ESSAYS IN INTERNATIONAL FINANCE

No. 42, May 1963

A MEMORANDUM SUBMITTED TO THE CANADIAN ROYAL COMMISSION ON BANKING AND FINANCE

SIR DENNIS ROBERTSON

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
Princeton, New Jersey

This is the forty-second number in the series ESSAYS IN INTERNATIONAL FINANCE *published from time to time by the International Finance Section of the Department of Economics in Princeton University.*

The author, Sir Dennis Robertson, is a Fellow of Trinity College, Cambridge, and was Professor of Political Economy at the University of Cambridge until 1957. At one time he was Cassel Professor of Economics at the University of London. In 1944 he was a member of the U.K. Delegation to the Bretton Woods Financial Conference. Sir Dennis holds several honorary degrees and is the author of numerous well-known books.

The Section sponsors the essays in this series but takes no further responsibility for the opinions expressed in them. The writers are free to develop their topics as they will. Their ideas may or may not be shared by the editorial committee of the Section or the members of the Department.

The submission of manuscripts for this series is welcomed.

FRITZ MACHLUP, *Director*
International Finance Section

With great sorrow and regret we have learned, at the moment of going to press, of the death of Sir Dennis Robertson [1890-1963]. We, like the rest of the economics community, feel this is a great loss to the profession in which he was a leader and discoverer, and an ornament by his style of writing, his humor, and his humanism.

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FOREWORD

In October 1961 the Canadian Government approved the establishment of a Royal Commission on Banking and Finance. This decision was based, among other considerations, on the understanding

"That it is desirable periodically to undertake a broad review of the function of the Canadian financial system; . . ." and

"That orderly economic growth is dependent in no small measure on the adequacy and adaptation of the financial institutions through which funds are made available for expansion and development; . . ."

Seven Commissioners were appointed and were asked, among other things,

"to enquire 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; and

"to make recommendations for the improvement of the structure and operations of the financial system. . . ."

In the course of their enquiries, the Commissioners invited a number of internationally known economists and other experts to give evidence on more general questions of monetary and financial policy. Among them were Dr. Edward M. Bernstein, formerly of the International Monetary Fund; Lord Cobbold, former Governor of the Bank of England; Dr. M. W. Holtrop, President of the Netherlands Bank; Professor Erik Lundberg, University of Stockholm; Professor Sir Dennis Robertson, University of Cambridge; Professor Paul A. Samuelson, Massachusetts Institute of Technology; Mr. Allan Sproul, former President of the Federal Reserve Bank of New York; Dr. Woodlief Thomas, former Advisor to the Board of Governors of the Federal Reserve System; and Professor Jacob Viner, Princeton University.

Most of these expert witnesses submitted statements to the Commission in the form of Memoranda of Evidence. Others presented only oral testimony. The Memoranda of Evidence are of great professional interest, not merely to those concerned with the Canadian economy but to economists and the financial community all over the world. The discussions were to a considerable extent centered on problems of international economics and on essential issues of policy in the economies

of the world today. In order to make them widely available without much delay, the International Finance Section of Princeton University requested the Canadian Royal Commission to approve publication of some of the statements of the experts in our series of essays. This approval was graciously granted.

The International Finance Section intends to publish several of the Memoranda as separate issues in this series of *Essays in International Finance*, either without any changes from the original text or with such revisions as the authors desire to make. The Section takes pride in presenting to its readers as the first of these issues the Memorandum prepared by Sir Dennis Robertson. He has chosen to have it reproduced without alteration.

It should be noted that loosely-bound folio sheets of the Memorandum, as well as the verbatim transcripts of oral testimony, can be purchased from the Commission's court reporters in Ottawa. The Royal Commission has not yet decided whether it will print all or any part of the Memoranda of Evidence in a separate volume or volumes. This decision will only be taken after the report of the Commission has been completed, probably in the fall of 1963. It is believed, therefore, that the International Finance Section is rendering a service to students of international economics by publishing some of the statements of the expert witnesses at this time. The Director and his associates express their gratitude to the Canadian Royal Commission and to the experts for their cooperation in this enterprise.

Fritz Machlup, Director

PREFACE

THIS memorandum is here reproduced in exactly the form in which it was signed for transmission to the Commission on July 28, 1962; no attempt has been made to revise it in the light of later events or of such better understanding of Canadian problems as I may have achieved during my short visit to Ottawa for oral questioning by the Commission on September 20, 1962.

It may therefore assist the reader to be reminded of a few dates. Mr. L. Rasminsky was appointed Governor of the Bank of Canada in July 1961. On May 3, 1962, the Canadian dollar, which had had no fixed par value since the autumn of 1950, was given a fixed par value of 92½ U.S. cents. At the end of June 1962, a number of emergency measures were taken to protect and restore the country's monetary reserves, which had fallen heavily since the end of 1961.

In the United Kingdom, Mr. Selwyn Lloyd, who since the previous July had been endeavouring to establish first a "pay pause" and then a policy of "wage restraint," resigned the office of Chancellor of the Exchequer, at the request of the Prime Minister, on July 13, 1962. The prospective establishment of a permanent National Incomes Commission was announced on July 26; but its terms of reference were not made known till the following November.

Dennis Robertson

A MEMORANDUM SUBMITTED TO THE CANADIAN ROYAL COMMISSION ON BANKING AND FINANCE

1. *Introductory*

In the admirable statement issued on the morrow of his appointment, the Governor of the Bank of Canada alluded to the "broad economic objectives of high-level employment, price stability and sustained economic growth." As a means to the attainment of these ends, he emphasized the need for the coordination of *financial* policy with *general economic* policy, the former in turn consisting in the three "interdependent and to some extent interchangeable" strands of *monetary* policy, *fiscal* policy and *debt-management* policy. I shall try to arrange my remarks in the light of these two dissections, the one of ends, the other of means; bearing in mind as regards the second that, as I understand it, the Commission's *primary* concern is with the genus "financial," and within that genus with the species "monetary."

Fashions change. Fifty years ago, all the limelight might have been concentrated on stable prices, thirty years ago on high employment. But nowadays no public personage can afford to let slip an opportunity of reminding us of what in my young days was taken for granted, namely that modern communities normally both are and desire to be experiencing growth, in the simple sense of an increase over any span of years—not necessarily in any single year—in the total of measurable real output or income. So Mr. Rasminsky was quite right to include growth; and I am sure no one realizes better than he both that the available methods of measuring it are imperfect, and that growth itself is at best a means rather than an end, and moreover is apt to be accompanied, as it has been in Britain, by damage of various kinds, some of which is inevitable, and some, while not inevitable, is not very likely to be avoided.

2. *Population Policy*

The Commission will not wish to spread its net unduly wide; but I fancy it may find itself impelled to indicate whether it is more concerned to promote increase of *aggregate* real income or of real income *per head*; and further whether it therefore regards a "population policy" as one

of the things with which financial policy must be harmonized. It seems to me that special strains on those in charge of financial policy are likely to arise in countries (such as Australia) which are anxious for non-economic reasons to encourage a smart rate of growth of population, or in countries (such as India) where population is in fact increasing faster than the framers of general policy would wish. I should imagine that taking a long view Canada, with her friendly neighbours and her abundant natural resources, should be relatively free from such pre-occupations, and able more or less to let population matters, both in respect of natural increase and of immigration, take their course.

Nevertheless the difficulty which has been found in the last few years in attaining the objective of high employment—or more strictly of low unemployment—draws attention to a special trouble which may befall a country whose free institutions and rich resources have made her for decades a magnet to the robust and enterprising—namely that a short period of needed digestion and reappraisal after a specially rapid up-thrust may face her with a temporary problem of superfluity of man-power from which a less dynamic economy would be exempt, and with which purely financial policies may prove inadequate to cope. One can only hope that such *reculements pour mieux sauter* will prove of short duration.

3. *Regional Policy*

More likely to be persistent is a problem from which Canada, with her large physical span and wide variety of natural conditions, cannot hope to be immune, namely the attitude to be adopted in the face of widely varying *regional* propensities to growth or decay. Ought special efforts to be made to bring work to the workers in the less fortunate areas? Or will such efforts only serve to obstruct the more growth-promoting solution of intra-national migration of labour towards the points of higher return? Is there conflict here between two of the "Rasminsky objectives"?

I cannot illustrate the problem better than by quotation from the paragraphs in which, in a most interesting recent (1961) Report, Professor A. K. Cairncross seeks to justify his proposal for doubling or trebling over a span of years the numbers engaged in certain specially selected industries in the Atlantic Provinces. The argument, he urges, is twofold:

> . . . the probability of a labour surplus after allowing for migration to other parts of Canada; and the probability that, for a limited range of industries, costs of production would not rise perceptibly (except perhaps in the first year or two) if a location in the Atlantic Provinces

> were selected in preference to a location in central Canada. . . . I fully accept the need to push ahead with the development of those areas of Canada that have the greatest growth potential, and I see long term advantages in encouraging the movement of labour from declining to expanding areas. But I recognize that there are limits to the scale on which labour transfers are possible *without inflicting lasting damage on the economic and social life of both types of area*; and there appears to me a serious danger that, at current rates of population growth, these limits would have to be exceeded if no special efforts were made to develop new industries in the Atlantic Provinces.*

In this instance, the argument thus runs, a laissez-faire policy would not, as at first sight might appear, be superior to an interventionist one from the point of view of the effect on the overall rate of growth, partly because those workers who migrated would not in fact become much more productive elsewhere, and partly because migration would not in fact be on a large enough scale to drain off and re-employ all the redundant labour. I have neither the knowledge nor the desire to impugn Cairncross's conclusion; though the words which I have italicized suggest to me that in reaching it he has attached more weight than he makes quite explicit to a third concept more elusive than either productivity or employment, namely the welfare of "the region" as such, distinct from the welfare of the individuals who dwell, or who no longer dwell, therein.

4. *Growth Policy*

Let us return to the concept of the rate of increase of output, and be content for the moment to deal with it as a national average, computed over all regions and all occupations. Given the rate of increase of the working population and the length in hours of the working year, this rate of increase of output may be regarded as depending, over a run of years, on two things,—the rate at which the country's stock of capital instruments of one kind and another is growing, and the rate at which improvements are being effected in technology and organization. These two elements of growth are not independent of one another, and at the present time much high-powered intellectual effort is being devoted by economic "model-builders" to analyzing their inter-relations. I doubt if the Commission will desire to give the time to go deeply into these sophisticated argumentations; and if it does I am not the man to expound them! I venture to think that, up to a point at least, useful results can be reached by treating these two factors in growth, which I will call for brevity capital formation and technical progress, separately; since the

* *Economic Development in the Atlantic Provinces*, p. 19. Italics mine.

role of policy with regard to them is inevitably somewhat different. Governments can take steps of various kinds to encourage both; but not even a totalitarian Government is able to determine, or even to predict for any length of time ahead, the rate of technical progress. On the other hand, such a Government *is* in a position to determine pretty closely the proportion of a country's productive power which shall be devoted annually to increasing its capital equipment; and, even in a country in which the ultimate powers of decision in this matter are still mainly decentralized in the hands of private individuals or corporations, the Government may itself be charged with making the relevant decisions over such a sizable part of the field, and be so confident of its powers of persuasion or prediction over the remainder, that the overall rate of capital formation has come to be regarded as virtually a matter of national policy.

The Commission may or may not be so well satisfied that there are good reasons for desiring Canada to grow at one rate rather than another, and so confident that what is desirable in this matter is also attainable, that they are ready to follow some notable precedents in tossing a growth-rate figure into the arena of discussion. I must confess that my own sympathies were on the side of the recent United States Commission on Money and Credit in their refusal, in spite of pressure from some of their members, to take such a course (1961 *Report*, p. 31). But whether or no, there are questions about the implications of growth for the various branches of financial policy which do seem to be clearly within the Commission's responsibility to face.

5. *Prices Policy*

Boring and academic as it may seem, I think it is helpful to start by considering how a Monetary Authority should behave in a country which was isolated from the rest of the world, and in which it was desired so far as possible to leave the pace of capital formation to be determined by the unfettered interplay of the decisions of private enterprisers and savers.

In general terms, the answer seems to be that in such conditions it should be the aim of the Monetary Authority to generate such a flow of monetary demand for final output as to enable the participants in the growth process—enterprisers, savers and hired workers—to realize their intentions with a minimum of friction and of distortion of the true significance of the monetary contracts which they are making with one another. Attainment of this aim could be described as the preservation of "monetary equilibrium"; and, assuming the Authority to be working with and through a modern system of deposit banking, we can put the

same thought in different words by saying that its aim should be to ensure that the creation of money by the banks is being carried on in just such a way and on just such a scale as to ensure that the banking system really is what bankers believe it to be,—an efficient instrument for putting the genuine savings of the public at the disposal of trade and industry.

When however we try to express this aim more precisely in terms of income and prices, we encounter difficulties. The first interpretation which suggests itself is that what from now on I will call for brevity the "money flow" should be caused to expand in proportion to any increase that may be occurring in the working force, i.e. that the aim should be (broadly) to preserve the stability not of prices but of money income per head. But that interpretation will be seen to be too restrictive when we reflect that another factor of production, namely capital equipment, is also growing, and that its owners will also be claiming their annual reward. So we are led on to think that the money flow should be expanded sufficiently to allow for this, though not sufficiently to balance that part of the increase in output which is due not to the growth of capital equipment but to technical progress. Thus the general level of prices of final output would be allowed progressively to fall, though by no means in full proportion to the increase of output.

When however we reflect further that what is going on may well be altering the relative scarcities of the two factors of production, Working and the Provision of Capital, we may well be hard put to it to see just how large an expansion of the money flow would be needed in order thus to preserve stability not of final prices but of what may be called the "average price of productive power." And remembering at this stage the difficulties which Monetary Authorities have in achieving what they want to achieve—remembering also the various pressures which they will be under to implement or acquiesce in a continuous *rise* in final prices—we may well be tempted to throw perfectionism to the winds, and to accept for practical purposes what to many people seems, though in fact it is not, the most "natural" objective of all, namely stability of the final price level.

To this temptation I, in common with some whose judgment I most respect (I may mention Professors Haberler and Robbins), have succumbed—though always with a twinge of conscience when I see the more scientific view movingly expressed by some discerning non-economist.* This makes it the more incumbent on me to insist on three things.

* For example by the Archbishop of Wales in a letter to the *Times* of Jan. 11, 1962, which concludes:

To a simple fellow like myself it seems that the lower prices which increased pro-

First, if questions arise of a possible conflict, and therefore a necessary compromise, between the "Rasminsky objectives," it should be remembered that the price-stability objective is itself already a compromise. Secondly, the practical case for stability refers only to the *average* of prices and in no whit impairs the case for requiring that in lines of production where technical progress is specially pronounced prices should continuously fall. Thirdly, and in appearance somewhat paradoxically, an understanding of the true reasons for ensuing "stability" may prevent us from launching undeserved criticism at a Monetary Authority if in the face of a *reverse* movement of productivity, occasioned by bad harvests or other natural misfortunes, it permits a *rise* in the price level. For such action may be in the true sense stabilizing, provided of course it is not allowed to touch off a "compensatory" rise in money incomes.

6. *Taxation Policy*

But we are getting to grips a little too quickly with the real world! Let us return to our imaginary country (beginning of §5), and for such a country take, with some reservations, stability of prices as a sufficiently good indication that monetary equilibrium is being successfully maintained. The next thing to observe is that in principle such a happy state of affairs may exist also in a country in which the Government is taking a hand in the growth process. On examining such a country, we might find that the Government was running a surplus of current receipts over current expenditure and using the surplus to repay old debts, thus appearing only on the supply side of the capital market; or we might find that it was using such a surplus to finance the creation of capital equipment, thus appearing in equal strength on both sides of the capital market, i.e. (by and large) not appearing at all. Or again we might find that it was chronically appearing on the demand side of the market, either partly to finance a current deficit, or exclusively to finance the creation of capital equipment. The Finance Minister may be framing his policies in these respects in the light of a combination of principles and rules of thumb which do not perhaps commend themselves to his political opponents but are, as things go, intellectually quite respectable; and he may be so fortunate as to find that the Monetary Authority can take

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ductivity makes possible would benefit everybody, but I recognize that there must be a flaw in my thinking, for increased productivity has not brought—and does not seem likely to bring—lower prices. Presumably there is good reason for this. Will someone explain?

Nobody did.

his decisions as data and yet do its particular job of preserving monetary equilibrium with success.

For instance, as Finance Minister in a country in which a number of branches of productive industry have passed into public ownership, I can easily see myself deciding that that fact affords no good ground for supposing that all their expenditures on capital development should be met out of taxation, and imposes on me therefore no obligation to achieve an "overall" budget balance. But I can also see myself deciding, with perhaps vulnerable logic but saving common sense, that I must turn a very critical eye on any suggestion that, because some piece of expenditure in the field of education or health is not only desirable in itself but should increase "productivity" in the future, it is therefore a proper subject for finance by loan rather than by tax.

Before giving limited endorsement, as I shall presently do, to the claims of Central Bankers and others that Fiscal Policy must be prepared to come to the aid of Monetary Policy in ensuing "monetary equilibrium," it is well, I think, thus to stake out a claim for Public Finance as a serious subject in its own right, with a philosophy and experience of its own, and incapable of being pushed around, in the interests of stability, beyond a certain point without damaging consequences.

7. *The Money Stock*

Still maintaining for a while longer the pleasant fiction of an isolated economy, let us put ourselves in the position of a Monetary Authority which, in the shape of a Central Bank, is endeavouring to pursue wholeheartedly the objective of monetary equilibrium. What weapons does it need, and what obstacles will it encounter?

As a minimum requirement it would seem that it must be in a position to exercise control, both in an upward and downward direction, over the quantity of money in the hands of the public. (I use the word "money" in the sense now common in Britain, and apparently also reasonably appropriate to Canadian conditions, of notes and coin plus *all* the deposit liabilities of the cheque-paying banks.) For the Bank to be in this position there must be a quantitative link, established by law or reliable custom, between the deposit liabilities of the banks and their reserve balances held with itself; and there must be an active market through which, by dealing in securities with the banks or their customers, it can operate on the magnitude of these reserve balances. These things the Bank of Canada has; and I gather that it is free from those inhibitions against dealing in long as well as in short-term securities