

The Porter Commission on Canadian Banking and Finance

For the second time in just over thirty years, a Royal Commission, after careful inquiry, has made a diversity of recommendations toward improvement of the workings of the Canadian financial system. In each instance appointment of the Commission was occasioned by the decennial renewal of Canadian banking legislation under which all chartered banks and, more recently, the central bank are incorporated. Ordinarily, renewals of the Bank Act and the Bank of Canada Act involve relatively non-controversial changes that, although discussed extensively in financial quarters, attract little attention from the public at large. In 1933, appointment of the Macmillan Commission arose from obvious malfunctioning of the financial system, evidenced not only in consequences of the depression but also in Canada's premature departure from the gold standard early in 1929. After surveying a relatively undeveloped financial system, the Macmillan Commission proposed structural modification through establishment of a central bank, a proposal subsequently enacted in 1934 (1). In contrast, appointment in 1960 of the Royal Commission on Banking and Finance, now known as the Porter Commission, was precipitated not by any dire economic crisis, but was a reflection of a growing dissatisfaction with the performance of the Canadian economy during the late 1950's when the rate of economic growth was among the slowest of western economies and unemployment continually exceeded 5 per cent from 1957 onward, at times reaching peaks of 7 per cent. Moreover, the Canadian public had just witnessed the debacle of an open debate between the Governor of the Bank of Canada and the Minister of Finance over ultimate

(1) See *Report of the Royal Commission on Banking and Currency in Canada*, Ottawa, 1933.

responsibility for then current policies so inappropriate to Canada's circumstances, a debate climaxed by the resignation of the Governor.

The terms of reference under which the Porter Commission was established were, in part,

to inquire into and report upon the structure and methods of operation of the Canadian financial system, including the banking and monetary system and the institutions and processes involved in the flow of funds through the capital market... (2)

Further, the Commission was instructed to make recommendations for improvement of the financial system, particularly in areas within the scope of federal legislation. In summary, the Commissioners regarded their task to involve examination of four key questions (3):

- (1) the role of financial policies in attaining national economic goals,
- (2) the scope for improvement of monetary policy,
- (3) the adequacy of safeguards to the public in dealings with the financial sector,
- (4) the ability of the financial sector to provide for the free flow of funds from lenders to borrowers.

The *Report of the Royal Commission on Banking and Finance*, a massive document of nearly 600 pages, represents over two years of study by the Commission and its research staff, during which the seven Commissioners received over 100 briefs from interested parties including the Bank of Canada, the Department of Finance, foreign central bankers (4) and a number of eminent professional economists (5). In addition to the *Report*, an appendix volume will be published containing supplementary statistics and research, and cer-

(2) *Report of the Royal Commission on Banking and Finance*, Ottawa, 1954, p. 9. Hereafter references to the *Report* in footnotes will be by page numbers only.

(3) p. 7 ff.

(4) Among the foreign central bankers were Lord Cobbold, formerly of the Bank of England; Marius Holtrop, De Nederlandsche Bank; Alan Sproul and Woodlief Thomas. Holtrop's submission has been published as *Monetary Policy in an Open Economy: Its Objectives, Instruments, Limitations and Dilemmas*, Essays in International Finance, No. 43, Princeton University.

(5) The economists included E. M. Bernstein, Erik Lundberg, Sir Dennis Robertson, Paul Samuelson and Jacob Viner. The briefs of Robertson and Viner have been published as Numbers 42 and 45 in *Essays in International Finance*, Princeton University. Samuelson's submission appeared as "Reflections on Central Banking", *The National Banking Review*, 1, September 1963, pp. 15-28.

tain papers by the research staff will be available in mimeographed form.

The *Report* itself can be regarded as divided into three distinct sections. The first describes four groups of primary participants in financial markets (individuals, businesses, governments and foreign investors) and considers their needs and behaviour in relation to financial markets. In the second part the functioning of various financial institutions and markets is assessed. Parts one and two, which together provide what is on the whole a competent survey of the operations of financial markets and their participants, are primarily concerned with the adequacy of safeguards to the public and the flow of funds through financial markets. The third part, focused upon financial policy and its impact on the economy, evaluates issues relevant to the first two key questions posed by the Commission, those questions oriented to economic policy.

By the very scope of the *Report*, no review of present length could ever do justice to the Commission's views on the numerous issues contained in the *Report*. Instead, attention will be directed toward three issues that played important roles in the *Report* and are likely to arouse controversy. First, the Commission's views on government intervention in financial markets through both regulation and direct participation will be examined. Next, consideration will be given to the Commission's approach to the formulation and conduct of economic policy, a topic which involved nearly one third of the *Report*. In particular, the Commission's views on appropriate objectives for policy and their interrelations, and on the prospective effectiveness and future role of monetary policy will be evaluated. Since these considerations were given particularly close attention by both the Radcliffe Committee and the Commission on Money and Credit, an attempt will be made to relate the Porter Commission's views to those of these previous groups. The final topic of the *Report* to be reviewed, one integrating aspects of the former two, concerns the multitude of issues arising from competition between banks and other financial institutions.

1 - The Government and Financial Markets

Ideally the Porter Commission expected the financial system "to meet the legitimate present and prospective needs of lenders and borrowers in an efficient, flexible, non-discriminatory and creative

way" (6). That freely operating financial markets best meet these needs through competition between lender and borrower provided the starting point for the Commission's analysis. Of the required characteristics of financial markets, creativity, particularly, was seen to require an innovative spirit most likely attainable under conditions "in which price and other competition is too intensive to be comfortable" (7). Recognizing that free-working financial markets may provide adequately for neither public protection nor finance to particular groups, the Commissioners did not discount entirely the need for government intervention in financial markets. In the context of this belief in competition constrained by these other considerations, the Commission undertook a careful assessment of the rationale of government participation and regulation in financial markets.

A. Government Participation in Financial Markets.

Upon examination the Commission found direct government participation either through guarantee or direct lending in the finance of such widespread activities as exports, small business, agriculture, fisheries, housing and home improvements. Though these government programs may have had a clear purpose arising from real needs of particular groups at some time in the past, the Commission stressed that these programs be carefully reappraised in relation to current conditions. The evidence derived from consideration of financial needs of groups involved, their alternative sources of available finance and the operation of the government schemes pointed to direct competition between some government programs and private sources of finance and, in addition, to administratively determined lending rates which do not reflect market forces and tend to introduce elements of government subsidy to programs intended only as sources of finance. In keeping with their belief in the efficacy of freely-working financial markets, the Commission

accordingly recommended... that some government guarantee programs be discontinued, that those which are retained be made more flexible and that government lending agencies should keep their rates in line with market rates (8).

(6) p. 8.

(7) p. 8.

(8) p. 562.

The Commission did recognize that development of the financial system may require some direct government participation in financial markets but suggested an interdependence between regulation of financial markets and the need for government participation such that

the best way to ensure that gaps calling for such special measures do not persist is to see that private institutions are not discouraged by legislation or government lending activities from meeting new credit demands without recourse to guarantees (9).

B. Government Regulation of Financial Markets

Though provision of protection for the public in dealings with financial markets was recognized as providing possible justification for government regulation of financial markets, the Commission believed

... an effectively executed and well-designed system need not lead to excessively rigid and detailed procedures which increase costs and reduce the efficiency and flexibility of the financial system (10).

To the Commission, the goal of public protection can best be achieved by

legislation which provides for adequate disclosure and sets high standards of self-regulation backed up by strong government supervision and powers to enforce proper practices (11).

Retention of minimum cash reserve requirements for the banks was accepted by the Commission, in part, from their useful yet non-essential role in monetary policy and, in part, from their role of formalizing working practices of sounder institutions while upgrading those of others (12). Where improvement of public protection was most urgent the Commission recommended stronger supervision of credit unions, closer integration of security markets and dealers into the framework of government regulation, and extension of maximum charges on personal cash lending. Elsewhere the Commission found certain existing regulations that made no contribution to public

(9) p. 234.

(10) p. 357.

(11) p. 560.

(12) p. 391.

protection and led to differentiated financial markets with reduced competition among lenders; viewing such regulations in conflict with their belief in freely competitive financial markets, the Commission proposed removal of interest rate limitations and lending restrictions for chartered banks, relaxation of valuation and equity rules for insurance companies and extension of the permissible range of activity of trust and loan companies.

II - The Commission's Views on Economic Policy

As a reflection of the widespread dissatisfaction with Canadian economic policy from the late 1950's onward, the Porter Commission devoted over 160 pages to questions of economic policy, its formulation and conduct. To the professional economist, the analysis of issues related to economic policy are likely to be the most interesting sections of the *Report*. In addition, the research studies conducted in the policy area deserve careful consideration on their own (13).

A. Relationships among Policy Objectives

With their realization that attainment of any commonly espoused goal of economic policy has in itself no direct inherent value and gains its purpose only through enhancement of economic, social and individual well-being, the Commission conveyed greater awareness of the essential intermediate nature of these goals of economic policy than either the Radcliffe Committee or, to a lesser extent, the Commission on Money and Credit. At its worst, the Radcliffe Committee discussed the employment objective solely in terms of inherent values resulting from achievement of full employment (14). In contrast, the Porter Commission finds

there is no inherent merit in drudgery and even less in employing half the population to dig holes and the other half to fill them in.

(13) The research studies to be published separately are listed on p. 576 of the *Report*. In addition to those listed, G. L. Reuber's study of the goals of policy is summarized in his "Objectives of Canadian Monetary Policy, 1949-61: Empirical Trade Offs and the Reaction Function of the Authorities", *Journal of Political Economy*, LXXII, April 1964.

(14) Great Britain, Committee on the Working of the Monetary System, *Report*, London, 1959, p. 18. Hereafter referred to as Radcliffe with appropriate references.

What we seek in espousing the objective of full employment is, of course, the removal of the material and psychological distress of the unemployed and avoidance of the loss of production which unemployment involves (15).

Similarly in the consideration of other objectives, while many elements of the relationship between the intermediate objectives (the targets of economic policy) and the ultimate goals of society may be present in Radcliffe and the Commission on Money and Credit, the analysis by the Porter Commission provided a greater degree of explicit recognition of the intermediate nature of economic targets, a recognition vital to a proper approach to trade-offs among economic goals.

All three reports examined the likelihood and significance of possible conflicts arising from attempts toward simultaneous achievement of the enumerated goals of economic policy. After evaluating the possibility of major conflicts among economic objectives, the Commission on Money and Credit minimized their significance, concluding

that all three goals — an adequate rate of economic growth, low levels of unemployment, and reasonable price stability — can be achieved simultaneously, and that they are fundamentally compatible if we do not expect the impossible for each (16).

In contrast, in their brief treatment the Radcliffe Committee realized the possibility of inconsistency among major objectives with "the choice between conflicting alternatives... a continuous process to be lived through all the time" (17). With the realization that "inherent and irreconcilable" conflicts may make fulfillment of all economic objectives impossible at any given time (18), the Porter Commission followed the Radcliffe position; yet throughout the *Report*, the Commission developed the nature and likelihood of these conflicts to a greater degree than its predecessor.

(15) p. 399.

(16) *Report of the Commission on Money and Credit*, Englewood Cliffs, N.J.; Prentice-Hall Inc., 1961. Hereafter referred to as C.M.C. with appropriate references.

(17) Radcliffe, p. 17.

(18) p. 417.

In considering the goal of productivity growth, the Commission distinguished carefully between once-and-for-all increases of productivity that occur with economic recovery from more permanent increases of productivity that occur over the long run (19). The goal of growth in productivity was identified solely with long run improvement. While the Commission on Money and Credit, through lack of distinction between long and short run productivity increases, had been led to identify achievement of high level employment as synonymous with attainment of long term economic growth (20), the Porter Commission, on the basis of staff research, found that high levels of demand may actually inhibit long term growth and suggested that experience shows both high and low employment associated with growth of productivity in the past (21). The Commission concluded that the possibility of any basic incompatibility between growth of productivity and other objectives of economic policy would be improbable.

The most likely of the conflicts among objectives seen by the Commission was between the attainment of price stability and full employment. Despite the Commission's view that the conflict need not be severe, difficulty in reconciling these goals was expected with unemployment below 4 or 5 per cent, that is throughout the entire range commonly accepted as satisfactory for the employment goal (22). In discussing possible reconciliation between these goals, the Commission decided

the social and economic gains to be realized from reducing unemployment justify putting heavy emphasis upon this goal and on the search for solution of the related problem of reconciling it with price stability (23).

In spite of both this avowal of the need to emphasize the employment goal and the Commission's strong endorsement of careful weighing of consequences of choice among alternatives, the *Report* is pervaded with undue concern for the failure to attain price stability, a tendency reflected in price stability alone among prox-

(19) C.M.C., p. 38.

(20) C.M.C., p. 31.

(21) p. 417.

(22) p. 419.

(23) p. 419.

imate goals of policy being regarded as having desirability for its own sake (24). In addition, inflation is described as leading

to higher unemployment, instability and an impaired rate of productivity increase by undermining business confidence, [and] the willingness to save (25)

and, further, as

a drug whose dose must continually be increased to get the same effect; if the authorities permitted the economy to become addicted, the inevitable return to reality could bring about very painful withdrawal adjustments (26).

While all these effects may be valid in a prolonged period of rapidly rising prices, the total price increase in Canada from 1957 to 1962 barely exceeded 7 per cent — an increase below that experienced by most competitors in the international economy which may even be partly accountable through inherent bias in price indexes (27). Even though the Commission carefully stressed the need to examine costs of failure to attain various objectives, the overly forceful statement of the need for price stability provides further rationale for continuing preoccupation with price stability at the expense of other economic objectives (28). Discussion of the cost of nonattainment of price stability more in keeping with the treatment of other goals would have provided a sounder foundation for rational choice in the formulation of economic policy.

In contrast to the Commission on Money and Credit, which ignored the external objective (29), and the Radcliffe Committee, which regarded the external goal solely in terms of maintaining the pound through strengthening London's international reserves (30), the Porter Commission rejected formulation of the external goal

(24) p. 399.

(25) p. 419.

(26) p. 419.

(27) p. 400.

(28) For documentation of this preoccupation with inflation, see REUBER, *op. cit.*

(29) C.M.C., p. 12.

(30) Radcliffe, p. 19.

in terms of intermediate objectives as current account surplus, stable exchange rate, or size of equity capital import, stating

the wider objective must be an external financial position which enables us to pursue national goals — including the broad political aim of promoting a stronger world economy — with as much independence as our obligations to an interdependent world will allow (31).

The Porter Commission stressed that no single measure adequately summarized the external objective and that choice of intermediate goals for internal policy must vary with changing circumstances. Conflicts between objectives requiring short run subordination of domestic goals to external, as during the exchange crisis of 1962, were recognized; yet the Commission emphasized that if domestic objectives are reasonably attained, conflicts between domestic and external objectives would be unlikely except as a result of particularly unfavourable international developments (32). Although the Commission presented a thorough comparison of the workings of flexible and fixed exchange rate systems, its analysis of Canada's external economic relations is based upon an acceptance of the present fixed exchange rate system (33). In this analysis, despite realization of the need for rate changes with fundamental disequilibrium, the Commission discounted possible exchange rate adjustments to such a degree that little guidance is given for recognition of fundamental disequilibrium (34).

The objectives of economic policy put forward in the *Report* — rising productivity, high and stable employment, price stability, and a sound external position — did not represent any departure from usual practice; nevertheless the analysis of these goals and their interrelations provided an appreciable advance beyond both the Radcliffe Committee and the Commission on Money and Credit. First, the Porter Commission placed the objectives of economic policy in the perspective of their roles as means to the ultimate goals of society to a greater degree than either predecessor. In addition and more significant, the treatment in the *Report* of the

(31) p. 401.

(32) p. 419.

(33) p. 480.

(34) p. 503.

interrelationships among objectives of economic policy, in particular the possibility of conflict, provided a considerable improvement over both the inadequate analysis of the Commission on Money and Credit and the limited treatment of the Radcliffe Committee.

B. Short Run Resolution of Conflicts

When confronted by conflicts that reduce the effectiveness of policy, the responsible authorities were seen by the Commission to have two alternatives: the acceptance of lower standards for certain goals and the improvement and extension of policy instruments available to the authorities (35). The Commission, regarding the former as the only possibility in the short run, refrained from suggesting relative priorities to be attached to goals, observing

the priorities assigned to the different objectives should reflect a careful consideration of the cost and benefits of abandoning or modifying each goal... [which] in turn will vary with what the public believes to be acceptable and desirable, with particular circumstances of the time, and with the record of the recent past (36).

Though the Commission pointed out the necessity for choice among objectives to reflect current conditions, a need still remained to set out principles for determination of costs of failure to attain particular goals. At one point, the Commission did indicate costs of unemployment in excess of 4½ per cent during 1961 and 1962 (37). With just this beginning the treatment by the Porter Commission advanced beyond both the Commission on Money and Credit and the Radcliffe Committee, for the former by acceptance of mutual compatibility had precluded considerations of choice while the latter had merely indicated dangers of prolonged pursuit of any one objective and provided no guidance for choice leaving relative weights to be determined by government (38). Further extension of the Commission's analysis to provide similar costs of nonattainment for other objectives could lead to a public enlightened to the

(35) p. 420.

(36) p. 420.

(37) p. 421.

(38) Radcliffe, p. 21.

implications of alternative policies, a force regarded by the Commission as conducive to the formulation of appropriate economic policies.

C. Resolution of Conflicts in the Longer Run

In the longer run, any conflict that may arise among objectives of economic policy may be lessened

by improving the timing and effectiveness of existing instruments, by co-ordinating and balancing differing policies better and — if necessary — by adding to the range of instruments used (39).

Scope for improved timing of policy could arise through shortening the inside lag, by reducing either the recognition lag (the time between need for action and recognition of this need) or the action lag (the time between recognition and taking the action). Reduction of the recognition lag depends on increasing knowledge of the economy and further developing ability to interpret current economic conditions. Expressing the hope that steps would be implemented toward improved collection of economic statistics, the Commission realized the limits to the immediate prospects of reduced recognition lags imposed by the slow progress possible in improved collection of statistics (40). From the *Report's* documentation of the continual persistence of inappropriate economic policies long after changed conditions became apparent, possible shortening of the action lag seems more feasible. As the Commission emphasized

the recent discontent in Canada with the general instruments of policy, and the increasing resort to more specific measures, is not a necessary result of the difficulties of using broad monetary and fiscal instruments effectively... [but] the process has stemmed at least as much from an unwillingness to use these instruments in the way necessary to achieve national goals (41).

Certainly the Commission's admonitions for flexible choice among economic objectives to reflect relative costs of nonattainment provide a sound basis for reduced action lags; however, the *Report* provides

(39) p. 421.

(40) pp. 534-35.

(41) p. 524.

only few proposals toward assurance of appropriate use of these instruments towards national goals in the future.

Close coordination of various strands of economic policy in a proper set was believed by the Commission to lead to a scale effect in which the total impact of economic policies taken in concert exceeds the sum of effects of the various policies taken separately (42). In emphasizing need for close coordination, the Porter Commission followed closely traditions set by its predecessors: the Radcliffe Committee which felt weakness and limitations to individual policies required general financial policy (43) and the Commission on Money and Credit which stressed proper mix rather than reliance on any single policy (44). Closer coordination would require each separate element to be available for use in direction and degree dictated by current conditions and economic objectives; yet elsewhere in the *Report* doubts were raised to the possibility of such single-minded use to any objective. Despite the Commission's recognition that debt management can make appreciable contributions toward achievement of economic goals, the Commission conceded

a countercyclical policy pressed in season and out might also involve the authorities in operations which would disrupt the market (45).

Similarly, though the external objective was regarded as a means to domestic goals, the need to apply monetary policy toward the external objective was recognized as requiring temporary abandonment of domestic targets (46). Moreover, inflexibilities in use of fiscal policy were seen to vitiate its effectiveness, particularly in the short run (47). While all financial policies are unlikely to be diverted from pursuit of domestic objectives at any time, it is equally uncertain whether concerted use of financial policy toward domestic goals can always be attained. Though the Porter Commission expected coordination of elements of economic policy can be improved sufficiently to provide more satisfactory attainment of economic objectives in the future, neither justification for this belief nor concrete proposals to this end were provided in the *Report*.

(42) p. 537.

(43) Radcliffe, p. 183.

(44) C. M.C., pp. 242-58.

(45) p. 56.

(46) p. 419.

(47) p. 521.

The remaining alternative for improved performance of economic policy, the extension of techniques available to the authorities, was on the whole dismissed by the Commission because

direct intervention in financial markets can disrupt unnecessarily and may in the long run inhibit the best development of the financial system (48).

Use of selective controls was seen to lead to evasion through development of alternative sources of finance which could cause permanent damage to the functioning of credit markets. Moral suasion was discounted for

market participants cannot be expected to act against their own interest except temporarily and in exceptional circumstances (49).

While, on the whole, use of variable asset requirements for banks was regarded as undesirable, provision was retained for infrequent use in emergencies but only with specific government approval (50). In keeping with the Commission's views on use of specific monetary measures, specific fiscal measures were rejected because of both possible disruptive effects and difficulty in achieving necessary exactness of timing in the current institutional framework (51). Despite a predilection toward use of indirect measures derived logically from belief in the efficacy of free functioning financial markets, the Commission did admit the possibility of conditions in which

it may be better to accept the costs and inequities of direct measures than allow excess demand pressures to remain unchecked (52).

D. *The Working of Monetary Policy*

In discussing the effects of monetary policy, the Porter Commission, consciously avoiding explanation in terms of mechanistic relationships between economic activity and quantity of certain specified financial assets, sought to explain the influence of monetary

(48) p. 474.

(49) p. 476.

(50) p. 476.

(51) p. 518.

(52) p. 474.

authorities over expenditure in terms of "credit conditions", an approach presented in the brief of the Bank of Canada (53). Credit conditions, which include

the cost, terms, general availability of credit to borrowers, and consequently the terms and yields on which savers invest their funds (54),

were seen to influence spending because expenditures can be increased only by either

reducing the rate of current savings in the form of financial assets, by borrowing, or by disposing of real or financial assets accumulated out of past income (55).

Quoting the Bank of Canada, the *Report* continued:

each of these methods of financing involves an impairment of the spender's position compared with what it might otherwise have been. Every spending unit must continually weigh the alternatives and advantages of an increase in spending against the risks, difficulties and disadvantages involved in financing it... (56)

Recognizing that the supply of money and other liquid assets must be considered as important determinants of credit conditions, the Commission did observe that changed credit conditions could also arise from other sources (57).

To a degree the Porter Commission's view of credit conditions resembled the liquidity arguments of the Radcliffe Committee; however, on closer scrutiny fundamental differences on the working of monetary policy become apparent. The similarity of view can be best demonstrated by the observation by the Radcliffe Committee that

a decision to spend depends not simply on whether the would-be spender has cash or "money in the bank", although that maximum liquidity is obviously the favourable springboard. There is the alternative of raising funds either by selling an asset or by borrowing... (58)

(53) p. 433.

(54) p. 423.

(55) p. 424.

(56) p. 424.

(57) p. 425.

(58) Radcliffe, p. 132.

Despite Radcliffe Committee's concern with non-monetary financial assets, the quantity of money was still allowed significant influence on variables relevant to expenditure decisions (59). Divergence between the approaches derives from their views of the means by which monetary policy affects credit conditions and, through credit conditions, expenditure. The Porter Commission placed reliance on direct effects of changed interest rates on the level of expenditure, a view rejected by the Radcliffe Committee. Agreeing that changes in liquidity are an important influence on expenditure, the Commissions then took opposite views on the relationship between interest rates and liquidity. The Porter Commission asserted

enhanced liquidity will be associated with lower interest rates, easier credit conditions in financial markets generally, and greater inducements to spend on real goods and services (60);

whereas the Radcliffe Committee argued

that movements in the rate of interest have a central part to play in bringing about changes in liquidity (61),

and that

decisions to spend on goods and services — the decisions that determine the level of total demand — are influenced by the liquidity of spenders... (62).

These statements make it apparent that while the Radcliffe Committee regarded interest rates as influencing expenditure through liquidity, the Porter Committee believed the impact of changed liquidity to be manifested through changed interest rates (63). Although the Porter Commission's description of the workings of monetary policy, in part, used the language of the Radcliffe Committee, the Porter Commission rejected the theoretical basis of the Radcliffe position and favored a more conventional approach to the description of policy.

(59) Radcliffe, p. 133.

(60) p. 425.

(61) Radcliffe, p. 131.

(62) Radcliffe, p. 132.

(63) For a view denying any distinction between "interest incentive" and "liquidity" effects, see A. E. JASAY, "The Workings of the Radcliffe System", *Oxford Economic Papers*, XII (1960), pp. 170-80.

E. *The Effectiveness of Policy*

From the studies of its research staff, the Porter Commission presented a sector by sector evaluation of monetary policy (64). In the corporate sector, the reliance on internal funds, the unimportance of interest costs relative to the uncertainty of cost calculations, and the availability of alternative sources of finance were found to mean neither higher interest costs nor decreased availability of funds would be likely to have any appreciable effect upon investment. Similarly because of the political necessity of providing certain services, effects of changed credit conditions on government expenditure were expected to be only minimal. On the whole, though consumer expenditure would be influenced only slightly by changed credit terms, reduced availability of N.H.A. mortgage funds would lead to decreased housing expenditure during periods of credit restraint. Finally, with a flexible exchange rate the maintenance of persistent interest differentials between Canada and other countries would through exchange rate movements affect foreign trade which in turn would influence the domestic economy. From this analysis of effects of monetary policy, the Commission declared

aside from the substantial effects which have on occasion resulted from sharp alterations in the availability of National Housing Act mortgage funds, the domestic effects of monetary policy have been quite limited in the short run. Moreover, while the time taken to implement changes in policy, and for the effects of such changes to effect employment and output, does not necessarily rule out the use of monetary and debt policies to exert a stabilizing measure in the short run, there are significant lags of this kind which mean that actions taken late in one phase of a short-run fluctuation can easily spill over into the next phase of the cycle when the requirements of stability may call for pressure in the other direction (65).

Despite both the apparently pessimistic conclusions about the size and timing of the impact of monetary policy on real expenditure and the lack of any definite prospect for improved timing and

(64) p. 428 ff.
(65) p. 430.

coordination, the Porter Commission, following the example of the Commission on Money and Credit, concluded

in all but the very shortest cyclical fluctuations the actions of the authorities can play a useful stabilizing role... (66).

An alternative choice before the Commission was acceptance of the Radcliffe relegation of stabilization policy to the provision of a suitable long term environment for the attainment of the economic objectives of policy (67). Since currently this opposing view in one form or another has gained considerable support among economists, the Porter Commission should have provided a clearer justification of their choice, particularly apropos this alternative.

III - Competition between Financial Institutions

In Canada as elsewhere, competition among financial institutions and its implications for both monetary control and the functioning of financial markets are contentious issues generating considerable debate. Compared with the United States, in Canada the problem is further complicated since a distinguishing feature of banks — that they are sole custodians of the payments mechanism — is absent, for checkable demand deposits are issued by some near banks. Furthermore, eight chartered banks are incorporated under the Bank Act and subject to cash reserve requirements, limitations on lending rules, and restrictions upon lending; yet nowhere in legislation is the scope of banking defined (68). Originally during the early development of banking, note issue was regarded as a prerogative of chartered banks that distinguished them from other financial institutions; but the subsequent de-emphasis of notes with the expansion of deposit banking and the ultimate transfer of sole right of note issue to the Bank of Canada eradicated this distinction between banks and other financial intermediaries. Though competitive with the chartered banks over a broad range of activity, the near banks are unrestrained by the restrictions of the Bank Act that limit the actions of the chartered banks. In their brief to the

(66) p. 438.
(67) Radcliffe, p. 177.
(68) p. 362.

Porter Commission, the Canadian Bankers' Association stressed the fundamental similarity of banks and near banks and maintained differential treatment of chartered banks was not only inequitable but detrimental to the operation of monetary policy (69).

The *Report* presents an analytical treatment of competition between banks and near banks that is a model of lucid presentation and provides a proper perspective for the basic theoretical issues (70). The essential similarity of banks and near banks reflects their common need to induce the public to substitute their liabilities for cash if any expansion of financial assets is to occur. Just as individual banks grow or contract relative to other banks in relation to their ability to attract deposits from the public, the position of any financial institution or set of financial institutions is determined not by any difference in kind but by their success in meeting the public's demand for liquid assets. Under the present reserve arrangements by which near banks hold cash reserves at the chartered banks, with a given cash reserve base, expansion of near bank liabilities either through shifts in public preferences or in response to changed interest rates will not directly reduce deposits or earning assets of the chartered banks since no absorption of reserves by near banks occurs. Any shift by the public towards liabilities of near banks leads to transfer of bank deposits from one member of the public to another through the intermediary with direct diminution of neither bank reserves nor deposits.

Although the Porter Commission recognized that the presence of near banks holding cash reserves at the chartered banks permits expansion of indirect financial assets beyond the limits for a banking system in isolation, the Commission stressed that present arrangements posed no serious problems for monetary control (71). The *Report* suggested chartered banks would impede expansion of near banks by meeting any increase of returns paid on near bank liabilities (72). Even though increased competition from other intermediaries may reduce the banks' share of total financial assets, if reserves and total deposits at chartered banks are not reduced by growth of near banks, chartered banks as a group would not have

(69) Canadian Bankers' Association, *Submission to the Royal Commission on Banking and Finance*, 1963, pp. 95-102.

(70) See particularly pp. 89-112.

(71) p. 393.

(72) p. 112.

any direct incentive to raise rates paid on their deposits for the result would be greater interest costs on the same quantity of deposits. Any expansion of near banks under present reserve arrangements would expand total financial assets unless the central bank intervenes by reducing the supply of reserves available to the banking system.

If the central bank should take account of growth of near banks through limiting cash reserves available to the chartered banks, the reduction of cash reserves, as pointed out in the Canadian Bankers' Association brief, would further erode the competitive position of the chartered banks in the financial system (73). Paradoxically the credit restriction would be the result of the present arrangement by which chartered banks serve as repositories for near bank reserves. If under alternative reserve arrangements near banks were required to hold their reserves with the central bank, shifts in deposits by the public from banks to near banks would reallocate reserves and deposits among financial institutions without increasing indirect debt. With this alternative reserve scheme, to meet rivalry of near banks the chartered banks could maintain their absolute position only by competing for their share of the reserve base by attracting deposits from the public. With banks and near banks holding reserves at the central bank, compensating central bank action would be unnecessary and any loss of reserves by the chartered banks would occur directly from increased competition from near banks.

Two policy issues concerning reserves — the range of applicability of reserve requirements, and the appropriate form of reserves for near banks — arose from the Commission's analysis of competition between banks and other financial institutions. For the former issue, both on grounds of equity and because of potential difficulties for monetary control that could arise from growth of "outside banks", the Commission recommended application of 8 per cent cash reserve requirements on all demand deposits and 4 per cent on all notice deposits of less than one year (74). By applying reserve requirements to liabilities that serve either as means of payment or as close substitutes without regard to issuing institution, the Porter Commission has avoided the pitfalls of extension of reserve require-

(73) See Canadian Bankers' Association, *Submission*, p. 101.

(74) pp. 391-92.

ments to near banks suggested by the Radcliffe Committee which maintained

further growth of new financial institutions would allow the situation continually to slip from under the grip of the authorities (75).

After adoption of the Porter Commission's proposals, once an intermediary competes directly with the banking system by issuing any liabilities maturing within 100 days, it would have to become subject to banking legislation and the resulting cash reserve requirements.

Despite the basis of the recommendation for extension of reserve requirements upon the Commission's careful comparison of the roles of banks and near banks in financial markets, it must be recognized that as long as near banks continue to hold their reserves with the chartered banks, extension of minimum reserve requirements to near banks would not by itself eliminate the necessity for compensatory restraint upon bank reserves to offset growth of near banks. On the second issue,

for the purpose of improved relationships between the banks and the near banks, and moreover, because the Commission could think of no valid reason why some banking institutions should be required to hold reserves in one form and others not (76),

the Commission proposed all reserves of banks and near banks, other than till money, be held with the central bank. As shown above, implementation of this recommendation would obviate the need for authorities to use instruments of monetary policy to counteract shifts in public holdings of liquid assets. Despite the Commission's emphatic avowal that these recommendations did not reflect concern with problems posed for monetary control under present circumstances, these proposals for extension of reserve requirements further the Commission's search for general principles with a continuing validity (77).

Although the Commission's realization of the fundamental similarity between banks and near banks led to proposed imposition

(75) Radcliffe, p. 134.

(76) p. 393.

(77) p. 10.

of banking legislation to near banks, the Commission also realized that subjecting near banks to bank regulation could cause a deterioration in the near banks present competitive position. A balance on equity was achieved by extension of access to clearing facilities and by granting the privilege of discount at the central bank to all near banks subject to the Bank Act. In addition, it was recommended both near banks and banks be relieved from certain competitive restrictions under a

regulatory framework... designed to encourage the financial system to be adaptable and creative within a competitive and non-discriminating environment in which there will be fewer arbitrary legislative distinctions and prohibitions than are now to be found (78).

IV - An Overall Assessment

Following both the Commission on Money and Credit and the Radcliffe Committee, the Porter Commission had its task made easier in some respects and more difficult in others. The Porter Commission's task was made easier through avoidance of well established pitfalls. In most cases careful provision of background for both views and recommendations combined with a more sophisticated level of analysis made for greater enthusiasm in the reception from the profession of economists than had been accorded the Commission on Money and Credit. An overall concern for consistency that pervades most of the *Report* — except perhaps the policy sections — should help prevent the cries of "not unanimous" that greeted the Radcliffe Committee. On the other hand, the close succession to previous reports meant the Porter Commission faced a more difficult task in attaining an independent viewpoint. While it is not argued independence in itself is inherently desirable, a report with a fresh viewpoint or approach to its problem would be far more likely to receive notice from economists and the financial world in general. Certainly the research carried out by the Commission was heavily influenced by comparable studies for the Commission on Money and Credit; the present world of complex financial arrangements lent appeal to the overall concern with liquidity expressed by the Radcliffe Committee; and the view that

(78) p. 396.

monetary policy to be effective must be supplemented by other policies reflected opinion of a large group of economists. In contrast, the Commission's treatment of application of reserve requirements to non-bank financial institutions diverged sharply from both the Commission on Money and Credit and the Radcliffe Committee. For certain topics the Porter Commission could not avoid drawing upon the work of previous studies in its analysis; however, overall the Report reflects a judicious assessment of "conventional wisdom", one which integrated that believed worthwhile and supplemented where judged necessary.

The selection of criteria for judgement of a document such as the *Report of the Royal Commission on Banking and Finance* is made difficult by its multi-varied functions. As a description of participants of the Canadian financial system and their activities in financial markets, the *Report* should likely serve as an important reference for many years to come. As a technical document (certainly not its chosen role) certain sections, particularly the descriptions of interrelationships among financial institutions, include expositions that could contribute to clarifying much hazy contemporary thought. Most important, as a document to shape public policy, the *Report* presents a set of recommendations that are a sound beginning for revision of the Bank Act. Whether implemented or not, the Commission's suggestions will necessitate careful reappraisal by all Canadian financial institutions of their relative competitive positions. Finally, but certainly not least important, the *Report* provided the raw material for a reawakening of the tradition of enlightened comment by economists that once characterized Canadian monetary and financial affairs.

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