 246.

The mortgage loan companies in 1962 held mortgages (mainly conventional residential mortgages) amounting to 77% of their total assets; an increase of 24.5% over 1945. Security purchases, like mortgages, are generally medium and long-term claims and are primarily held against the federal government and corporations. The terms of these assets mirror the maturity dates on debentures which are the principal instruments used to attract loanable funds. Most debentures are issued with maturities ranging from one year, the minimum allowed in Ontario, to ten years, and are held mainly by individuals. These liabilities are not regarded as liquid or marketable claims by either the companies or their holders. This fact, plus the convenience of the money market, has enabled the loan companies to maintain a very low liquidity position (table III reflects a marked increase in cash holdings during 1964 of \$37 million).

Since the war, deposits and other demand liabilities have generally declined in the face of increased debenture holdings and comprise about 16.8% of total liabilities or \$304 million (approximately 1/3 that of the deposits held with caisses populaires). These deposits are not issued by all mortgage loan companies and those in use are held mainly by individuals. One-half of the deposits are chequable with clearing arrangements established with the chartered banks. Finally, these deposits are not very active and reflect

velocity movements which are similar to chartered bank savings deposits.

In conclusion, it is evident that the banking function performed by the mortgage loan companies is a minor one. In view of this and the illiquid nature of other liabilities held against these companies, the appropriate classifications for mortgage loan intermediation seems to be a questionable near-bank. In order not to muddle the analysis with too many terms it is perhaps best to place the mortgage loan companies in the near-bank category while recognizing that, in fact, they really fall somewhere between other near-banks, such as trust companies and finance companies, and non-banking financial intermediaries such as insurance companies, pension funds, etc.

The two most significant liability claims against the trust companies are demand deposits (36.9% of total liabilities) and term deposits in the form of guaranteed investment certificates (53.8% of total liabilities. See Table IV p. 33). The latter have shown the most rapid growth since the war with about 1/2 the funds coming from individuals while approximately 40% is drawn from business corporations. The G.I.C. is a specially tailored instrument designed to suit the investor and may range in maturity anywhere up to five years with a minimum value of \$100. The attractive yields of these instruments generally offsets their lack of marketability although some companies have been

TABLE IV
Trust Companies²⁶
(end 1964)

<u>Assets</u>	<u>\$ mn.</u>	<u>%</u>
Cash	82	2.9
Short-term Securities	169	6.1
Bonds	872	31.2
Mortgages	1422	51.0
Can. Preferred and Common Stock	68	2.4
Foreign Securities	6	0.2
Other Assets	170	6.2
	<hr/>	<hr/>
Total Assets	2789	100.0
 <u>Liabilities</u>		
Demand Deposits - chequable	506	18.1
- non-chequable	523	18.8
Term Deposits (investment certificates, etc.)	1500	53.8
Other liabilities	21	0.8
Shareholders Equity	240	8.6
	<hr/>	<hr/>
Total Liabilities	2789	100.0

²⁶ Bank of Canada Statistical Summary (April, 1965), p. 246. The data gathered in the above balance sheet covers intermediary business. Items are also listed at book value. it does not include estate, trust, and agency funds.

known to redeem them in unusual circumstances. Indeed, some of the bigger companies have developed a large market for certificates of one year or less in competition with other short-term investments such as commercial paper, chartered bank deposit receipts, and treasury bills.²⁷ It is this source of funds that has accounted for the recent rapid growth of some trust companies. It is an area where other institutions, notably the chartered banks, offer little competition since interest rates seem to be the important factor. The trust companies pay between 5% and 5½% on their investment certificates while the chartered banks are hard pressed to offer anything more than their standard personal savings account at 3% for balances of less than \$25,000 for a period less than one year.²⁸

In 1964 demand deposits were approximately divided between chequable and non-chequable with the latter showing a marked increase over the last two years. This increase in non-chequable deposits has been attributed to the efforts of some companies to discourage the active use of deposits by means of service charges. Nevertheless, chequing privileges remain

²⁷The Royal Commission, p. 182.

²⁸The chartered banks offer term deposit accounts but the minimum value is usually \$10,000. There is evidence of change in this area. The banks have begun^{to} recognize the need for more competitive instruments with lower minimum levels and more varied maturity ranges.

one of the feature attractions for loanable funds and these deposits turn over at the rate of three to four times a year; more than twice the rate of a bank savings account. The trust companies have been particularly competitive in attracting individual savings towards their deposit accounts. Evidence of expanding branches, higher interest rates, more suitable hours and even gifts and bonuses testifies to the increased competition launched against the chartered banks and other intermediaries.

The banking function tends to be small among the larger trust companies, relative to their other non-intermediary operations. For many of the new companies however, banking is their main business. It is evident that by the end of 1964, money totalling \$506 million had been created, along with a sizeable volume of near-money in the form of highly liquid, low maturing investment certificates and non-chequable deposits. The quantitative importance of chequable deposits alone is roughly 3% of the money supply. It therefore appears that trust companies in general, according to our criteria, qualify as near-banks, while a few must properly be termed banks.

e) Sales Finances and Consumer Loan Companies

The sales finance and consumer loan companies are leaders in the field of consumer credit, along with the chartered banks and credit unions. The finance companies

direct loanable funds toward the consumer sector of the economy for the purpose of purchasing durable goods, notably automobiles. There are two recognized forms of financing: the first is called "retail financing" and entails the purchase of installment contracts between dealer and consumer; the second is called "wholesale financing" where the contract purchased is entered into by the manufacturer and dealer.²⁹ While the finance companies have entered other fields such as financing purchases of equipment and machinery by businesses, the loan companies concentrate almost exclusively on consumers, granting cash loans to people not able to obtain credit elsewhere.³⁰ Finance and loan companies, having no deposit business, absorb loanable funds from the financial market. They are considered intermediaries in the flow of funds between "the capital and money market on the one side and the goods market on the other."³¹

²⁹Submission by the Federated Council of Sales Finance Companies, to the Royal Commission on Banking and Finance, p. 7. Note that the latter form of financing does not directly qualify as consumer credit. However, wholesale financing does facilitate the extension of credit at the retail level.

³⁰By 1963 consumer goods financing accounted for 54% of the finance companies main receivables, down from 64% recorded in 1955. Equipment financing has continued to grow steadily while some companies have moved into interim financing on real estate and construction as well as property and equipment. The field is becoming increasingly diversified.

³¹Canadian Economic Research Associates, Sales Finance Companies in Canada, Toronto, (1958), p. 7.

During the early post-war years the heavy demand for consumer credit resulted in the rapid growth of finance and consumer loan companies. However, in the last decade the growth rates of these companies have lagged somewhat behind the trust companies and credit unions; even so, asset holdings during this period were doubled. This slower growth in part reflects the recent inroads made by the chartered banks into the personal lending field. The following chart indicates the growing competition in consumer lending. Of particular note are the advances made since 1956 by the chartered banks and the credit unions and caisses populaires.

Table V
Balances Outstanding³²

	<u>Dec. 31, 1964</u>	<u>Percentage Change From</u>			
		1962	1960	1958	1956
	\$mn.	%	%	%	%
Chartered Banks	1,793	+52	+109	+224	+296
Quebec Savings Banks	15	+15	+150	+150	+400
Sales Finance Co's.	967	+21	+ 17	+ 26	+ 28
Consumer Loan Co's.	901	+26	+ 64	+125	+153
Life Insurance Policy Loans	397	+ 7	+ 15	+ 30	+ 47
Department Stores	508	+19	+ 38	+ 80	+108
Furniture & Appliance Dealers	169	+ 1	-0.6	-0.6	+ 4
Oil Co. Credit Cards	59	+20	+ 37	+ 69	+127
Credit Unions & Caisses Populaires	776	+34	+ 79	+143	+243
Total	5,585	+30	+ 55	+ 97	+125

³²The Financial Post, May 29, 1965.

The most significant feature of the finance companies' balance sheet is the liabilities column or sources of funds. These companies obtain almost all their funds by selling notes and debentures to other financial institutions and by borrowing from the chartered banks. Rather than directly competing for the savings of ultimate lenders, the finance companies attract savings indirectly through the money and security markets. In these markets they offer a great variety of debt instruments as an alternative to bank term deposits, trust company investment certificates, and loan company debentures.

Table VI

Liabilities of Sales Finance Companies³³

	Bank Loans		Short-Term Notes		Long-term Notes and bonds and Debentures		Other Liabilities		Capital and Revenue		Total	
	\$mn.	%	\$mn.	%	\$mn.	%	\$mn.	%	\$mn.	%	\$mn.	%
1953												
10 largest co's.	191	22.8	212	25.2	244	29.1	108	12.9	84	10.0	839	100.0
1957												
10 lgst. co's.	156	12.1	409	31.8	420	32.7	158	12.3	143	11.1	1236	100.0
1962												
10 lgst. co's.	90	5.0	515	28.4	691	38.1	277	15.3	241	13.3	1814	100.0
1962												
all other co's.	65	26.9	49	20.2	44	18.2	37	15.3	47	19.4	242	100.0
<hr/>												
1962												
Total	155	7.5	564	27.4	735	35.7	314	15.3	288	15.0	1056	100.0

³³The Royal Commission, p. 211.

The sales finance industry is highly concentrated as indicated by the above table. Statistics produced by the D.B.S. show that the ten largest companies out of 150 have about 90% of the total business. Although most of the smaller companies still rely heavily upon bank credit, the ten largest companies concentrate their borrowings upon short-term and long-term notes and debentures. The swing away from bank credit is largely the result of restraints placed on these credit lines during the tight money periods of the late 1950's. This action, initiated by the central bank, forced the finance companies to seek an alternative credit "cushion". The finance companies are the principal borrowers in the money market and the activities in this area continue to increase both due to the above mentioned restrictions and because interest costs are lower.

The finance company debt instruments are generally issued through investment dealers. They are seldom traded on the market mainly because they are personally tailored to meet the specific needs of customers. Short-term notes have five specified maturities ranging from thirty days to one year. Other instruments are individually negotiated to meet particular needs, for example, securities maturing in less than 30 days. Most companies specify minimum acceptable amounts of \$25 or \$50 thousand however, even these companies will often take "nuisance" amounts as low as \$5,000,

especially when market conditions are tight.³⁴ The cost of this money market borrowing fluctuates widely with changing economic circumstances, ranging from rates as low as 1½% in 1954, 55 and 58, to those as high as 7% in 1957 and 1959. Long-term notes and debentures comprise the bulk of all paper issued by the finance companies and varies in maturity anywhere up to 20 years. These notes are usually privately placed with insurance companies and other institutional investors.

It is difficult to assess the extent to which finance companies carry on a banking business. They have traditionally refrained from accepting deposit liabilities and therefore must be judged on the basis of their short-term note issues. These notes are effective substitutes for money in that they serve as a store of value while retaining a high degree of liquidity. Short-term notes are not ordinarily redeemable before maturity and few are actually traded on the market. However, those notes with maturities up to 90 days appear to be in the majority of all short notes issued.³⁵ Such evidence as there is does not justify that consideration be given these notes as means of payment nevertheless, their

³⁴B.K. MacLaury, "The Canadian Money Market: Development and Impact", Harvard University Thesis, (February 1961) p. 181.

³⁵Ibid., p. 184.

high liquidity readily identifies them as near-money. To the extent that some finance companies do redeem their notes on demand or short notice, they approach a banking business but by-and-large the finance industry would appear to be most appropriately placed in the near-banking category. It should be noted finally that some finance companies concentrate more heavily than others in placing long-term paper thus reflecting longer-term investments in their asset portfolios. Such companies would be most correctly regarded as non-banking financial intermediaries wince the liquid liabilities they create are small in proportion to the more illiquid claims.

The consumer loan companies are not permitted under the Small Loans Act to accept deposits and therefore rely principally on two main resources for drawing funds. The larger companies obtain funds either from their American parent or Canadian owner, the latter generally being an installment finance company. The smaller companies must rely mainly upon the chartered banks and their own shareholders. For the industry as a whole only a very small proportion of their resources are secured through short-term money market operations.

A final observation, which is subsequently developed, concerns the cyclical fluctuation in the growth rates of the finance and consumer loan companies. Evidence has shown that these fluctuations have an inverse correlation to the growth patterns of other intermediaries which maintain a broad

similarity. It is evident that during periods of monetary restraint the finance and loan companies enjoy a decided competitive advantage in attracting loanable funds. This has been attributed in part to the inelastic nature of demand for credit by borrowers and thus their acceptance of higher interest rates. This necessarily allows for higher rates on liabilities sold in drawing loanable funds. Another advantage noted is that these companies rely mainly upon the central financial markets, in both Canada and the U.S., for funds. Consequently, this more sophisticated source of funds, being more sensitive to interest rate changes than the general public, will make substantial amounts of additional funds available to the companies if attractive rates are offered.³⁶

The money market has been a boon to the finance and consumer loan industries both in terms of cost and availability of credit. However, problems have arisen recently due to an over-dependence on this source of short-term funds. Some companies finance risky and long-term loans while borrowing heavily in the short market. The problem arises that some companies are unable to meet their short-term commitments as a result of their illiquid asset position. The money market has expanded rapidly over the last few

³⁶The Royal Commission, p. 219.

years with the increased business from finance and loan companies. Some observers fear that this growth is being undermined by elements of instability.

f) Mutual Funds and Pension Funds

The investment companies are intermediaries selling securities to the public and investing the proceeds in diversified investment portfolios. There are two types of investment companies in Canada. The first and traditional type is the closed-end company which periodically sells debt and equity claims in the same manner as industrial companies. These liabilities are traded in securities markets while a large number of them are closely held. There are approximately 23 closed-end companies with assets over \$525 million.³⁷

The second type of investment company is the open-end company or "mutual funds". These companies issue liabilities in the form of "special" or "class A" shares which are sold and redeemed at all times at prices based on the current value of the company's assets. The mutual funds have a great attraction mainly to small savers and have shown a phenomenal growth rate in the past ten years. This growth has been attributed largely to a booming economy with rising prices and stock values and increased savings. In 1962 there were 65 different types of mutual funds most

³⁷ Ibid., p. 251.

of them being established in the last 15 years. These companies have increased their asset holdings by 480% from 1955 to 1965 with a present total of \$1462 million.³⁸

Table VII
Mutual Funds³⁹
 (end 1964)

<u>Assets</u>	\$mn.	%
Cash	25	1.7
Short-term Securities	48	3.3
Bonds	160	10.9
Mortgages	12	0.8
Cd'n. Preferred and Common Stock	967	66.1
Foreign Securities	227	15.5
Total Assets	1462 ^{a)}	
<u>Liabilities</u>		
Shareholders Equity	1126	98.8
Other Liabilities	14	1.2

a) at market value

³⁸ Financial Post, May 29, 1965.

³⁹ Ibid.

There is a variety of mutual funds, each following slightly different investment patterns. There are bond funds for example; which, as their name suggests, invest mainly in bonds and debentures (97.0% of total assets in 1962). Alternatively, there are stock funds which purchase primarily common stock (92.0% of total assets in 1962). In addition there are so-called "balanced" funds that are more diversified in their portfolio and switch their assets when more favorable rates appear (in 1962 70.4% common stock and 17.4% bonds and debentures). The industry as a whole invests over 3/4 of its funds in common stock, primarily issues of well established companies, with all branches of industry represented. The mutual funds, through their dealings in the stock market, are considered to have a significant influence on equity prices. This is one area where the institutionalizing of investment has furthered rather than hindered equity financing.

The share held by the individual investor represents a relatively liquid asset in that it can usually be redeemed on demand at its net value. However, these shares differ widely from those issued by the credit unions which we earlier identified as good money substitutes. An increasing proportion of shares are being issued on a regular payment or contract basis rather than through lump sum purchases and thus resemble the savings scheme developed in pension funds and insurance policies. Like the insurance policy, a

mutual fund contract is usually "loaded at the front-end" to bear the acquisition fees and other charges. As a result, if an investor wishes to redeem his shares early in the life of the contract he may suffer substantial loss. It is evident that the shares held against a mutual fund are tailored to attract long-term savings and are not to be regarded as short-term liquid claims.

The pension funds are similar to the mutual funds in being intermediaries for which both lending and borrowing operations tend to be of a long-term nature. More than 30% of the country's personal savings are directed toward approximately 9,000 pension funds. The assets in "trusteed"⁴⁰ funds have increased from an estimated \$1180 million in 1952 to \$4,572 million in 1962. During this decade the annual growth rate has declined from 16% to 13%. In addition to the "trusteed" pension plans, which account for two-thirds of the total assets, there are smaller plans in the hands of life insurance companies and trust companies as well as annuity plans offered by the federal government. Although the trusteed plans hold the bulk of assets; in number they represent only 12% of the total pension plans in existence.

⁴⁰The savings in this type of fund may be invested by a selected trustee which could be either a corporate trustee (i.e., a trust company), an investment company, or an individual or a group of individuals.

In 1961 close to 75% of the assets of trustee pension plans were bonds, (provincial 32%, federal 15%, municipal 11%, other 17%). In addition 9.6% of total assets were stocks, 9.2% mortgages and 6.5% were other assets. It is evident that these institutional funds are not so important in the stock market as are the mutual funds, nevertheless, \$393.2 million in common and preferred stocks were held by trustee funds in 1961 and this amount appears to be increasing. It is also evident that pension funds provide a principal source for government borrowing.

While this analysis of the mutual funds and pension funds has been very brief it does serve to indicate generally the nature of their operations. It is clear that both forms of intermediation are vital to the flow of savings toward the financing of long-term government and corporate expenditure. These institutions are quite different to the other banking and near-banking intermediaries described so far. The liabilities issued are contained in contract form assuring these intermediaries of a certain flow of funds virtually guaranteed against withdrawal or depletion. The funds are specifically designed to take in long-term savings and to bear the risk in purchasing such illiquid assets as stocks and long maturing bonds. There is no doubt that the correct term of reference for the pension funds and mutual funds is non-banking financial intermediary.

g) Insurance Companies

The life insurance companies may be placed in the same category as the pension and mutual funds in so far as they are also intermediaries specializing in purchasing and creating long-term claims. The liabilities issued by the insurance companies such as life insurance contracts, pension and annuity plans, etc., absorb over 25% of personal savings in Canada; only Canada savings bonds and chartered banks exceed this amount. The insurance industry is concentrated in 16 federally registered companies out of a total of 105 (recorded in 1961) which hold over 90% of the industry's total assets. In addition, it is also highly international with 13 of 36 federal companies controlled outside Canada and holding 65% of the business.

Savings are accumulated not only from the sale of annuities but also from the "level premium" plan utilized in the sale of life insurance. Under this method :

a fund or reserve must be accumulated in the early years to meet the rising level of claims that will occur during the later years of such policies. These reserve requirements lead to the accumulation of personal saving through life insurance.⁴¹

The type of insurance plan is, of course, an important factor in the volume of savings accumulated. The plans offered

⁴¹Canadian Life Insurance Officers Association, Submission to the Royal Commission on Banking and Finance (Toronto, 1962), p. 25.

include straight term insurance as well as a number of more sophisticated plans, including pension and annuity plans, which embody a variety of saving features. In recent years term insurance has increased more rapidly than other plans. This trend reflects the competition for long-term savings by mutual funds, trust companies, pension funds, and various government retirement assistance plans. While the insurance companies have traditionally not had to offer high returns on savings, since the purchase of protection was the dominant need, growing competition from other more attractive long-term assets is necessitating some gradual changes.

TABLE VIII

Federally Registered Life Insurance Companies⁴²

(December 1962)

<u>Assets</u> ^{a)}	<u>\$mn.</u>	<u>%</u>
Cash	45	0.5
Bonds:		
Government of Canada	677	7.4
Provincial	917	10.0
Municipal	651	6.7
Corporate	2005	21.8
Foreign	131	1.4
	<u>4,345</u>	<u>47.8</u>
Stocks:		
Canadian	220	2.4
Foreign	54	0.6
Mortgages	3639	39.6
Real Estate	311	3.4
Policy Loans	372	4.1
Other Assets	197	22.1
Total Assets	9,183	100.0

a) Assets in Canada

⁴²The Royal Commission, p. 244.

The investments of federally registered insurance companies conform to certain legal restrictions set up by the federal government. The above table indicates their asset position which reflects important changes since the end of the war. During this period the trend in asset holdings has been away from bonds, which were 77% of total assets in 1945, and toward mortgages which were only 10% of total assets. Also, bonds held against the federal government have decreased while corporate bond holdings have continued to expand in the post-war period, largely due to their more attractive yields.

Generally speaking, insurance companies are long-term investors. Their holdings of securities are mainly in maturities over ten years which make up approximately 80% of total holdings. The life companies do tend to move into short-term holdings when interest rates are low and expected to rise but this change in assets is not observed to be great.⁴³ Changes in interest rates do not have the same influence on the insurance companies as they would have on others such as the chartered banks. Unlike the banks, restrictive monetary policy does not sharply reduce the flow of funds available for investment. Thus the insurance companies attract a fairly steady flow of funds and this

⁴³The Royal Commission, p. 246.

influences the long-term nature of their investments which they usually hold until maturity.⁴⁴ The general consensus is that insurance companies tend to be overly conservative in their investments. A principal example is where they "shy away" from equity purchases. They are allowed to hold 15% of their total assets in common and preferred stocks but have in fact only averaged around 3%. This area has come under criticism during the post-war period due to the inadequate supply of equity funds for financing Canadian economic growth. Toward this supply the insurance companies have made only minor contributions relative to their great potential.

The insurance policy is similar to the liabilities issued by the pension funds and mutual funds in that it is designed to draw a specified amount of savings over a contracted period of time. This makes the insurance policy a non-marketable and generally illiquid asset. Although the cash value that is built up in specific policies is available for lending at pre-established interest rates, this source of credit is not widely used (see Table V, p. 37). The typical holder of a life policy or annuity regards this asset

⁴⁴ Some life companies do have facilities for trading securities in the secondary market but other companies feel that securities held are too illiquid to warrant being traded to higher earning securities and that there is no real advantage in this operation due to the costs of trained personnel.

as a long-term investment having little, or no use in meeting current or short-term debts. The insurance company easily fits into the category of non-banking financial intermediary.

h) Summary

Up to this point we have reviewed the operation of a number of financial intermediaries and have noted in particular their contribution to the total financial assets held by the public. We have noticed that there is great similarity among many of the liabilities created as well as unique differences which characterize the institutions against which the liabilities are held. It has been our intention to identify each institution on the basis of its nearness to a chartered bank in terms of money creation. In this respect, it is clear that chartered banks are unique, being the only private institutions that create assets recognized by definition, as money. However, as we have shown, there are a few intermediaries which create assets that serve exactly the same function as money. Such intermediaries for example, as the caisses populaires, credit unions, trust companies, and mortgage loan companies, do, to either a large or small extent, create chequable demand deposits which serve as a store of value as well as means of payment. To the extent that these institutions perform this function they are operating exactly in the same capacity as banks. The credit unions and caisses populaires are

readily recognized as banks because of the large volume of business devoted to a banking function. For the trust companies the banking function was much less prominent in their over-all operation, and almost negligible in so far as the mortgage loan companies were concerned.

In addition to creating money, many intermediaries create liquid assets which serve as close substitutes for money. We considered this function to be a second criteria of banking. In the case of the chartered banks, term deposits of short maturity were considered as near-money. Also in this category were trust company notice deposits and guaranteed investment certificates, finance company notes and debentures, and some credit union shares. The trust companies were classified as near-banks because they create a sizeable volume of both money and near-money assets, the latter being available in a number of short maturities which are occasionally redeemable. Similarly, the finance companies were placed in the near-bank category due to the short maturities on their note issues which allowed them to be quickly liquidated and thus to serve as a means of payment.

Two other institutions, the mortgage loan companies and the consumer loan companies, were briefly described. The former create only a small volume of demand deposits while their term deposits are subject to a minimum maturity requirement of one year. The latter rely mainly upon their

parent companies and the chartered banks for credit, creating for themselves only a minimum amount of short-term paper. Both these institutions approach the banking function but not to the same extent as other near-banks. We have classified these intermediaries as near-banks recognizing that they, in fact, fall somewhere between the near-bank and non-banking financial intermediary categories.

In the final category of non-banking financial intermediaries we placed the mutual funds, pension funds, and the insurance companies. There is little doubt that the contributions made by these institutions to the stock of money, including near-money, is very limited.

Even in the final analysis we are not sure if we have clarified the issue. We have offered, however, one version of the definition of banking and we have fitted the various financial institutions to it. We have produced some perspective among the intermediaries which enables one to see a relationship among the many liabilities they create. For example, one might visualize these liabilities ranked on a liner scale according to their nearness to money. At the end of the scale closest to money, liabilities are readily substitutable for one another in response to small differences in the rate of

return. At the other end liabilities are not substitutable since it is difficult to find a substitute for the service provided by a life insurance claim or pension claim. This distinction between intermediaries may also be applied to the other side of the balance sheet. On the asset side the financial intermediaries may be classified according to their liquidity position. In general, the near-banks and non-banking financial intermediaries will appear progressively less liquid than the chartered banks and their asset portfolios will generally be more specialized.⁴⁵

In our analysis we referred repeatedly to Table I, page 20, to indicate the relative growth rates of the various intermediaries. These figures indicate that between 1945 and 1962 the proportion of personal savings held at the chartered banks has declined from 73.3% to 45.8%. It is evident that this can be largely attributed to the creation of Canada Savings Bonds after the war, but in addition, there is a notable increase of claims drawn on the credit unions, caisses populaires, trust companies and mortgage loan companies. Considering that the absolute value of the above liabilities has increased some \$13,740 millions during the 12 year period, the growth in near-bank⁴⁶ intermediation has

⁴⁵There are obvious exceptions here; for example, credit unions are classified as banks and yet they are highly specialized in making personal loans to their members.

⁴⁶From here on, we will use the term near-bank in general reference to any financial institution outside the banking system which creates liquid assets that are recognized as good substitutes for money.

indirectly made a large contribution to the stock of money available to finance aggregate spending. We have made specific reference to a number of factors aiding in the rapid post-war growth of certain intermediaries. In summary, there are two reasons given to explain the chartered banks loss in position.

One writer states that

the main reason for this development must be found in the structure of interest rates. It must be remembered that in the last decade, interest rates have been generally higher than at any other time in our financial history.⁴⁷

We mentioned earlier the competitive problem created for the chartered banks by the 6 per cent ceiling on interest rates. While this does present a problem it should not be over-emphasized. For one thing, in addition to the loans restricted, the banks may purchase a number of securities, as well as mortgage agreements, on which the 6 per cent ceiling does not exist. Also, when the banks have included service charges and taken account of re-payment techniques, the effective annual rate of interest may well be boosted to between 9 and 11 per cent.⁴⁸ Finally, we should not forget

⁴⁷R.M. McIntosh, "Chartered Banks at the Crossroads," Business Quarterly, XXIX (Winter, 1964), 34.

⁴⁸The effective rate of interest on consumer loans is derived by taking into account the system whereby a loan is repaid. For example, although a loan may in effect cost 6% simple interest for a year, the amount of the initial loan held, "as cash in the pocket", is gradually reduced following each monthly repayment. Thus a true or effective cost of a loan should be based on the net amount of money held during each month of a given year.

to note the number of foreign currency loans made without ceiling restrictions.

A second and perhaps more important reason for the banks' loss in position is noted by the Porter Commission.

It is their observation

that the banks have been somewhat slow to adapt to the changing situation by developing new types of deposit instruments tailored to the requirements of their customers.⁴⁹

There are probably many other less obvious reasons for the post-war outgrowth of near-banks and other financial intermediaries. Nevertheless, time and space demand a conclusion to the first part of our discussion. The important single observation is that attention has been centered on the development of near-banks and non-banking financial intermediaries not simply because of their obvious implications for the future of chartered banking, but also due to their influence upon over-all liquidity in the economy. This latter consideration will be important when we turn to examine the stability implications of near-banking intermediation. In preparing for this analysis, the first step will be to develop the counterpart to the money stock concept of financial intermediation. That is, the function of

⁴⁹

R.M. McIntosh, op. cit.

financial intermediaries in facilitating the flow of funds from ultimate lenders to ultimate borrowers. Once this is accomplished it will be evident that financial intermediaries have important stabilizing effects upon the level of interest rates and thus upon the general level of economic activity. We now proceed to the second chapter to pursue this task.

CHAPTER II

THE ROLE OF THE NEAR-BANKS AND OTHER FINANCIAL INTER-MEDIARIES IN FACILITATING THE FLOW OF LOANABLE FUNDS FROM SAVING TO INVESTMENT AND THE STABILITY IMPLICATIONS DERIVED FROM THIS FUNCTION.

- a) Contemporary Versus Traditional Views of Financial Intermediaries
- b) The Market for Loanable Funds
- c) Market Equilibrium and Stability Implications
- d) The Gurley-Shaw Thesis
- e) Elasticity of the Demand for Money and Income Velocity of Circulation of Money - Reaction to the Gurley-Shaw Thesis
 - 1) elasticity of the demand for money
 - 2) destabilizing portfolio shifts
 - 3) destabilizing movements in velocity
- f) A Review of Recent Commission Reports
 - 1) United States
 - 2) Britain
 - 3) Canada

In this chapter it will be our intention to examine further the relationship between chartered banks and other financial intermediaries. In addition there will be a more detailed analysis of the activities of these institutions and their economic implications.

Considerable controversy has been stimulated in recent years over the findings and reports of such authorities as John Gurley and Edward Shaw of the United States, and the Radcliffe Committee in Great Britain. These studies have prompted a re-examination of interest-rate theory to include the influence of a number of rapidly developing financial intermediaries which are outside the direct control of the monetary authorities. It has been observed that these intermediaries, by performing in much the same way as commercial banks are able to effect a multiple expansion of credit and thereby satisfy demands for funds by spending units. This activity has stimulated attention because it may take place even while monetary restraint is restricting credit operations of the banking system.

The theoretical analysis that is developing on the above subject is still very much in its infancy, judging from the sharp disagreements on certain of its basic tenets. While the theory itself does not receive broad acceptance, the policy conclusions are even more in question due largely to a serious lack of statistical evidence. Nevertheless, monetary theory is undergoing some major renovations on the

subject of financial intermediaries and it will be our purpose to examine them.

Before proceeding to the following analysis a further question of terminology must first be clarified. In our study repeated reference will be made to financial intermediaries in which case it will be necessary to distinguish between banks, near-banks, and non-banks. Therefore, since attention is to be centered upon intermediaries outside the direct control of the central bank, it will be useful if we regard these institutions as outside intermediaries, as opposed to inside intermediaries or chartered banks.

a) Contemporary Versus Traditional Views of Financial Intermediaries

The traditional distinction between chartered banks and outside intermediaries is that only the former issue liabilities which serve as widely accepted means of payment.

Commercial banks are the only private institution whose debt serves as a generally accepted medium of exchange, as money. Money is a unique asset; some others can substitute for it to some degree in some uses, but there is no fully adequate substitute.¹

In addition, the rather dubious distinction is made about

¹ J.M. Culbertson, "Intermediaries and Monetary Theory", The American Economic Review, XLIX (1958), 128.

chartered banks; that public preferences play no role in determining their total volume of chequable deposits or the total quantity of money. It is argued that increases in bank deposits result from increases in bank assets (bank credit extension) while outside intermediaries cannot increase their assets (extend credit) until they receive additional funds from the public. That is, outside intermediaries are unable to create money in the form of chequable deposits but must wait upon the public to provide them. As a result these intermediaries are regarded merely as brokers in the flow of funds from saving to investment.

Under a fractional reserve system, commercial banks can create loanable funds: their operations can make *ex post* savings exceed *ex ante* savings. In contradistinction, other private financial institutions - collectively as well as individually - can lend no more than they have received from depositors and, therefore cannot create loanable funds either in an *ex post* sense or in an *ex ante* sense.²

Traditional theorists emphasize the medium of exchange function of money, a function in which money, defined as currency and chequable bank deposits has virtually no effective substitute. For this reason it is argued that control of the stock of money will have a significant influence on the flow of expenditure. This influence may be direct, in that a reduction in the money

²Joseph Aschheim, "Commercial Banks and Financial Intermediaries, Journal of Political Economy, LXVII (1959), 66.

supply reduces liquidity and leads to a decrease in spending by the public in order to restore their cash balances. Or, it may be indirect, first creating an unwillingness by the public to part with money, thus raising interest rates, and secondly, leading to a contraction in demand for credit and a decline in loan-financed expenditure.

Another view, important to our analysis, has been labeled "pre-Keynsian". This is the view that the demand for money function is perfectly interest inelastic. If such were the case, a decline in interest rates, following an increase in the money supply, would not cause a build-up of idle cash balances;³ total adjustment toward equilibrium would be made only through an increase in active transactions balances. Under these circumstances the resulting change in income is exactly proportional to the initial change in money and therefore the income velocity of money is regarded as a constant. Studies conducted since the Keynesian revolution have attempted to show that velocity is really quite stable and although there have been significant variations from trend these variations move in direct relationship to changes in the quantity of money.⁴

³Cash balances are recognized as idle if held for a period longer than the interval between income receipts.

⁴Clark Warburton, "Monetary Velocity and Monetary Policy". Review of Economics and Statistics, XXX (1948), 309.

In the world described above, monetary policy, concentrating its direct influence upon the money supply, would have a most effective control over economic activity since a decrease in money would be complemented by a corresponding decrease in its rate of turnover. On the contrary, as the demand for money function develops traces of elasticity, the effectiveness of monetary policy decreases. In this second world, idle cash balances will accumulate as interest rates decline and will serve to finance expenditures even while money is being tightened. The traditionalist argues that idle balances, save for exceptional periods like after the war, do not exist in any significant scale.⁵ The traditionalist therefore, by discounting the influence of idle balances, seriously questions a basic tenet of Keynesian interest rate theory.

Contemporary theorists find much to disagree with in the above traditionalist views. To begin with, there is strong criticism brought against the traditional distinction between banks and outside intermediaries. Those who would consider banks unique because of the liabilities they issue are reminded that:

from the point of view of the pressure of effective demand, the crucial step is that which increases the

⁵A.B. Cramp, "Financial Intermediaries and Monetary Policy", Economica: New Series, XXIX (1962), 147-150.

power to acquire goods and services, on the part of people inclined to exercise it immediately; and banks are by no means the only firms to place this power in the hands of others.⁶

While banks have traditionally been considered the only institutions capable of creating money, and are therefore unique in the role of credit creation, it has been shown that outside intermediaries are equally important credit creators. In fact, outside intermediaries, such as credit unions or trust companies, are quite capable of initiating a multiple expansion of credit and, in addition, they increase the potential amount of credit that may be extended for any given increase in the money supply. It will be a useful exercise to briefly examine the credit-creating process of a near-bank.

We assume, at the outset, that attempts by a near-bank to attract funds are successful and its new customers transfer their savings from chartered banks. When the near-bank receives these deposits, it deposits the sum in its own bank account, leaving the total deposits of the banking system unchanged (omitting the small amount of currency withheld by the near-bank for its day-to-day operations). The result of this transfer of funds is merely to change the ownership of bank deposits; the deposits of private individuals have fallen, being replaced by investment

⁶R.S. Sayers, "Monetary Thought and Monetary Policy in England", Economic Journal, LXX (1960), 713.

certificates, shares, etc., and the deposits of the near-bank have risen by the same sum. The near-bank now uses the newly-acquired funds to finance mortgage loans, personal loans, etc., extending credit for active transactions purposes. In one sense the near-bank has merely transferred bank deposits, formerly in the hands of non-spenders, into the hands of those actively engaged in spending. In another sense, since the loans and investments of the banks are unaffected by the shift in deposits, loans by the near-bank represent a net addition to the credit extended to the public.

A near-bank will generally retain some cash reserve ($= r$), in the form of a bank deposit. It can therefore lend, in the form of mortgage loans, etc., an amount equal to $1-r$ times the increase in its deposits. The following simple example is often used to demonstrate credit creating abilities of a chartered bank; it can be applied equally well in the case of a near-bank.

Let the shift of funds from the chartered banks to near-bank equal \$1,000. Out of this amount a cash reserve will be retained equal to 20% or $1/5 \times \$1,000 = \200 . The amount loaned out will therefore be $1 - 1/5 = 4/5 \times \$1000 = \800 . Now, the initial balance sheet position for the near-bank is;

Assets	Liabilities
increase in deposits . . . \$ 1,000.	newly issued claims \$ 1,000...

and the final balance sheet position is;

Assets	Liabilities
cash reserves on deposit at chartered banks . . . \$ 200.	\$ 1,000.

Total loans in form of
chartered bank deposits \$ 800.

Thus, \$800 credit is created on a cash reserve base of \$200. If any portion of this increase in credit extended by the near-bank should result in a further rise in near-bank deposits, a further increase in credit will be possible in a manner analogous to that in which the bank multiplier works. Richard Thorn has identified this so-called "nonbank multiplier" and notes that its value depends on two factors:

- 1) the percentage of reserves held by the near-bank against its liabilities,
- 2) the proportion of near-bank loans and investments that returned as deposits.⁹

The size of the "nonbank multiplier" will vary directly

⁹ Richard Thorn, "Nonbank Financial Intermediaries, Credit Expansion and Monetary Policy," International Monetary Fund Staff Papers, VI (1957-58), 371.

with the return flow of savings and inversely with the reserve ratio. Thorn reports that from evidence gleaned from United States experience the multiplier appears to be somewhere between 0.8 and 1.3.¹⁰ Its nearness to unity suggests that a near-bank can expand its loans and investments by an amount roughly equal to any increase in its deposit liabilities. For example, an increase in deposits of \$1,000. will permit a multiple expansion of credit, after successive rounds of income periods, amounting to \$1,000.

While both banks and outside intermediaries are capable of expanding credit, in the above sense, there still remains certain distinguishing features. Warren Smith has drawn attention to the fact that the time periods involved in the credit expansion are entirely different. Multiple expansion through the banking system is much more rapid since:

the restoration of reserves to the commercial banking system within a few days of the time they are lost through lending is a built-in feature of our payments mechanism. . . .¹¹

Thus while bank credit expansion is closely related to the operation of the payments mechanism, the credit expansion of outside intermediaries is much slower being related to

¹⁰In Canada, excluding cash leakages and assuming each bank is fully loaned-up, a comparative credit multiplier for the banking system would be $12\frac{1}{2}$.

¹¹Warren Smith, "Financial Intermediaries and Monetary Controls", Quarterly Journal of Economics LXXX lll (1959), 536.

the time between income periods. That is, the funds loaned out for expenditure purposes return to outside intermediaries in the form of savings retained from monthly or bi-weekly pay receipts.

A second notable distinction between the credit expansion of banks and outside intermediaries is that the latter are subject to more important leakages. Whereas the entire flow of funds goes through the banks during each round of spending (payment turnover period) only the portion allotted to outside intermediaries goes through these institutions each round (each income turnover period).¹² This all adds up to saying that the banks are distinctly more powerful in expanding credit, not only because they are by far the largest single type of credit institution, but because they enjoy certain advantages attributed to present financial arrangements. These advantages however, are not altogether clear in Canada. In Quebec, for example, the caisses populaires play a large role in the provinces payments mechanism. It is apparent that present cheque clearing facilities operated by these institutions, ensures a comparatively rapid return flow and hence speeds up the operation of

¹²We are ignoring the leakage that results when coin and currency are withdrawn to circulate outside the banking system.

the credit multiplier.¹³

Earlier we mentioned certain views that were associated with traditional monetary theory. Now that we have examined certain contemporary views regarding outside intermediaries, it will be useful to relate these views to their theoretical underpinnings.

While traditional theorists have emphasized the medium of exchange function of money, contemporary observers, such as the Radcliffe Committee and the Gurley-Shaw group, may be regarded as emphasizing the store of value function of money. This latter function is one in which money has a number of close substitutes capable of offsetting the influence of spending brought about by a reduction in the money supply. This new view focuses on the demands for, and supplies of, a wide spectrum of assets (not just money), and regards structure of interest rates, asset yields, and credit availabilities (rather than the quantity of money) as the linkage between monetary and financial institutions on

13

It was pointed out in Chapter 1 that 25% of the provinces savings were held in chequable deposit accounts operated by the caisses populaires. We also noted that these institutions are capable of clearing their own cheques without access to the banking system although inter-clearing arrangements have been established for clearing cheques between the banks and the caisses populaires. Because of their relative size within the province, the leakage effect on the caisses populaires multiplier tends not to be as great as it is for other near-banks in other parts of the country. Of course, outside Quebec, cash leakages from the caisses become very large.

and policies on the one hand, and the real economy on the other.¹⁴

Contemporary theory recognizes that the strength of the effects on the flow of spending from a given change in the stock of money is highly indeterminate. In the first place, it will depend on the degree to which the direct change in money is offset by induced opposite changes in highly liquid money substitutes.

The more adequate the non-monetary financial assets are as substitutes for money in transactions, precautionary, speculative, and . . . diversification balances, the smaller may be the money supply for any designated level of national income. For any level of income, the money supply is indeterminate until one knows the degree of substitutability between money created by banks and financial assets created by other intermediaries.¹⁵

It is possible to imagine, for example, the case where an increase in money substitutes completely neutralizes the intended effects of a change in the money supply.

Even if one assumes a net change in liquidity, as a result of monetary policy, there is still no assurance that there will be significant effects on spending. This in turn must depend upon certain important conditions. Firstly, one must take into account the marginal responsiveness of interest

¹⁴James Tobin, "Commercial Banks as Creators of Money", Banking and Monetary Studies, ed. Deane Carson (Homewood, Illinois: Richard D. Irwin, Inc., 1963), 414.

¹⁵John Gurley and Edward Shaw, "Financial Intermediaries and the Saving-Investment Process", Journal of Finance XII (1956), 258.

rates to changes in the money supply. In the particular case where idle cash balances in the economy develop to sizeable proportions, the response might well be zero. Such a situation is depicted graphically by the Keynesian liquidity trap and is characterized by a perfectly elastic demand for money function. Any increase in the money supply by the monetary authority merely piles up in idle balances with no attendant change in the level of interest rates necessary to induce people to hold these balances. In this case, velocity is no longer regarded as a constant function of the money supply (contrary to traditional thinking) since a change in the level of idle balances, in order to accommodate a change in spending, will change velocity without requiring a corresponding change in the money supply. This, of course, creates problems for monetary control since a change in the money supply could be offset by an opposite change in velocity.

The above situation need not necessarily exist and, in fact, a more normal environment is one where the demand for money is only moderately elastic. Under these conditions interest rates might be expected to respond more strongly to monetary pressure. Nevertheless, even in this case the desired change in the flow of spending will only be realized if there exists a responsiveness between spending (essentially investment spending) and changes in interest rates

and loan availability. If the marginal efficiency of capital is rising, owing to confidence in investment prospects, responsiveness will tend to be strong. However, if there is a "collapse of confidence", due to a depressed economy, responsiveness will be weakened.

In summary it is apparent that a number of important factors must be considered before attempting to predict the economic effects of a given change in the money supply. Some contemporary observers, recognizing its shortcomings, are quite skeptical of the so-called "supply of money" approach to monetary policy. Others argue that existing control techniques are adequate but must be broadened to touch more directly a number of near-bank institutions. While there may be disagreement in emphasizing policy changes, there is general agreement among these groups that effective monetary policy is no longer a direct route from the banking system, through the money supply, and into the spending stream of the economy.

An important buttress of contemporary monetary theory is the existence of idle balances. Indeed, one writer notes that without them the so-called "Radcliffe expansion" would be impossible.¹⁶ The truth of the matter is that the

¹⁶ A.B. Cramp, p. 143. The "Radcliffe-expansion" takes place when a rise in interest rates on money substitutes induces holders of money balances to transfer part of their balances to the near-banks, who then re-lend them to finance expenditures.

Keynsian liquidity preference theory depends upon changes in the hoards of idle balances. Lacking idle balances there is no way in which intended investment can be financed other than through the creation of new money. If we assume that the banking system is fully loaned-up and that the central bank allows no change in reserves, the only way new spending can be financed is through drawings from the stock of idle balances. These drawings can be made in three different ways. The first way may be simply that the public, including non-financial institutions, increases its demand for money to be used for transactions purposes. Such an alteration in the public's spending habits may be motivated by expected price and income changes or perhaps by factors altering the system of payments in the community. Any of these expected changes might create an increase in current expenditure which is fed by the activation of idle balances. A second way in which the liquidity provided by idle balances is used to finance expenditure plans, is through the "switching" operations of chartered banks. During a period when credit is scarce and demand for loans is strong, the banks may exchange short and medium term securities for idle balances, thus increasing their reserves and allowing an expansion of loans. The result of this process, like the first, is not to change the value of the money supply but

only to increase its velocity.¹⁷ The third way in which the level of idle balances may be drawn down is through the activities of near-banks and other outside intermediaries who bid for these balances by offering various money substitutes (including insurance policies, mutual fund shares and pension contracts). This latter process also tends to increase the velocity of circulation of money assuming, of course, that these intermediaries loan out the idle balances for expenditure purposes. In summary, we might picture a given stock of idle balances being activated by either the chartered banks, the public, or outside intermediaries. In addition, the government may be considered a fourth contestant competing for idle balances, while the central bank, in attempting to tighten the money supply, will be a fifth party bidding for these idle balances. In fact, it will be the purpose of the monetary authority to absorb these idle balances through open-market operations, in order to prevent their being activated and thus adding to inflationary pressures. An abundance of idle balances means that monetary policy can be effective only if relatively large amounts of money are withdrawn from the economy. Only when these balances have been reduced, will policy measures

¹⁷Strictly speaking an increase in velocity is analogous to an increase in the money supply. A 25 per cent rise in velocity, from an accounting standpoint, amounts to the same thing as a 25 per cent increase in the quantity of money (with velocity fixed) so far as monetary demand is concerned.

become an effective deterrent upon the flow of expenditure in the economy. Thus, given an adequate supply of idle balances, any of the above mentioned ways for activating these balances can be an effective impediment to monetary policy, necessitating wider and stronger measures by the authorities.

Idle balances have been shown to exist in relatively large quantity. In 1947 James Tobin empirically tested the value and nature of idle cash balances.¹⁸ Tobin's approach was to subtract from total deposits an estimate of active balances gained from the maximum recorded velocity of circulation. He also discovered a rough relationship between idle balances and interest rates which plotted on a graph described an interest elastic liquidity preference function (i.e., demand for money function). Another writer observes that there is significant statistical evidence pointing to the existence of ample idle balances.¹⁹ For example, in England there has been a noticeable growth of deposit accounts (largely idle balances) while the ratio of money to income has remained constant. In Canada also, during the

¹⁸ James Tobin, "Liquidity Preference and Monetary Theory", Review of Economics and Statistics, XXIX (1947), pp. 124-131.

¹⁹ A.B. Cramp, pp. 150-151.

post-war period, savings deposit accounts (a good portion of which consist of idle balances) have shown a rapid growth.²⁰ A.B. Cramp notes finally that in England there has been:

evidence of balances held, well in excess of those required for transactions purposes, regardless of changes in the money/to income ratio of the economy.²¹

Traditionalists regard idle balances as a fixed stock which gradually diminishes as various drawings, which were described earlier, are made. Thus they would conclude, for example, that the process of credit expansion through outside intermediaries must be halted when the stock of idle balances is exhausted. We are reminded, however, that balances directed into the spending stream by near-banks and other outside intermediaries will be absorbed as income by the suppliers of goods purchased.

If the marginal propensity to save is positive, new savings will result, and they will accrue initially in money form. Thus the process of credit expansion by intermediaries will in some degree have replenished the stock of idle balances.²²

²⁰Reference was made in Chapter 1 to the rapid growth of savings accounts not only at the chartered banks but also those at caisses populaires, credit unions and trust companies. Savings accounts at the chartered banks turn over approximately $1\frac{1}{2}$ times per year. It was pointed out that the bulk of these funds are held in a relatively small proportion of accounts whose owners regard as a more permanent, yet conveniently accessible form of interest bearing investment.

²¹A.B. Cramp, Ibid.

²²Ibid.

There is, therefore, no such close limit to the credit expansion process as some might suggest.

This is not, of course, to say that there is no limit to the expansion. As income velocity rises, average money holdings must tend to fall.²³

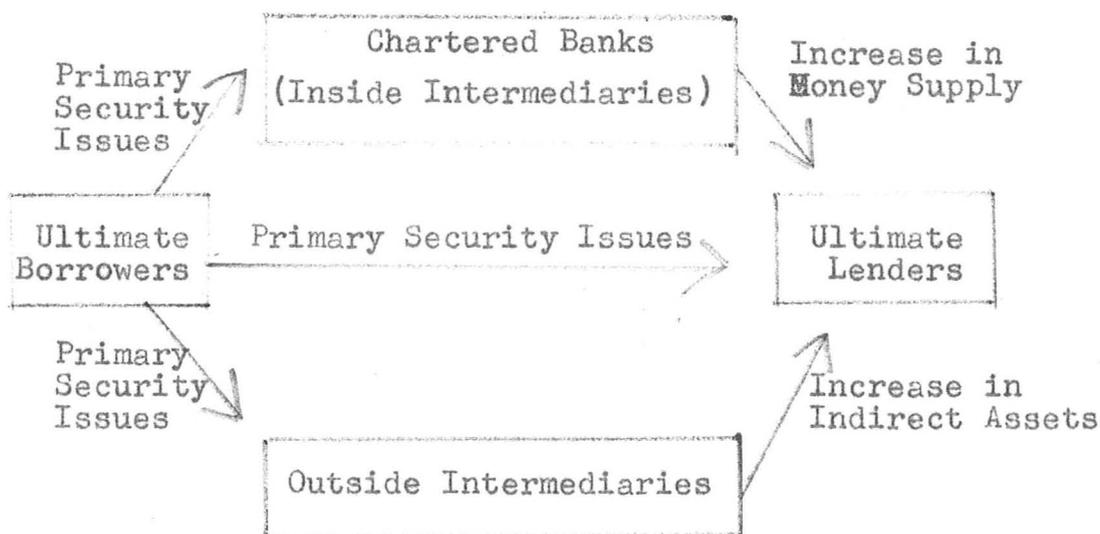
b) The Market for Loanable Funds

The principal function of financial intermediaries is to purchase primary securities from ultimate borrowers at one stratum of interest rates and to issue indirect debt for the portfolios of ultimate lenders at a lower stratum of interest rates. The market within which these transactions take

²³ Ibid. With a shift from deposits to shares the stock of money declines and hence raises income and transactions velocity. At the beginning of the shift hoards of precautionary and speculative balances may be used to satisfy rising transactions demands by the public and intermediaries, but these hoards have limits. "Eventually, further economizing with a declining stock of money becomes difficult because money and near-monies do not provide, of course, equivalent quantities of liquidity to the holder. Money is a special asset whose marginal rate of substitution rises as near-monies are substituted for it. In any given set of circumstances, consequently, unlimited shifts to shares by the public seem to be controllable by these automatic market adjustments, and therefore the potential expansion of intermediaries is limited." See Donald Shelby, "Some Implications of the Growth of Financial Intermediaries", Journal of Finance, XIII (1958), 539.

place is depicted below.

Diagram 1²⁴



In the above model ultimate borrowers represent deficit economic units who wish to increase cash holdings and/or for whom expenditures on current output exceed their current income. They comprise consumers, business firms, and government units who are forced to seek financial assistance to supplement their deficit money balances. In exchange for cash to spend ultimate borrowers issue interest bearing primary securities of generally low liquidity and high risk.²⁵ For example, corporations and

²⁴ John Gurley, "Liquidity and Financial Institutions in the Postwar Period," a submission to the Joint Economic Committee (Washington: January 25, 1960), p. 21.

²⁵ There are obvious exceptions here. For example, treasury bills are to be regarded as primary securities but are usually issued in short maturities of 90 and 120 days.

municipal and provincial governments float stock and bond issues in order to finance capital investment and consumption expenditures. Individuals too sell mortgage and installment contracts in order to raise funds to meet current needs. To the extent that treasury bills and other short-term instruments of the public debt serve to finance current expenditures, they would also qualify as primary securities. However, when bills and other instruments come to be traded in secondary markets they no longer qualify as primary security issues. In this intermediate stage they are being traded for speculative and other similar purposes and while they may influence prices and yields of other paper of various maturities, they do not serve to finance current expenditure on goods and services.²⁶ Primary securities may be sold to businesses, consumers, governments and financial intermediaries.

Ultimate lenders are individuals, including corporations, who wish to reduce their cash holdings or those for whom expenditures are exceeded by current income. This surplus income is in the nature of savings and is transferred to ultimate borrowers in order to effect the necessary ex post

²⁶We might qualify this statement by pointing out that the proceeds from primary security sales may not go directly into current expenditures for goods and services. For example, they may be used to purchase or retire other primary security issues.

equality between savings and investment. Such is the flow of funds in the economy; from income to expenditure units by way of financial transactions and back to income units again in the form of wages, rents, profits, and interest.

Current expenditure may be financed in two ways: either internally from accumulated savings or current income, or externally from borrowing. In a world of balanced budgets the former will predominate while in a world of deficits and surpluses the latter will be a popular form of finance. In the United States a rough historical estimate places the amount of external finance at an average of approximately 10 per cent of GNP.²⁷ If we take the current 1965 GNP in Canada to be \$50 billion this represents \$5 billion of our present annual expenditure that is financed externally.

External finance of current expenditure may be carried out in three ways. The first is a form of direct finance whereby ultimate borrowers sell primary securities directly to ultimate lenders in exchange for money, i.e., chartered bank deposits or currency. In this case no intermediation takes place and loanable funds are created by transferring cash balances from lender to borrower via a brokerage firm or investment dealer who creates no credit and thereby merely serves the function of bringing the trading parties together. Thus liquidity in its highest

²⁷ John Gurley and Edward Shaw, "Financial Intermediaries and the Saving-Investment Process", Journal of Finance, XII, 258.

form (i.e., money) is moved from an idle position to an active position in exchange for interest bearing securities of high risk and low liquidity. The important observation following this transaction is that there has been no net change in the economy's over-all liquidity position.

A second form of external finance depicted, is ultimate borrowers acquiring their necessary funds through the sale of primary securities to outside intermediaries. In order to purchase these securities the intermediaries, including near-banks and non-banks, utilize loanable funds they have been successful in drawing from ultimate lenders who accept in exchange indirect assets (for example, guaranteed investment certificates, credit union and mutual fund shares, time and checking deposit certificates, debentures, insurance policies, etc.) As a result of these transactions, the borrowers have acquired additional liquidity while the lenders have been able to maintain a substantially unchanged liquidity position.²⁸ Thus, contrary to the first form of financing, the economy's over-all liquidity position has been expanded. The amount of this expansion is measured by the quantity of indirect assets,

²⁸This statement, of course, assumes that ultimate lenders switch from holding idle cash balances to holding liquid claims on outside intermediaries. Public preference, however, might tend toward insurance policies, mutual fund contracts or pension plans. In this event liquidity is substantially altered for ultimate lenders and the result of creating loanable funds by outside intermediaries resembles more closely the first form of financing described above.

in the form of near-money, created by the outside intermediaries. We note also that there has been no change in the money supply (as it is officially defined). In an earlier example we indicated that this process merely results in transferring ownership of chartered bank deposits; first, from ultimate lenders to outside intermediaries, and finally, from outside intermediaries to ultimate borrowers.

A third financing possibility pictured, is ultimate borrowers acquiring cash balances by issuing primary securities to the chartered banks. The banks themselves purchase these securities by creating loanable funds (i.e., deposit liabilities). The ability of the banks to perform this function depends upon their reserve position which is controlled by the central bank. In Diagram 1, page 78, however, it is shown that the ultimate lender has an influence over the bank's capacity as a purchaser of primary securities. This is very much the case and places the banks in direct competition with outside intermediaries in bidding for the savings of ultimate lenders. The fact is that if the banks fail to attract these savings directly, and instead they go toward purchasing claims on outside intermediaries, they are bound to suffer a relative decline in their position in the financial community. This can come about as a result of the increase in money substitutes, created by outside intermediaries, which renders the existing money supply excessive in the light of current demand.

Ultimate lenders have indicated that they prefer to hold near-bank claims rather than money. The central bank may now desire to remove the excess money from the system. In so doing, bank reserves, earning assets, money issues, and profits are contracted.²⁹

If we assume that the central bank does not take action to eliminate the excess supply of money it will leave the banks with excess reserves. These excess reserves reflect the loss, to the banking system, of its responsibility for sustaining a flow of money payments - a loss attributed to the competitive operations of outside intermediaries. While money balances have been rejected in favour of liquid near-bank claims, thus leaving the banks with excess reserves, the banks can "force these balances out again" thereby regaining control of the money supply.³⁰ However, this can only be accomplished;

by accepting a reduced margin between the yield of primary securities they buy and the cost to them of deposits and currency they create The banks can restore the money supply, but the cost is both a decline in their status relative to other financial intermediaries and a reduction in earnings.³¹

Thus it becomes apparent that the ability of the banks to grow, measured in terms of primary asset holdings, depends on their success in persuading others to hold their

²⁹ John Gurley and Edward Shaw, XII, 261.

³⁰ Ibid.

³¹ Ibid., p. 262.

liabilities.

If the banks retaliate (against competing outside intermediaries) by raising their own deposit rates - within the limits set by their earnings - they will restrict the ability of outside institutions to grow at their expense.³²

External financing of current expenditure through the banking system differs in one important respect from the other two forms of financing already described. When the banking system creates loanable funds, by purchasing primary securities, it not only adds to the community's over-all liquidity position, it also brings about an increase in the money supply. The operation of outside intermediaries is distinguished by the fact that the liquid claims created for their customers do not qualify as money. It is for this reason that increased spending, as a result of the lending activities of outside intermediaries increases the velocity of turnover of the existing money supply. The influence upon velocity is not solely characteristic of outside intermediaries but it is a significant result of their lending operations.³³ Velocity therefore becomes an important tool for measuring the impact of these intermediaries

³²Report of the Royal Commission on Banking and Finance, (Ottawa: Queen's Printer, 1964), p. 111. The Commission notes in addition, however, that "the fact that one institution worked to a lower cash ratio than another would place it in a stronger competitive position than its rival, other things being equal, since its proportion of earning assets would be higher". Ibid., p. 109.

³³The velocity of circulation of money may also be influenced by such factors as bank switching; government

upon the economy.

f) Market Equilibrium and Stability Implications

In turning to examine the stability implications of financial intermediaries, it will be of use if we now examine more carefully the supply and demand functions in the market for loanable funds. The demand for loanable funds is simply the total amount of planned net issues of primary securities offered in financial markets by ultimate borrowers. On the other hand, the supply of loanable funds reflects the demand for primary securities by ultimate lenders, the chartered banks, and outside intermediaries. Underlying this demand is the planned saving of ultimate lenders, plus any increase in the stock of money, and minus any increase in the demand for money to hold as idle balances. The supply of loanable funds is perhaps made clearer if we consider that its absolute amount is increased in the event that any of the following take place:

1. Ultimate lenders increase their demand for primary securities,
2. Ultimate lenders increase their demand for indirect assets drawn against outside intermediaries,
3. There is an increase in the stock of money.³⁴

retirement of securities from the banks, individuals including corporations, or outside intermediaries; and changes in the public's spending habits.

34

John Gurley, "Financial Institution in the Saving-Investment Process," Money and Economic Activity, ed. Lawrence Ritter (Boston: Houghton Mifflin Co., 1961), p. 324.

The point to note in the above is that the supply of money is only one of three important items comprising the total supply of loanable funds. It is possible that the supply of loanable funds will increase as a result of either or both of the other two factors increasing while the money stock remains fixed.

The conditions for market equilibrium are met when issues of primary securities by ultimate borrowers are equal to the demand for primary securities by ultimate lenders, the banks, and outside intermediaries. When demand for loanable funds is in excess of supply, the interest rates on primary securities rise and other terms of lending tighten. Alternatively when the supply of loanable funds is in excess of demand, the interest rates on primary securities fall and other terms of lending are eased. The rise and fall of interest rates, of course, due to their influence upon spending, can have positive or negative effects. Any stimulus to aggregate demand during periods of less than full employment is a positive factor toward raising the level of gross national product; but fluctuations in interest rates may be destabilizing if they tend to encourage investment and consumption expenditure at a time when all available resources are being fully employed. Under these circumstances, inflationary pressures will tend to offset the real growth of productivity leading to inequities and inefficiencies in the economy. We are primarily interested in examining

the stability aspects of the activities of outside intermediaries. One way this can be accomplished is to observe the influence of these intermediaries upon the general level of interest rates.

In an economy where there is no financial intermediation all deficit spending, financed externally, is done directly by the savings of ultimate lenders. In the event that the demand for loanable funds exceeds the existing supply, the necessary ex post equality between these two variables is achieved through a rise in the rate of interest. This rise in interest cost will continue until such time as ultimate borrowers are willing to curtail their spending plans, due to the high cost of obtaining funds, or until ultimate lenders are attracted to bear the risk of holding additional primary securities in exchange for their savings. It is likely however, that ultimate lenders will desire to hold assets that bear less risk, more liquidity, and are of greater diversification than is possible of most primary securities. To the extent that this is true and to the extent that ultimate lenders are attracted by the service features and other benefits offered by financial intermediaries, they will choose to purchase claims on these latter institutions.³⁵

³⁵In Chapter 1, we described in considerable detail the financial operations performed by various intermediaries. It is clear that these intermediaries exist to serve a great variety of needs expressed by the public. One particularly significant feature of their operations is the ability to

Claims purchased on the chartered banks take the form of money, as do the loans, extended by the banks to borrowers. This ability to create money and thus increase the supply of money in the economy has been described earlier. It is important now to note that to the extent that chartered banks enter the market to satisfy the excess demand for loanable funds (assumed above), they provide a stabilizing influence. That is, banking intermediation serves to supplement direct financing and eases the upward pressure on interest rates. In fact, where additions to the money supply persist, through the creation of bank credit, the rising trend of interest rates could be reversed.

The ability of chartered banks to facilitate the movement of loanable funds from ultimate lenders to ultimate borrowers is also shared by outside intermediaries. Indeed, ample evidence was provided in Chapter 1 showing how these

absorb assets of higher risk while issuing highly liquid liabilities. This ability may be attributed to some of the following factors: (1) administrative economy and expertise in negotiating, accounting, appraising and collecting, (2) reduction of high risk per dollar of lending by the pooling of independent risks with respect both to loan default and to deposit withdrawal, (3) government guarantees of the liabilities of the institutions and other provisions (bank examination, investment regulations, supervision of insurance companies, last-resort lending) designed to assure the solvency and liquidity of the institutions. See James Tobin and William Brainard, "Financial Intermediaries and the Effectiveness of Monetary Controls", American Economic Review Papers and Proceedings, LIII (1963), 383.

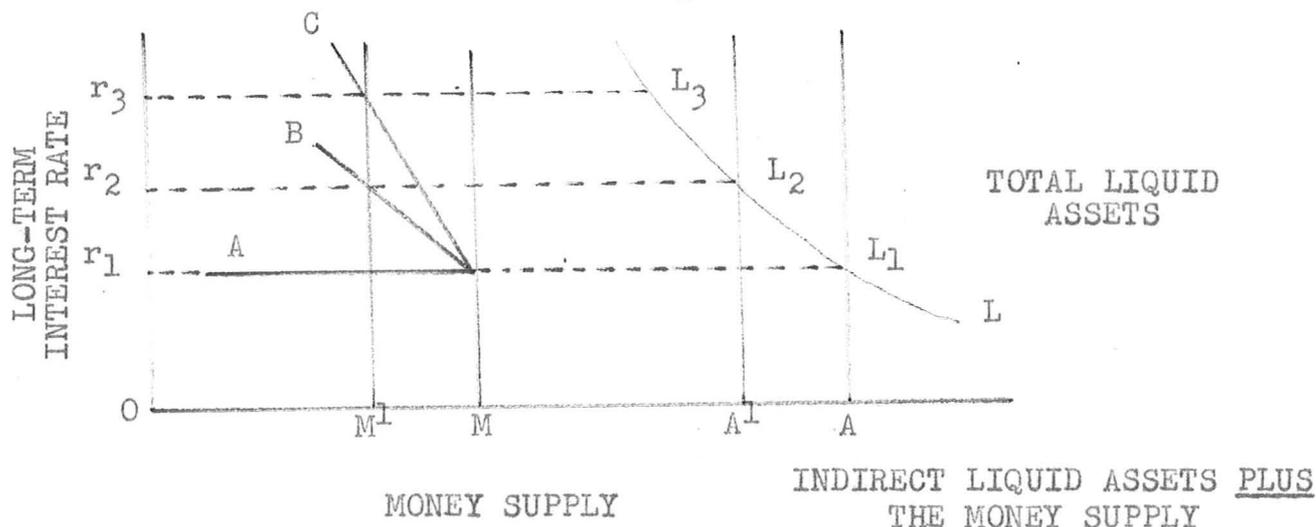
intermediaries have proven themselves to be highly successful competitors of the chartered banks. Particularly during periods of rising interest rates, outside intermediaries, notably the near-banks, have been able to provide attractive benefits and services to ultimate lenders with little change in the latter's liquidity position. Although the credit created by the near-banks has no effect on the money supply (as officially defined), it does provide for additions to the supply of loanable funds. Since this is true the near-bank operation is analogous to the operations of chartered banks in being able to offset upward pressure on interest rates. In concluding we might add, that where both the chartered banks and near-banks (and also other outside intermediaries) prove to be stabilizing influences, the implication is that they both might very well prove to be destabilizing influences. For example, in the case where the monetary authority regards higher interest rates as the desired weapon to combat inflation, any increase in loanable funds will only serve to aggravate an already unhappy situation.³⁶

³⁶In Chapter 1 we briefly discussed the concept of stability. As a reminder we note that when reference is made to stabilizing or destabilizing influences we are thinking in terms of final impact on the economy. For example, an undesired increase in expenditures on current output, fed by additions to the supply of loanable funds, may lead the economy through a period of inflation and toward a period of recession and unemployment.

(d) The Gurley-Shaw Thesis

At this state of our analysis it is clear that both chartered banks (inside financial intermediaries and near-banks) and non-banks (outside financial intermediaries) have similar effects upon the economy. Indeed, both can create an excess supply of loanable funds, can effect an over-all excess stock of money,³⁷ can produce an excess of ex ante investment over saving, and in so doing can change the economy's rate of growth. It has always been recognized that the chartered banks can do this because they can create money: that is, they affect the supply side. The significance of the thesis submitted by John Gurley and Edward Shaw is that it has been shown that outside intermediaries can also produce these effects because they influence the demand side for money. In order to demonstrate the influence of indirect liquid assets (issued by near-banks) upon the demand for money we will utilize the following theoretical model.

³⁷ A given stock of money is rendered excessive when demand for this money declines.

Diagram 2³⁸

Note: A) represent three demand functions for money functions
 B) for money functions
 C) for money functions
 L represents the total demand for liquid assets (including money) function

In the following analysis we assume that the level of income and total primary securities are both given and that, initially, there is a certain supply of money associated with some long-term rate of interest. In addition, we assume there are near-banks which create claims on themselves that the public accept as perfect substitutes for money.³⁹ These claims are indirect liquid assets, but they are not counted as part of the money supply. The

³⁸ John Gurley, "Liquidity and Financial Institutions in the Postwar Period", p. 53.

³⁹ It is logical, of course, that if this assumption were true these claims would be identical with money.

sum of the two is the public's holdings of liquid assets.⁴⁰

Case 1 begins where the interest rate is r_1 , the money supply is OM , indirect liquid assets are MA , and the total liquid assets are OA . The monetary authority, imposing a tight money policy upon the economy, now moves to reduce the money supply to OM^1 by selling primary securities. We assume that, at the same time, near-banks purchase primary securities and create indirect liquid assets exactly equal to the decline in the money supply. Therefore, at the end of the process, total liquid assets remain unchanged at OA and the rate of interest stays at r_1 . In this first case the offsetting increase of indirect liquid assets produces a demand for money function that is perfectly interest elastic (see curve labelled A). Attempts by the monetary authority to raise the level of interest rates, in order to curtail spending, have been rendered ineffective by the activities of near-banks.

In Case 2, we continue to assume the perfect substitutability between money and indirect liquid assets. Like Case 1, we examine the effects of a decrease in the money supply; however, this time, instead of indirect liquid assets increasing, they remain constant. Total liquid assets

⁴⁰

We are abstracting from other liquid assets such as treasury bills, bankers' acceptances, and bank time deposits. In this demonstration we assume that these liquid instruments and others like them remain constant.

are reduced by AA^1 (i.e., from OA to OA^1), equal to the decline in the money supply MM^1 , and the economy moves to point L_2 on the total liquidity schedule. The reduction in liquid assets raises the interest rate to r_2 and produces a less elastic demand for money function (see curve labelled B). Thus, with no offsetting liquidity created by the near-banks, monetary policy is shown to be more effective in influencing interest rates.

In Case 3, the money supply is again reduced from OM to OM^1 . This time however, indirect liquid assets are also reduced so that total liquid assets fall by more than the money supply (something more than MM^1). The economy moves to point L_3 on the total liquidity schedule and the interest rate rises to r_3 . With both the money supply and indirect liquid assets reduced, interest rates have risen from r_1 to r_3 describing again a less elastic demand for money function (see curve labelled C). This serves to demonstrate that when both banks and near-banks are directly controlled in their ability to create liquid assets, monetary policy is able to influence greatly, changes in the level of interest rates.

In the above cases the three different shapes developed in the public's demand for money function indicate how the latter is very much dependent upon whether indirect

assets, rise, remain constant, or fall. The analysis indicates that the commonly accepted relationship between the supply of money and level of interest, incorporated into the familiar Keynesian model of the L_2 curve, is not sufficient. Although in the above cases, the rate of interest and money supply are perfectly correlated, we may not conclude that the rate of interest depends only on the supply of money. It is shown to be dependent upon both the supply of money and the supply of indirect liquid assets, all other things remaining equal.

The foregoing analysis assumes that the relationship between money and indirect liquid assets is one of perfect substitutability, that is, both serve equally well as stores of value and means of payment. In more realistic terms, however, indirect liquid assets are not perfect substitutes for money and therefore any increase in their supply will reduce the demand for money less than proportionately.⁴¹ Thus, an increase in indirect liquid assets, accompanied by an equivalent decrease in the money supply, will leave the public with less liquidity which will be associated with a higher rate of interest. Each of the above cases may be considered using various degrees of

⁴¹ John Gurley, Op. cit. In his analysis Gurley assumes that an increase in indirect liquid assets reduces the demand for money on the average by one-half of the given increase.

substitutability.⁴² Even though the influence of indirect liquid assets upon the demand for money will not be as dramatic, the following conclusion still holds.

1. Given a constant money supply, the creation of money substitutes reduces the public's demand for money balances thus rendering the existing stock of money excessive.
2. In the short run outside intermediaries will spend the excess money balances on primary securities, thus depressing interest rates to a level where the public is willing to hold all of the unchanged money supply.
3. The decline in interest rates will tend to stimulate investment which in turn places upward pressure on price levels and wage rates.
4. In the long run the latter adjustments will lower the real value of the money supply (thus tending to raise interest rates slightly) and in general leave the economy with a higher price level and a lower rate of interest than in its original equilibrium position.

In summing up the implications of their thesis, Gurley and Shaw note that monetary policy is not very effective in preventing inflation; concentrating only on the

⁴² So long as the money substitute is less than perfectly elastic (i.e., substitutable) any desired effect on the rate of spending in the economy can still be achieved by the monetary authority; although it will require a larger change in the money stock to bring it about, the greater are the elasticities of substitution and supply. See Abba Lerner, "Financial Intermediaries and the Effectiveness of Monetary Controls; Discussion", American Economic Review Papers and Proceedings, LIII (1963), 402.

banks, it does not seriously impair the lending activities of other institutions. In addition, monetary policy is not considered equitable; it places most of the restraint on the banks while allowing other institutions to expand. Finally, Gurley and Shaw recommend that similar controls, such as reserve requirements of some sort, be applied to other institutions besides banks, to make monetary policy both more effective and more equitable.⁴³

(e) Elasticity of the Demand for Money and Income Velocity of Circulation of Money - reaction to the Gurley-Shaw thesis

It would appear that the central issue is not whether the development of outside intermediaries leads to a secular decline in the demand for money⁴⁴, but rather whether the

⁴³ Gurley and Shaw also emphasize the implications of unrestricted near-bank development upon economic growth. Gurley suggests that this unfair competition facing the chartered banks weakens the latter's position in attracting sufficient amounts of capital to sustain "their ability to participate vigorously in the risky frontiers of economic growth. They might gradually, due to lack of adequate capital, seek to hold safer and safer assets as they become less viable, a situation which at the same time would invite further 'propping up' of the banking system by subsidies in various forms." See John Gurley, "Agenda for a National Monetary Commission: Discussion", American Economic Review Papers and Proceedings, XLVIII (1958), 105.

⁴⁴ It has been pointed out that a relatively smaller stock of money increases the leverage effect of monetary controls. This is held to be true since a small money stock behind income, transactions, and assets, will yield greater effects from any changes in its total volume. See Donald Shelby, "Some Implications of the Growth of Financial

liabilities of outside intermediaries are such close substitutes for money that they increase the interest-elasticity of demand for money. This latter issue:

...is an empirical question; and the empirical evidence so far is that shifts by the public from money into thrift assets in periods of monetary restraint have not had a significant influence on velocity.⁴⁵

A number of views have been expressed regarding the destabilizing influence of outside intermediaries upon the economy. Perhaps the above opinion can best be examined by briefly reviewing three interrelated topics; 1) elasticity of the demand for money, 2) destabilizing portfolio shifts, 3) destabilizing movements in velocity.

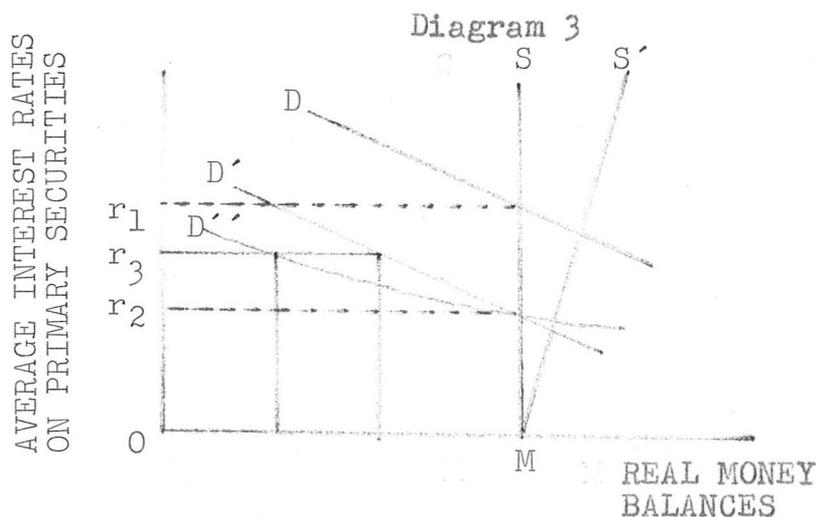
1) Elasticity of the demand for money

Don Patinkin adapts the Gurley-Shaw thesis to a Keynesian model in order to visually demonstrate that following an increase in money substitutes (indirect liquid assets), the demand curve for money both shifts leftward and becomes

Intermediaries, Journal of Finance, XIII (1958), 540. There is however, some question as to the potency of this increased leverage. As one writer observes, it may tend to weaken monetary control due to the increased uncertainty concerning short-run impact on the total supply of liquid assets; since its effects are less predictable there may be further reluctance to use it. See David Fand, "Intermediary Claims and the Adequacy of Our Monetary Control", Banking and Monetary Studies, ed., Deane Carson (Homewood, Illinois: Richard D. Irwin, Inc., 1963), p. 243.

⁴⁵ Harry Johnson, "Monetary Theory and Policy", American Economic Review, LII (1962), 373-74.

more elastic.⁴⁶



In the above diagram if the demand curve shifts from D to D'' it follows that, if the real supply of money remains constant at OM , the rate of interest must decline from r_1 to r_2 . Now, the implication is that if the monetary authority wishes to raise the level of interest rates from r_2 to r_3 , through open market operations, it must decrease the real

⁴⁶ Don Patinkin, "Financial Intermediaries and the Logical Structure of Monetary Theory", American Economic Review, LI (1961), 109. The greater the supply of liquid assets which are close substitutes for money, the greater the elasticity of liquidity preference is likely to be. Alvin Marty, however, denies that there has been any adequate proof that elasticity will increase. "I know of no theoretical presumption that the introduction of a rival asset does increase the market elasticity of demand for money at every rate of interest." See Alvin Marty, "Gurley and Shaw on Money in a Theory of Finance", Journal of Political Economy, LIX (1961), 59.

money supply progressively more as the presence of outside intermediaries influences both the position and elasticity of the demand for money function. In addition, it is evident in the above diagram that when near-bank claims are introduced which serve as perfect substitutes for money, the money supply function SM is dislodged from its assumed perfectly inelastic position. This adds an additional element of instability to effective monetary control. This later influence is not so evident in the United States where perfect substitutes for money are rare. However, in both Canada and Britain chequable deposits accounts are operated outside the banking system and comprise a small, but significant, near-bank money supply. It is therefore argued that when the above theoretical evidence is presented, chartered banks are discriminated against when monetary policy must compensate for the activities of near-banks.

There is no doubt that near-banking intermediation has had some impact upon the elasticity of the demand for money function. The difficulty arises however, in attempting to answer the question - how much? In order to gain some perspective on the role played by the near-banks it will be useful to consider briefly the following interesting viewpoint.

While there is general agreement that an increase in money substitutes will increase the elasticity of the demand for money, it does not necessarily follow that the

recent growth of near-banks is the only contributing factor. Warren Smith indicates that the development of a broader and more efficient government securities market has also played an important part.

The existence of a highly developed open market in government securities has tended to turn cash holdings of the private non financial sector of the economy into a common pool on which all can draw to finance expenditures and thus has mobilized these resources more effectively in support of economic activity.⁴⁷

Since our own money market was formally established in 1954, Canadians have increased their efficiency in handling cash balances, having become more sensitive to interest rate differentials. The market has also contributed to the flow of funds from inactive to active balances by providing the means whereby assets are more readily transferable from one economic unit to another. In addition to offering a source of funds to the near-banks, such as the finance companies, the money market provides funds for government, bank, and corporate borrowing. It has been observed that the development of the Canadian money market has:

- 1) undeniably increased the liquid asset holdings of the non-bank public. 2) undoubtedly facilitated the transfer of these assets from one economic unit to another within the public sector; 3) and possibly removed an obstacle which had previously stood in the path of "switching" operations by the banks during periods of restriction.⁴⁸

⁴⁷Warren Smith, "On the Effectiveness of Monetary Policy", Money and Economic Activity, ed., Lawrence Ritter (Boston: Houghton Mifflin Company, 1961) pp. 335-36.

⁴⁸Bruce MacLaury, "The Canadian Money Market: Development and Impact", 336. Also see Hyman Minsky for an

2) Destabilizing portfolio shifts

There are many factors which influence the flow of savings into near-bank claims. Arthur Benovie notes that this flow is positively correlated with such independent variables as the rate of interest on near-bank claims, and changes in the money supply and personal saving.⁴⁹ Alternatively, a negative correlation exists with the interest rate on corporate bonds and treasury bills, changes in stock prices, the growth rate of GNP., and the stock of individual indebtedness. We have already emphasized the economic significance of one important shift; that is, shifting from money to near-bank claims as interest rates on these claims rise. It was observed that the result of this shift was to effect an overall expansion of credit. In addition, another important shift must be noted.

interesting thesis regarding money market development through institutional innovation. It is Minsky's view that an increase in money substitutes (through institutional innovation) leads to a decline in liquidity, leaving money market assets more vulnerable and increasing the chances of insolvency and illiquidity. Minsky explains that during a period of increasing economic activity little is known (or from appearances, cared to be known) about the limitations of new institutions and paper in the money market since throughout the boom there is little concern regarding a financial crisis. Thus, the new found profit opportunities are generally exploited to such an extent that the market becomes unstable. As this instability spreads, any slight deviation from equilibrium may have widespread repercussions. Perhaps the prevailing Canadian situation reflects in part this unwholesome development. See Hyman Minsky, "Central Banking and Money Market Changes" Money and Economic Activity, ed., Lawrence Ritter (Boston: Houghton Mifflin Co., 1961), p. 344.

⁴⁹ Arthur Benovie, "Financial Intermediaries and the Effectiveness of Monetary Policy: Discussion" American Economic Review Papers and Proceedings, LIII (1963), 410.

For example, in the event that a tight money policy reduces the availability and increases the cost of credit, a shift from near-bank claims to money is not an unlikely result. Such a shift, of course, would reduce the overall expansion of credit.

In the United States, David Fand has conducted a study of portfolio shifts of liquid assets during the period 1952 to 1962.⁵⁰ Fand's analysis is based on the assumption that if destabilizing shifts are significant, it is expected that claims drawn on near-banks (savings and loan companies and mutual savings banks) would grow relative to, or at the expense of, claims on the banks or currency during the expansion phase of the business cycle. The findings of this study indicate that savings and loan shares reflect a steady growth with "no discernible cyclical pattern". Also, deposits at mutual savings banks tend to accelerate in recessions thus proving to be stabilizing rather than destabilizing. The only real destabilizing portfolio changes appeared to be between demand and time deposits at the commercial banks.

In an experiment, similar to the one above, Warren Smith has tested the period from 1953 to 1957. In his conclusion, Smith notes that portfolio shifts between demand

⁵⁰ David Fand, "Intermediary Claims and the Adequacy of our Monetary Controls", Banking and Monetary Studies, ed. Deane Carson (Homewood, Illinois: Richard D. Irwin, Inc., 1963), p. 243.

deposits and near-bank claims have not been important. While holdings of near-bank claims have increased more rapidly than the money supply during the postwar period:

the growth has been steady and has shown no discernible tendency to speed up when interest rates have risen or to slow down when they have fallen. There is certainly no indication of systematic cyclical shifts between money and these intermediary claims. In the absence of such systematic shifts, there is no reason why the fact that the public's holdings of these claims has been increasing faster than its holdings of money balances should create any particular problems for the monetary authorities.⁵¹

Near-bank switching is also examined by Smith, for in addition to raising funds by selling their own indirect assets, outside intermediaries, like the banks, may activate idle balances by switching short term and medium term assets for loans, mortgages, etc. After observing the pattern of switching operations (during the recession of 1954 and the tight money period between the end of 1954 and middle of 1957) Smith does not find significant destabilizing sales by near-bank institutions. During the tight money period he finds that spending, financed by the activation of idle balances, was facilitated largely by commercial banks.⁵² In Canada too, it has been observed that switching operations, leading to

⁵¹ Warren Smith, "Financial Intermediaries and Monetary Controls, American Economic Review, LXXIII, 546.

⁵² Commercial banks obtain \$14.5 billion or 64.4% of the funds they advanced to the private sector through sales of treasury securities, whereas the corresponding magnitudes for outside intermediaries were \$0.8 billion or 1.7%. See ibid., p. 548.

perverse fluctuations in velocity, may be "primarily attributable to the activities of the banks".⁵³ There are a number of reasons why this is true. In the first place the chartered banks' portfolios have shorter maturity structures which facilitates switching by reducing the capital loss on security sales. On the contrary, near-banks and other outside intermediaries are more specialized in providing long term funds for mortgage finance, fixed capital investment, etc. Also near-banks tend to maintain their holdings and depend upon repayment flows, and their success in attracting current savings, for portfolio adjustments.⁵⁴

3) Destabilizing movements in velocity

The problem of income velocity change, as related to the problem of economic stability, centres, not so much

⁵³R.C. McIvor, "Some Aspects of Canadian Financial Intermediaries", (unpublished) May, 1964.

⁵⁴Marvin Rozen offers the interesting view that during a tight money period, so long as idle balances are large, credit expansion through bank switching will predominate, while, after these balances diminish, the flow of current savings, presumably going mostly to the near-banks, will become more important. Rozen supports this view by noting that idle balances are likely to be held by large holders sensitive to changes in financial asset prices (thus anxious to purchase bank securities when interest rates rise). On the other hand, he notes that the current flow of personal savings is likely to be spread more widely in smaller amounts, and to gravitate to near-banks (only when idle balances are limited do rate differentials between banks and near-banks widen sufficiently to attract the small savings holder). See Marvin Rozen, "Credit Controls and Financial Intermediaries", American Economic Review, LII (1962), 189-190.

on its secular increase, of which there is ample evidence during the postwar period (see Chart I, p. 118a),⁵⁵ but rather, on its cyclical fluctuations. In our earlier analysis we emphasized the point that in addition to the influence on velocity by outside intermediaries, there are influences from other economic units including the banks, government, and public. As a result, it appears that there is little agreement as to the extent of the role played by outside intermediaries in effecting cyclical changes in velocity. But what of velocity itself? Is there reason to believe, as the Gurley-Shaw group implies, that velocity movements are highly destabilizing? Apparently not, for the views on this subject are well divided into two distinct camps.

In the one camp, velocity fluctuations are recognized as having considerable impact upon the economy. Hyman Minsky contends that the techniques discovered for economizing cash balances during periods of restraint are not forgotten during periods of ease; and as a result, changes in velocity are not symmetrical in both directions.⁵⁶ The Radcliffe Committee have clearly stated that they see no limit to velocity fluctuations;

...we cannot find any reason for supposing, or any experience in monetary history indicating, that there is any limit to the velocity of circulation....⁵⁷

⁵⁵R.C. McIvor, "Some Aspects...", p. 112.

⁵⁶Hyman Minsky, "Central Banking...", pp. 182-4.

⁵⁷Committee on the Working of the Monetary System, op. cit., p. 133.

In Canada also, there have been those of the opinion that velocity is capable of moving almost without limit. Toward the end of the 1950's the former governor of the central bank, James Coyne, held the following view:

...to my mind that is the central problem of monetary policy, how you estimate or try to influence that velocity of circulation...

Senator Leonard: Of course, there is an effective limit to an increase in velocity of circulation.

Mr. Coyne: we have never found it. It might be very dangerous to try to find it. I think most periods of inflation...have come to an end before the effective limit in velocity of circulation has been reached.⁵⁸

Economists in the opposing camp do not regard velocity changes with the same alarm. Lawrence Ritter, for example, notes that anti-inflationary monetary policy is often criticised for being ineffective but also it is criticized for being too drastically effective if it is effective at all. That is, it may precipitate an economic collapse through shattering confidence in financial markets. Ritter therefore remarks that:

changes in velocity...provide the needed safety valve, tempering and graduating the impact of monetary policy and thereby enabling the central bank to apply more restraint than it might otherwise risk.⁵⁹

In his study Ritter shows that there is a close relationship between velocity and interest rates. He observes it to be evident that when interest rates are low and idle balances large, a small rise in interest rates is likely to result in a

⁵⁸ Canada, Senate, Standing Committee on Finance, Proceedings on the Threat of Inflation (Ottawa, 1959) p. 448.

⁵⁹ Lawrence Ritter, "Income Velocity and Anti-inflationary Monetary Policy," Money and Economic Activity, Ed., Lawrence Ritter (Boston: Houghton Mifflin Co., 1961), p. 351.

large transfer of funds to active balances, thus increasing velocity substantially.

In this phase there is considerable truth to the "offset" view point. But as interest rates continue to rise, due to continued monetary restraint and persistent demands for funds, idle balances are likely to approach minimum levels. Correspondingly, velocity is likely to encounter an upper limit, a rough and perhaps flexible ceiling, but a ceiling nevertheless. As it becomes increasingly difficult to obtain the release of additional funds from the now depleted idle balances, velocity will be subject to new constraints, economic activity will become increasingly responsive to monetary policy, and further expansion of GNP. will be inhibited.⁶⁰

George Garvey also supports this view, velocity changes need not pose a great threat to effective monetary policy. It is his belief that the monetary authority merely needs to take expected velocity changes into account when setting up their policy measures. He notes that in the United States existing financial arrangements are such that:

the occurrence of sharp upsurges or reverses in velocity that would interfere to any significant extent with the execution of monetary policy is highly unlikely.⁶¹

Perhaps at this point it will be useful to review our position. At the outset we recognized that, independent of monetary control, a number of factors have operated to effect both secular and cyclical changes in the velocity of circulation of money. The extent to which near-banks have

⁶⁰ Ibid., p. 352.

⁶¹ George Garvey, "Structural Aspects of Money E Velocity," Quarterly Journal of Economics LXXIII (1959), 447.

contributed to these destabilizing pressures can only be roughly estimated. Finally, we have examined velocity itself and discovered that there are two contradictory views. One is that velocity may be stretched almost without limit and thus may become highly destabilizing; while the other view holds that velocity fluctuations are indeed limited and provide a space for breathing inside the confining walls of monetary controls. Gurley and Shaw have indicated that the recent growth of outside intermediaries provide a potential offset to effective monetary policy. Both in their secular and cyclical development it is contended that near-banks pose first, a threat to the chartered banks in being able to operate unimpeded by monetary controls, and secondly, a threat to the economy through destabilizing pressures upon prices and wages. The problem is obviously one of degree and because of the serious lack of statistical proof and satisfactory means of measurement, the variety of emphases placed on near-bank development cannot be resolved into any conclusive statement. Perhaps the best answer to our problem is to conclude this chapter by briefly reviewing some of the comments made by the commissioners of recent studies conducted in the United States, Canada and Britain.

f) A Review of Recent Commission Reports

1) United States

In the United States the Commission on Money and Credit do not believe that velocity effects, due to the movement of funds out of currency and demand deposits and into near-bank

claims, have been great.⁶² The major influence upon velocity fluctuations is observed to be households and non-financial corporations who are the primary holders of demand deposits. Evidence collected shows that shifts in corporation savings balances are generally into short-term treasury securities rather than into near-bank claims. As for households, the flow of their idle balances appears to be stabilizing rather than destabilizing. That is;

the cyclical effect of the flow of funds into the savings institutions is more likely to increase velocity in recessions than in booms and thus to assist rather than offset the effect of monetary policy.⁶³

The switching operations of near-bank institutions from "bills" to long-term loans are also thought by the Commission not to be a significant contribution to cyclical variations in velocity. In so far as the Commission is concerned, evidence is only fragmentary as to the extent that near-banks are responsible for either cyclical or secular movements in velocity.

The evidence of the post-war years indicates that the increase of money substitutes has played a role in the rise in velocity, but there is disagreement as to its relative importance. There is also little agreement as to whether money substitutes are likely to have a significant role in influencing the trend of velocity in the future.⁶⁴

⁶² The Report of the Commission on Money and Credit, (New Jersey: Prentice Hall, 1961), p. 78.

⁶³ Ibid., p. 79.

⁶⁴ Submission by the Bank of Canada to the Royal Commission on Banking and Finance, May 31, 1962.

Direct control of the near-banks is therefore not felt to be warranted. It is, in fact, believed by the Commission, that any effects the near-banking sector has on velocity over the cycle are too small to warrant controlling. Over the long run any effects will be stabilized by regulating the long-run money supply.

2) Britain

The Radcliffe Commission in Britain is more prepared to support the Gurley-Shaw thesis. It is apparent that there is reason to doubt the effectiveness of monetary policy in controlling near-bank operations (velocity fluctuations) through discriminatory variations of commercial bank reserves. In fact, the "supply of money" approach to the control of aggregate demand is rejected on the grounds that it concentrates on only one form of credit, (i.e., money) and fails to include within its immediate reach all of the other credit creating institutions in the financial sector of the economy. In addition, the committee stresses that a more direct and broader influence over the entire structure of interest rates is essential if monetary policy is to be effective. The Radcliffe people advocate extensive use of debt management counter-cyclical policies in order to influence "general liquidity"; only a so-called "change of gears" in the level and structure of interest rates will bring about a significant influence on both the cost, and more importantly, the availability of credit.

It is important to note that a highly developed financial system adds considerable weight to the degree of substitutability that exists between other liquid assets and money. It is probable that the growth of near-banks and other intermediaries throughout the financial sector of Britain have proven to be a more obvious constraint to monetary policy than was in evidence in the United States.

3) Canada

In Canada there is no real agreement over the ability of the central bank to control near-bank intermediation. Governor Rasminsky expresses the view that present monetary controls exert ample influence over the supply of loanable funds to effectively curtail spending - given a reasonable length of time for the restrictive measures to permeate the market.⁶⁴

A much different impression however, is derived from former Governor Coyne's statement to the senate committee in 1959.

He said in his testimony that

[In addition to the banks] there are many other institutions granting credit, and many which are in the business of taking deposits. There are many other forms of securities - the short-term notes of installment finance companies, the financial paper of large corporations, the promissory notes which in the hands of a holder are very nearly the equivalent of money, and which in total can be very important and have a very significant effect on the total rate of spending throughout the country, but which are not directly subject to any

⁶⁴Submission by the Bank of Canada to the Royal Commission on Banking and Finance, May 31, 1962.

regulation by the central bank, or very much regulation of anybody else.⁶⁵

The most serious offenders coming under Mr. Coyne's charges would appear to be the installment finance and consumer loan companies. In his 1956 annual report, the Governor envisioned "a rival banking system" developing. During the 1950's, on several occasions, direct controls were brought to bear against these companies. For example, in 1955, 1956, and 1959, limits were placed on the credit lines extended to the finance companies by the chartered banks. As was noted earlier in Chapter 1, this has had no real effect upon the growth of finance companies since they merely switched their borrowing operations to the money market.

The Royal Commission on Banking and Finance generally reflects Governor Rasminsky's view. It observes that the impact of monetary policy generally influences all financial institutions. The exact timing and relative impact, however, will tend to vary among different institutions for several reasons: some are slower than others to respond, all may work to slightly different cash ratios at different times, cash may shift between institutions working to somewhat different ratios, and market imperfections may slow or impede the transmission of cash through the system. Never-

⁶⁵ Canada, Senate, Standing Committee on Finance, Proceedings on the Threat of Inflation in Canada, (Ottawa, 1959), p. 446.

theless, the real effects of such factors as these are shown in the Commission's mathematical Appendix to be relatively minor. In general, the Commission concludes that

if the institutions are able to compete for funds on reasonably equal terms, action by the central bank will affect them all, whatever their cash reserves and wherever they may be held, by affecting the terms on which they borrow or lend.⁶⁶

Both banks and outside intermediaries are regarded as fundamentally the same in their ability to expand credit. The major supply of idle balances is drawn by the outside intermediaries from the chartered banks. This leads to a multiple expansion of credit and further spending, and suggests a competitive problem. That is, the banks could prevent this from happening by raising their rates of interest on deposits.

Changes in velocity, which may be attributed to the activities of both banks and outside intermediaries, are recognized to keep within "a reasonable limit". The Porter Commission observes that an increase in velocity will halt either when ultimate lenders restrict the flow of funds, due to the cost and inconvenience of running down their liquidity positions; or borrowers, as a result of rising interest rates, eventually curtail their demand for funds.

Short-run changes in the velocity of money are thus usually a reflection of the reaction of savers and

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The Royal Commission, p. 96.

borrowers to changing credit conditions and are not a separate factor which in some way 'off-sets' the attempts of the authorities to ease or tighten the financial system.⁶⁷

It is also recognized, however, that the financial system is sufficiently elastic to allow for "considerable stretch" due to economizing on cash balances. But while this elasticity tends

initially to blunt the effects of monetary restraint on real spending, [it] is at the same time a reflection of that restraint through the economy as a whole and does not mean that the policy is thereby made ineffective.⁶⁸

In concluding, one might say that in Canada the attitude toward the stability implications of near-banking activities generally reflects little concern. The capital market in this country is vastly less complex than its counterpart in Britain. As a result there is not the degree of substitutability among credit forms. Thus the monetary authority faces somewhat fewer difficulties in regulating the economic system. While cyclical fluctuations in velocity have been evident during the postwar period, they have not been out of control. A closer look at these fluctuations and the part played by the near-banks and other intermediaries will be examined in the following chapter.

⁶⁷
Ibid., p. 100.

⁶⁸
Ibid.

CHAPTER III

AN EXAMINATION OF THE ACTIVITIES OF VARIOUS FINANCIAL INTERMEDIARIES AND THEIR INFLUENCE UPON: (a) THE MONEY SUPPLY, (b) THE DEMAND FOR MONEY, (c) THE INCOME VELOCITY OF MONEY.

- a) A review of monetary policy from 1954 to 1964.
- b) Caisses Populaires and Credit Unions.
- c) Trust and Mortgage Loan Companies.
- d) Sales Finance and Consumer Loan Companies.
- e) Life Insurance Companies.

During World War II in both Canada and the United States, prices and interest rates were maintained at abnormally low levels. With the relaxing of controls after 1946, the post-war economy faced the problem of adjusting to a position of equilibrium. Among many factors aggravating a smooth adjustment, was the presence of large pools of liquid assets built up during the war years which threatened to spill over into markets for current output, resulting in serious inflation. In a submission to the U.S. Joint Economic Committee, John Gurley observed that the monetary authority during the post-war period, failed in its attempt to mop up excess liquidity. More specifically, Gurley stated that:

despite restraint on monetary growth, there was a large expansion of nonmonetary liquid assets during the post-war period, which mainly took the form of increases in liquid claims on financial institutions lying outside of the direct control of the monetary authorities, and which reduced the economy's demand for money balances. This liquidity expansion, along with the growth of real output, forced the economy to seek general equilibrium by moving . . . to substantially higher price levels and only later to substantially higher interest rates.¹

Gurley's observation may well apply to our own Canadian experience; for indeed, after the war the economy has been subjected to recurring inflationary cycles which have

¹
Liquidity and Financial Institutions in the Postwar Period, by John Gurley, U.S. Joint Economic Committee (Washington, 1960), p. 21.

severely tested the resourcefulness of monetary policy. It has been evident also that there was a rapid expansion of near-bank liquid assets. For example, during the decade from 1954 to 1964 GNP. increased 73% from \$27.1 billion to \$47.0 billion while growth rates of various financial intermediaries were well in excess of this.²

It is important to recognize, however, that many factors contributed to post-war instabilities remaining unchecked. Whatever importance might be given to the destabilizing activities of near-banks, they must be considered in the light of other factors: such as, conflicts arising out of debt management and fiscal policies during the early years after the war, the vulnerability of our open economy; time lags experienced in effective policy measures, and not the least, an absence of a well-developed money market. All these factors and more, have made the job of monetary control a very demanding and difficult one.

Nonetheless, our study concentrates on the activities of the near-banks and requires that we abstract largely from other influences. Thus our attention will be focussed on the post-war growth of "nonmonetary liquid assets" and their

²In Chapter I, we noted the following percentage changes in near-bank asset holdings: trust companies 291%, mortgage loan companies 235%, caisses populaire and credit unions 211%, sales finance and consumer loan companies 197%, chartered banks 70%.

influence upon the economy.

Before moving directly toward examining the economic activity of Canadian near-banks, it will perhaps be useful to outline in more detail the period of time during which these activities take place. Our study covers a ten year period within which there are three distinct phases of monetary restraint and four phases of monetary ease. It is during these cyclical changes that near-bank activity can best be assessed for its destabilizing influence and therefore, it is imperative that these cycles be well defined.

a) A Review of Monetary Policy

Monetary Ease (October 1953 to August 1955)

It was not until the latter part of 1953 that the post-war upsurge in consumer and investment demand finally ran its course, and the economy, both in the United States and Canada, entered a period of recession. By the end of the third quarter of 1953, monetary policy had changed from one of restraint (mid-1950 to mid-1953) to one of expansion (October, 1953 to August, 1955). From October, 1953 to December in the following year the central bank was a net purchaser of government securities (\$179 million excluding treasury bills); as were the chartered banks, who experiencing no increase in loans during the year, placed their excess reserves in government securities, notably treasury bills (treasury bill holdings increased \$116 million over the previous year). During 1954, the general public substantially

altered their asset portfolio switching out of government securities and into chartered bank deposits. The general level of interest rates reacted to the above pressures, and to the large injections of new money into the system, by showing a marked decline. The treasury bill rate stood at 1.08% on December 30th, 1954 down from 1.88% a year earlier, while the rate on 20 year government bonds dipped from 3.29% to 3.21% (see Chart I, p. 118a).³

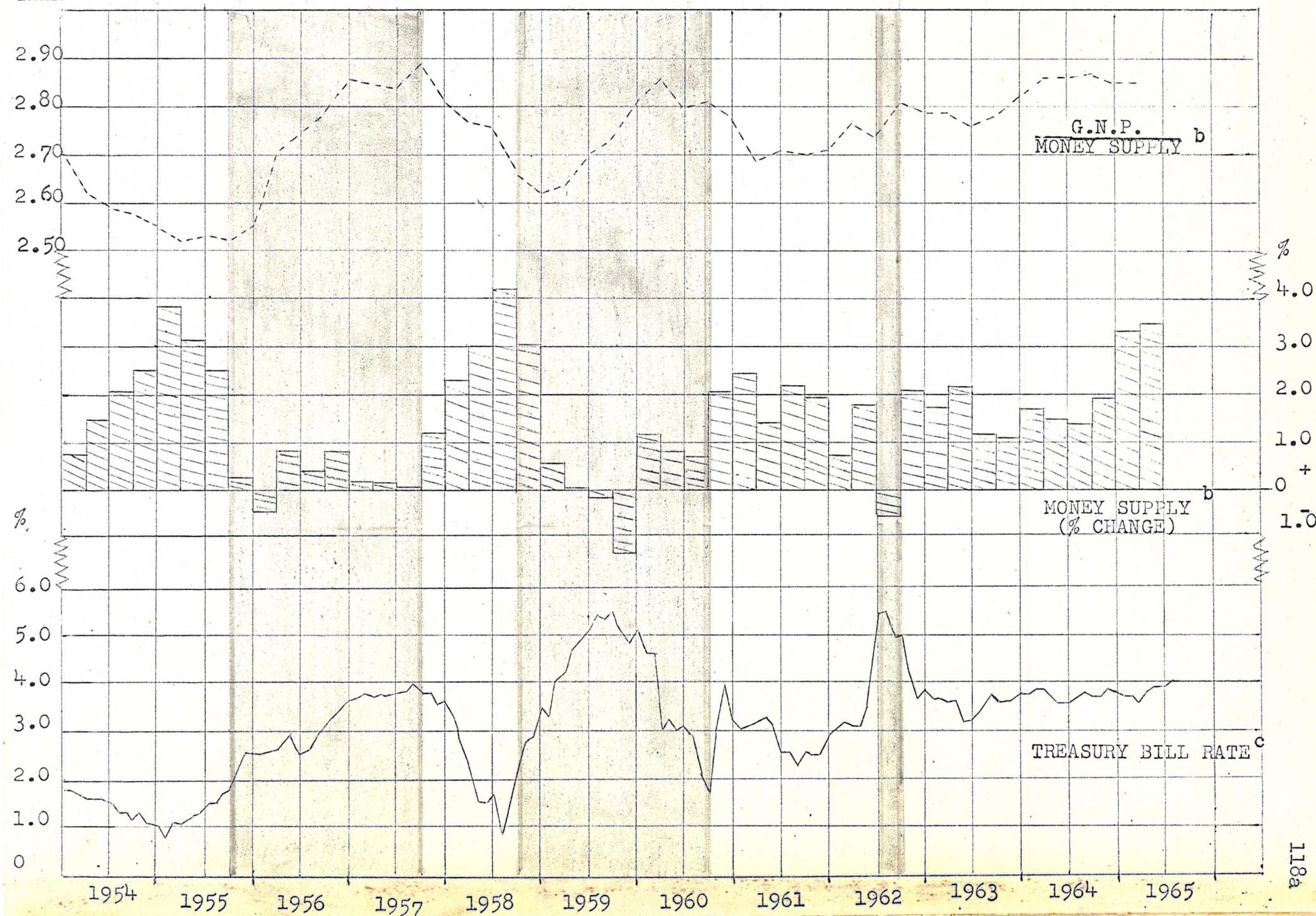
Monetary Restraint (August 1955 to August 1957)

By the spring of 1955, the demand for bank loans began to show a marked increase and since bank reserves had reached a high of 8.6% in March, loan expansion was possible without liquidating other assets. During the third quarter, however, as cash reserves declined to 8.3%, the banks began to sell government securities in order to raise loanable funds (see Chart II, p. 118b).⁴ The first major period of monetary restraint during the decade of our study began in

³ Chart I plots the changes in money supply, treasury bill rate and income velocity of money. These variables have been selected as principal indicators of monetary policy and their historical pattern of fluctuation describes the various phases through which monetary policy passes. Note that the shaded areas are made to represent periods of monetary restraint.

⁴ Chart II describes the switching of assets from securities to loans by the chartered banks. This technique, practised at a time of monetary restraint, is one of the principal forces contributing to cyclical fluctuations in the income velocity of money. Notice the similarity in amplitude described in Chart I: the same applies for each period of restraint and ease.

TIMES
PER
YEAR



Note! Shaded areas represent periods of monetary restraint.

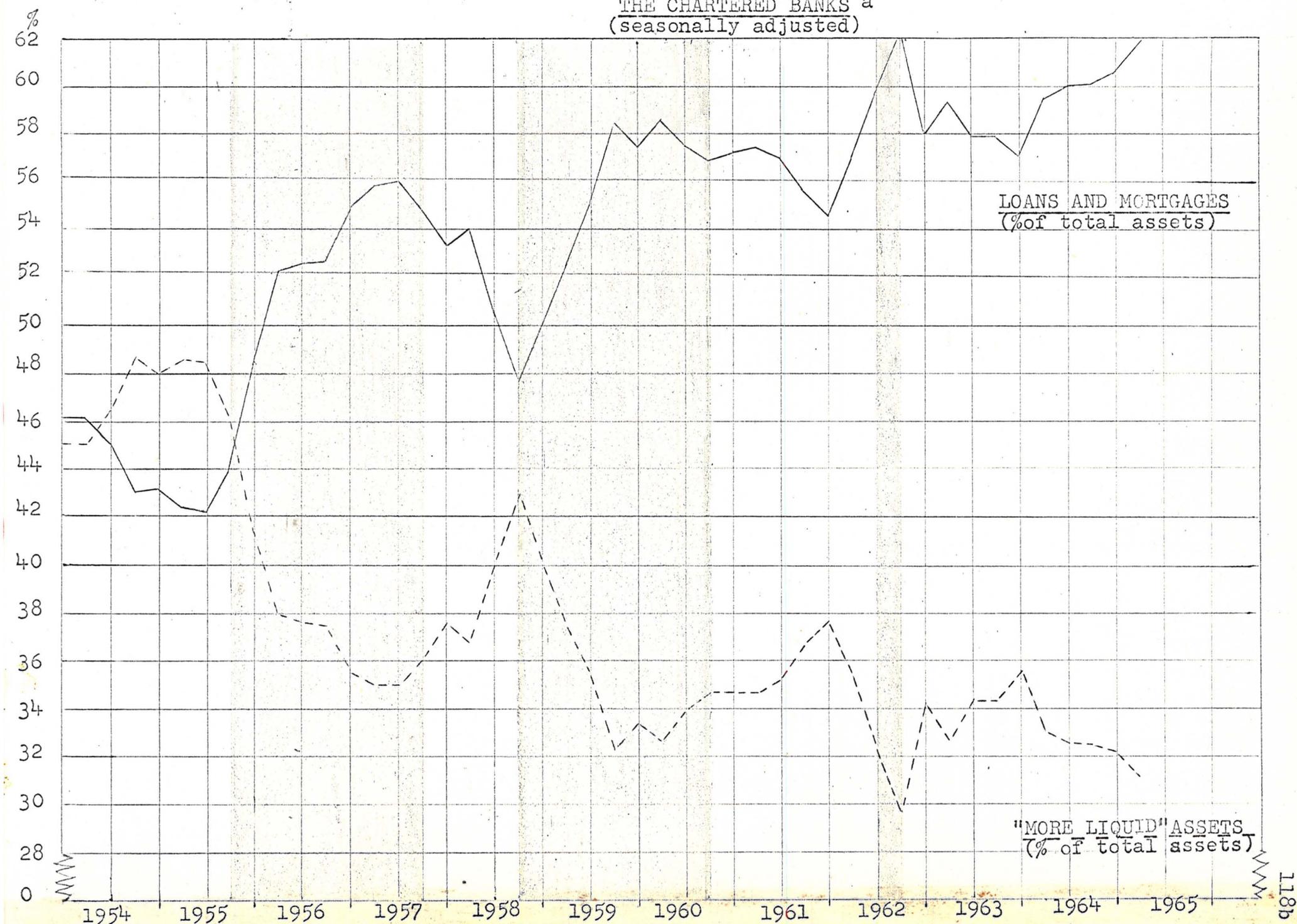
a Source: Bank of Canada Statistical Summary Supplement and D.B.S. Statistical Review (various issues).

b The money supply is based on a quarterly average and excludes Government of Canada deposits. The block chart represents the percentage change in money supply over the previous quarter.

c The treasury bill rate is plotted on a monthly basis.

ASSET PORTFOLIO SHIFTS BY
THE CHARTERED BANKS ^a
(seasonally adjusted)

CHART II



Note! Shaded areas represent periods of monetary restraint.

^a Source: Bank of Canada Statistical Summary Supplement (various issues).

^b "More Liquid" Assets include: Bank of Canada deposits and notes, Cdn. day-to-day loans, treasury bills, Gov. of Canada direct and guaranteed bonds, net foreign assets, call and short loans to stock brokers and investment dealers.

the third quarter of 1955 and continued into the third quarter of 1957.

In August, 1955, the central bank announced an increase in Bank Rate to 2% and after two succeeding adjustments it stood at 2 3/4% by November. Also at this time, the chartered banks were persuaded to restrict their term loans to business and agree to maintain a 15% liquid reserve effective the following May. For the duration of 1955 and all of 1956, despite large purchases of government securities by the central bank in order to stabilize financial markets, interest rates rose rapidly sharpened by the strong demand for loanable funds. By the end of 1955 the treasury bill rate stood at 2.56% (1.08%, December, 1964) and the rate on 20 year government bonds was 3.41% (3.21%, December, 1954).

During 1956, demand pressure was sustained by further development in the investment boom. As available resources were rapidly drawn into production and slack in the economy was taken up, inflationary pressures continued to build up, largely as the result of these internal forces. At this time monetary policy began to play a greater, and almost singular, part in the "mix" of central economic policies. Whereas both fiscal and debt management policies tended to be out of step with existing economic conditions, monetary restraint was

virtually the only discretionary policy weapon used.⁵

Throughout 1956 total borrowing by businesses, individuals, and public bodies (outside of the federal government) is estimated to have increased by 15%. From June, 1955 to June, 1956, bank loans increased by 28% being financed by large sales of government securities, however this source of funds was just about dried up by the end of the year (see Chart II p. 118b). Prices continued to rise in Canada with the consumer price index up 3% for the year. The Bank of Canada raised its Bank Rate four times until November when it fixed it at 1/4 of 1% above the weekly treasury bill rate. For the second year in a row the central bank was a large net seller of Government of Canada securities which, along with its other activities, forced interest rates steadily upwards. By year end the treasury bill rate closed at 3.67% (2.56%, December, 1955) while the 20 year bond rate touched 4.0% (3.41%, December, 1955).

Monetary Ease (August, 1957 to December, 1958)

While interest rates continued to rise up to August, 1957, expenditures by consumers and businesses began to weaken; the seasonally adjusted unemployment rate began to rise and the wholesale price index turned down. By December, 1957,

⁵The Royal Commission, p. 416. The Commission notes that this situation has occurred a number of times during the last decade (particularly up to 1961) however, there were periods such as the exchange crisis in 1962 when all economic policies seemed to be working toward the same objective.

unemployment reached a level of 6.2% having increased from 3.7% where it stood in the first half of the year. Although the Bank of Canada reported an increase in the money supply of \$486 million from July 21st to December 31st, and a rise in chartered bank assets of \$483 million (mainly liquid assets), it is criticized for not acting quickly enough to meet the cyclical downturn (see Chart I p. 118a). One writer notes that while the money supply increased moderately, it was largely offset by cash leakages, leaving the chartered banks reserves roughly unchanged.⁶ Thus it would appear that monetary expansion came somewhere between the end of the third and fourth quarters of 1957. The yield on treasury bills declined from a high in August of 4.08% and reached 3.62% at year end. Long-term interest rates were also down from their peak of 4.34% during 1957 to 3.78% recorded for 20 year bonds in December. The Bank of Canada balanced the year off as a net seller of Government of Canada securities (\$119.5 million), an amount considerably lower than the previous year (\$780 million in 1956).

The central bank reported that the recession had worked itself out during the first quarter of 1958, but nevertheless unemployment continued to rise reaching 7.9% in October, and paradoxically, the consumer price index increased by 1½% in the

⁶ Paul Wannacott, "The Canadian Dollar, 1948-1958", Toronto: University of Toronto Press, 1960, p. 87.

first four months. This unlikely combination mirrored the problem confronting the central bank throughout the year. According to the governor, the appropriate policy was one of restraint⁷. However, such a program was impeded by the activity of the federal government in financial markets. Large government borrowings in February and May (mainly from the non-bank public) contributed to a growing uneasiness in bond markets. Fear of inflation, resulting in rising interest rates and falling bond prices, developed a reluctance on the part of non-bank investors to increase their holdings of government securities. As a result a third government issue in mid-July had to be absorbed directly by the chartered banks and Bank of Canada.⁸ With the mid-July announcement of the Conversion Loan scheme the central bank found itself a principal figure in the market supporting bond prices in every maturity, and although it managed to offset most of its purchases by selling short-term securities, its assets were increased by \$74 million. The central bank continued to support bond prices until November. However, the inflationary implication of this expansion turned the central authorities toward selling some of the longer issues

⁷"Ideally it would have been desirable to have ... held to a minimum the degree of monetary expansion to be added to that which had already occurred in the latter part of 1957". Bank of Canada, "Annual Report", 1958, pp. 5-6.

⁸During the first half of 1958 the general public, on balance, reduced its holdings of government marketable securities by \$45 million while the Bank of Canada increased its holdings by \$107 million and the chartered banks increased their holdings by \$691 million. Throughout this period the banks reduced their loans by \$300 million and thus their total assets rose by \$392 million.

and interest rates rose sharply (see Chart I p. 118a). This marked the end of the period of monetary expansion, the large part of which was generated due to priority given to debt management policy, and established the beginning of the second significant period of monetary restraint which was to run into the third quarter of 1960.⁹

Monetary Restraint (December, 1958 to September, 1960)

1959 was an expansion year with unemployment declining, GNP. rising 7% in value, and prices increasing by 2%. The money supply showed little growth throughout the year with a significant decrease in the final quarter (see Chart I p. 118a). The chartered banks expanded their loans rapidly for the first 9 months principally through large scale switching operations (see Chart II p. 118b), however after mid-August loans levelled off and then declined as sales of government securities ceased. Many observers believed that this expansion was unnecessarily restricted by the ill-timed Conversion Loan. While the economy showed signs of strength, there were still underlying currents of weakness (high level of unemployment for example) that should have been countered by easier monetary conditions. As it turned out, interest rates rose

⁹The remarkable accomplishment of the Conversion Loan was in its demonstration of the potency of debt management policy. The average maturity on all government marketable securities was increased from 6 years and 2 months to 10 years and 7 months in a period from July 15th to September 15th. Unfortunately, this reduction in liquidity proved to be badly timed and played a considerable part in the unwarranted restriction of the 1958-60 expansion.

throughout most of the year¹⁰ and chartered bank loans were possible only because these institutions pared down their liquid assets to minimum levels.

For the first three-quarters of 1960 the money supply continued at approximately the same level as during 1959. In the second quarter, contrary to expectations, GNP. declined more than 1% and unemployment continued to rise from where it turned up in the third quarter of 1959. While market forces tended to strengthen, interest rates declined, and the central bank entered the market as a net seller in the first quarter to offset this trend. In the second quarter interest rates levelled off but again declined in the third quarter, reflecting the strength of public demand for securities rather than monetary policy. It was not until late in the fourth quarter that dramatic steps were taken by the monetary authorities to influence yields and a large net addition to the money supply coincided with a decrease in interest rates.

Governor Coyne, in his annual report for 1960, noted that the rise in unemployment and the continuing decline in GNP. per head were really fundamental structural problems and that the conditions developing in 1960 were only partly in the nature of another cyclical downswing. Nonetheless, while the governor argued that existing conditions could not be

¹⁰Treasury bill yields rose to 6.16% in August but closed the year at 5.12% (3.49%, December, 1958) while the rate on 20 year bonds continued to rise reaching 5.30% at year end (4.42%, December, 1958).

readily solved by traditional monetary policy there was considerable alarm generated by continuing tight money, and many observers were calling for easier credit conditions to encourage expansion.

The decrease of interest rates in the final stages of the fourth quarter in 1960 marked the end of the period of restraint. Treasury bill yields declined to 3.25% at year end (5.12%, December, 1959) and 20 year bonds were quoted at 5.19% (5.30%, December, 1959). The stage was being prepared for a period of monetary expansion that was to continue, except for a brief period in 1962, all the way through to 1965.

Monetary Ease (October, 1960 to 1965)

Credit conditions were eased considerably during 1961 and, while the demand for loans declined, the chartered banks rebuilt their "more liquid assets" (see Chart 1, p.118a). The money supply increased by 9%, a rate almost double that of the previous year, and interest rates generally declined.

The year 1962 was marked principally by the midsummer exchange crisis and, while economic expansion was still being promoted by the central bank, other more important issues received immediate attention. Monetary policy

had as its immediate objective the restoration of confidence in the country's ability and determination to maintain the exchange rate.¹¹

In order to encourage an adequate inflow of capital to cover the large current account deficit and repair the damage to

¹¹ Annual Report, 1962, p. 4.

Canada's foreign exchange position, the central bank sold large quantities of government securities allowing interest rates to rise to record levels. This rise began in May, accelerated sharply in the second half of June, and by mid-July, yields on the whole maturity range of government securities were in the vicinity of $5\frac{1}{2}\%$. This brief period of monetary restraint ended with the lowering of the Bank Rate to $5\frac{1}{2}\%$ on September 7th (established at 6% in June). Following two more adjustments, it reached 4% on November 12th indicating the intention of the monetary authorities to encourage economic expansion.

The policy of monetary ease, re-established in September, 1962, continued throughout 1963. GNP. increased in value by 6%, unemployment dropped to 5.1% (lowest quarterly rate since mid-1957), and prices and costs rose only moderately, reflecting the substantial slack still remaining in the economy. The Bank Rate was lowered from 4% to $3\frac{1}{2}\%$ in May but returned to its original level in August when capital inflows deteriorated due to the July announcement of the U.S. interest equalization tax. While borrowings in the U.S. long-term market were virtually terminated and bond prices weakened, large Russian wheat sales in mid-September provided the needed exchange reserves and stability gradually returned to the government securities

market.¹² These events serve to exemplify the openness of the Canadian economy and our dependence on foreign capital markets. At the end of 1963 interest rates and credit availability remained generally unchanged from the beginning of the year. Tight money was avoided and the policy pursued by the central bank added substantially to chartered bank assets and the money supply.

In 1964 the money supply increased by 7.3% supporting a very substantial growth, in GNP., of over 8%. Monetary policy was generally regarded as expansionary although it was conducted in such a way that the chartered banks were forced to draw down their liquid asset holdings. In the governor's words the banks were brought to:

a position where their lending policies could be expected to be sensitive to any appreciable further decline in liquidity.¹³

Once again the Bank Rate was increased in sympathy with international pressures motivated primarily by increased Bank Rates in England and the United States. This action served to indicate the Bank of Canada's intention to support bond prices and succeeded in stabilizing market prices by year end. The central bank, by utilizing large cash balances held by the federal government, was able to counter the above market stabilizing activity and thereby

¹²Prior to the September wheat sales, pressures had already begun to ease up with the announcement of Canada's likely exemption from the tax.

¹³Annual Report, 1964, p. 3.

minimize the influence upon its cash reserve management. While the central bank was selling securities, in order to offset market disturbances, it was able to restore chartered bank reserves by placing, with the banks, a portion of federal government deposits.

Unemployment, which declined throughout 1964, continued this trend in 1965. It was generally recognized during the latter year that most of the slack had been taken out of the economy and the consumer price index was increasing markedly. Injections into the money supply reached record levels during 1965, however during the last quarter of the year it became generally apparent that the central bank was once again pursuing a policy of tight money. This last period of monetary restraint has continued up to early 1967.

Following this general picture of the period under study, it becomes appropriate to consider various approaches toward the examination of financial intermediaries. Since we are interested in uncovering any destabilizing activities of Canadian near Banks, it would certainly be useful to examine their influence upon the supply of money. It was pointed out earlier that the creation of chequable deposits outside direct monetary control, dislodges the supply of money schedule from its , assumed perfectly interest inelastic, position. While the net increase of this near bank money may be compensated for,

it becomes de-stabilizing when changes in its volume move in opposite directions to that of monetary policy. Therefore, one principal line of attack on the problem of near-bank intermediaries, is to examine certain of their liabilities in terms of relative volume and cyclical fluctuation in growth.

A second line of attack which proves quite useful. is to determine the cyclical (rather than secular) impact of the pertinent institutions upon the demand for money. In theory it was observed that the highly liquid liabilities of near-banks (assets in the hands of the public) tend to decrease the demand for money and increase its elasticity. At the same time this effect is equivalent to an increase in velocity of money since it implies that the community wishes to hold smaller money balances at each given level of interest rates. The problem arises however, that any attempt to closely define this near-bank effect upon velocity requires isolating it from the total influence contributed by a host of factors; (i.e., chartered bank switching operations, changes in public expenditure, alterations in fiscal policy, etc.). This problem can be partially solved by a slight alteration in course. Most of the emphasis nowadays is placed on income velocity of money, owing to its close relationship with GNP. Nonetheless, transactions velocity, when the information is available, is useful to determine in a more refined way, the nature of each institution's effect upon the economy, operating through the payments mechanism. Thus it

will be our intention, where possible, to examine the transactions velocity of near-bank chequable deposits and their relevant cyclical pattern.

A third line of attack, which is really an extension of the one above, is to probe near-bank pressure on cyclical fluctuations of income velocity by observing changes in their assets and liabilities. This approach offers more insight into the intermediaries' operations, particularly during various phases of the business cycle. Again statistical evidence is sparse, but that which is available will be used to determine the impact of monetary policy upon near-bank activities and the ability of these institutions to continue financing undesired current expenditure.

b) Caisses Populaires and Credit Unions

Both the caisses populaires and credit unions create money in the form of chequable savings deposits. Theoretically this causes the supply of money curve to drift from its assumed vertical position to one which is less than perfectly inelastic. This quantity of money, in addition to that which is created by the trust and mortgage loan companies and other near-banks, adds an element of instability to the monetary system by being outside the direct control of the central bank.

The dollar value of near-bank money is substantial. At the end of 1961 total deposits (mainly chequable) created by the locals of both credit unions and caisses populaires was \$813.7 million and represented 5.7% of the money supply

(i.e., chartered bank deposits and currency held by the general public). This figure becomes more impressive if we include the chequable deposits created by trust and loan companies which at the end of 1964 totalled \$660 million or 3.9% of the then current money supply. The grand total of this money created outside the banking system is 8.7% of the money supply and would be still larger if we included the shares created by credit unions, a significant proportion of which are chequable.¹⁴ It is evident that such magnitudes cannot be ignored and are certainly important enough to warrant some closer analysis. For example, it will be useful to examine the amplitude in the growth rates of these monetary liabilities in order to determine whether or not they are destabilizing.

At the outset it should be recognized that even when a large proportion of the money supply is outside the direct control of the central bank, so long as cyclical fluctuations in its growth rate are in sympathy with monetary policy, it is not to be regarded as destabilizing. On the other hand, in the event that cyclical fluctuations operate in the opposite direction to monetary policy, they will undoubtedly intensify inflationary or deflationary pressures in the economy or at least make it more difficult for monetary policy to achieve its stability objectives.

The growth rate of deposit liabilities of caisses

¹⁴ It was noted earlier that while certain credit unions maintain chequable deposits, they are quite inactive turning over on the average less than once a year.

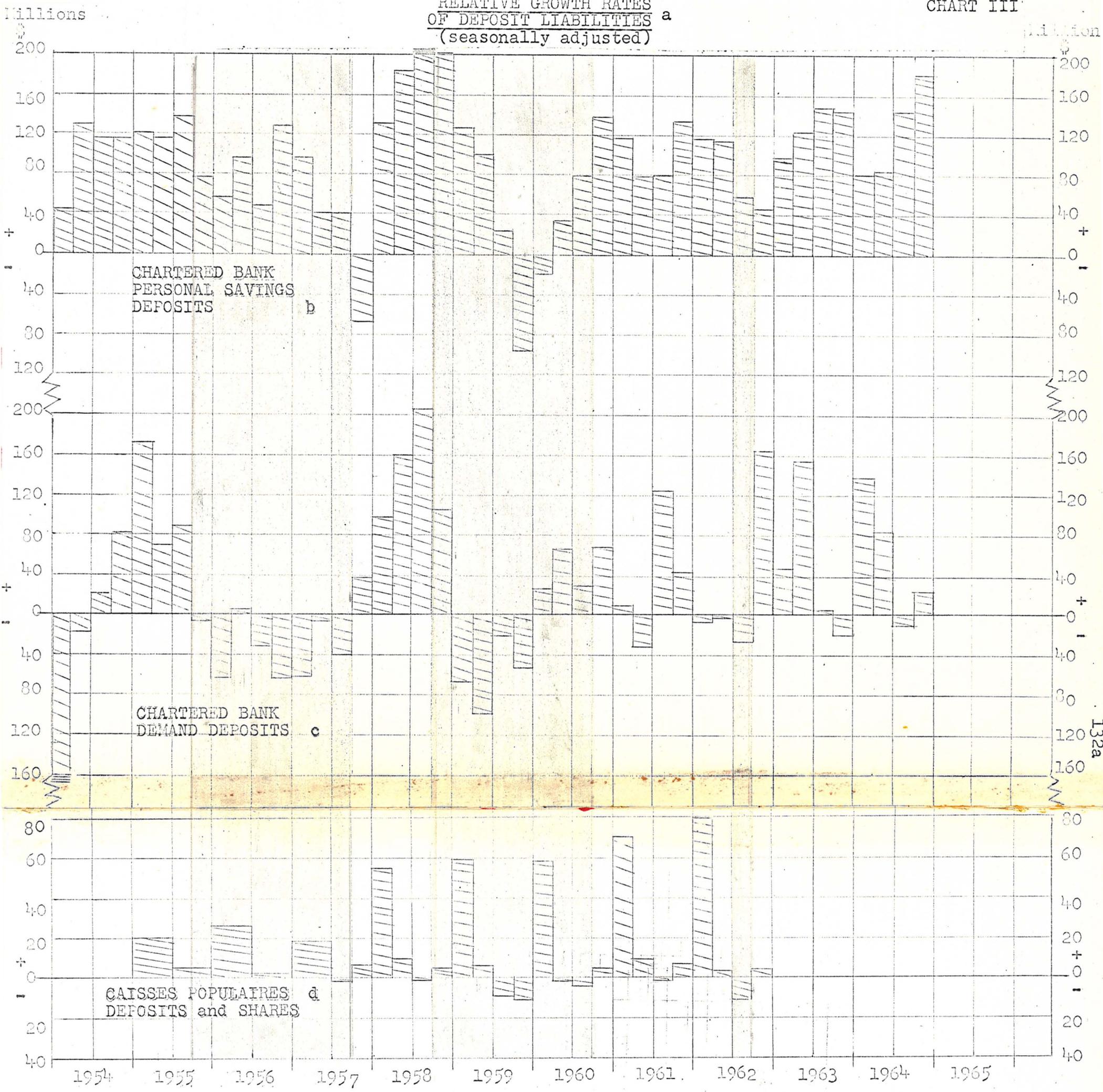
populaires and credit unions is particularly distinctive because of its strong secular upward trend. This typifies the relatively youthful industry developing from a small base. Nevertheless, when deposits and share-figures are adjusted to allow for seasonal influences, there is evidence of cyclical variation (see Chart III, p. 132a).

Upon comparing the relative growth in deposit business between the chartered banks and caisses populaires (see Chart III, p. 132a), it is evident that the former shows a much more solid response toward a tightening of credit. During the 1958-60 period of monetary restraint, both the personal savings and demand deposits of the chartered banks were markedly reduced, beginning in the first months of tight money and continuing to the extreme low, reflected by savings deposits, during the final quarter of 1959. While caisses populaires deposits did decline during the 1958-60 period, they did so much more slowly and without showing the same extremes in amplitude. One observer notes that:

. . . it took a very severe contraction of the banking system to cut in half the growth of caisses populaires.¹⁵

The credit unions present an even more stable picture than the caisses populaires. While once again figures are only a sampling of the industry, they indicate a relatively

¹⁵Gilles Mercure, "Credit Unions and Caisses Populaires", Working Paper prepared for the Royal Commission on Banking and Finance, (November, 1962), p. 101.



Note! Shaded areas represent periods of monetary restraint.

^a Source: Bank of Canada Statistical Summary Supplement, 1964. And, Credit Unions and Caisses Populaires: Working Paper Prepared for the Royal Commission on Banking and Finance.

^b Chartered bank savings deposits including personal deposit receipts and other notice deposits.

^c Chartered bank current account deposits and other demand deposits less Canadian dollar float. Excludes Government of Canada deposits.

^d Includes chequable deposit liabilities of only the members of La Federation de Quebec des Unions Regionales des Caisses Populaires Desjardins.

CREDIT UNIONS

TABLE I

FOUR CENTRAL SOCIETIES ^a
 (seasonally adjusted) ^b
 -millions-

	<u>CASH</u>	<u>LOANS</u>	<u>INVESTMENTS</u>	<u>SHARES AND DEPOSITS</u>	
1956	1.3	12.2	7.1	14.8	
	1.4	12.9	9.0	16.8	
	1.0	13.9	7.5	16.3	MONETARY
	1.2	11.5	7.1	15.6	RESTRAINT
1957	.8	16.6	8.9	18.5	
	1.3	16.9	9.1	18.4	
	1.4	17.0	7.2	16.7	
	1.7	17.0	10.3	19.0	
1958	1.5	19.4	14.5	24.4	MONETARY
	1.2	18.3	15.4	23.8	EASE
	1.7	16.1	17.3	25.7	
	1.6	17.3	18.1	26.2	
1959	3.3	19.8	22.7	33.4	MONETARY
	3.9	21.3	19.8	32.1	RESTRAINT
	2.6	22.4	18.1	29.7	
	2.3	26.4	12.7	26.8	
1960	2.7	31.3	13.8	33.9	
	2.6	29.2	14.4	33.9	
	2.9	28.7	15.1	35.6	
	2.6	28.8	14.8	33.6	
1961	4.5	32.8	21.7	45.4	
	3.0	33.3	17.3	42.2	MONETARY
	3.6	33.1	24.3	46.4	EASE
	3.4	31.6	24.3	48.5	

a

Source: Credit Unions and Caisses Populaires: Working Paper Prepared for the Royal Commission on Banking and Finance, by Gilles Mercure (Ottawa, 1962), appendix II, III - F.

b

Includes approximately 84% of the assets of all credit union centrals in December, 1961.

steady growth in deposit and share business throughout both periods of monetary ease and restraint (see Table I, p. 132b).¹⁶

The figures assembled serve to indicate that while cyclical swings are apparent in the deposit growth of caisses populaires, and to a lesser extent in the deposits of credit unions, these cyclical fluctuations are generally within the bounds of monetary policy and are moving with it. In addition, the impact of these fluctuations is much less in amplitude than comparable fluctuations for the chartered banks and the same comparison in terms of magnitude becomes even less important. In general one does not find significant evidence of destabilizing activity. While these credit institutions do contribute to the uncontrollable portion of the money supply, appropriate compensating action can be taken by the central bank in its long-run policy.

As we turn now to examine the impact of caisses populaires and credit unions upon the demand for money, it is useful to note the turnover rates of their chequable deposits. Unfortunately, incomplete data prevents an historical examination of cyclical movements in transactions velocity. Nevertheless, the data available shows that caisses populaires chequable deposits turn over 2.7 times per year, an

¹⁶ Credit unions chequable deposits, in total, are regarded as insensitive to monetary policy. (See Ibid., p. 103).

amount roughly double that of chartered bank savings accounts, but 20 times slower than the banks current accounts. The magnitude that this turnover rate represents could be significant if, contrary to current opinion, it was thought to be destabilizing.¹⁷ However, over the past decade the transactions velocity of caisses' chequing deposits has shown a gradual secular increase from a level of 2.4 in 1950.

Credit union chequable deposits turn over between 20 and 40 times per year and are comparable in nature to chartered bank current accounts. In certain societies share deposits are also chequable; however these instruments turn over at the much slower rate of 5 times per year. Once again only a partial analysis is possible due to a lack of statistical data, but observations have been made which suggest that fluctuations in transactions velocity reflects the same patterns as perceived in asset shifts. Pursuit of this latter concept leads us to the third line of attack. That is, the influence of caisses and credit unions upon the income velocity of money.¹⁸

The credit unions share the personal loan market with the finance companies, consumer loan companies, and now the chartered banks. In contrast to their competitors the credit union operation tends to be quite inflexible with

17

It was observed earlier that in the province of Quebec drawings against local caisses amounted to over \$1 billion per year. While still significant this amount is dwarfed by the annual chequing disbursements of the chartered banks in the province which totals \$87 billion.

18

Notice in Chart I, p. 118a that while income velocity

regard to loan expansion. The flexibility of the chartered banks derives from the fact that during a period when loan demand falls off, idle funds are used to build up bond portfolios which can be easily liquidated when the demand for loans increases. On the contrary, the credit unions are much less elastic having comparatively little margin to change the volume of their business in times of tight money. As it is described by Gilles Mercure, the "structure of assets and liabilities of credit unions is very much frozen."¹⁹

The reason for the above is perhaps attributed to two factors. The first is the nature of loan demand within the credit union society. It is apparent that there is always an over-flow demand for credit union loans and even at the end of 1957, when economic activity was very low, there was a waiting list of loan applicants.²⁰ It would therefore seem that the only limiting factor in the growth rates of these institutions is their ability to attract savings or borrow, thus their loans are closely correlated with the

depicts a secular increase over the decade it is also given to wide fluctuations. To some extent the near-banks contribute to this destabilizing influence and it will be our purpose to determine how much.

¹⁹ Gilles Mercure, p. 140.

²⁰ Ibid., p. 139.

growth of their own resources.²¹

The second factor contributing toward inflexibility is the liquid reserve position of most credit unions. One is immediately struck by the relative smallness and stability of credit union reserves. However, since loans and savings approach broadly similar turnover rates there are few occasions when a need arises for cash.²² During 1959 for example, the local unions were generally able to maintain their growth rates with little evidence of switching assets, except among the larger societies in Saskatchewan. The credit union centrals on the other hand, upon which the locals rely for borrowing, did feel the pinch of monetary restraint. This is indicated by a decrease in shares and deposits and in the liquidation of investments in order to finance the rapid increase in loans to locals (see Table I, p. 132b).²³

In conclusion, it follows, therefore, that while the

²¹

One exception is in Saskatchewan where larger societies do appear more flexible toward varying cash and borrowings to meet loan demand. Considering all of the locals together, however, changes in reserves, even during the tight money period of 1959 have only been marginal (see Table I p. 132b).

²² It is apparent that credit union borrowers reflect the same sort of insensitivity to price changes as do the borrowers from other consumer credit institutions. Thus all of these institutions tend to compete very little on a price basis.

²³ It is apparent, from the directions concerning new loans sent down to the locals, that the lending powers of the centrals were rapidly being exhausted toward the end of 1959.

local unions may contribute to the secular increases in income velocity of money, the stable growth of their loans would contribute very little to the cyclical fluctuations in this variable.

With respect to the central unions, monetary policy has more effect, accounting for some cyclical variation in their balance sheet. Whereas the locals have little regard for term and marketability, the centrals, in choosing their investments, give more consideration to their liquid reserve position. Even so the evidence available suggests that short-term securities are still not widely held and it has only been in recent years that managers of centrals have demonstrated an awareness of these more liquid holdings.²⁴ Nonetheless, the general consensus is that these managers "all show a great reluctance to sell securities at loss from book values". Since most loans are made on a short-term basis it is generally regarded as unprofitable to liquidate a long-term investment on a good yield basis in order to provide funds for short-term investment with only a slight yield improvement.

In conclusion, the general picture is that switching of assets is virtually non-existent at the local level and

²⁴The investment portfolio of the Saskatchewan central is comprised mainly of provincial bonds and some Canada bonds; 65% are over 10 years while less than 15% are shorter than 5 years.

only marginal (although starting to grow) at the central level. If the centrals should continue to increase their stock of liquid assets some destabilizing activity might develop during future periods of monetary restraint. In Finally, the credit unions, while increasing their lending activities slightly during tight money, make no significant contribution toward increasing the supply of loanable funds.

On a consolidated basis, they are able to reduce their cash ratios very slightly and increase their borrowings not much more; the total increase in their credits is less than 5% of normal.²⁵

The caisses populaires, unlike the credit unions, direct the bulk of their funds to members for real estate financing purposes.²⁶ While this lending is significantly influenced by the resources of the caisses and their ability to attract savings, it tends to be more elastic than that of the credit unions.²⁷ Unlike the credit unions, the caisses

²⁵Gilles Mercure, p. 202.

²⁶These loans represent an estimated one third of the total conventional residential mortgages made by all financial institutions in the province of Quebec. See Ibid., p. 144.

²⁷Mercure notes that the relationship of mortgages to total assets fluctuates between 40% and 44% "which indicates some flexibility and marked cyclical changes in their recourse to rationing practises." See Ibid., p. 145. The evidence of one league indicates that for the decade mortgages fluctuated from a low of 49.5% (Jan. 1955) to a high of 53.4% (December 1959). During 1959 the total fluctuations, between a low of 50.5% (end of first quarter) and high of 54.4% (end of fourth quarter) was 2.9%. In comparison, trust company mortgages reached their peak in the third quarter of 1959 2.5% higher than their level in the first quarter.

are forced to ration their applicants only occasionally since their loan demand tends to be more sensitive to economic conditions. Also contributing to their potential flexibility, is a relatively large liquid reserve which should conceivably allow some stretch to their loan expansion during monetary restraint. In 1959, for example, the caisses populaires could have maintained their regular pace of lending and in fact increased it, even though the growth of total liabilities was slowing down.

In fact, this has not been the case in 1959; all to the contrary, the growth of their mortgages and personal loans portfolios slowed down, with little time lag. . . .²⁸

It generally follows that an institution will maintain a significantly liquid reserve position when the bulk of the funds are drawn from chequable deposits, turning over twice a year, and invested in mortgage loans which turn over only once in 5 to 7 years. Indeed, for the caisses, adequate reserves are particularly important since these institutions follow a policy of borrowing very little, even during periods of monetary restraint.²⁹ An interesting observation in this connection is that while investments may happen to reflect significant liquidity, they are not regarded by caisses managers as a means whereby their lending activities may be insulated from changes in monetary policy. In fact, during 1959

²⁸Gilles Mercure, p. 146.

²⁹The caisses locals apparently regard the centrals as exclusive sources of borrowing and the latter enforce strict terms and collateral requirements on any loans they make.

it has been noted that tight money had the effect of intensifying liquidity preferences of the caisses with only a very slight liquidation of their investments. The aversion caisses have toward borrowing contributes to the high degree of sensitivity that exists between the lending operations of the caisses and changes in their savings business. For example, it was apparent that as interest rates rose during the 1959 period of monetary restraint, the flow of idle balances to the caisses was restricted after a brief lag. Responding to this curtailment in their flow of funds the caisses cut back their loans. Such action indicates that while these institutions might have sufficient elasticity to impart some destabilizing pressures upon the economy, they are not prone to do so.

The investment operations of the caisses also reflect their tendency to refrain from switching assets during periods of monetary restraint. In the first place the Act governing caisses populaires limits them to four good types of marketable securities, thereby restricting their ability to conduct profitable trading operations. In addition, trading of securities is not regarded favorably, "either as a matter of principle or because of a lack of confidence in their skills".³⁰ The evidence available suggests that maturities purchased tend to be concentrated between more than one year

³⁰ Gilles Mercure, p. 167.

and less than four years. While the locals lean toward holding mainly school board and municipal issues (the latter comprise 75% of the locals' securities), the centrals are observed to "buy and sell frequently" in order to adjust their widely fluctuating cash position. However, they also show a reluctance to sell securities at a loss from book value.

In conclusion, it would appear that if the present trend continues toward more sophisticated investment practices, the degree of responsiveness to market forces will tend to increase and may intensify the efforts of these institutions to economize on cash balances. Nonetheless, in the past caisses populaires have not proven to be de-stabilizing in their activities and have supported rather than worked against monetary policy.

c) Trust and Mortgage Loan Companies

In an earlier chapter we noted that, while both the trust and mortgage loan companies offer chequable demand deposits, those of the former play a more important role in the economy's payments mechanisms. It was also apparent that the trust companies have enjoyed a rapid rate of growth relative to the chartered banks and this has largely been reflected in the rapid increase in purchases of guaranteed investment certificates. With respect to demand deposits, those which are chequable have tended to increase at a lower rate than non-chequable deposits, and therefore, in the past few years have

grown relatively less important. Notwithstanding this the trust and loan companies together add an amount totalling \$660 million (or 3.9% of the money supply) to the uncontrolled portion of the money supply. In itself this amount is not of alarming significance and requires relatively ^{little} compensating or offsetting action by the monetary authorities to allow for its growth. As a result there is little evidence of discrimination against chartered bank growth due to the secular growth in near-money created by trust and loan companies. Nevertheless this uncontrolled portion of money could be more important if thought of as part of a larger total contributed by all the near-banks. Therefore, it will be useful to examine the cyclical movements in the growth of chequable deposits for destabilizing tendencies.

Table II p. 142a indicates that chequable deposits tend to grow strongly during periods of monetary ease and to level off and decline during the succeeding period of restraint. This tendency was particularly evident during 1955-57 but in 1958, a period of easy money, the cyclical peak extends into the first quarter of 1959. Similarly, the growth rate bottoms out in the first quarter of 1960 and begins to increase some time prior to the change in monetary policy. The discrepancy might perhaps be attributed to an error in setting the limits of monetary restraint, however we may recall that in 1960, even though monetary policy was not altered until late fall, conditions were easing up in financial markets as early as the spring and summer of that year. The

GROWTH OF SELECTED LIABILITIES for
TRUST AND LOAN COMPANIES ^a
(seasonally adjusted - \$ thousands)

TABLE II

	CHEQUING DEPOSITS	NON - CHEQUING DEPOSITS	TERM DEPOSITS, INVESTMENT CERTIFICATES, DEBENTURES.	
1954	206,904.9	35,363.2	245,491.9	
	220,782.3	40,060.7	293,858.7	
	235,862.5	45,457.1	307,707.6	MONETARY EASE
	244,982.3	32,654.9	326,922.2	
1955	261,010.3	57,151.1	349,980.3	
	274,059.1	59,100.8	346,138.2	
	276,693.3	60,040.9	354,878.0	
	274,498.7	56,239.7	361,982.8	
1956	268,861.5	54,285.1	356,231.8	
	259,089.3	53,576.2	350,591.9	
	254,913.4	57,938.3	382,720.5	MONETARY RESTRAINT
	260,851.0	58,261.9	390,367.1	
1957	260,161.1	45,192.2	380,498.1	
	259,205.1	49,289.5	395,891.0	
	259,163.5	45,222.3	389,079.3	
	262,292.0	54,317.9	439,064.5	
1958	273,400.0	70,655.8	491,292.1	MONETARY EASE
	297,744.2	74,010.2	532,735.0	
	317,651.7	83,696.9	560,511.1	
	326,913.4	90,728.3	515,287.8	
1959	331,320.1	92,297.2	518,971.9	
	317,195.8	82,334.2	525,185.0	MONETARY RESTRAINT
	313,848.7	83,910.0	569,538.8	
	306,347.1	85,427.4	649,503.4	
1960	300,336.9	90,230.6	708,551.7	
	313,063.6	116,939.6	750,080.8	
	320,818.5	129,173.1	786,090.9	
	334,321.1	129,205.0	787,261.6	

^a Source: The Role of the Trust and Loan Companies in the Canadian Economy,
(Toronto, 1962), P. 11 - 57.

evidence indicates that chequable deposit growth tends to be generally in step with monetary policy.

The observed fluctuations in the growth of trust company chequable deposits has an interesting relationship with the rise and fall of the treasury bill rate. Whereas interest rates on chequable deposits are relatively stable,³¹ the fluctuation in treasury bill rates, which are important substitutes for trust company demand deposits, tend to attract funds from these deposits during tight money periods; while the flow of funds is reversed during periods when bill rates decline. This indicates that the ability of the trust companies to attract idle balances depends to a great extent upon the type of monetary policy in operation. Additionally, it is also apparent in Table II, p. 142a that term deposits, investment certificates, and debentures are also influenced by monetary policy. While these instruments depict a strong secular growth, it has generally been during periods of ease, that this growth was fastest. At times when the treasury bill rate was climbing, the flow of funds attracted toward these investments slowed down.

In their analysis, the Porter Commission note that a tightening of the money supply is likely to influence the trust companies more than the mortgage loan companies. This was apparently due to the fact that demand deposits, for which

³¹ Report of the Royal Commission on Banking and Finance, Appendix Volume, Ottawa: Queen's Printer, 1965, p. 230.

interest rates tend to be inflexible, are relatively more important to the trust companies as a means of drawing funds. The inflexibility of interest rates also applies to short-term guaranteed investment certificates and altogether it places these companies in an unfavourable competitive position, particularly during periods of rising interest rates. The trust companies, particularly during periods of monetary ease, have generally benefited from borrowing in the short-term money market. In times of restraint however, this source of funds tends to expose these intermediaries

more quickly and completely to the volatility of short-term interest rates and to sharp changes in the flow of highly liquid funds.³²

The inability or unwillingness to raise their rates in competition with others in the short market, obliges the trust companies to suffer a decrease in their supply of loanable funds. On the other hand, the mortgage loan companies are less dependent upon deposits and, being prepared to pay higher interest rates, they are able to continue their growth during times of monetary restraint (e.g., 1959).

It is not entirely clear why the trust companies adhere to this policy of inflexibility; however, it does strengthen their responsiveness to monetary policy. One explanation for their failure to be more aggressive for funds is that they

regard the demand for their own mortgage funds as being of sufficiently high elasticity in periods of tight money that

³²The Royal Commission, p. 186.

their ability to raise lending rates was severely circumscribed. This being so, their competitive position in raising funds in such periods necessarily suffered, through their inability to offer more attractive rates on their own instruments.³³

In turning to examine the influence of trust and loan companies upon the demand for money, we might first observe the transactions velocity of their chequable demand deposits. From Table III, p. 145a, a number of observations can be made. First of all, in relation to chartered bank deposits, trust and loan chequable deposits turn over much slower than highly active current account deposits. It is evident that the latter are really quite stable and show a strong steady increase. Relative to chartered bank savings deposits, trust and loan deposits are roughly comparable in both velocity and cyclical fluctuation. A close comparison indicates that active current account deposits turn over at slightly double the rate of trust and loan chequable deposits and show a tendency toward increasing this margin; also trust and loan deposits tend to appear more unstable, particularly between 1958 and 1960. Both the trust and loan deposits and bank savings deposits trace a path of destabilizing cyclical movements. For example during 1955-57, the velocity of both forms of deposits continued to grow strongly well into the middle of the tight money period. Again during 1958-60 both grew strongly, reaching peaks at the end of 1959 and at the beginning of 1960 respectively, and only

³³R.C. McIvor, "Some aspects of Canadian Financial Intermediaries", May, 1964, p. 126.

ANNUAL VELOCITY OF CHARTERED BANK CURRENT DEPOSITS, SAVINGS DEPOSITS AND TRUST AND LOAN CHEQUABLE DEPOSITS (seasonally adjusted - quarterly average) TABLE III

	CURRENT DEPOSITS TURNOVER RATE ^a	SAVINGS DEPOSITS ^a TURNOVER RATE	TRUST AND LOAN CHEQUABLE DEPOSITS TURNOVER RATE ^b	
1954	34.91	1.48	2.44	
	38.43	1.47	2.48	
	37.88	1.42	2.28	MONETARY
	38.90	1.43	2.56	EASE
1955	40.00	1.39	2.24	
	37.86	1.40	2.20	
	39.26	1.42	2.28	
	36.76	1.25	2.20	
1956	41.15	1.51	2.40	
	43.03	1.53	2.56	
	43.66	1.59	2.60	MONETARY
	41.50	1.51	2.44	RESTRAINT
1957	48.56	1.56	2.60	
	46.58	1.51	2.52	
	48.96	1.56	2.44	
	47.10	1.56	2.48	
1958	51.95	1.40	2.52	MONETARY
	51.90	1.42	2.52	EASE
	49.73	1.40	2.76	
	48.96	1.41	2.56	
1959	56.66	1.46	2.72	
	55.88	1.54	2.92	MONETARY
	59.78	1.57	3.12	RESTRAINT
	59.88	1.65	3.60	
1960	68.99	1.58	3.64	
	66.53	1.53	3.60	
	65.03	1.57	3.48	
	61.68	1.49	3.36	
1961	71.64	1.51		
	68.21	1.53	n.a.	MONETARY
	67.27	1.51		EASE
	66.56	1.54		
1962	75.55	1.62		
	70.69	1.57		
	75.37	1.58	n.a.	MONETARY
				RESTRAINT
	75.91	1.63		
1963	79.30	1.56		
	78.95	1.59		
	75.56	1.57		
	77.69	1.62	n.a.	MONETARY
				EASE
1964	84.94	1.71		
	82.72	1.72		
	83.41	1.64	n.a.	
	86.65	1.65		

Source: D.B.S. Cheques Cashed in Clearing House Centres (annual, 1954-1964 inclusive). Note that the velocity of chartered bank chequable deposits is calculated in terms of total money supply (bank deposits and currency) and total cheques cashed against savings and current accounts - figures are placed on an annual footing.

^b Source: The Role of the Trust and Loan Companies in the Canadian Economy (Toronto, 1962), P.II - 52.

toward the end of monetary restraint did they show signs of weakening.

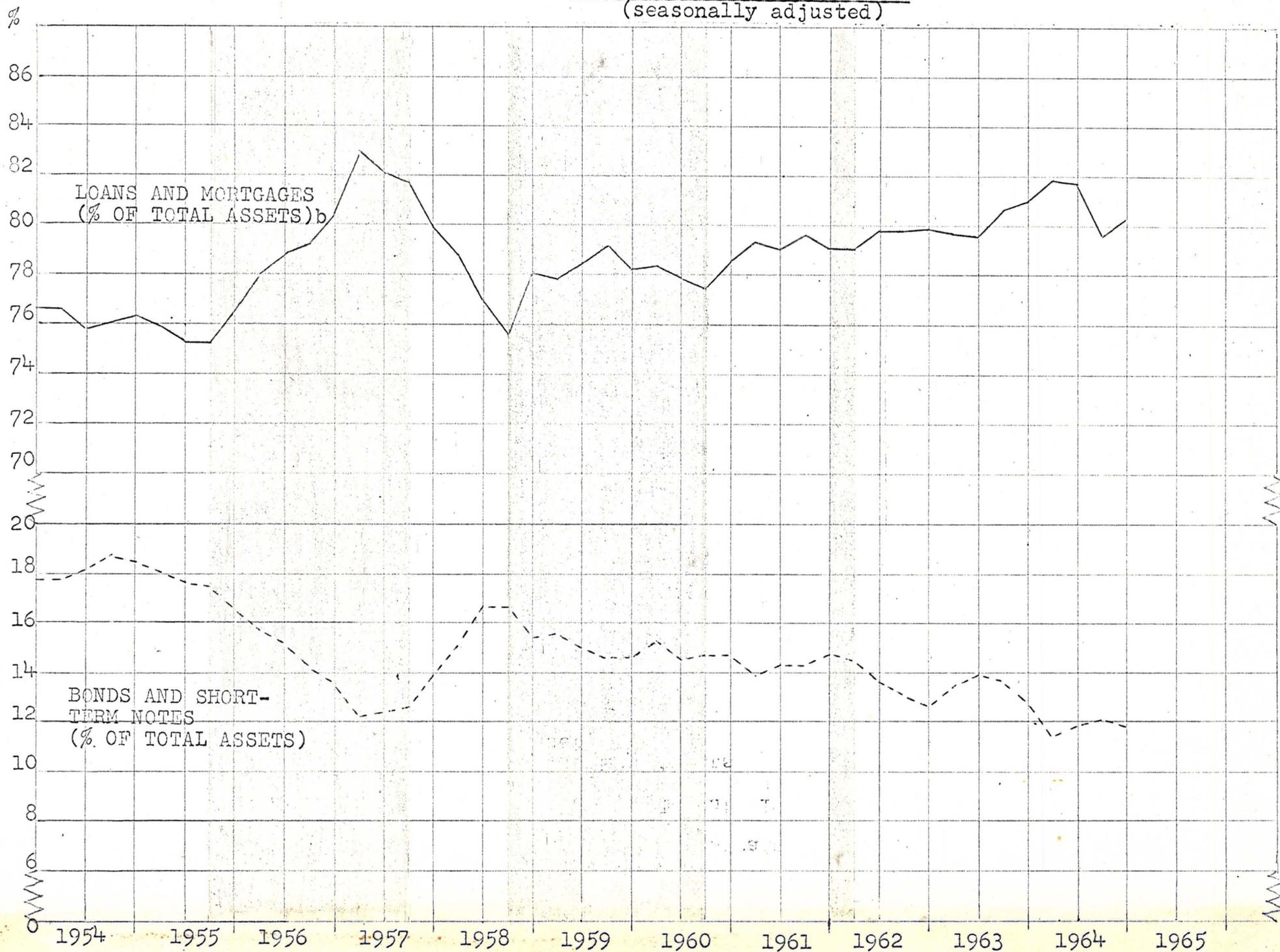
The above observations emphasize the similarity between savings deposits at the chartered banks and chequable deposits at the trust and mortgage loan companies. While evidence of some instabilities in the near-banks' liabilities has been presented, it is necessary to bring this into proper perspective. For example, during the first period of monetary restraint the increase in transactions velocity of money (i.e., chartered bank deposits and currency) was equivalent to \$3.5 billion or a 37% increase in the money stock, while the increase in velocity of trust and loan chequable deposits was equal to about 24 million or an increase of 1/4 of 1% in the money stock.³⁴ The same relationship is borne out during 1958-60 and serves to indicate that while velocity of trust and loan deposits increases in a destabilizing manner during tight money periods, it loses its importance due to its relatively small size. Nonetheless, on the assumption of a continuation of current growth rates, potential future importance could command more serious attention.

With regard to income velocity of money it is useful to compare the cyclical patterns of mortgage loan expansion in Charts IV and V, p. 146a,b, with changes in velocity shown

³⁴ Role of the Trust and Loan Companies in the Canadian Economy, The: A Study prepared for the Trust Companies Association of Canada (Toronto, May, 1962), p. 11-52.

ASSET PORTFOLIO SHIFTS BY
THE MORTGAGE LOAN COMPANIES ^a
(seasonally adjusted)

CHART IV

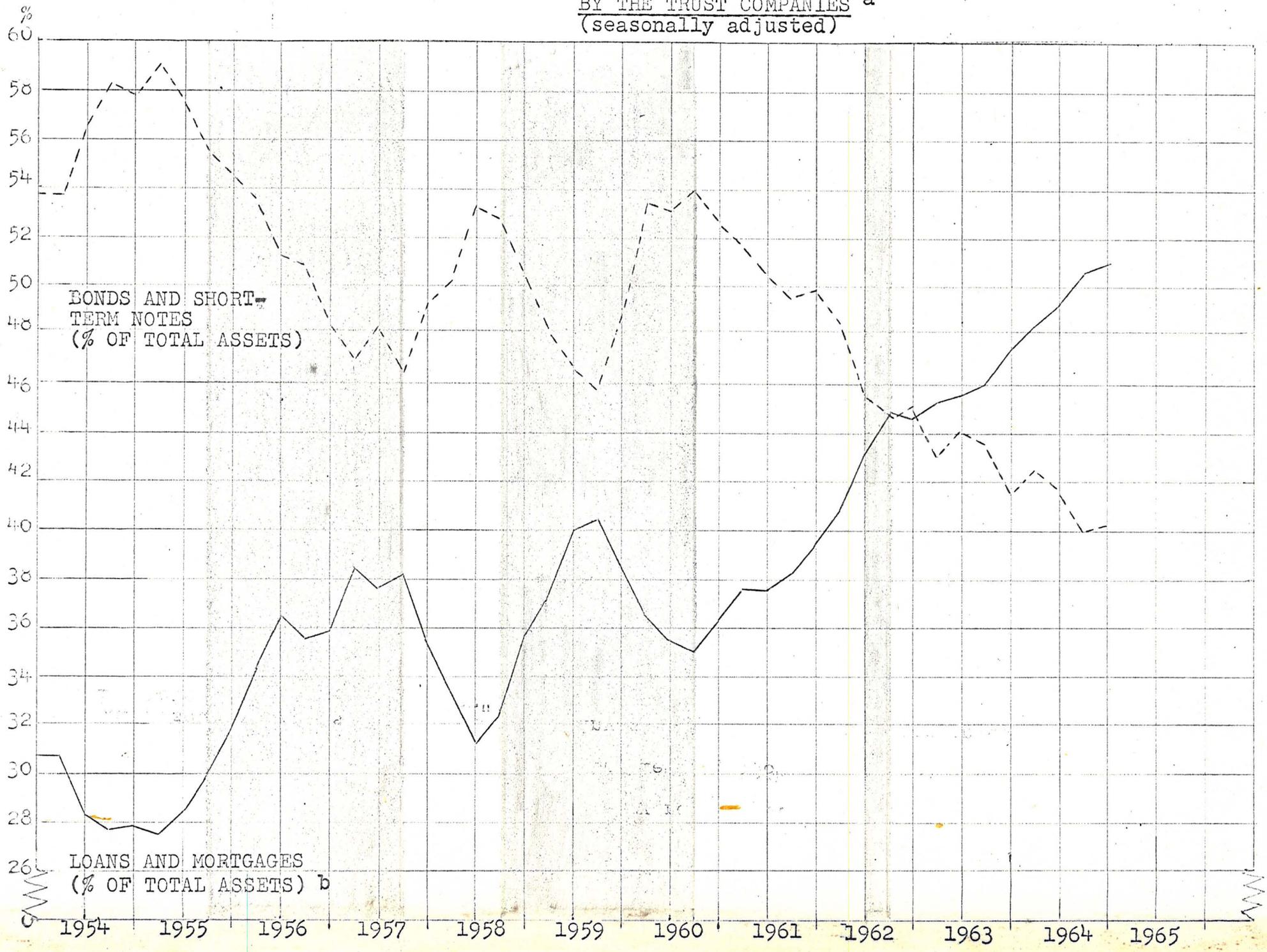


Note! Shaded areas represent periods of monetary restraint.

^a Source: Bank of Canada Statistical Summary Supplement, 1964.

^b "Total Assets" includes assets other than investments in subsidiary companies, real estate, equipment, and "other" assets.

ASSET PORTFOLIO SHIFTS
 BY THE TRUST COMPANIES ^a
 (seasonally adjusted)



Note! Shaded areas represent periods of monetary restraint.

a

Source: Bank of Canada Statistical Summary Supplement, 1964.

b

"Total Assets" includes assets other than investments in subsidiary companies, real estate, equipment, and "other" assets.

in Chart I, p. 118a. We recall that as demand pressures intensify and credit is restricted, cash balances are economized and the existing money supply turns over at a faster rate. Similarly, during these times financial intermediaries are called upon to provide funds and, while being restricted in their activities by the current monetary policy, they endeavour to pare down liquid balances to minimum levels and direct these funds into loans and mortgages, etc. Charts IV and V, p. 146a,b, and Chart II, p. 118b, indicate that the chartered banks, trust companies, and mortgage loan companies react quite typically during these periods of monetary restraint and each adds its influence to the upward pressure on income velocity.³⁵

In the three charts showing asset portfolio shifts of the financial intermediaries compared above, it is necessary to abstract from the strong secular increase in the growth rates of all three institutions, particularly the chartered banks and trust companies.³⁶ The charts do serve to indicate

³⁵ It is interesting to note in Chart I p. 118a the close relationship between mortgage loan fluctuations and the rise and fall of the treasury bill rate. Since a rise in treasury bill rate reduces the flow of funds to the various institutions, particularly the trust companies, this suggests that if loans are to increase at such times the loanable funds must be generated internally.

³⁶ Such an abstraction has been statistically attempted by the Porter Commission. The procedure was to estimate the trend in relative growth rates of particular institutions and to remove it. The figures remaining depicted a nearly pure cyclical pattern and were used to substantiate the Commission's claim that the institutions we have so far discussed operate

the nature of switching operations of these important financial institutions. In all periods of monetary restraint loans and mortgages are buttressed by the sale of short-term notes and other liquid assets. This activity, if carried beyond reasonable limits, is surely the most serious threat to effective monetary policy. It is interesting to note that the chartered banks (see Chart II, p. 118b) reflect the most destabilizing of these activities. It is quite apparent that cyclical fluctuations are more pronounced for the trust companies than for the loan companies (see Charts IV & V, p. 146a,b) although the trust companies seem to show the earliest signs of monetary restraint; particularly during 1955 to 1957. The amplitude of the cycles however, is still more pronounced for the chartered banks, and most significantly so during the second period of restraint.

While the above comparison may not be conclusive proof, it does suggest that in this particular area the action of the banks is a more serious destabilizing factor. This certainly becomes true if we consider the vast difference between the absolute magnitudes of the securities liquidated. Indeed, when compared to the massive switching operations of the chartered banks, similar activities of the trust and loan companies "pale into insignificance".

d) Sales Finance and Consumer Loan Companies

Both the sales finance and consumer loan companies refrain from issuing deposit liabilities that are chequable

well in line with the direction of monetary policy. See The Royal Commission, p. 218.

and thus serve as a means of payment. These companies draw the bulk of their funds either from the money and capital markets (in both Canada and the United States), if they are sufficiently large, and/or, from credit lines established with the chartered banks. This latter source is important to most small companies and serves as an emergency credit "cushion" for some of the larger institutions. However, a number of firms have withdrawn from the banks due to the credit restrictions in 1956 and 1959 and due to the attractive lower interest costs in the money market. A third source of funds, particularly for many of the consumer loans companies, is the Canadian or U.S. parent company. It is thus evident that the loanable funds supporting the finance and consumer loan industry are increasingly being drawn from areas which are not under direct monetary control. Indeed, these institutions, drawing funds from foreign sources and from local money markets sensitive to rate changes, are often able to continue their operations unimpeded by current monetary restrictions.³⁷

The sales finance and consumer loan companies have undoubtedly contributed greatly toward pushing the velocity of income to its peaks, as depicted in Chart I, p. 118a. There

³⁷It is not suggested that this ability to borrow in foreign markets and thus circumvent monetary control makes the finance and loan companies unique. On the contrary, it is clear that a number of institutions, including municipal and provincial governments, borrow from foreign capital markets when the interest rates in Canada rise relative to those abroad.

SALES FINANCE COMPANIES
CHANGES IN LIABILITIES ^a
(seasonally adjusted - \$millions)

(Dec)	BANK LOANS		SHORT-TERM NOTES ^b				OTHER NOTES & DEBENTURES		
	+	-	+	-	+	-	+	-	
1954	195	-	164		340				
1955	194		160	4	387	47			MONETARY EASE
	266	71	169	9	371		16		
	292	26	201	32	363		8		
	317	25	227	26	363		-		
1956	312		271	44	423	60			
	379	67	288	17	449	26			
	377		363	75	455	6			
	406	29	327	36	475	20			MONETARY RESTRAINT
1957	381		351	24	552	77			
	374		365	14	545		7		
	369		365	-	548		3		
	295	74	378	13	562	14			
1958	291		332	46	599	37			MONETARY EASE
	302	11	318	14	580		19		
	312	10	281	37	569		11		
	367	55	260	21	554		25		
1959	388	21	281	21	594	40			
	349		338	57	613	19			
	417	68	364	26	617	4			MONETARY RESTRAINT
	390		404	40	614		3		
1960	408	18	435	31	720	106			
	378		396	39	715		5		
	339	39	392	4	716		1		
	353	14	414	22	703		13		
1961	299		448	34	750	47			
	290		397	51	729		21		MONETARY EASE
	264	26	353	44	742	13			
	260		343	10	750	8			
1962	260		341	2	809	59			
	320	60	335	6	787		22		
	285		370	35	793		6		RESTRAINT
	271	14	422	52	799		6		MONETARY EASE

a Source: Bank of Canada Statistical Summary Supplement, various issues. Includes installment and other finance companies licensed under the Small Loans Act and affiliates engaged in making personal loans. Exclude: subsidiaries of merchandisers who finance sales of their parent companies only.

b Comprises notes with an original maturity of one year or less.

is every indication that funds continue to flow strongly toward these intermediaries well on into periods of monetary restraint. In Table IV, p. 149a for example, it is apparent that during each period of monetary restraint there have been relatively large increases, in both short and long-term paper, while any significant decrease in these instruments has been pretty well confined to periods of monetary ease. Thus the finance companies pump large doses of liquid assets into the economy and loan out the funds they have received in exchange. This activity reaches its peak at a time when the monetary authority is attempting to reduce general liquidity. It is for this reason that the activities of the various near-banks have been publicly declared destabilizing. We are perhaps most familiar with the 1956 Annual Report of former Governor Coyne in which the sales finance and consumer loan companies were referred to as being "out of step with the trend of credit policy". The governor also stated that:

while consumer credit may be a useful adjunct of modern merchandising, large fluctuations in the volume of such credit make it a de-stabilizing factor working against the stabilizing efforts of fiscal and monetary policy.³⁸

³⁸ Annual Report, 1956, p. 27. During these expansion years the central bank regarded the spending of consumers on such durable products as new cars to be excessive in the light of current income. It also believed that it was an unhealthy feature of the boom in that it contributed to inflation and also because the loan repayment period tended to coincide with the following period of recession thus increasing its severity. Others, however, have criticized this view. There is the question, for example, of whether the net additions to consumer credit, during the two periods

One may wonder why it was that the finance and loan companies were singled out for criticism, particularly in the light of operations pursued by other intermediaries; notably, the chartered banks which were increasing liquidity contrary to the wishes of the central monetary authority. We are thinking mainly of the switching operations which persisted well into both periods of monetary restraint and which contributed to the rise in income velocity of money. The basic difference of course is that this switching of assets, participated in by the banks, insurance companies, trust and loan companies, and caisses centrals, generates funds internally while the funds raised by the finance and loan companies are external and drawn from outside sources. The end result still remains the same, both creating undesirable pressures upon the economy through the expansion of their loans. Still, the finance and loan companies bear the brunt of the criticism. Perhaps this stems from the fact that there appears to be no limit to the rates they offer in attracting funds and hence, no end to their supply of loanable funds to

of restraint, actually reached proportions necessitating concern. The year 1959, as a case in point, still held considerable slack which could conceivably have absorbed further spending on consumer's durables. In extending the above criticism of the central bank's view it is held that "the net increase in consumer credit in 1956 was only about one-fifth of the net increase in business credit. Moreover, the net gain in consumer credit in 1956 was substantially less than the gain in the previous year; while business credit increased more in 1956 than in 1955". See Canadian Economic Research Associates, Sales Finance Companies in Canada (Toronto, 1958), p. 39.

finance current expenditure.³⁹

A significant portion of the market for consumer credit is depicted in Chart VI, p. 152a. Once again it is necessary to recognize that there is a strong influence from the secular trend of consumer credit growth; particularly during the second period of monetary restraint when the chartered banks entered the personal lending field on a large scale.⁴⁰ Nevertheless, there is enough evidence to demonstrate a variation in reaction to monetary policy by the various institutions depicted.⁴⁰

During 1955-57 the chartered banks show a marked decrease in personal loan business as early as the second quarter in 1956. The consumer loan companies react in a similar, but less dramatic manner but the finance companies continue to show considerable strength in credit expansion up until the final quarter of 1956 and again, a large increase in the first quarter of 1957.

The second period of monetary restraint bears out a

³⁹ Some observers have taken exception to the central bank's claim that the finance and loan companies possess the ability to offer "any necessary rate of interest" in raising funds. They claim there are at least two factors limiting the expansion of these companies. The first is that they are unable to pass on any rate of interest to borrowers due to considerations of risk. The second is that these companies traditionally limit their expansion by not allowing their liabilities to exceed four times their credit base. Thus it is argued that expansion during monetary restraint is limited by the credit worthiness of the companies themselves. See Ibid., p. 73.

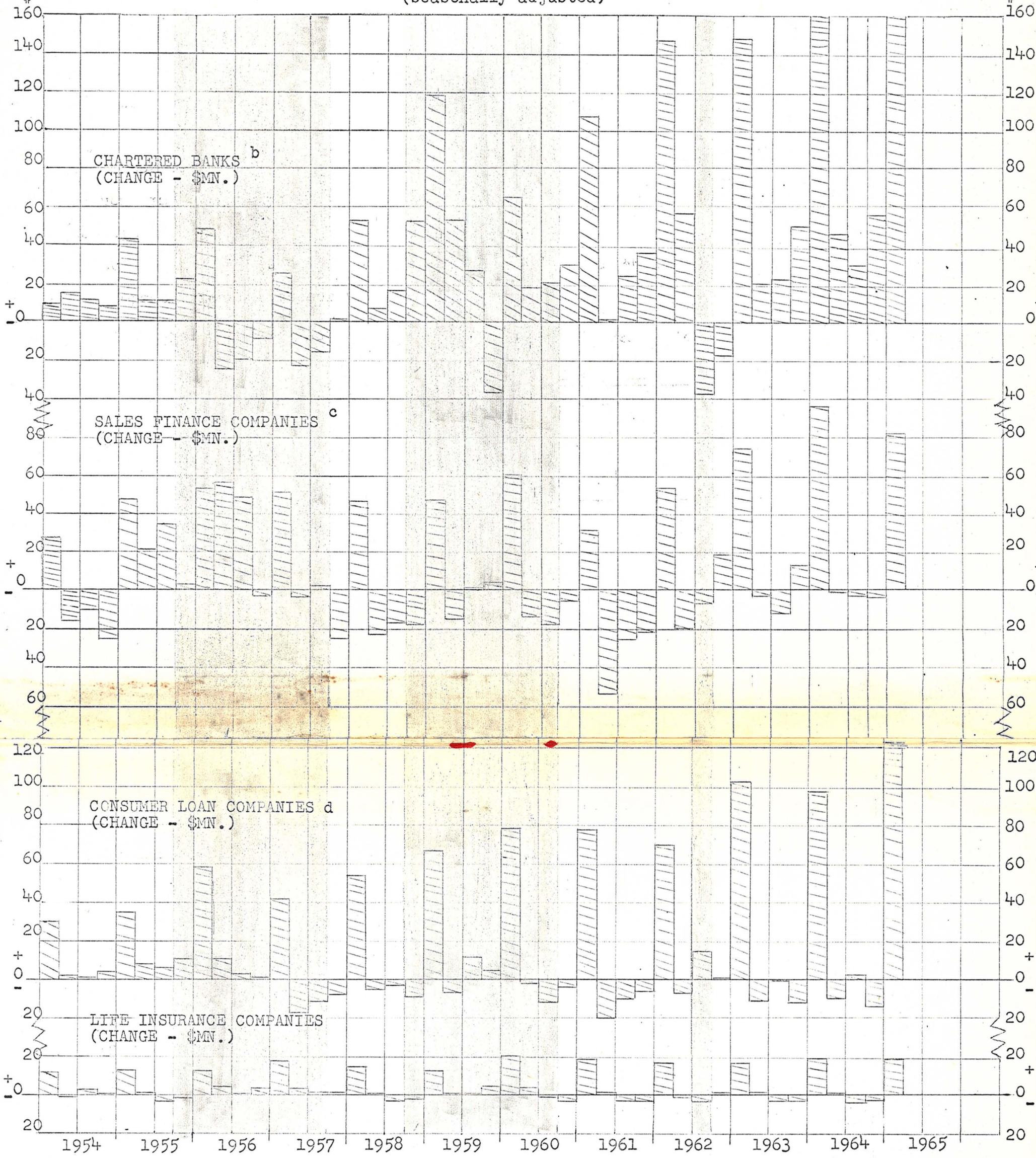
⁴⁰ In footnote 36 p. 147, reference was made to the Porter Commission's efforts to eliminate the trend line from

CONSUMER CREDIT BALANCES OUTSTANDING
FOR SELECTED HOLDERS a
(seasonally adjusted)

CHART VI

Millions \$

Millions \$



Note! Shaded areas represent periods of monetary restraint.

a Source: Bank of Canada Statistical Summary Supplement, 1964, P.98.

b The corresponding chart indicates the quarterly change in personal loans other than those fully secured by marketable bonds and stocks and home improvement loans.

c The corresponding chart indicates quarterly changes in conditional sales agreements held in connection with financing of retail purchases of consumer goods.

d The corresponding chart indicates the quarterly change in installment credit and cash loans.

slightly different comparison; but our conclusions are basically the same. It is evident that the chartered banks add considerably to their share of the consumer credit market. Nonetheless, after an initial increase, most notable during the first quarter of 1959, the banks' operations continue to reflect credit restrictions by decreasing throughout the year to a low point in the final months of 1959. Following an increase of some 120 millions during the peak months bank loans fell off to the point where they reflected a decrease in the final months of close to 40 millions; however as monetary policy began to ease, consumer loans at the banks began to show important increases and have continued to do so.⁴¹

Both the sales finance companies and consumer loan companies were restricted in their operations during the second period of tight money but this tends to reflect more the competition from chartered banks than from monetary policy. Both institutions found their rate of growth decreased but

the growth of assets for various financial intermediaries. The resulting cyclical pattern reveals most institutions in step with monetary policy; however, the cyclical growth pattern of sales finance and consumer loan companies is directly opposite to the direction desired by the monetary authorities. See The Royal Commission, p. 218.

⁴¹It is interesting to note that while personal loans recovered their previous growth in the first quarter of 1960, total loans and mortgages continued to decline until the final quarter of the year which is recognized as the terminating point of monetary restraint.

neither suffered anywhere near the dramatic cut back experienced by the banks. In fact, important increases in credit are shown during the early months of 1959 and again in 1960 and this growth during tight money is in contrast to the much greater losses suffered during the following period of monetary ease. In short one may conclude that the finance and consumer loan companies have suffered severe set backs when competing for customers with the chartered banks. However, as credit continues to tighten and the banks must conserve their dwindling cash balances and turn customers away, the finance and loan companies are able to attract loanable funds and thereby expand their loans. Evidence of this is borne out in Table V, p. 154a. It is apparent that increases of outstanding balances are most important during periods of tight money. One of the largest recorded increases for example, comes during the final months of 1959 and the first quarter of 1960, a time when monetary policy was most restrictive.

A closer look at Table V, p. 154a reveals an interesting point. One may notice that while outstanding balances continue to rise seemingly unimpeded, the purchase of new paper begins to decrease by the final quarter of 1956 and as early as the second quarter of 1959. Representatives of the industry claim that even at these early times a more cautious attitude was developing toward acquiring new business and indeed monetary policy was having an effect. In addition it is noted that the increase in outstanding balances was due to the

SALES FINANCE COMPANIES
RETAIL AND WHOLESALE PAPER OUTSTANDING
(seasonally adjusted - \$millions) a

	PAPER PURCHASED		ESTIMATED REPAYMENTS b				BALANCE OUTSTANDING		
	+	-	+	-	+	-	+	-	
1955	n.a.		n.a.				804		
							860	56	
							913	53	
							936	23	
1956	511		477				1018	82	
	670	159	579	102			1131	113	
	681	11	587	8			1196	65	MONETARY
	569		523		64		1217	21	RESTRAINT
1957	632	63	600	77			1309	92	
	598		589		11		1310	1	
	624	26	601	12			1316	6	
	513		537		64		1269	47	
1958	571	58	614	77			1294	25	MONETARY
	549		567		47		1256	38	EASE
	535		564		3		1218	38	
	576	41	553	11			1216	2	
1959	649	73	628	75			1299	83	
	630		620		8		1303	4	MONETARY
	660	30	613		7		1329	26	RESTRAINT
	618		574		39		1346	17	
1960	698	80	636	62			1472	126	
	642		632		4		1467	5	
	583		613		19		1432	35	
	660	77	612		1		1451	19	
1961	586		644	32			1467	16	MONETARY
	555		608		36		1383	84	EASE
	558	3	595		13		1340	43	
	692	134	669	74			1335	5	
1962	702	10	706	37			1402	67	
	682		676		30		1400	2	
	623		609		67		1400		RESTRAINT
	774	151	661	52			1481	81	
1963	815	41	770	109			1600	119	
	760		761		9		1586	14	MONETARY
	680		673		88		1582	4	EASE
	940	260	789	116			1695	113	
1964	985	45	893	104			1870	175	
	886		875		18		1868	2	
	784		813		62		1828	40	
	856	72	842	29			1806	22	

a

Source: Bank of Canada Statistical Summary Supplement, 1964.

b

Repayments are estimated by subtracting the net change in balances outstanding during a period from the paper purchased. The figures therefore include cancellations and other adjustments.

longer repayment terms reported to be necessary to cover rising car prices.

In the final analysis one is persuaded to agree that the cyclical growth of the finance and consumer loan companies shows considerable tendency toward being "out of step with the trend of credit policy". However, the extent to which this has disrupted the desired impact of monetary policy and has necessitated stronger and inequitable pressures against the chartered banks thereby restricting their growth, remains open to speculation. Over the past year these credit institutions have shown their vulnerability; consequently there appears to be very definite limits within which they must operate. Such an upset has a dual effect in that it drives the industry toward more conservative lending policies as well as setting the public against unreasonably high interest rates on finance company liabilities. Thus, minus even formal monetary control, there still remains the natural checks of the competitive market; these enforce themselves upon any institution which operates outside of that area which is commonly regarded as good business. Nevertheless, there is obviously a need for some formal control even if only to prevent the shock of these natural checks from permeating wide areas of the financial market.

Perhaps the Porter Commission aptly summarizes a popular attitude regarding the activities of the finance and consumer loan companies. While some may criticize the destabilizing influence which these companies have upon the economy, the

Commission notes that this:

is how a price system should work. The cyclical behaviour of the liabilities of the sales finance and consumer loan companies shows that funds do flow to the borrowers willing to pay most for them, particularly when rates are high and funds are limited. Thus, the fact that lending by these companies rose in tight credit conditions of 1956 - 57 and 1959 is not evidence of a failure in the workings of general monetary policy but of an appropriate response to market forces.⁴²

e) Life Insurance Companies

The life insurance industry plays a major role in the transmission of funds from saving to investment. However, these intermediaries are distinct from the other institutions in our study since they are generally characterized by a long-term financial operation. They are in the same category as the mutual funds and pension funds. The life insurance companies, of course have no effect upon the supply of money, since the only liabilities they create are generally long-term and are not recognized as being very liquid. Also, because of the contracted nature of their source of funds, the flow of savings towards these institutions tends to be smooth relative to the near-banks and is without significant cyclical fluctuations.⁴³ In addition, it is apparent in Chart VI, p. 152a that life insurance policy loans, which comprise only 3.8% of total assets, do not reflect the same amplitude in their cyclical pattern as do consumer loans from other institutions.⁴⁴ Even

⁴²The Royal Commission, p. 219.

⁴³One important reason for this is that interest rates are generally not regarded as an important factor in drawing idle balances.

⁴⁴Life insurance policy loans have declined in

mortgage loans which now comprise 50% of total assets show a similar lack of cyclical variation in their rate of growth despite the fact that this growth has been very rapid since the war.

There is one area in the life insurance operation however, that has generated interest regarding the stability question; this concerns the switching of assets. The question has been raised as to whether and to what extent, the life companies indulge in switching operations in order to create loanable funds during a period of tight money. It will be of interest to give this question some further consideration for it does relate to the stability implications of near-bank financial intermediaries.

The insurance industry has reported that the influence of monetary policy "flows essentially from changing interest rate levels".⁴⁵ The principal investment category is long-term paper; however short-term bonds and commercial paper are acquired on a small scale mainly during periods when security prices are falling. This latter activity is somewhat in contrast to other credit institutions which tend to pare down

importance from 1957 when they were 4.7% of total assets. At the end of 1964 these loans were roughly one-quarter that of credit union and caisses-populaires consumer loans and less than one-quarter of the loans made by sales finance and consumer loan companies.

⁴⁵The Canadian Life Insurance Officers Association, Submission to the Royal Commission on Banking and Finance (Toronto, 1962), p. 70.

their short-term securities in order to finance loans during periods of monetary restraint. Since the life insurance companies are evidently most concerned with the long-term paper market, it is through this area of the financial market that monetary policy must strike these institutions. Therefore, the success, with which monetary policy restricts the credit operations of the insurance industry, depends on the influence it has on yields in the long-term market. It follows from this that since long-term rates are usually the last to feel the pressure of central bank open market operations (given that a "bills only" policy is general practise), the insurance companies are generally slow to react to monetary restraint, especially compared to the chartered banks.

An additional reason for the slow reaction to monetary policy is that among the many insurance firms only an exceptional few large companies participate actively in trading securities. While it is true that within the last decade there have been notable portfolio shifts out of Government of Canada bonds and into corporate bonds and mortgages, these asset changes have not been recognized as occurring as suddenly or as dramatically:

as are for instance, the portfolio changes which banks undergo, being largely a matter of re-directing the investment of new funds and the proceeds of maturing assets.⁴⁶

The presence of a more developed secondary market, particularly in mortgages, would no doubt contribute toward more insurance companies* becoming actively involved in capital

⁴⁶The Royal Commission, p. 244.

markets. As it is, most companies are not as sensitive to yield differentials as they might otherwise be and consequently are inclined to pursue quota investment purchases rather than placing funds where they might achieve a better return. Given a broader and deeper secondary market it is conceivable that a number of life companies would increase their elasticity through adopting more sophisticated investment techniques. There is no indication however, that resulting fluctuations in growth would be of a de-stabilizing nature. In fact, a broader participation in the market for securities would serve to increase the responsiveness of insurance companies to monetary policy. As current evidence indicates, the hesitation to show a book loss on investments works to lock in most companies at a small change in long-term yields. It is, therefore, conceivable that should this sensitivity to yield changes grow, or if yield changes for policy purposes should increase, the insurance companies would react in the desired direction.

CONCLUSION

The period from 1954 to 1964 has shown probably the most outstanding growth by financial institutions in our country's history. Of particular interest to us has been the rapid development of several institutions, notably the trust companies, credit unions and caisses populaires, which conduct a business so closely approaching a banking function that they have come to be called near-banks.

One may ponder at great length the many variations in definition that have been suggested in order to describe a banking function: whether to list the typical functions of an existing bank (i.e., chartered bank), whether to consider the ability to create an instrument recognized as a medium of exchange, or whether to take account of a particular asset structure, etc. All of these things together might well be typical of a Canadian chartered bank as we know it; however they also serve to adequately describe other institutions not commonly regarded as banks. It therefore seemed appropriate that, since we were to be concerned with the influence of economic policy upon general liquidity, an important criterion of banking must be the distribution of instruments of high liquidity by a given institution.

We recognized at the outset that, while a necessary

function of money was to serve as a store of value, it was no less important that it serve adequately as a medium of exchange. We then proceeded to analyze the several instruments issued by the near-banks including; various forms of deposits, certificates, shares, and notes, and found that while a few achieved the perfectly liquid state of money, many were close enough to money in terms of liquidity that they too could have a significant influence upon spending, since it was possible, within a short space of time, to convert them into cash. Thus it became apparent that while all these near-money instruments fulfilled the store of value function, they also approached very closely the medium of exchange function. In short, it was clear that the ability of an institution to create these highly liquid instruments could have important implications upon effective monetary control; for three reasons. One, if their size should reach significant proportions; two, if their ability to grow was to remain outside of the direct control of the monetary authority; and three, if their growth was out of step with the trend of monetary policy.

If present near-bank growth rates were to continue, the impact upon our financial community would be extremely dramatic. Neil McKinnon has compiled a statistical picture of this potential growth.

Table I

Projected Growth of Total Deposits and Similar Obligations
of Chartered Banks, Trust Companies and Credit Unions¹

(\$ millions)

	1960	1965	1970	1975	1980	1985	1990
Chartered Banks	12,991	15,376	18,297	21,773	25,910	30,833	36,691
Credit Unions	1,195	2,366	4,685	9,276	18,366	36,365	72,003
Trust Companies	1,091	2,073	3,939	7,484	14,220	27,018	51,334

While the above table no doubt greatly exaggerates the situation and fails to consider the relatively small base from which the trust companies and credit unions are developing, it does serve to indicate the possibility of these institutions becoming vastly more important, if not the main depositories in Canada. Given that such a projected trend were conceivable, one can well imagine the economic implications of this development.

Chapter I was largely devoted to fitting several financial institutions to the adopted criteria of what was accepted to be a banking function; that is, the business of issuing liabilities characterized by a high degree of liquidity -

¹ Neil J. McKinnon, "Submissions to the Royal Commission on Banking and Finance", Canadian Bankers' Supplement (Spring, 1963), p. 133.

say less than 100 days to maturity. We identified for example; the deposits and investment certificates of the trust companies; the notes and debentures issued by the finance companies, and the shares and deposits created by the credit unions and caisses populaires. The chequable deposits offered by these near-banks were identified as money since they are an integral part of the economy's payments mechanism; the other instruments, although not immediately serviceable as a means of payment, were recognized as good substitutes for money.

Most of Chapter II was devoted to describing the operation of near-banking intermediaries within the context of contemporary economic theory. In so doing we discussed the influence of near-banks upon liquidity, the level of interest rates, and economic activity in general. While a number of opinions were considered, it became generally apparent that the near-banks play an important role in affecting such theoretical functions as, the supply and demand for money, and the elasticity and income velocity of these functions.

The thesis developed by John Gurley and Edward Shaw, as well as the study performed by the Radcliffe Commission, were instrumental in placing the near-banks in their correct perspective. It is significant that both these studies chose to treat these intermediaries as though they were banks, having equal ability to create loanable funds and effect a

multiple expansion of credit. The Gurley-Shaw group in particular, were mainly concerned with the strong secular growth of near-banks during the post-war period. This growth necessitated compensating policy measures by the monetary authority in the form of increased restraint upon the growth of the banking system.

As a supplement to the analysis by Gurley and Shaw, attention was given to the cyclical nature of near-bank activity and the stability implications of this activity working upon the elasticity of the demand for, and income velocity of, money. It was evident that the creation of loanable funds by the near-banks could have important destabilizing effects if their cyclical increase was contrary to that desired by the monetary authorities.

In order to further our analysis, some statistical evidence was examined. In so doing, three approaches were used. The first was concerned with the impact of near-bank chequable deposits upon the money supply; the second examined the influence of near-bank operations upon the demand for money; and the third was more directly concerned with the impact upon the income velocity of money. The following briefly summarizes our findings.

The caisses populaires and credit union locals, along with the trust and loan companies create chequable deposits totalling approximately 9% of the money supply

(i.e., chartered bank deposits and currency held by the general public). It is clear that while this near-bank money has not yet reached alarming proportions, it continues to grow at a rapid rate. This secular growth is particularly evident among the caisses populaires and credit unions and reflects a relative insensitivity to monetary policy, especially compared to the growth of chartered bank deposits. Evidence of cyclical variation in deposit growth was shown by the caisses populaires, however this tended to generally coincide with the trend of monetary policy.

The growth of chequable deposits with the trust and mortgage loan companies reflects a distinct cyclical pattern. It was observed that trust company deposits in particular, tend to follow closely the rise and fall of interest rates on government treasury bills. That is, when the bill rate rises, as during a period of monetary restraint, trust company deposits cease to grow and begin to decline. This propensity has been attributed largely to the failure of these companies to offer competitive interest rates and thus, like the chartered banks, they experience a loss of loanable funds during credit tightness. The mortgage loan companies and more recently, a number of smaller trust companies, concentrating their business in the savings and loan field, have been much more sensitive to changing economic conditions. These latter companies have been quick

to raise their deposit rates in line with other money market rates and have been instrumental in siphoning off large quantities of idle cash balances normally directed toward the banks and Canada Savings Bonds. While these idle balances could have been directed into chequable deposit accounts, thus building up this uncontrolled portion of money, they were directed mainly, toward term deposits in the form of debentures and guaranteed investment certificates. These latter instruments are less liquid and often unredeemable. The minimum term is usually one year.

In conclusion, the most important creators of chequable deposits are the chartered banks and to a lesser extent, in descending order of size; the caisses populaires, trust companies, mortgage loan companies, and credit unions. While no direct control, in the form of reserve requirements, etc., exists over these near-bank money balances, there is little evidence that immediate steps need be taken in this direction. One still may argue that bank controls should apply to near-bank money for reasons of equity. However, with regard to monetary control, near-bank deposits have proven to be quite stable and their growth has not been so rapid that sufficient allowance could not be incorporated into central bank long-run policy.

In attracting loanable funds from ultimate lenders, the near-banks issue liabilities of high liquidity. In accepting these liabilities, in exchange for their idle cash

balances, the public demonstrates that at a given level of interest they wish to hold smaller money balances (currency and/or chartered bank deposits). Following this exchange, the near-banks activate the idle balances they have collected by creating new loans and the end result is to increase the activity of the existing money supply. In short, the income velocity of money has been increased. The same thing would happen if for example, the chartered banks sold off a portion of their treasury bill holdings and used the proceeds to extend additional loans, or the public decided to alter its present spending program, or there was a change in fiscal policy. All these factors might have a de-stabilizing influence on current monetary policy. Our problem was to determine the particular influence of near-bank activity. In order to do so, we examined two things. The first was the transactions velocity of the actual money created by near-banks; the second was the relative impact upon income velocity by near-banks through changes in their asset and liability structures.

Chequable deposits created by the caisses populaires compare with bank savings deposits in their rate of turnover. In 1950 they demonstrated a turnover rate of 2.4 times per year and this has changed slightly to around 2.7 to date. For the credit unions chequable deposits turn over 20 to 40 times per year and in this respect are comparable to chartered bank current accounts. Transactions velocity of the above is not regarded as de-stabilizing and both

institutions reflect a cyclical pattern generally in step with the trend of monetary policy. It has, in addition, been observed to follow the general pattern of asset portfolio shifts of the respective near-banks.

Trust and loan company chequable deposits turn over at approximately twice the rate of bank savings deposits and compare closely with these latter deposits in their cyclical velocity patterns. The turnover rates of these deposits tend to grow rapidly into the middle of the period of monetary restraint, however as tight money continues, the rate of turnover peaks out and turns down during the latter half of the monetary phase. One might conclude that so long as these deposits make up only a relatively small proportion of the total money supply, such evidence of instability as does exist, is almost of negligible consequence. Nonetheless, if past growth continues, and this applies to all near-banks considered, more attention may be necessary in the future.

The second factor considered in determining the extent of de-stabilizing near-bank activity offered greater scope for analysis since there was more statistical data available regarding asset and liability positions. A more detailed account of these operations among the various financial intermediaries was therefore possible.

The credit union operation was noted to be quite inflexible with regard to loan expansion. This was attributed first, to the fact that there is always a ready demand for credit necessitating rationing of borrowers. This indicates

that the only factor limiting expansion was the ability to attract savings. Secondly, it was apparent that savings in the credit unions turn over about the same rate as loans thus allowing these institutions to operate on a very low cash reserve. The result of such a low reserve, coupled with a reluctance to sell their other liquid asset holdings, creates a very stable growth pattern. Only the central unions reflect some flexibility in their asset portfolio, but even so, there is still a reluctance to switch from short-term bonds into loans. We conclude finally, that credit union growth is generally unaffected by monetary policy since loanable funds are generated internally from their members. Only by curtailing the lending policy of the central unions to their locals, can the bite of monetary policy be increased; and since many locals rarely borrow from their centrals, this is only a partial solution.

Caisses populaires loans are considerably more elastic than those of the credit unions and indicate a higher degree of sensitivity to monetary policy. The caisses retain a much larger liquid reserve position which, as in the case of the chartered banks, allows for considerable flexibility in their handling of loans. This however, has not proven a significant factor in the past, since the caisses do not regard these reserves as a means of circumventing tight money. In addition, the flow of funds toward these institutions reacts rapidly to monetary restraint and this influence reaches their loan policy within a brief period of time. In conclusion, the caisses populaires and credit unions have not proven a serious de-stabilizing

factor; however since their operation is similar in many ways to a chartered bank, and since, particularly in Quebec, they play a significant role in the economy's payments mechanism, it would seem appropriate to bring them under controls similar to that which now exist for the banking system.

Upon comparison of the mortgage loan companies and trust companies, a marked cyclical variation was observed in the growth of their loans and mortgages. It is evident that these institutions are able to supply a significant portion of the increased demand for loans during periods of monetary restraint, by liquidating relatively large portions of their more liquid assets. This is an important contribution to the increase in income velocity of money which characteristically takes place during the upswing in the business cycle. It is apparent however, that this activity in loan expansion is limited, generally peaking out approximately half-way through a tight money phase as monetary policy begins to take hold. When the two are compared, the trust companies reflect considerably more amplitude in their cyclical growth pattern than the mortgage loan companies, although much of this is perhaps influenced by the strong secular trend in their loan growth rates. Both, nevertheless, respond at roughly the same time to monetary restraint. When comparing the asset shifts of these institutions with those of the chartered banks, one notices that the latter reflect a somewhat stronger and

wider cyclical activity. This perhaps exemplifies the greater impact of the bite of monetary policy upon the banking system. It would seem therefore, that the banks pose a more destabilizing influence upon the economy than either of the other two institutions, and this certainly appears to be true when the relative magnitudes of total loans are considered. In short, the mortgage loan companies describe a much smoother growth pattern, more in line with the credit unions, whereas the trust companies although more volatile, are still less extreme when compared to the chartered banks. This perhaps indicates the relative influence of monetary policy upon each of these three institutions. Being as one would expect, much stronger upon the chartered banks, monetary policy still curtails the expansion of the mortgage loan and trust companies.

The finance and consumer loan companies demonstrate the most important constraining influence upon the effectiveness of monetary policy. Statistics indicate that these institutions experience their most rapid rates of growth during times of monetary restraint. This is generally a reflection of the nature of the industry itself which deals in a market of relatively inelastic demand. Such being the case, the loan companies are able to compete more effectively at times of increasing rates of interest. Other institutions tend to be more conservative in raising interest rates and more restricted in passing on the higher cost of borrowing to their customers. Hence, the finance and consumer loan companies play

a large role in enhancing the cyclical swing in the income velocity of money and consequently, are a principal target for criticism concerning de-stabilizing near-bank activity.

The consumer credit industry described above has been allowed to operate under only minimum, and it is often thought inadequate control. The recent display of these instabilities, as illustrated by the difficulties encountered by Atlantic Acceptance, will most surely prompt some future action by the federal authorities to bring the activities of these institutions more into line with those of others in the consumer credit field. Whether these future controls will add to the effectiveness of monetary policy is uncertain. At the present time there does not seem to be great concern over the ability of the finance and loan companies to expand during periods of monetary restraint. Rather this expansion is regarded as a tendency of market forces to draw available funds to areas most willing and able to pay the necessary price.

It is interesting to note that the period of monetary restraint, beginning toward the end of 1965 and running through to 1967, depicts a somewhat different pattern in the growth of the finance and consumer loan companies. Contrary to their usual outstanding growth during tight money periods, these institutions have found it necessary in some instances to restrict their operations. The flow of funds was badly disrupted by the Atlantic Acceptance fiasco during the early months of 1965. Fear of directing funds toward the loan

companies is still very much in evidence throughout money markets two years later. In addition, the chartered banks have now moved into the consumer credit field on a large scale and, with the general level of interest rates rising well above the 6% ceiling currently restricting conventional loans, the banks have strongly promoted their more profitable consumer credit business even in the light of monetary restraint. Finally, the finance and consumer loan companies have found expansion difficult during the past year and a half because at times funds were simply not available at any price. This period witnessed a number of institutions, particularly the chartered banks, competing for idle balances in almost any maturity and at heretofore unheard of rates. One might conclude that de-stabilizing growth rates of the finance and consumer loan companies, while perhaps outside the direct control of monetary policy, are certainly controlled by the natural checks of the free market. As this market expands and imperfections are eliminated, the indirect control associated with free competition will no doubt similarly increase.

Finally, the insurance companies were examined for their contribution to the supply of loanable funds. It was noted that these companies are somewhat slow to react to monetary policy since this reaction depends upon a change in long-term interest rates. Also, only a few large companies trade actively in the capital market; hence the industry as a

whole is not overly sensitive to yield differentials. Nonetheless we have noted some evidence of switching operations, but they were much less volatile than those for example, carried on by the chartered banks. In general the insurance industry reflects a very stable growth pattern and is not given to the wider cyclical swings characteristic of other financial intermediaries. Also, their participation in the more flexible consumer loan market remains on a relatively small scale. Nevertheless, as one might expect, such increases as do appear, while of a modest nature, tend to be concentrated inside the tight money period; at such a time loan demand is at its peak. Decreases in consumer credit generally appear during the succeeding period of monetary ease. This tendency is of course, a factor in the over-all expansion of credit throughout the economy and would necessitate closer attention if it were to reach greater proportions. However, with the trend developing more toward term contracts, and away from the more elaborate cash value combinations, there is not likely to be a serious problem here for some time to come. It is also apparent that individuals prefer to use their cash value accruals as collateral on bank loans rather than risk cutting into the principal of their insurance contract.

As a general conclusion, one might postulate that from the statistical evidence present before us, there is little cause for serious alarm over the de-stabilizing activities of near-banks. One is inclined to agree that the

present near-bank contribution to the money supply and their influence upon the velocity of money can be effectively controlled by both long-run policy considerations, and monetary pressures initiated through the banking system and financial markets generally. It still remains true however, that a number of the institutions we have studied perform a banking function and, all things being equal, should be classified as banks and come under similar controls. The case for this action is strengthened if one considers the future growth potential of certain of these financial intermediaries. As Gurley and Shaw have pointed out, compensating policy measures directed toward the banking system in order to take account of near-bank growth, could seriously hamper the growth of the chartered banks and their role in the financing of economic growth in Canada. As for the growth of the near-banks themselves, this will no doubt continue as the financial community expands, to better serve the needs of economic units. The senior role played by the chartered banks in this expansion is unquestionably assured, provided they show a willingness to adapt to changing conditions within the marketplace and provided they are able to effect the type of competition they have been painfully slow to develop over the past ten years.

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