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# Initiatives to Develop Canadian Capital Markets: A Case Study

## Introduction and Overview

The purpose of this note is to examine various initiatives that Canada has undertaken to develop a viable domestic capital market. It is part of Canada's contribution to a series of case studies describing G-20 countries' respective experiences with globalisation. The purpose of the case studies is to provide an assessment of the challenges faced and the benefits achieved as countries have opened their economies and have become more integrated into the global economy.

One of the key messages the G-20 has delivered to emerging countries is the importance of a viable domestic capital market which would enable domestic borrowers (both private and public) to fund themselves in their local currency and in longer-term maturities. Well-developed domestic capital markets could potentially insulate emerging nations from some of the effects of global financial shocks by providing them with more stable and secure sources of liquidity.

It has been said that Canada is a leading example of a country in which the development of a money market was officially encouraged and assisted.[1] This case study will give special attention to the initiatives undertaken by the Bank of Canada in the 1950's and 1960's to develop an active money market in Canada. The primary emphasis by the Bank of Canada at that time was on the development of the treasury bill market so that it would be in a better position to effectively conduct monetary policy. However, as fiscal agent for the Government of Canada, the Bank, along with the Department of Finance, also had a strong desire to promote longer term capital markets in order to provide the Government with low cost and stable financing. By taking the steps, which will be outlined later, Canada was able to face the challenges of financing large fiscal deficits in later years.

The case study will begin with a brief overview of the development of capital markets in Canada prior to the 1950's. By the early 1950's Canada was in a strong position to encourage the expansion of domestic capital markets. There may be some similarities between Canada's situation then and the challenges some emerging countries currently face with respect to fostering the development of domestic markets. For example, Canada was a relatively small economy reliant on foreign trade. It was much more influenced by fluctuations in commodity prices than is currently the case and had a long history of foreign capital inflows to finance major resource development and national transportation systems.

The second section will detail initiatives taken by the Bank of Canada, in close cooperation with the Department of Finance and financial market participants, starting in 1953 through to the late-1960's. There were many factors (both domestic and international) that

1. see Wilson, J.S.G. (1993, 297)

influenced the growth of Canadian capital markets during that period, but there was nonetheless a clear link between the initiatives taken by the Bank and the expansion of the domestic money market.

The third section will provide an overview of capital market developments from the 1970's to the present. The Bank of Canada and the Department of Finance continued to work closely with financial market participants to make adjustments to the Governments's borrowing programs in light of changing economic and financial market conditions (including the increasing influence of international investment and portfolio flows on Canadian markets). The Bank of Canada also introduced significant changes to the framework for implementing monetary policy, with close attention to the importance of an efficient and liquid domestic market.

The final section will provide a summary of some of the initiatives undertaken in recent years to promote continued efficiency in the Government of Canada securities markets as government borrowing requirements have fallen significantly. The case study will conclude with observations on Canada's experience and identify several challenges for Canada in the years ahead.

**Capital Markets in Canada: Where were they in 1950?**

Canada had a fairly well-established financial structure in place before the Bank of Canada opened in 1935. Although a money market did not exist in any real sense, a fairly well-developed bond market was in place at that time. The bond market had developed without the same kind of active Government promotion that, in later years, was aimed at the money market. Canada's legal system and strong ties to Britain during its early years supported the early development of a bond market.

The history of Government of Canada marketable bonds in the domestic market dates back to 1868 with the issue of 6% ten-year bonds. The Government continued to issue bonds in the domestic market to retire foreign debt which had been issued by the provinces prior to Confederation in 1867. However, the Government also continued to issue bonds denominated in both sterling and U.S. dollars, in the London and New York markets. During World War I there were substantial borrowings in the domestic market for war financing, largely through syndicates of domestic dealers. Between World War I and World War II, domestic bond financing was mainly for refunding operations. When World War II began, the Government of Canada again relied extensively on the domestic capital market to provide war financing. During those years, the Government was able to raise about $13 billion, all domestically and most of it long term. By the early 1950's, Canada had a framework in place for a domestic bond market and had many years of experience from borrowing in both domestic and international markets. Although there was no real money market by the early 1950's, short-term Government of Canada bonds were held in large amounts outside the banking system and were actively traded.

Unlike the bond market, the development of the money market required the active involvement of the Bank of Canada and the Government. Prior to World War I, Dominion of Canada treasury bills payable in sterling were sold in the London market. Treasury bills were issued directly to banks during World War I to provide temporary accommodation between War Bond issues, but were discontinued shortly thereafter. The creation of the Bank of Canada in 1935 marked a major step forward in the growth of capital markets in Canada. As the first Governor, Mr. Graham Towers, noted in the first annual report of the Bank of Canada: "It is universally recognized that a central bank is hampered in its operations where an active bill market does not exist... Under present conditions a fairly satisfactory market can be established, if there is a sufficient volume of treasury bills, if there is good institutional distribution of these, and, in particular, if it is the commercial banks' policy to hold treasury bills as secondary reserves."A first auction for treasury bills had been held in 1934, and regular fortnightly auctions were introduced in 1937. However, there was very little secondary market activity as the banks typically held the treasury bills until maturity. The banks used the New York call loan market extensively to meet their liquidity requirements. The liquidity and availability of the U.S. dollar call loan market attracted the banks to New York. Exposure to potential short-term foreign currency exposure risks did not seem to deter the banks from accessing the New York Market. "To a large extent, banks relied on the facilities of the New York market where they had long been active to meet any requirements for liquidity. Undoubtedly, the availability of the well-developed New York market and its close proximity to Canadian financial centres had been an inhibiting factor in the development of even a rudimentary money market in Canada".[2] Some regulatory features of the banking system, such as the Bank Act's imposition of an interest rate ceiling on bank lending, also caused distortions and hindered the development of the money market.[3]

Despite the slow progress, the Bank saw the establishment of a money market as very important for the development of Canada's financial system and more broadly, its economy. From 1935 to 1952, the market for treasury bills was almost entirely limited to chartered banks and the Bank of Canada. The Bank made limited use of the treasury bill market to conduct open market operations. A short term corporate paper market was also almost non-existent prior to the early 1950's.

It should be noted that the Bank of Canada and the Government had more pressing issues upon which to devote attention from 1935 to the post-war years (i.e., the Depression, World War II, post-war recovery). But, by the early 1950's there was a growing view in the Bank of Canada that the basis had been laid for a strong and sustained economic expansion- a completely different environment than that which had existed since the Bank's creation in 1935.

**Initiatives: 1950's through the 1960's**

Beginning in 1953, various steps were taken to encourage the growth of the money market in Canada. Although the Bank was primarily concerned about its ability to conduct monetary policy, Governor Towers expressed a broader perspective in his testimony before the House of Commons Standing Committee on Banking and Commerce in 1954: "A broad and responsive market in Government of Canada securities, and the existence of a machinery which makes such a market possible, helps to develop a better market for other securities and to channel funds where they are most needed for the development of the country."[4]

The principal objective was to broaden the market for treasury bills and other short-term paper by encouraging larger investment dealers to hold inventories and be willing to make markets. Then, as now, the Bank of Canada's view was: "the money market is at the heart of the process by which the Bank implements monetary policy. We, (the Bank), also have a somewhat separate interest in the money market that reflects our role as fiscal agent for the Government".[5]

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2. Watts, G. (1993, 93)
3. In 1934, an interest rate ceiling of 7 per cent on bank loans was introduced. The ceiling was lowered to 6 per cent in 1944 and remained in place until the 1967 Bank Act revision.
4. Watts, G. (1993, 99)
5. Crow, J. (1989 speech to the Toronto Money Market Association)

The first step was to introduce a weekly auction of treasury bills and gradually increase the amount issued. Concurrently, the Bank instituted arrangements for purchase and resale agreements (PRA) with a number of investment dealers to encourage them to take a “jobbing” (or inventory) position in treasury bills and other short-term Government of Canada securities. Under the PRA arrangements, the Bank would, if required, provide short-term accommodation to these money market “jobbers” up to a specified limit by purchasing treasury bills and/or other short-term Government of Canada bonds under an agreement to re-sell the securities at a pre-determined cost to the dealers. Initially, the rate was set below the call loan rate charged by the chartered banks.

In 1954, further steps were required as the PRA facilities were more attractive than the call loan market and dealers were relying extensively on the Bank of Canada facility to finance their inventories. After extensive consultation with the banks, and with the cooperation of both the banks and dealers, a new short-term financing vehicle, called day-to-day loans, was introduced in to the Canadian market. These loans were made by the banks to the designated Bank of Canada dealers (jobbers) within the limits of the dealers’ Bank of Canada PRA lines and against the pledge of the same types of securities that were eligible for PRA. The day-to-day loans were highly liquid assets for the banks, which they began to use to adjust their cash reserves. Dealers were able to finance treasury bill and other short-term Government of Canada securities through day loans and began to actively seek customers. Almost immediately the amount of PRA extended by the Bank fell to zero and the PRA facility was used infrequently from that point onwards.

The 1954 revision to the Bank Act was also a key factor in the development of the money market in Canada. A new system of calculating minimum required bank reserves held at the Bank of Canada was introduced under the revised Bank Act. Under the new system, the banks were able to calculate in advance their required minimum deposits at the Bank of Canada, since the requirement was based on a monthly average rather than on a daily basis as had been the case previously. The new system required banks to maintain a minimum monthly average of 8 per cent of their Canadian dollar deposits. This change, along with the banks’ more extensive use of day loans to adjust their cash reserves, contributed to a more active treasury bill market.

Another important initiative was taken in 1956, again following extensive consultation with the banks. The banks agreed to achieve and maintain minimum liquid asset ratios of 15 per per cent of the statutory deposits, that is a secondary reserve ratio of 7 per cent in addition to the 8 per cent cash reserve ratio. Significantly, secondary reserves included excess cash, day-to-day loans and Government of Canada treasury bills. This change had an important bearing on the underlying demand for treasury bills as the banking system grew.

A direct result of these initiatives was that the amount of treasury bills outstanding grew substantially. These initiatives also provided an impetus for the growth of a market in other short-term instruments. Other borrowers began to make use of the money market as an alternative to bank loans, although growth of the money market outside treasury bills remained relatively slow. Some financial companies, as well as non-financial (such as the grain companies), began to issue paper to meet strong seasonal fluctuations in their cash flows.

The next major initiative undertaken by the Bank of Canada in developing the money market took place in 1962. Bankers’ Acceptances (BA’s) were officially introduced in Canada in June 1962 as part of the official effort to encourage a more active money market. Once again, the original guidelines were developed through extensive consultation among banks, investment dealers and the Bank of Canada. One important aspect was that acceptances would be issued by firms to finance only those activities described in Section 18 of the Bank of Canada Act.[6] This was to satisfy the legal restrictions on the Bank of Canada as to the type of assets it could hold on its balance sheet. In order to encourage the involvement of the dealers already designated as jobbers by the Bank of Canada, BA's were added to the list of eligible collateral for PRA from the Bank of Canada and for day-to-day loans from the chartered banks. The Bank of Canada was also prepared, on occasion, to buy and sell eligible BA's for its own balance sheet requirements. [7]

The BA market grew slowly in the early 1960's, in part due to high stamping fees initially charged by the banks. Secondary trading was also very limited, as dealers preferred to hold BA's for their own account. This was very profitable for them, given that they were financed by relatively inexpensive day-to-day loans from the banks. In 1968, the Bank of Canada established a ceiling on the amount of BA's that the jobbers could use as collateral for PRA in order to encourage their circulation in the money market. At the same time, banks were allowed to accept BA's bearing their own stamp as eligible day-to-day loan collateral (up to then only acceptances of other banks had been allowed). Banks also began to take acceptances as collateral against special call loans to dealers and started to purchase BA's for their own accounts. All these developments enhanced the liquidity of the BA market and contributed to its growth.

By the end of the 1960's, the foundations had been laid for the growth of a vibrant money market in Canada. The Bank of Canada had clearly defined objectives behind its actions to develop the money market, and the banking and investment dealer communities were consulted and provided with appropriate incentives to actively participate in the money market. Regulations and governing legislation were amended as required to meet the objectives of both the Bank of Canada and the Government. For example, a key event in the evolution of capital markets in Canada was the removal, in 1967 Bank Act revision, of the aforementioned interest rate ceilings on bank lending. [8]

**Overview: 1970's to present**

Since the mid-1970's, the market for Government of Canada treasury bills and marketable bonds has shown innovation and, until the mid-1990's, rapid growth. The Government of Canada, and the Bank of Canada, have an ongoing commitment to promoting efficient, liquid and competitive domestic capital markets. The Bank of Canada looks at markets as an effective channel for conducting monetary policy and, in recent years, to promote broader stability in the financial system. The government continues to look to the capital markets to provide it with stable, low-cost funding as well as promoting well-functioning markets in Government of Canada securities. Because of the "risk-free" nature of Government of Canada securities, they provide the

6. At the time of their introduction, it was agreed that BA's would be used exclusively to finance the production or marketing of goods, wares and merchandise as defined in the Bank Act. This is an important distinction from BA's which were prevalent in other countries (notably the U.K. and the United States) which were used primarily to finance international trade.

7. The Bank rarely participated directly in the market for BA's. However, the Bank of Canada has recently initiated a program of purchasing (and if required, selling) BA's in the secondary market in order to facilitate the management of its own balance sheet. These activities are conducted through the new classification of investment dealers, called primary dealers, and have neither monetary policy nor market development motivations behind them.

8. Crow, J. (1989 speech to the Toronto Money Market Association

benchmark against which all other domestic fixed income instruments are priced. They also form the basis for other financial market transactions, such as swaps, repos and a host of other financial market derivatives. Government of Canada securities also have been attractive portfolio investments for international investors which has contributed to the market's liquidity.

Over the years, the Bank of Canada and the Department of Finance have worked to improve the efficiency of Canadian capital markets through their own initiatives and by supporting those of others, including various regulatory agencies. This cooperative approach to market development has created an active market for short-term corporate paper and has led the introduction of numerous new products such as short-term interest rate derivatives (e.g. Bankers' Acceptances future contracts, called BAX, traded on the Montreal Exchange and a myriad of over-the-counter derivative products). In more recent years there has also been a rapid growth in securitized commercial paper in the domestic market, and the longer-term corporate market has expanded in Canada after being relatively dormant since the early 1970's. In 1998, for example, net new issues of corporate bonds exceeded long-term issues by the public sector for the first time since 1973.

### Recent Initiatives in the Canadian Market for Government of Canada Securities[9]

In light of the significant improvement in the Government's financial position in recent years, the Department of Finance and the Bank of Canada, in close consultation with a broad range of financial market participants (investment dealers, investors, banks and various regulatory agencies) have focussed their efforts on ensuring a liquid, well-functioning market for Government of Canada securities. This section will briefly outline some of the initiatives.

The improvement of the government's financial situation has meant that there has been an absolute drop in the amount of its outstanding market debt[10]. In December 2000 this debt amounted to Can$414 billion, while in December 1996 it stood at Can$439 billion. The composition of the Canadian dollar denominated debt has also changed dramatically in recent years. Starting in the early-1990's, the government pursued a strategy of reducing the sensitivity of public debt to changing interest rates by increasing the portion of fixed-rate debt from about 50% in 1992-93 to about two-thirds by 1998-1999, where it is now. The average term to maturity of outstanding Government of Canada debt has increased from 4.0 years in 1990 to 6.5 years currently.

In order to maintain a well-functioning domestic market and keep borrowing costs low, the Government focuses on the key aspects of liquidity, transparency, regularity and integrity. For this reason, the government borrows on a regular, pre-announced basis in key segments of the market, builds large bond benchmarks and maintains effective rules for Government of Canada auctions. Market participants are consulted extensively on the government's debt strategy and adjustments to its debt programmes. The Bank of Canada plays an important role in advising the government on its debt strategy and implementing the debt program on behalf of the government as its fiscal agent.

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9. Much of the material in this section is covered in more detail in the Bank of Canada Review. 1999 (Summer) article by N. Harvey. Various publications from the Department of Finance also provide details on different issues and initiatives related to the market for Government of Canada securities.

10. Includes domestic marketable bonds, treasury bills and foreign currency denominated debt; excludes retail debt

The Bank of Canada has also adjusted its own participation at the regular treasury bill and bond auctions to mitigate, to the extent possible, the effect of declining net new issuance. As the government increased the average term to maturity of its outstanding debt, the Bank of Canada reduced its holdings of treasury bills and increased its holdings of bonds to be broadly in line with the structure of outstanding debt. This adjustment was made in part to reflect the way in which monetary policy is implemented in Canada. The framework for implementing monetary policy in Canada has changed dramatically from the days when the Bank Rate was set weekly at 25 basis points above the average yield on the auction of 90-day treasury bills. The Bank's operating target for monetary policy is now the middle of a 50 basis point target band for overnight financing, which the Bank can reinforce if necessary through conducting repo operations (or reverses) with a designated group of primary securities dealers (similar to the previous "jobber" designation). This has meant that the Bank no longer has the same need for substantial holdings of treasury bills on its own balance sheet for potential open market operations. Therefore, the Bank made changes to its own auction participation to reflect not only changes to the manner in which monetary policy was being conducted, but also to ensure that the public float of treasury bills was as large as possible during a period of rapidly declining net new issuance by the government.

The major changes that have affected the amount and issuance of government securities, together with the desire to maintain and enhance market liquidity and efficiency, have led to a number of initiatives on the part of authorities and market participants. Among the measures taken are changes to the auction rules for government securities and their oversight by the Bank of Canada, as well as guidelines governing a code of conduct in secondary markets for fixed income products in Canada adopted by the Investment Dealers Association of Canada (IDA). In addition, the Bank of Canada and the federal government have modified bond and treasury bill auctions to maintain benchmark sizes as large as possible. For example, treasury bill auctions are currently held every second week, and the auction of 30-year bonds is now twice yearly (as opposed to quarterly auctions previously). The Bank of Canada also conducts buyback operations for Government of Canada bonds in order to maintain the size of the benchmark issues and maintain as much liquidity as possible in the secondary market for the benchmark issues. The buybacks are currently held at each regular quarterly auction of two-year, five-year and ten-year bonds as well as the semi-annual auction of 30-year bonds.

The initiatives undertaken in the 1950's and 1960's laid the necessary groundwork for the development of the fixed income market in Canada into one of the most vibrant markets by international standards by the mid-to-late 1980's. Efforts now are directed at preserving the integrity and efficiency of the market for government securities in an era of declining supply.

**Lessons Learned and Challenges Ahead**

This note has looked at a number of initiatives that Canada has undertaken to develop a domestic capital market. The period 1950-1970 was, for the Bank of Canada, a time of intense market-building. Since then, the Bank of Canada, working with the Department of Finance and market participants, has introduced many technical improvements in the market's operations in Canada. Today's system can trace its origin, and successes, to the direct initiatives taken in the 1950's and 1960's. Developing an efficient treasury bill market led to the expansion of private capital markets, both short and long-term, and also provided the public sector with access to the broader capital markets in later years as government borrowing requirements soared through the 1980's into the early 1990's.

The clear and ongoing policy objective of developing an active money market was instrumental to the success of the initiatives undertaken. Financial market participants were willing to work cooperatively with public authorities in an environment that was consistent with their own business interests. One of the overriding objectives, from the outset, was to make the market for Government of Canada securities attractive for investors, both domestic and international. International participation in the secondary market was very important to provide liquidity, especially during periods of large government financing requirements.

The approach Canada pursued almost 40 years ago may not be entirely appropriate in today's world. In particular, Canadian authorities showed preferential treatment to domestic banks and dealers to encourage them to become more active in Canadian fixed income markets, especially those for Government of Canada securities. Even today, primary dealers of Government of Canada securities are required to maintain trading operations in Canada in order to have direct access to auctions and, for some, lines of credit from the Bank of Canada.

In addition, Canada undertook initiatives that provided domestic firms, and in later years, foreign firms with Canadian operations, with appropriate incentives to expand their capital markets activities. However, today, the environment is dramatically different. Smaller financial centres, such as Canada, are faced with different competitive forces as financial markets have become more globalized and improvements in communications and information technology have changed the economics of capital market activities, especially those related to government fixed income securities. The continuing movement towards a more globalized economy presents challenges to public authorities as they strive to pursue policies that preserve and enhance the continued efficiency and competitiveness of capital markets.

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