

CENTRAL BANKING IN CANADA

by

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## Chapter I.

### Introduction.

Referring to the world's present state of "economic anarchy" in the course of his statement before the monetary committee of the Imperial Economic Conference held at Ottawa last summer, the Hon. N. C. Havenga, leader of the delegation of the Union of South Africa, said:

"But we lack the gear-lever which will link up the machinery of production through universal joints to the differential of consumption which will set in motion the wheels of progress!"<sup>1</sup>

If, in Canada, as elsewhere, only palliatives have resulted from our "anti-depression" efforts, and if all the fundamental forces which brought about our present trouble are still operating, at least an increasing number of people are trying to find the required "gear-lever" in the control of money and credit. In doing this they are in good company, for the "MacMillan Committee" of financial experts in Great Britain in 1931 described the drastic fall in the price level throughout the world as

".....a monetary phenomenon which has occurred as the result of the monetary system failing to solve successfully a problem of unprecedented

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1. Report of the Imperial Economic Conference, Ottawa, 1932, p. 127.



"difficulty and complexity set it by a conjunction of highly intractable non-monetary phenomena."<sup>2</sup>

With the control of monetary systems is closely linked the question of central banking. Hence we have recently been witnessing a strong demand for a central bank in Canada and an equally forceful denial of the need for such an institution.

The advocates of the central bank find the time most opportune from their point of view. Canadian bank charters are granted for periods of ten years. The charters were last extended in 1923. Normally, then, a decennial revision of the Bank Act would have taken place in 1933. Stating as its reasons, however, that a thorough inquiry into the entire banking and monetary system was desirable before another revision, and that it wished to await the outcome of the proposed world economic conference, the government on February 15, 1933, asked for and received permission to extend the existing charters until July 1, 1934.<sup>3</sup> Interest that was aroused in anticipation of a revision this year will now be focused on the parliamentary session of 1934. Past revisions have not usually aroused very general interest. Owing to the fact, however, that the

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2. Report of the Committee on Finance and Industry, London, June, 1931. (The MacMillan Report.) p. 93.

3. House of Commons Debates, Feb. 15, 1933, p. 2275. See also House of Commons Debates, March 21, 1933, p. 3444.

present depression has caused economic subjects to be more widely and more deeply studied than ever before, the coming revision is already arousing widespread interest. This unusual interest on the part of the general public, together with the proximity of the date of revision of the Bank Act, gives encouragement to those who would have a central bank created in Canada.

Looking back beyond the immediate present the central bank protagonists find support in the banking tendency of the post-war period. In 1920, when the International Financial Conference met in Brussels, one of the resolutions which it passed was to the effect that ".... in countries where there is no Central Bank of Issue one should be established."<sup>4</sup>

Before the war many of the advanced commercial countries, such as Great Britain, France, Italy, Germany, Japan, the United States, Australia and others had central banks, but since the war central banks have greatly increased both in number and in scope. The year 1920 saw the organization of the Czecho-Slovak National Bank and the South African Reserve Bank. In 1922 the Genoa Conference of the League of Nations advised the establishment of a central bank by

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4. Kisch and Elkin. Central Banks. p. 2.

each of the newly-created states of Europe, and recommended "that such central banks should stand in close relationship to the governments of the countries in which they were located."<sup>5</sup> The years that have followed have seen the creation of many central banking institutions. Out of the Dawes Plan came the reorganization of the German Reichsbank. Central banks were instituted in Soviet Russia, in some of the Balkan countries, in certain of the countries hewed out of territory that had belonged to the empires of Austria and Russia, and in a few of the South American states. A reserve bank was planned for India, but the plan has since been dropped. The most recent, and to Canadians the most interesting, development in central banking circles, however, is to be found in New Zealand. In 1930 Sir Otto Niemeyer of the Bank of England surveyed the banking system there. Following his recommendations, as Hon. J. G. Coates, Minister of Finance of New Zealand, says:

"The Government is going ahead with a plan to establish a federal reserve bank in New Zealand. Our idea is that there should be an Empire chain of central banks, and New Zealand is going to supply her link."<sup>6</sup>

The extent of the growth of central banks may best be pictured, however, from the following table adapted from a

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5. Willis and Beckhart. Foreign Banking Systems. p. 10.

6. The Financial Post, Toronto, Dec. 17, 1932.

list given in "Foreign Banking Systems", by Willis and Beckhart.<sup>7</sup> It will be seen that this bears out the statement of Kisch and Elkin that, "The lack of a Central Bank is now exceptional in advanced countries."<sup>8</sup>

1656	-	Bank of Sweden
1694	-	Bank of England
1800	-	Bank of France
1809	-	Bank of Finland
1814	-	Netherlands Bank
1816	-	Bank of Norway
1817	-	Austrian National Bank
1818	-	National Bank of Denmark
1821	-	Bank of Portugal
1828	-	Bank of Java
1829	-	Bank of Spain
1835	-	National Bank of Belgium
1842	-	National Bank of Greece
1859	-	Bank of Italy
1875	-	German Reichsbank
1880	-	National Bank of Roumania
1882	-	Bank of Japan
1883	-	National Bank of Serbia
1885	-	National Bank of Bulgaria
1896	-	Bank of Uruguay
1898	-	National Bank of Egypt
1905	-	Swiss National Bank
#1912	-	Commonwealth Bank of Australia
#1914	-	The Federal Reserve System of the United States
1920	-	Czecho-Slovak National Bank
1920	-	South African Reserve Bank
1922	-	Bank of Latvia
1922	-	Bank of Lithuania
1922	-	Reserve Bank of Peru
1922	-	State Bank of Russia
1924	-	Bank of Danzig
1924	-	Bank of Poland
1924	-	National Bank of Hungary
1925	-	Central Bank of Chile
1927	-	Bank of Esthonia
#1933	-	Bank of New Zealand

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7. Willis and Beckhart. Foreign Banking Systems. p. 10.

8. Kisch and Elkin. Central Banks. p. 11.

# Additions by writer.

It is not without powerful and reputable opposition, however, that the march towards more and greater central banks goes on. The bankers of New Zealand, for instance, have been united in protest against the declared policy of the government to found a central bank there, and the very able Minister of Finance, the Hon. Downie Stewart, has resigned from the cabinet owing to disagreement with the other members of the ministry on banking and monetary policy. In Canada, too, the banks appear to be a unit in resisting the proposal that a central bank be organized here. During the past few months annual meetings have been held by the ten Canadian chartered banks and by the Canadian Bankers' Association. At these meetings a public declaration of attitude towards the proposal for a central bank for Canada has been made by:

Mr. J. A. McLeod  
President of Canadian Bankers' Association  
Sir Charles Gordon  
President of the Bank of Montreal  
Mr. M. W. Wilson  
General Manager, Royal Bank of Canada  
Mr. S. H. Logan  
General Manager, Canadian Bank of Commerce  
Mr. J. A. McLeod  
General Manager, Bank of Nova Scotia  
Mr. A. E. Phipps  
General Manager, Imperial Bank of Canada  
Mr. H. B. Henwood  
General Manager, Bank of Toronto  
Mr. C. A. Bogert  
General Manager, The Dominion Bank  
Mr. C. A. Roy  
General Manager, The Provincial Bank of Canada

Mr. Beaudry Leman

General Manager, Banque Canadienne Nationale

It will be noted that the only bank not represented in the above list is Barclay's (Canada). There was no definite expression of opinion given at the annual meeting of this bank by the president, Sir Robert Borden. Whether the ten bankers listed above were expressing their own personal opinions, or "official" opinions, or both, is not clear, but without exception the attitude expressed is one of stern warning against and strong opposition to the suggestion of a Canadian central bank. They object to such a bank on the grounds that it would be dangerous to disturb the present banking system with its proven efficiency, security, and stability; that there is grave doubt as to the efficacy of central banks generally; that there would be danger from the political factor; that in a country like Canada, which is a debtor country and has no money market, a central bank could not function adequately; that a central bank could not create any more credit than already exists; that the cost would be burdensome; that in any case we have in the Finance Act all that is needed in the way of central banking machinery. Sir Charles Gordon, President of the Bank of Montreal, says, for instance, "There is no need of a central bank in Canada. For all practical purposes such an agency already exists under the

"Finance Act, which for eighteen years has admirably performed its purpose."<sup>9</sup> Mr. M. W. Wilson, General Manager of the Royal Bank of Canada, expresses himself as follows:

"I have frequently said, and still believe, that the banking system of Canada adequately serves the needs of this country. .... I confess a reluctance to tinker with our financial machinery in a time like this."<sup>10</sup>

The President of the Canadian Bankers' Association, Mr. J.

A. McLeod, says in part:

"I have, perhaps, said enough to make it clear that the projected establishment of a central bank in Canada raises some exceedingly difficult problems, and is not without elements of danger. It is not my intention (nor would you wish me to do so) to take a position on this great question at the moment. Nevertheless, because the project is surrounded with such difficulties, you will agree with me that the time has come when, in no controversial spirit, the bankers should make their views known to the public."<sup>11</sup>

Thus we see that expressions of opinion supporting both sides of the argument with respect to central banking in Canada have come from sources that have great weight and must command attention. If we add to these the innumerable articles written by newspaper editors, and by contributors to popular magazines, to the "financial page",

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- 9. The Vancouver Daily Province, Vancouver, B.C., Dec. 5, 1932.
  - 10. The Vancouver Sun, Vancouver B.C., Jan. 12, 1933.
  - 11. Mr. J. A. McLeod, Presidential address to annual meeting of Canadian Bankers' Association, Toronto, Nov. 10, 1932 -- private copy.

etc., we assuredly have need to "read not to believe but to weigh and consider."



## Chapter 2.

### The General Functions of a Central Bank.

It is essential, therefore, that if the question of a central bank in Canada is to be "weighed and considered" impartially, we should have an informed conception of what such an institution is and what its chief functions are. In the first place it must not be confused with the many so-called "national" banks of various countries, functioning in the same way as ordinary private banks. There are many banks in the United States, for instance, bearing the name "national" that have no more truly national significance than, say, "National Biscuits", or the "National Waste Manufacturing Company". On the other hand all central banks are national in that they have a nation-wide influence. Some of these are privately owned and completely independent of the government, such as the Bank of England and the German Reichsbank. Others are national in the additional sense that they are true state organizations, such as the Federal Reserve Board of the United States, the Riksbank of Sweden, and the Commonwealth Bank of Australia. Whether independent of the government or fully state-controlled, however, a central bank may, in a broad general way, be regarded as playing

three main rôles--a bankers' bank, a government's bank, a "people's" bank.

The chief feature which distinguishes a central bank from an ordinary commercial bank is that it is essentially a bankers' bank. Though some central banks do a certain amount of business directly with the public, the central bank as a rule does not enter into competition with the other banks. Its chief customers are the commercial banks and other financial houses rather than the general public. It is to the ordinary banks as those banks are to the people. Just as private individuals and corporations deposit their funds with their bank, so the central bank is the depository of the cash reserves of the commercial banks. This concentration of cash in one central storehouse reduces the total volume of reserves needed by the whole banking system and hence makes for more efficient use of these reserves than if they were immobilized in the hands of a number of banks. Such centralization is also necessary if the central bank is to be able to exercise credit control over the banking system. The central bank also performs a great service for the commercial banks by acting as a clearing house agency. These banks may settle their clearing house balances by drawing cheques upon their reserve balances in the central bank.

This largely eliminates the cost of transferring cash from one bank to another under police protection. Again, just as many private banks issue notes to the public, so does the central bank issue currency to member banks. Loans, too, may be made by the central bank to commercial banks against deposited collateral, just as an ordinary bank may issue loans to individuals on satisfactory securities. Another fundamental function of a central bank is that of rediscounting. When a private individual gets short of ready cash he may, if he is fortunate enough to possess bonds, or good notes or bills of exchange, take these to his bank as collateral security for a cash loan. In the same way, when a commercial bank becomes overloaded with commercial paper or securities, and has reached its loanable capacity, it may go to the central bank and have its paper rediscounted for currency. Finally, the central bank is largely responsible for the solvency of the whole banking system of the country.

A leading function of a central bank today is that of acting as the government's bank. Usually it is the depository of the government's funds and of its gold reserves. The government is one of its chief customers. The "MacMillan Committee" of British financial experts said in 1931:

"In practice the tasks which have been imposed upon the central bank make it imperative that it should hold the account of the government, for the financial operations of the government are conducted on a scale so great as seriously to derange the money market unless special measures are taken to counteract the inconveniences which result from the inflow of revenue or the temporary easiness which results from interest and dividend payments. This task ought to devolve upon the central bank in virtue of its general function as guardian of the money market, and does in fact devolve upon it when it carries the Government account."<sup>12</sup>

The central bank also becomes the fiscal agent of the government, receiving tax funds, advancing short term loans in times of temporary shortage, and in many other ways acting as an intermediary to smooth the relationship between the Department of Finance and business. At all times it must be ready to make large payments, national or international-- payments which may seriously involve the "transfer problem"-- transactions which few private banks would be prepared to arrange. Speaking of the Commonwealth Bank of Australia, Willis and Beckhart say:

"....some reference should be made to the war services it rendered. More than anything else these services have given the institution its present authority and high place in the mechanism of Australia banking. .... the arrangements it made for the raising of war loans in Australia, a country hitherto quite unacquainted with the flotation of large security issues."<sup>13</sup>

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12. Report of the Committee on Finance and Industry, London, June, 1931. (The MacMillan Report). p. 16.

13. Willis and Beckhart. Foreign Banking Systems. p. 87.

Similarly, remembering the huge financial operations of the United States during and after the war, informed persons consider that it was an exceedingly happy circumstance which brought the Federal Reserve system into existence in 1914. Then again, representatives of the central bank instead of the government, may often represent the country at various conferences where the expert knowledge of the financial condition of the country is required. Then, too, when it assumes the duty of issuing the legal tender notes of the country, as previously mentioned, it performs a government service.

In addition to being a bankers' bank and a government's bank, however, the central bank is coming to be regarded by many as a "people's" bank. Its vast power is not just a privilege, but is bound up with heavy burdens and serious responsibilities. Willis and Beckhart point out that many people are of the opinion:

".... that a central bank should be at hand as a mechanism for controlling and directing movements of prices, for forcing other (non-central) banks to accept the orders of the government, and to cooperate with it in carrying out its projects, and for controlling the money market situation on behalf of government operations. It has thus come about that the advocacy of central banking and the effort to enlarge its breadth and powers has taken shape as a "social" movement."<sup>14</sup>

With this "social" function in mind, advocates of a central bank maintain that control of money and credit is a prime function of government, and that that function should be vested in a state-controlled institution exercising its powers in the interests of the people as a whole rather than having it operated in the pursuit of profit for the shareholders of a private institution. With something of this in mind the "MacMillan Committee" remarks:

"It follows that the functions of a central bank and the obligations resting upon it are of a very special character, calling for skill, experience and judgment of a kind different from those which must be possessed by commercial bankers. No banker can neglect the rules of prudence and of safety, but the object of a commercial banker is to make a profit. The situation of the Central Bank is such that it must often undertake operations which are not only not profitable, but result in losses. Its aim must be the safety of the financial system and the economic welfare of the country."<sup>15</sup>

Of similar opinion is a Canadian authority, Mr. A. F. W. Plumptre, lecturer in money and prices at the University of Toronto. A series of articles by him appeared in The Financial Post late in 1932 on the problem of a central bank for Canada in the light of foreign experience and of Canadian conditions. Expressing himself in favor of such

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15. Report of the Committee on Finance and Industry, London, June, 1931. (The MacMillan Report.) p. 16.

a bank for Canada he does so on the basis of the benefits to be derived from its "social" function in the sense suggested above. After enumerating six objects of a central bank, all of which are included in the outline of functions above, he indicates that it is the sixth object which would really make the gain worth the cost. This sixth object he defines as follows:

"To ensure that credit and note issue were controlled, not for private profit but in the public interest."<sup>16</sup>

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16. Plumptre, A. F. W. A Central Bank for Canada. p. 21.

### Chapter 3.

#### The Control of Money and Credit and the Central Bank.

If, then, this "social" function is as important in central banking generally as the MacMillan Committee would seem to indicate, and if in Canada, in particular, it is the all-important feature relative to a central bank, as Mr. Plumptre declares, it is highly necessary that it should be thoroughly analyzed. Nothing has yet been said here, for instance, as to how this supposedly desirable function may be carried out by a central bank. Yet the whole question is highly controversial. In succeeding paragraphs an attempt will be made, therefore, to explore briefly the possibilities of control of money and credit generally and the so-called "management" question, and in the light of knowledge thus gained a detailed examination will then be made into the situation in Canada, past and present, relative to the same problem.

If control of money and credit is to be exercised intelligently in Canada the first necessity is that the objectives of such control be clearly defined. In general we think of two main purposes, (a) the control of foreign



exchange rates and (b) the control of the general price level.

For the sake of commerce and for the purpose of facilitating international financial transactions in general, we usually desire reasonably stable foreign exchange. At times, of course, a country may, as a matter of policy, deliberately create an exchange disparity, such as when New Zealand recently manipulated its exchange to achieve certain ends. New Zealand is vitally concerned with the export of agricultural products, and she hoped that depreciation of her currency would encourage these exports. On the other hand, if a rise in internal prices should accompany this depreciation, the burdens of the depression would be redistributed within New Zealand. Both these ends might be attained in a measure if the rise in home prices should be small enough to leave a disparity between this rise and the rise in the price of foreign money.

In Canada during the past year we have had very real and painful experience with an uncontrolled exchange. Importers and exporters, as well as those who have had debts to pay in American or other funds, have been confronted with continuous changes in exchange rates. They have had to pay a premium of from ten per cent. to twenty per cent. on American dollars, but have been able to

obtain English pounds at a discount of from ten per cent. to twenty per cent. Canadian importers and debtors have not enjoyed the advantages of an exchange rate at par with the United States, and our manufacturers and exporters have not had the advantages of a par exchange with sterling. It is generally admitted now that the trade arrangements made at the Imperial Economic Conference at Ottawa last summer were largely invalidated within two months by exchange handicaps. Worst of all, perhaps, was the uncertainty of the rates. The trouble seems to have been that there was no central, responsible, directing authority planning or pursuing any policy at all. There is room for great difference of opinion as to what policy should have been adopted. Many believe that it should have been our policy to adhere strictly to the gold standard, thus maintaining a parity between our currency and those of other 'gold' countries--assuming, of course, that this could be done. Others maintain that we should have depreciated our currency to the level of sterling and should have stabilized it there. In other words we should have joined the "sterling bloc". Still others assert that we should have tied our money neither to gold nor to sterling, but should have fixed a standard of our own based on commodity price indexes. Since Canada returned to the gold standard in 1926 her official monetary policy has been the

first one outlined above--that of stabilizing her exchange by adherence to the gold standard. Whether or not this was the wisest policy, the unfortunate point is, as will be shown in a later section, that the Finance Act (our substitute for a central bank) permits unlimited inflation, and is, therefore, in its very principle, opposed to the successful functioning of the orthodox gold standard. In other words, while our policy ran in one direction our "machinery" ran in the opposite direction, with resultant instability in our exchange. Our first objective, then, in the control of money and credit, should be to determine upon a monetary policy and then "stick" to it and see that it is carried out.

So much for the objectives of foreign exchange control. Price control, on the other hand, aims at preventing injustices between debtors and creditors; guarding savings against loss through currency depreciation; increasing the regularity of employment; lessening the extremes between booms and depressions; preventing one class of income from increasing at the expense of another through monetary phenomena; avoiding social friction and disturbance generally, etc. Low prices are not necessarily harmful. Neither are high prices. It is the change in the level of prices that causes the suffering attending business

depressions and booms, because there is inequality of gain and loss between various economic groups. The objective of price control in Canada, then, would be the smoothing out of the peaks and valleys of our price history.

Having stated what might be the objectives of monetary control in the common interest, it will next be necessary to see if their attainment is possible, and if so, how. Let us, then, consider the possibilities of control of foreign exchange.

It has generally been considered that the best way to maintain stability in foreign exchange is to adhere strictly to the gold standard. Before the World War most 'gold' countries maintained a system whereby the standard unit of account and of value was defined by statute as a fixed weight of gold of a specified fineness; this gold unit was made full legal tender; there was free (unlimited) coinage of gold; reserves of gold were used to ensure unrestricted and free convertibility of all paper money into gold at par; there was freedom of exchange back and forth between gold in the form of money and gold in the industrial arts; and the import and export, or the international movement of gold, was untrammelled. This system was regarded as "automatic". There was no political "management". The number of units of purchasing power

depended upon the productiveness of the gold mines and the extent to which gold was used in the industrial arts. Exchange rates were kept moderately stable by reason of the fact that if they rose above, or fell below, the specie points, gold would be exported or imported to effect international adjustment of balances of payments instead of buying or selling foreign exchange. It was this "automatic" system that had been in force in the province of Canada or in the Dominion of Canada for the sixty years preceding 1914, and again from 1916 to the end of 1928 when operations under the Finance Act pushed us off the edge of the gold standard. Whether or not that was the best system for Canada then, or would be the best now, will not be argued here. What interests us now is simply that such was the system used, and in such a way did Canadian and most other exchange rates operate.

Since the Great War, however, the gold standard has undergone many changes. Thus we speak of gold exchange or gold bullion standards. The monetary unit of a country having such a standard is still defined as a fixed weight of gold, but this unit is derived by linking the domestic unit with the gold unit of some other country having a more orthodox gold standard. Hence unlimited coinage of gold is usually prohibited, convertibility of

currency into gold is abandoned, export of gold is restricted, et cetera. Then, again, reparations and war debt payments, the monetary and banking habits of a people, central bank policies, arbitrarily fixed exchange rates, tariffs, quotas, dumping duties, and all the other impediments to international trade have radically modified the "automatic" nature of the gold standard. Therefore we find the MacMillan Committee saying, "The sense in which the gold standard can be said to be automatic is thus very limited."<sup>17</sup> Hence the same committee takes it for granted that under the gold standard there has been, and must be, management, ".... but the action to be taken and the precise moment at which it should be taken, remain in the sphere of discretion and judgment, in a word, with "management".<sup>18</sup> Dr. Gustav Cassel not only maintains that money and exchange rates have been managed but that a great deal of our trouble is due to the fact that they have been badly managed.<sup>19</sup> Whatever may have been the case in the past, therefore, we cannot now look for stability of foreign exchange in any so-called "automatic" system.

What, then, are the possibilities of management or

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17. Report of the Committee on Finance and Industry, London, June, 1931. (The MacMillan Report.) p. 21.

18. Ibid.

19. The Crisis in the World's Monetary System, Chapter I.

control of exchange? The MacMillan Committee speaks of:

"Certain technical devices for directly influencing the foreign exchanges, namely, sales or purchases of foreign balances (i.e. so-called "gold-exchange" methods), dealings in foreign exchange, and small variations in the Bank's buying price for gold."<sup>20</sup>

Early in the course of the Great War the British Government determined to stabilize the rate of exchange between sterling and the American dollar. During the first few months a heavy demand for funds in England, as foreign securities were sold, led to a high exchange rate in New York. Then the heavy imports of goods from the United States lowered the rate in New York. Gold could not be shipped from England, so sterling fell further in the United States. Then the British Government, by purchasing American securities in England and by negotiating a large loan in the United States, was able to "peg" the pound at \$4.76. There the pound was kept until after the war. More recently when sterling dropped rapidly in New York as a result of Britain going off the gold standard in September, 1931, the British Government established an "Exchange Equalization Fund" to be used, as the name suggests, to moderate the fluctuations between the pound and the dollar. Information is lacking as to the degree of success or failure of the

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20. Report of the Committee on Finance and Industry, London, June, 1931, (The MacMillan Report). p. 152, Sec. 356, (4).

plan, but a Canadian banker, who does not wish to be named, predicts the failure of an "experiment which will have cost upwards of \$150,000,000". Whether this banker means that the fluctuations will not have been mitigated, or the fund will not show a profit, or both, he does not say. It is not our purpose at this stage to pass judgment upon the wisdom, or otherwise, of attempts to control foreign exchange rates. It is interesting to note here, however, that Dr. Cassel, speaking to the Royal Institute of International Affairs, London, in September, 1932, on "Monetary Reconstruction", said:

"For these reasons I very much doubt the wisdom of any endeavour to control foreign exchange. You must always remember that to control foreign exchange is to control the relation between the value of your own currency and the value of some other currency. You may be the master of your own currency, but you cannot be the master of the other currency."<sup>21</sup>

On the other hand Mr. A. F. W. Plumptre, lecturer on money and prices at Toronto University, in his recent writings in support of a central bank for Canada says:

"Therefore, a proposed Canadian central bank should be thought of not so much as a bank of note issue and Finance Act rediscount, but rather as a bank of exchange rate control."<sup>22</sup>

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21. Cassel, Dr. Gustav. International Affairs, September, 1932, p. 665.

22. Plumptre, A. F. W. A Central Bank for Canada, p. 20.



It can scarcely be said on evidence discernible that Canada has made up her official mind on the relative merits of control or laissez-faire with respect to exchange rates. Generally she has been blissfully unconscious even of the existence of such a problem. Late in 1931, however, the government called a meeting of Canadian bankers to consider the advisability of organizing a foreign exchange market.<sup>23</sup> The idea was that Canada might thereby be enabled to make her own exchange rates with other countries independent of New York and thus prevent the latter from depreciating Canadian money. The meeting evidently decided that the proposal was unwise, but another plan was decided upon. This was to ease the pressure on the exchange rate by preventing the export of Canadian capital.<sup>24</sup> An unofficial attempt was made to persuade Canadians not to buy foreign securities and not to recall Canadian securities from abroad by purchase. To a certain extent, therefore, foreign funds were retained in Canada. This attempt at control of the exchange was given up, however, after a few weeks of half-hearted effort. At present official efforts towards control seem to be limited to exhortations on the

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23. The Mail and Empire, Toronto, December 16, 1931--quoted by C. A. Curtis, in "The Canadian Monetary Situation".

24. The Mail and Empire, Toronto, December 22, 1931--quoted again by C. A. Curtis.

virtues of "proud" or "sound" money with the apparent hope that confidence in our credit will be thereby instilled in the minds of foreigners and fortitude and faith will continue to be an attribute of the Canadian mind, the grounds for such pride, soundness, and faith being conveniently left to the imagination.

In the past it seems not to have been the policy of either the banks or the government to exercise control over our exchange rates. Until the passage of the Finance Act in 1914 such matters were entirely in the hands of the banks, but there is no evidence that they exercised their powers in this respect. Since 1914 the responsibility for such control has rested with the Department of Finance, but there has been no manipulation of interest or discount rates with the object of regulating the exchange. Neither do the banks to-day practise such control. Recently an authoritative spokesman of each of four of our largest banks was asked the question:

"Does your bank, along with other banks, vary interest or discount rates with the purpose of regulating foreign exchange?"

With one slight modification the answer was an unqualified, "No". One answer went on to show that such an attempt at regulation would be fruitless and possibly harmful. Indeed Canadian bankers generally seem to see great difficulties

and little hope of success in attempts at exchange control. In the Financial Post<sup>25</sup> of Toronto recently have been appearing a number of articles in opposition to the suggestion of a central bank, by one who signs himself, "A Canadian Banker", and who claims to express the views of the Canadian Bankers' Association. One whole article, practically, is devoted to discouragement of the idea of exchange control.

Some of the effects of central bank control of the foreign exchanges should be considered. It has frequently the effect of a protective tariff. It is likely to create or perpetuate a condition of dis-equilibrium in international price levels. In addition, to the extent that exchange control protects certain industries, it is open to the familiar objections to tariff protection. The most effective export industries are handicapped because the restrictions reduce foreign demand by reducing the means of payment and because they may be placed at a disadvantage in securing raw materials. The reduction in total trade reduces specialization, and the unit cost of transacting a smaller volume of trade will probably be increased. The use of exchange restrictions to force exports and resist imports

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25. Financial Post, Toronto, January 7, 1933.

may exert a depressing influence on commodity prices and injure the very country that imposes the restrictions.

If a country has an international standard, such as the gold standard, its monetary control agency will likely consider that its first and fundamental duty is to maintain the domestic currency at par with gold. This may mean that the domestic currency will be maintained at an artificially high value by restrictive legislation. If so, exports will be discouraged. To the extent that the exchange rate prescribed overvalues the local currency, as is usually the case, the effect is to raise the prices of commodities to foreign buyers, relative to the prices that would otherwise prevail. Exports are thus impeded. For instance, after England returned to the gold standard in 1925, she used the movement of exchange rates as a guide to bank policy, and economic policy had to conform. The artificially high valuation which she placed upon her currency put her at a disadvantage in international trade. Depression and unemployment were thereby intensified.

Discount rate regulation is fairer than exchange restriction. It does not cause anyone to be arbitrarily excluded from obtaining funds. Those whose need and economic strength are the greatest are assured of accommodation by the very fact that the less urgent demand is excluded by

the higher rate exacted. Exchange control is subject to the arbitrary judgment of individuals. The weakest, rather than the strongest, may survive. Besides, exchange control is often tinged with mercantilism, nationalism, and the selfish interest of influential individuals.

If there existed an effective international bank, if the world's central banks were working in intelligent co-operation, if we had an agreed estimate of the present stock of gold available for monetary purposes, and if the amount of new gold likely to be added annually were known, then gold could be so used as to keep its commodity purchasing power from varying greatly. But these conditions do not exist. Hence the value of gold is determined by the monetary policies of the leading 'gold' countries. If, then, Canada controls her exchange to maintain her money stable in terms of gold, her economic policies have to conform, and her price level fluctuates with the gold prices of the leading 'gold' country--the United States. The monetary policy of the United States in recent years has been such as to cause progressive depression of commodity prices.

Whatever the merits or demerits of attempts at control of foreign exchange may be, the fact is that practically nothing has been attempted in that connection in Canada.

Should active regulation be considered in the future, study should be given to the possibilities in the following<sup>26</sup>—arbitrage, forward buying, the balancing of the budget as a regular policy in normal times, a normal balance between imports and exports, discount rate regulation, central bank foreign balances, foreign loans when necessary, and regulation of the quantity of home currency and of the domestic price level.

Having now considered some of the possibilities and methods of foreign exchange control let us next consider price regulation in the same way. Here again we have a subject that is extremely controversial. In the Quantity Theory of Money we find expressed the relation between money, credit and prices. Stated simply this theory is that, other things remaining the same, the purchasing power of money and credit varies inversely with the quantity in circulation. It is now acknowledged by its supporters that many circumstances enter in--such as business psychology, the use to which money is put, rapidity of circulation, the quantity of commodities, et cetera--to distort the relationship expressed in this theory. At least it is true, however, as Lionel D. Edie says:

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26. Largely based on the suggestions of Lionel D. Edie in "Money, Bank Credit and Prices", p. 56.

"That an increase of the quantity of money raises prices, and a diminution lowers them, is the most elementary proposition in the theory of currency, and without it we should have no key to any of the others."<sup>27</sup>

This theory has an important bearing upon the relation between the gold standard and international prices. Among the causes that are tending to affect the general level of prices is a fluctuation in the ratio between the supply of and the demand for gold. Those countries which adhere to the gold standard have tied their fortunes to the unknown factor of the future demand for and supply of gold. Gold as a money basis has achieved significance by reason of its scarcity. The most important demand for it is for monetary use. It is of great importance, then, that consideration should be given to the quantity of gold available for monetary purposes.

According to the calculations<sup>28</sup> made by Mr. Joseph Kitchin in 1931, the net annual increase of monetary gold necessary to maintain stability of the commodity price level would be from 3.1 per cent. to 3.4 per cent. if the world's rate of development did not slow down. On the other hand he estimated that for the twenty years following

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27. Edie, Lionel D. Money, Bank Credit and Prices. p. 188.

28. Kitchin, Joseph. The International Gold Problem. p. 68.

1930 the probable net increase would be 1 1/2 per cent. Assuming, then, that the existing available supply of monetary gold is not great, and that future production is more likely to decrease than increase, only drastic economies in the use of gold as a basis for the super-structure of credit can prevent a steady fall in commodity prices.

It will be well, then, to examine some of the factors bearing on the use of gold in recent years. A tremendous saving has taken place owing to the decrease of gold coins in circulation and the vast increase in the use of cheques and credit generally. On the other hand the return of so many countries to the gold standard following the war increased greatly the world's total bank reserve requirements. According to M. Charles Rist,<sup>29</sup> during the four years centering around 1925, twenty new countries contributed to the extension of the area of the gold standard. Perhaps the greatest cause of the inefficient use of gold, however, is to be found in its mal-distribution. The payment of war debts and reparations, and the growth of nationalist economic policies, together with the absence of any great degree of international co-operation, brought about

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29. Rist, Charles. The International Gold Problem. p. 195.



movements of gold on an unprecedented scale. The net result was that the United States and France acquired far more than their proper share of the world's gold supply, with the consequence that other nations, such as Germany and Great Britain, had too little.

Given a limited supply of gold to begin with; a decrease in production of new gold; an increase in central bank reserve requirements; huge international transfers of funds necessitated by payments of war debts and reparations; impediments to the free movement of goods owing to nationalistic economic policies; and the mal-distribution of gold; it is not surprising that a drastic fall in the price level took place, and many countries were forced off the gold standard. If, then, the gold standard is to be maintained in the future; if those countries which have abandoned it are to return to it; and if there is, at the same time, to be stability in commodity prices, many of those causes cited above as responsible for the present situation, will have to be removed.

In addition to the economies in the use of gold already suggested as possible in the above discussion, there remains the great saving that could be made if bankers and the public generally understood the true function of gold to-day. Gold is no longer necessary as backing for notes. Furthermore

it is not now in reality used as such. Yet citizens who can not get gold for notes, and bankers who have not the gold to give for notes, still imagine that gold backing is desirable. On this point it will be well to hear the views of two eminent economists. Sir Cecil Blackett says:

"The idea that you keep gold for the purpose of making the internal currency of any country, or any Western country at any rate, convertible, is one which ought to be exploded right away. It would be a tremendous gain if we could get people to understand that just that amount of currency is required in a country which is enough to keep prices stable..... and the amount of gold that is required ought not to have any direct relation to the amount of currency that is out.

"The amount of gold that a central bank requires, if we could persuade public opinion to see the truth, is the amount that will make it perfectly safe for meeting an external balance of payments against it at any given moment. That ought to be the sole purpose in a peaceful world for which a gold reserve is kept--to meet an external balance of payments that is against that country."30

Mr. J. M. Keynes says:

".... the gold which a central bank holds ought to have no particular relation to its note issue.....the right criterion for the amount of the gold reserve is the amount of the sudden demands that a country may be subject to internationally before it can take other measures of regulation....."31

It is vitally important, then, that the proper function of gold should be understood. Its misuse had been a leading

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30. Blackett, Sir Cecil. The International Gold Problem. p. 179.

31. Keynes, J. M. The International Gold Problem. p. 186.

cause of the recent drastic fall in commodity prices. With intelligent management, and a reasonable degree of co-operation, however, the central banks of the world could dictate gold's value in terms of other commodities. In short, wise monetary policy could maintain a reasonable degree of stability in international prices.

Before going on to explore the means by which control of prices is attempted it may be well to examine the evidence both of the opponent and of the advocate of such control. Owing partly, no doubt, to the fact that a time of depression makes reforms popular, there are not as many witnesses in defence of our present system as there are proponents of greater price regulation. One of the strongest cases made against central bank price control is that made by a very noted American banker, Dr. Benjamin M. Anderson, Economist of the Chase National Bank of the City of New York. In his bank bulletin of May 16, 1932<sup>32</sup>, he attacked the Goldsborough Bill because it directed the Federal Reserve authorities to raise and stabilize the general average of commodity prices. After describing "the old-fashioned doctrine" relative to central bank policy he says:

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32. The Chase Economic Bulletin, May 16, 1932. The Goldsborough Bill and the Government Security Purchases of the Federal Reserve Banks.

"Whereas the new theory asks central banks to stabilize the commodities market, I maintain that they have a great task in steadying the money market."<sup>33</sup>

Then he goes on to ask what central banks can do with respect to commodity prices, and answers:

"First they can influence commodity prices only through their influence on the money and capital markets. Second, central bank policy is only one of many factors governing money rates and governing the volume of money and capital available in the money and capital markets.

"There are five main sources of capital: (1) Consumers' thrift, (2) The turning back of business profits, to industry and trade, (3) Taxation, when the proceeds of the taxes are used for capital purposes and very especially the purpose of reducing public debt, (4) Direct capitalization, as when a farmer spends his spare time in building barns and fences, or putting in sub-soil drainage, or when a farmer allows his herds and flocks to grow instead of selling off the annual increase, (5) New Bank Credit, the product of bank expansion, based on excess bank reserves, which may grow out of (a) inflowing gold, or (b) increased central bank credit. It is the abuse of this source of capital which is responsible for our present financial problems."<sup>34</sup>

Continuing his argument he asks what the power of central bank policy is with respect to money and the capital market, and answers:

"First, its direct influence is only on the money market. It can influence the capital market only indirectly as it first affects the money market. Second, in its influence on the money market it can affect only the supply

33. The Chase Economic Bulletin, May 16, 1932, p. 4.

34. The Chase Economic Bulletin, May 16, 1932, p. 5.

"side. Demand it cannot control. Taking money market and capital market together, it can affect the supply side of only one of the main sources of capital, our number (5) above..."<sup>35</sup>

Then he follows up his argument with:

"If it is unreasonable to ask a central bank to fix money rates and interest rates, far more unreasonable is it to ask a central bank to fix the level of commodity prices. Central bank policy is only one factor in the money and capital markets, and the state of the money and capital markets is only one of many factors affecting commodity prices. In no way, except through the regulation of the money and capital markets, can the central banks influence commodity prices, and this influence is an influence at second or third remove and of indeterminate degree."<sup>36</sup>

The same writer then goes on to try to show that the whole Quantity Theory of Money is fallacious.<sup>37</sup> Commenting in approval upon Dr. Anderson's argument, a prominent Canadian banker, who does not wish to be named, says:

"With regard to the regulation of commodity prices, and without going into the matter at length, we think it sufficient to point out that the Quantity Theory of Money in its simpler forms has long been discredited among most modern economists of repute."

With respect to the use of the bank rate as a method of control the same banker quoted Viscount Snowden as follows:

"The effect of the Bank Rate on industry is much exaggerated. I have studied the relation of the

35. The Chase Economic Bulletin, May 16, 1932, p. 6.

36. Ibid., p. 8.

37. Ibid., p. 9.

"Bank Rate to the volume of industrial output and employment over a number of years and it is difficult to find any connection."<sup>38</sup>

In Canada our bankers seem to be almost a unit in opposition to anything in the nature of price control through the monetary agency. "A Canadian Banker", who represents the views of the Canadian Bankers' Association, writing in a December, 1932, issue of the Financial Post of Toronto, says:

"We have been surfeited in the past few months with many positive assurances that credit control by a Canadian central bank will solve our most serious economic difficulties. A much more balanced view was recently expressed to the effect that credit control is by no means easy to exercise in countries such as Canada where the total trade is so vitally affected by the volume and value of the exports of one or two commodities and where these commodities may vary so greatly in price and in the quantity produced, that if harvests are good and prices high attempts to contract are not likely to be successful in checking a boom, nor if short harvests and low prices prevail is it probable that "efforts to pump money into circulation" will be very effective."<sup>39</sup>

In recent weeks practically all the Canadian banks have held their annual meetings. At these meetings the Presidents and General Managers have pronounced their views upon many topics of current interest. They are unanimous in their opposition to inflation as a means of raising the price

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38. Viscount Snowden. London Spectator, October 8, 1932.

39. Financial Post, December 17, 1932.

level. For instance, stern opposition was voiced by Sir Charles Gordon<sup>40</sup>, President of the Bank of Montreal, at the annual meeting in Montreal on December 5, 1932.

Mr. W. G. Gooderham, President of the Bank of Toronto, says:

"Theoretically, a restricted and temporary measure of currency inflation is tempting, but one dose almost invariably calls for another, and who is to say where the line should be drawn? In any event inflation is not the remedy for depressed prices."<sup>41</sup>

Mr. M. W. Wilson, General Manager of the Royal Bank of Canada, admits the need of price adjustment to-day, but does not say how it could be brought about:

"On previous occasions we have stressed the importance of restoring the world price structure to approximately 1924-28 levels. .... The vital necessity for increasing prices is now commonly recognized, but the difficulty of countering deflation increases as the depression continues."<sup>42</sup>

In 1928, the President of the Canadian Bankers' Association, giving evidence before the Banking and Commerce Committee at Ottawa said:

"The Banker is primarily and mainly concerned about the safety of his advances..... He is not thinking about the volume of credit in the country nor the effect which the granting or withholding of credit in the particular

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40. Vancouver Daily Province, Vancouver, B. C., December 5, 1932.

41. The Financial Post, Toronto, January 21, 1933.

42. Ibid.

"instance will have upon the price level of commodities in the country."<sup>43</sup>

A short time ago a responsible official of each of four of our largest Canadian banks was asked the question:

"Does your bank in any way, in co-operation with other banks and the Department of Finance, attempt to influence commodity prices?"

The unanimous answer was, "No".

At the same time they were asked:

"In your estimation could commodity prices and foreign exchange be regulated to a worthwhile degree by co-operation of the banks for that definite purpose or by some agency of the government?"

With one exception the answer was, "No".

On the evidence that has been cited above it is clear that the banks of Canada to-day pursue no conscious policy with respect to the volume of money and credit and have no faith in positive monetary action for the control of prices.

We shall now state the case for control of the price level. In his prize essay entitled, "Price Stabilization", printed in the May, 1932, letter of the Royal Bank of Canada, Mr. J. F. Clark, a student of McGill University, says:

"Sir Josiah Stamp has stigmatized the instability of the value of the monetary unit as the greatest evil of our time. The recent catastrophic fall in prices has shaken the very foundations of our social, political, and

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43. Proceedings of the Committee of the House of Commons on Banking and Commerce, 1928.



"economic structure. It is absolutely imperative, if modern civilization is to endure, to solve the problem of preventing drastic changes in the price level."<sup>44</sup>

After relating some of the difficulties and some of the achievements of central bank efforts to control prices through control of money and credit the same writer says:

"But the essence of the problem of credit control, and so indirectly of the control of business activity and prices by a Central Bank, is to take action in time..... ."<sup>45</sup>

In the March, 1932, Monthly Letter of the Royal Bank of Canada, there appear extensive quotations from Right Hon. Reginald McKenna<sup>46</sup>, Chairman of the Midland Bank, England, which have the approval of the writer of the letter. Mr. McKenna claims that if people are not frightened by the term "managed currency", and are willing to risk exchange fluctuations, they can keep their currency constant in purchasing power either on or off the gold standard.<sup>47</sup>

In a previous paragraph it has been stated that on the basis of their recent utterances the presidents and general managers of our Canadian banks can be said to be practically unanimous in their opposition to attempted control of prices by monetary policy. An interesting exception appears to

44. Monthly Letter of the Royal Bank of Canada, Montreal, May, 1932.

45. Ibid.

46. Ibid., March, 1932.

47. Ibid.

exist among our bankers, however, in the person of Dr. Donald Marvin, Economist of the Royal Bank of Canada. In the June, 1931, issue of his bank's monthly letter he discusses at great length, and with evident approval, the recent findings of the Federal Reserve Bank of New York relative to credit and prices.<sup>48</sup> He points out that, for the past ten years, one of the best equipped statistical laboratories in the world, at this bank in New York, under the guidance of Mr. Carl Snyder, has been gathering the data from which the trend of production, credit, and prices may be calculated. He reproduces four charts illustrating Mr. Snyder's findings. The fourth one shows the close relation of trade credit and the general price level. It is interesting to note the comments of an academically trained Canadian economist-banker, such as Dr. Marvin, upon the findings depicted by these charts. He says in part :

"This relationship between volume of production and trade and volume of credit is one of the most important discoveries which has ever been made by the statistician. It implies that there is a mathematical relationship between volume of production and credit on the one hand, and the price level on the other. .... The accuracy with which the line showing the theoretical price level corresponds to the actual price level is, in itself, a remarkable verification of the quantity theory of money."<sup>49</sup>

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48. Royal Bank of Canada Monthly Letter, June, 1931.

49. Ibid.

Then in conclusion he says:

"..... Can it be that had the growth of credit paralleled the increase in volume of production and trade there would have been no substantial changes in the general price level, no major business cycles, no booms, no severe depressions? This is indeed a startling concept, affording hope that the social injustices inherent in all major changes in the general price level might be avoided by proper control of credit. This is surely a counsel of perfection not fully attainable in human affairs, but it is clearly within the power of the great central banks, through appropriate interest rates and open market policies, to control within reasonable limits too rapid increase in the volume of credit and also to prevent contraction of the normal growth of credit, which is the basis of the present world tragedy."50

It would seem appropriate here to add to the weight of argument already given in support of the control of money, credit and prices, one of the conclusions of the MacMillan Committee, widely recognized as perhaps the ablest authority on the subject to-day. In their report we find:

"It will be sufficient for our purpose, in putting forward our recommendations in Part II of the report, to hold that it should be our object to increase the power to exercise deliberate control over the price level; that there is nothing inherently impracticable in this; that with the gradual growth of knowledge and experience, and particularly with the further development of suitable machinery for regular international co-operation, the possibilities of such deliberate control should steadily increase; and that we should forward these ends to the best of our powers by being ready to attempt the task and to gain experience by practise."51

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50. Royal Bank of Canada Monthly Letter, June, 1931.

51. Report of the Committee on Finance and Industry, London, June, 1931. (The MacMillan Report.) p. 94.

Having dealt with the question of price control at considerable length from the point of view of theory, with the purpose of showing the possibilities of such control applied to Canada, it would seem advisable to give a practical and recent illustration of the theory in actual operation. This we find in the recent experience in Sweden<sup>52</sup>, and it is the more appropriate in the light of the very great similarity between Sweden and Canada in many respects. Both countries--(1) are off the gold standard (2) export timber, wood pulp, paper, and raw ores (3) produce the bulk of their own food supplies (4) import foods not produced at home (5) import coal and mineral oils (6) have a high standard of living and rather rigid, high wages (7) have heavy taxation (8) have variable balance of trade (9) conduct their trade largely in terms of foreign currency, and (10) have no bill or money markets.

Sweden, however, has a central bank, the Sveriges Riksbank, and this bank has been conducting something of a monetary experiment since Sweden and so many other countries followed Britain in her departure from the gold standard in September, 1931. Of all the countries operating managed currencies none offers an instance of monetary policy more

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52. Most of the data on Sweden was taken from an article in the Midland Bank Monthly Review, October-November, 1932.

closely adapted to local conditions or more clearly defined than Sweden. Because of the general uncertainty of the world's monetary situation after Great Britain's suspension of gold payments, and because of a lack of declaration of a positive monetary policy by Great Britain, Sweden felt it impossible to pursue any definite policy in relation to sterling. It was therefore decided to attempt stabilization of the internal purchasing power of the krona.

Sweden's monetary authorities had two objects in view. In the first place it was desired in the interests of public confidence to avoid any marked rise in prices. Secondly, it was desired in the interests of industry, already struggling against the impediment of inelastic costs, to arrest the long-standing downward trend. It was considered necessary to collect extensive statistical material showing the production and turnover as well as the movement of prices of different goods and services. Weekly tabulated statements were obtained covering the entire price system. These statements contained foreign quotations, Swedish wholesale prices at different stages, and Swedish retail prices.

Guided by the information thus obtained, the Riksbank pursued its policy of internal price stabilization. Since there is no money market in Sweden, and since the central

bank has little control over the volume of bank deposits owing to the fact that it holds only a part of the cash reserves of the commercial banks, it cannot act through the quantity of money. It is confined, therefore, to operating on the allocation of bank assets through interest rates, and to exerting a direct influence over exchange rates. Commenting upon the apparent success of the Riksbank's policy a writer in the Midland Bank Monthly Review says:

"It can be said, however, that up to date the internal purchasing power of the krona has been kept stable, partly by deliberate action of the central bank, notwithstanding grave disturbances and disequilibria, industrial, trading and financial, both within Sweden and without."<sup>53</sup>

At first, then, internal price level stabilization was Sweden's prime consideration. At a later stage, however, it was found possible to achieve approximate stability of the sterling exchange in conjunction with stability of the price level.

In a previous paragraph many points of similarity were noted between Sweden and Canada. Here it might be well to observe some differences between the two countries. One difference is to be seen in their positions in international finance. For the past two decades Sweden has been a

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53. Ibid.

capital-exporting country, though only on a small scale. Another is that Sweden has set an outstanding example of restraint with regard to the import trade and transactions in exchange. Her tariff rates have been kept comparatively low, and the import quota system has been sedulously avoided. Only mild and temporary restrictions have been placed upon purchases and sales of foreign currencies. Hence it may be said that few countries have preserved freedom of movement for goods and capital in so high a degree as Sweden.

As Canadians considering the advisability of organizing a central bank for Canada we must weigh and consider the case for and against the possibilities of control of money and credit in a "social" sense. Balancing the evidence available, it seems fair to conclude that in general, at least, control of money and credit is possible, that prices can be regulated to a very profitable degree, and that very extensive social advantages can be realized by such control.

## Chapter 4.

Monetary Control in Canada Previous to 1914.

In the light of what we have seen with respect to regulation of foreign exchange, control of the price level, and management of monetary questions in the social interest generally, we shall now examine the Canadian pre-war monetary system.

During the early French regime the money<sup>54</sup> used in Canada was mainly the money of France, the denier, the sol, and the livre. In 1685 Canada made her first great monetary experiment, the introduction of card money. The French court had failed to send out a supply of money for the payment of its soldiers and officials before "freeze-up" on the St. Lawrence River, so the Intendant, De Meulles, obtained a quantity of playing cards, cut them in quarters, and marked and sealed them for different amounts. The only backing of this paper money was confidence in the promise of the Intendant to redeem it when "real" money arrived in the spring. It was accepted by the merchants and other people of Quebec and was duly redeemed as promised.

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54. The material used here was largely obtained from, "The Romance of Canada's Money", by Paul Montgomery.



Many and varied were the kinds of money used during the next century and a half, but it is not necessary to mention them here. During the war of 1812-14 paper money in the form of Army Bills was used to finance Canadian military operations. The years 1817 and 1818 saw the opening of our first Canadian banks, the Montreal Bank, and the Quebec Bank, respectively. Each of these banks issued its own printed notes. It was not until 1853, however, that the real basis for our pre-war monetary structure was laid.<sup>55</sup> In that year the province of Canada adopted the gold standard and this standard was maintained without breach until 1914.

In 1871 the passing of the Uniform Currency Act gave the Canadian monetary system legal sanction.<sup>56</sup> The Canadian gold dollar contained the same quantity of gold as the American--23.22 grains of pure gold. The American gold dollar and British sovereigns (at  $\$4.86\frac{2}{3}$ ) were legal tender. Little Canadian gold coin was struck, as Canadians preferred to use paper money in the form of Dominion notes or of the notes of the chartered banks.

Thus we see that the pre-war Canadian money system was based on the gold standard. It consisted of two

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55. Curtis, C.A. The Canadian Monetary Situation. p. 314.

56. Beckhart, B.H. The Banking System of Canada. p. 291.

divisions, however, (1) the government issue and (2) the bank issue. Of these we shall first consider the government issue. After the establishment of a branch of the Royal Mint in Ottawa in 1908 a few \$5 and \$10 Canadian gold coins were struck.<sup>57</sup> Our fractional currency consists of fifty, twenty-five, ten, and five-cent silver pieces, and bronze cents or coppers, all of which are limited legal tender, but not redeemable in standard money.

Dominion notes may be divided into two groups. First there are the notes of less than \$5 in denomination. Since there are no bank notes under \$5 the small Dominion notes serve as hand-to-hand currency. These were therefore never presented for redemption in any large numbers. In 1914 the amount of such notes in circulation averaged \$24,586,000.<sup>58</sup> Secondly there are large notes of \$50--\$5,000 used as cash reserves for the commercial banks. These notes were in circulation in 1914 to the value of \$89,596,000.<sup>59</sup> The banks find these notes more convenient to handle than gold, so they use them more than the latter for reserves. No specified reserves are required of banks

57. Beckhart, B. H. The Banking System of Canada. p. 292.

58. The Canada Year Book, 1931, p. 885.

59. Ibid.

by law, but of such reserves as they keep, 40 per cent. must be Dominion notes. Since the large Dominion notes are used mainly for the settlement of clearing house balances, and for reserves, they are often presented for redemption. Previous to 1914, however, there was never any doubt of the ability of the Treasury to redeem its notes. As Mr. C. A. Curtis says:

"Its duties were practically automatic--the exchange of gold for notes, and notes for gold."60

It should be said here that during the period from 1868 to 1914 the proportions of gold backing required by law were frequently altered, yet the general principle always was that a set maximum (\$50,000,000 in 1914, before the passing of the Finance Act) need only be partly backed by gold, but all issued in excess of this fixed sum should be covered dollar for dollar by gold. Thus we had an orthodox form of gold standard. It was the "automatic" system so-called. Hence the Department of Finance was not called upon for any degree of "management".

The second division of our pre-war money system will now be considered. This was the bank system. There was no central bank in fact or theory. Each of the banks was a bank of branches (not a bank with branches), spread all

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60. Curtis, C. A. The Canadian Monetary Situation. p. 316.

over the country. The head office, it is true, acted somewhat as a central bank for the branches. It directed their policy, provided them with funds, and to a certain extent acted as a rediscounting agency. As a branch might be 3,000 miles away from the head office, however, rediscounting facilities were not adequate, especially in an emergency. As for the whole banking system, it could get cash reserves in addition to its own total of gold and gold-covered Dominion notes only outside of Canada. To do this it had to borrow abroad, or withdraw its call loans from abroad, or sell its securities. Thus there was a serious lack of rediscounting facilities for the banks as a whole.

The seriousness of this lack was not felt at first, however, on account of the elasticity of the note issue. Bank notes were elastic because they were credit issues, and because they were profitable and convenient for the banks. Chartered banks were permitted to issue their own notes up to the full amount of their unimpaired paid-up capital. By about 1907, however, it was evident that expansion of the note issue had practically reached its limit due to the failure of bank capital to increase. This was the year of the financial panic in the United States. There was no such panic in Canada, but the banks

took every precaution.<sup>61</sup> They gave warnings to their customers, withdrew call loans from New York and London, sold securities, and contracted their loans as much as possible. Nevertheless a serious shortage of currency was evident, and the government met the situation by suspending the Dominion Notes Act to permit of the issue of \$10,000,000 additional notes, which the banks might borrow at 4 per cent. on certain securities.

Thus the much-vaunted elasticity of the bank notes had for the first time been proven to be inadequate. Because of a lack of sufficient currency the banks had been forced to contract their operations and the government had come to their assistance. Growing out of this evident inadequacy of the bank notes we have what is known as the crop-moving provision in the amendment of 1908. This provision, further extended in 1912, permits the banks to increase their circulation, from September to February inclusive, up to 15 per cent. of their paid-up capital and surplus. Notes so issued are subject to a Dominion tax not to exceed 5 per cent. per annum.

It is interesting to note, then, that--(1) in a time of emergency (1907) the banks by themselves had been

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61. Minutes of Proceedings, Evidence, etc., 1913, p. 551

unequal to the situation and the government had come to their assistance, and (2) to meet a wholly normal, recurrent, seasonal need they had required "emergency" currency to supplement their own ordinary resources.

The next demonstration of the inadequacy of the pre-war banking facilities was to herald the end of an era in the whole history of our banking system. The outbreak of the war in 1914 created an emergency which the banks were incapable of meeting. To cope with the heavy withdrawals of gold from the banks by nervous depositors an Order-in-Council was passed, which later became the Finance Act, permitting advances of Dominion notes to the banks against collateral deposited in the Finance Department. Referring to this B. H. Beckhart says:

"The situation existing there revealed a weakness in the Canadian bank note in that it seemed unable to expand to meet a war demand for currency. Were there a central rediscounting bank, operating along lines of the Bank of France or the Federal Reserve Banks, which were empowered to coin commercial paper into bank notes, this situation could have been met."<sup>62</sup>

Previous to the passing of the Order-in-Council in 1914 the utter lack of regular rediscounting facilities, other than those provided for the branches by the head offices,

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62. Beckhart, B. H. The Banking System of Canada. p. 294.

made the banks absolutely self-dependent with respect to cash reserves. They had, therefore, to keep a constant watch on the liquidity of their position. No matter what the call for cash, each bank had at all times to be able to pay on demand or admit insolvency and close its doors. Thus they guarded their position cautiously, and in so doing kept the gold standard secure. As far as the Department of Finance was concerned, as stated before, its function with respect to the gold standard was automatic. Any necessary management of the gold standard rested with the banks. Insofar, then, as any control was exercised--control of money and credit generally, control of exchange, or control of prices--it was either through the somewhat automatic working of the gold standard itself, or through the regulating of that standard by the banks. Or, as Mr. C. A. Curtis puts it:

"The responsibility for credit control rested with the commercial banks of Canada and was bound up with their own solvency."<sup>63</sup>

As we shall see later, however, the passage of the Finance Act removed this responsibility from the shoulders of the banks and placed it upon the government, thus closing an era of our banking history.

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63. Curtis, C. A. The Canadian Monetary Situation. p. 317.

## Chapter 5.

The Finance Act as a Substitute for  
a Central Bank

It is the main thesis of Canadian bankers and others opposing the creation of a central bank for Canada that we have already in the form of the Finance Act a De Facto central bank that is entirely adequate. Recent utterances of spokesmen of some of our banks constitute a veritable hymn of praise for the Finance Act as a substitute for a central bank. Hear Sir Charles Gordon<sup>64</sup>, President of the Bank of Montreal:

"There is no need of a central bank in Canada", Sir Charles declared. "For all practical purposes such an agency already existed under the Finance Act, which for eighteen years had admirably performed its purpose."

Mr. Frank A. Rolfe<sup>65</sup>, President of the Imperial Bank of Canada, said:

"The proposal to establish a central bank in Canada is one for which it is difficult to see the necessity. It would not provide additional credit beyond what is already accorded by our Canadian Banking Systems, with the assistance of the present Finance Act."

Mr. A. E. Phipps<sup>66</sup>, General Manager of the same bank

64. Vancouver Daily Province, Dec. 5, 1932.

65. Saturday Night, Dec. 3, 1932.

66. Ibid.



is quoted as saying in reference to the Reconstruction Finance Corporation of the United States:

".... If you can imagine the United States with a Finance Act instead of a Federal Reserve System, there would have been no cause for the enactment of special laws, and in fact there need never have been any money panic."

Mr. H. B. Henwood<sup>67</sup>, General Manager of the Bank of Toronto, is quoted as saying:

"....., we are well satisfied with the present simple and effective machinery by which we are able to borrow under the Finance Act for our needs during the peak periods of business, by putting up ample security with our government."

Mr. S. H. Logan<sup>68</sup>, General Manager of the Canadian Bank of Commerce, observes:

"....., but I submit that every function of central banking essential for Canada is already being fulfilled through the operation of our existing banks with the auxiliary service of the Finance Act,....."

Another well known Canadian banker, who does not wish to be named, has been kind enough to express his opinion on the same theme. It is in part as follows:

"Having regard to Canada's economic position the Finance Act affords an effective substitute for a Central Bank. The facilities of rediscount which it offers are, as you may know, as

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67. The Financial Post, Jan. 21, 1933.

68. The Vancouver Daily Province, Jan. 10, 1933.

"wide as those provided by any central bank and less encumbered with legalistic restrictions than most. This is particularly evident by comparison with the Federal Reserve Act of the United States for example. .... It is obvious that there can be no restriction of credit for legitimate purposes so long as Canadian banks have this facility at their disposal, and this contradicts the principal argument of those now advocating a Central Bank for this country."

In 1923 Professor Swanson<sup>69</sup> gave testimony as follows pertinent to the central bank question:

".... I don't think it is required in Canada. Our banks have the resources right now. It is not the case that we have not the money. No Federal Reserve scheme superimposed on our banks could increase the credit to a much greater degree than the banks can increase their credit right now....."

Professor Beckhart<sup>70</sup>, in his book on our banking system, says of the Finance Act, after making a number of criticisms:

".... At the present time, it is probably all that Canada needs by way of a central bank. If used by the banks, not continuously, but simply as a means of financing seasonal requirements, its introduction will probably be beneficial."

In view of the fact that Professors Swanson and Beckhart so expressed themselves before our experience with the boom of 1928-29 and the present depression, it would be interesting to know whether or not they would voice the same opinion in 1933.

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69. Proceedings of the Select Standing Committee on Banking and Commerce, 1923, p. 784.

70. Beckhart, B. H. The Banking System of Canada. p. 400.

Sufficient evidence has now been given to indicate the general attitude of those who oppose the institution of a central bank on the score that the Finance Act is an adequate substitute. This evidence establishes the necessity for a close examination of the Act if the question of the central bank is to be understood adequately. In later sections answering arguments will be given to the above statements and a close examination will be made into the operations of the Act to make it possible to arrive at conclusions. Before doing this, however, it will be necessary to enquire into the history of the Act.

The circumstances surrounding the passing of the Finance Act are described authentically by the Minister of Finance of the war period in "The Story of Canada's War Finance".<sup>71</sup> He pictured the state of excitement of the world at the end of July following the delivery of the ultimatum to Serbia by Austria. The stock exchanges of all the leading financial centres had closed. Uneasiness and apprehension led creditors to seek gold, and this great demand for gold dislocated the international exchanges. Eventually this panicky gold psychology spread to Canada and soon created a serious situation. Heavy

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71. White, Sir Thomas. The Story of Canada's War Finance.

withdrawals of gold from the banks took place in various parts of the country, and more serious runs on the banks were feared. The situation became so grave that on August 3 a delegation from the Canadian Bankers' Association, including their President, Mr. D. R. Wilkie, went to Ottawa to obtain government assistance to meet the emergency. No machinery existed to take care of such a situation. The ready cash reserves of the banks would not meet the demands of their creditors. As explained in Chapter 4 above, the pre-war banking system was such that each chartered bank was completely responsible for its own solvency, and if it could not meet demands upon it for cash it must close its doors. Reserves which had seemed adequate for the banks in peace-time were totally inadequate to meet the war-time situation. There was no central bank to go to for additional cash. No legislation existed to provide for such an emergency. Assistance must be obtained from the government or the banks faced probable insolvency and closing of their doors.

Hence on the same day, August 3, an Order-in-Council was issued providing protection for the banks against their threatened insolvency. It made bank notes legal tender, thus permitting the banks to meet their depositors' demands with their own notes instead of having to pay out gold or

Dominion notes. But this was not enough. The quantity of their own bank notes was limited to the amount of their unimpaired paid-up capital together with the gold and Dominion notes which they had on deposit in the Central Gold Reserves. To make an increase of bank notes possible it was provided that the emergency circulation, hitherto confined to the crop-moving season from September to February inclusive, might be issued through the whole year. In addition the Government was to issue Dominion notes to the banks, at interest, against securities deposited by them with the Department of Finance. This extra supply of Dominion "legals" might be used directly or might be deposited in the Central Gold Reserves and so used as a base on which bank notes could be issued.

Upon the above Order-in-Council being signed by the Governor-General, as it was immediately, a very full account of what had been done was given to the papers. The action taken was explained as being necessary in order to conserve gold, to increase the currency and make it more flexible, and in general to ensure stability of the financial structure. The public was reassured, and confidence was maintained through the whole course of the war.

In the following week (August 10) a second Order-in-Council was passed. This one supplemented the first by

suspending the redemption of Dominion notes in specie. Thus the gold standard was legally abandoned, and, as it turned out, was not to be restored until 1926. As stated above, public confidence had already been restored by the Order-in-Council of August 3. The effect of the two Orders-in-Council was to supply adequate currency to the public and to protect the gold reserves of the country. Altogether the emergency situation was met very effectively by these emergency measures.

At the special session of Parliament called a little later in August to cope with the war situation, the above-mentioned Orders-in-Council were embodied in the Finance Act and thereby ratified. The wording of certain parts of the Act makes interesting reading in view of the circumstances surrounding its genesis. There can be no controverting the fact that the Act was passed to save the banks from insolvency, as abundantly proved by the statements of no less an authority than Sir Thomas White, cited in a previous paragraph. Hence the all-inclusive nature of the full title is worth noting--"An Act to conserve the Commercial and Financial Interests of Canada".

Then again, in view of the fact that it was the desire to save the banks that made the Government willing to go so far as even to abandon the gold standard, the following

words of the Act are intriguing:

"In case of war, invasion, riot or insurrection, real or apprehended, and in case of any real or apprehended financial crisis, the Governor in Council may, by proclamation published in the Canada Gazette,...."<sup>72</sup>

(It then goes on to say what may be done under these conditions.)

While a preamble in such terms may have been desirable, to say the least it lacks frankness as a statement of the purpose of the provisions of the Act.

It might be mentioned here in passing that some of the least well-informed of those who uphold the adequacy of the Finance Act as a substitute for a central bank make two assertions:

- (1) That the above quoted clause re "war, riot or insurrection", etc. still holds, regardless of the 1923 revision. (This is usually stated by such people in defence against the argument that the Act permits of uncontrolled inflation.)
- (2) And at the same time--that the Finance Act is all we need in the way of a central bank.

It is surely absurd to try to maintain these two premises at the same time. Otherwise we must conclude that:

- (1) we must have a "riot" to produce our central

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<sup>72</sup>. The Finance Act, Part I, 4.

bank, and that

(2) all we need in the form of a central bank is a sort of an "unsubstantial faery thing" that appears only in times of emergency.

The argument is rather trivial, it is true, but nevertheless much confused thinking is met with on the subject of central banking, and should be combatted.

In the main the Finance Act is a recapitulation of the two earlier Orders-in-Council. Its most important provisions follow the preamble quoted above in Section 4, Part I. Summarized, they are as follows:

Under the conditions described in the preamble the Government was authorized:

- (a) to make advances to the banks by the issue of Dominion notes upon the pledge of securities deposited with the Minister of Finance.
- (b) to allow the banks to pay out their own notes as legal tender instead of gold or Dominion notes.
- (c) to extend the "crop-moving" provision for the issue of excess circulation over the whole year.
- (d) to suspend the redemption in gold of Dominion notes.
- (e) to proclaim a moratorium on debts.



The other sections of the act in large part merely elucidate further the above provisions and lay down regulations for their operation.

In view of the vital importance of the Finance Act it will be well to summarize certain facts about it before going on. It should be remembered that:

- (a) it was introduced in 1914 as an emergency measure to prevent insolvency of the banks and to avoid a financial panic.
- (b) it was continued in force throughout the war because of an "apprehended financial crisis".
- (c) it allowed the war-time inflation of the currency, and this in turn formed the base for "an inflated super-structure of credit."<sup>73</sup>
- (d) it was used to finance the war, or, as Beckhart says, ".... as a means of securing men and supplies on the basis of 'manufactured' purchasing power."<sup>74</sup>

It is of vital importance to note that although the Finance Act was passed as a war emergency measure only, it has been continued as a sort of rediscounting machinery. The provision for making advances of Dominion notes to the

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73. Beckhart, B. H. The Banking System of Canada. p. 400.

74. Ibid.

banks upon the deposit of collateral with the Department of Finance--the temporary provision which permitted unlimited war-time inflation--has been made a permanent feature of the Canadian monetary system. This was done by passing the Finance Act of 1923, which gave permanent authority to the Department of Finance to make advances of Dominion notes to the banks, gave complete control over the rate of interest to the Treasury Board, and in a general way elaborated the Act of 1914. The fact that the emergency measure of 1914 was made permanent in 1923 is known by all too few people. The real significance of the fact is appreciated by still fewer persons. It is well then that the significant part of the 1923 Act, Section 5, should be quoted word for word:

"At ANY TIME<sup>75</sup> when there is no proclamation in force under the authority of paragraph (a) of section four of this Act, the Minister may make advances to the chartered banks and to the savings banks to which the Quebec Savings Bank Act applies by the issue of Dominion notes upon the pledge of the securities hereinafter mentioned:

- (a) Treasury bills, bonds, debentures or stocks of the Dominion of Canada, Great Britain, any province of Canada, and of any British possession;
- (b) Public securities of the Government of the United States;

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75. Italics by writer.

- (c) Canadian municipal securities;
- (d) Promissory notes and bills of exchange secured by documentary title to wheat, oats, rye, barley, corn, buckwheat, flax or other commodity;
- (e) Promissory notes and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes and which have been used for such purposes. 1923, c. 48, s. 2."

It will be noted that when there is a proclamation in force under the authority of paragraph (a) of section 4 of the Act advances may be made, and when there is not a proclamation in force advances may be made by authority of section 5 above quoted. Hence at all times, and not just in the case of emergencies, such advances may be made to the banks by the Minister of Finance. The Rt. Hon. Arthur Meighen<sup>76</sup>, ex-Prime Minister of Canada, exhibited a keen appreciation of the significance of this provision for making advances to the banks when, before the Bankers' Educational Association at Toronto, on January 21, 1931, he spoke these words:

"....Under the Finance Act of later years, our government was authorized to advance to banks against specially named classes of collateral, government notes by way of temporary loans, and no provision was made for a gold reserve against these notes.... As to the money advanced under the Finance Act it is indefinite, consequently

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76. Quoted from a popular pamphlet entitled, "Bank of Canada, Why Not?" p. 6.

"loans of unstated amounts, WITHOUT LIMIT<sup>77</sup>, depending wholly upon the discretion of the Finance Department, can be made WITHOUT A GOLD RESERVE."<sup>78</sup>

Nowhere has the writer found the importance of the change wrought in our monetary system by the Finance Act as clearly interpreted as in the writings of Professor C. A. Curtis<sup>79</sup>. Summing up the pre-war monetary situation in Canada he says:

"The Government's duties were automatic and fixed and the Government itself might almost be described as an onlooker at the credit system. The banking system, on the other hand, was intimately involved in maintaining the gold standard. And I have assumed that the maintenance of the gold standard implies a modicum of credit control at least. Thus the responsibility for credit control rested with the commercial banks of Canada and was bound up with their own solvency.

"This whole system was completely transformed by the changes consequent on the outbreak of war in 1914." (He goes on to recite the provisions of the Finance Act.)

Again he says:

"Previously the control of bank credit rested solely with the banks themselves, but now it was transferred to the agency which had the power to add to the reserve of the banks, that is the Department of Finance. The Act which made this fundamental change in the Canadian monetary structure received less consideration than any other major change ever made in Canadian monetary legislation..... It is to be doubted if the government or the public ever adequately realized the significance of the Act."<sup>80</sup>

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77. Italics by writer.

78. Italics by writer.

79. The Canadian Forum, March, 1932, p. 207.

80. The Journal of Political Economy, June, 1932, p. 319.

In later sections of this chapter it will be shown that the Department of Finance has not been conscious of the new responsibility placed upon it by the Finance Act, that the banks have definitely shed the responsibility for monetary control which was theirs before the Act was passed, and that therefore Canada's monetary system is one in which no one accepts the responsibility for credit control.

In addition to making permanent the arrangement for making advances to the banks, the Finance Act of 1923 provided:

- (1) that bank notes should continue to be legal tender for three years more;
- (2) that for three years longer Dominion notes would not be redeemable in gold;
- (3) that for the same three years the export of gold would be prohibited except by special license;
- (4) that the above provisions would lapse unless specifically extended at the end of the three years.

As it turned out they were not extended, so Canada automatically resumed the gold standard on July 1st, 1926.

Having noted the evidence to the effect that the Finance Act is regarded by many as an adequate substitute for a central bank, and having traced the history of the Act, we shall now examine it in operation to see wherein

it does or does not fulfil the requirements of a central bank.

To what extent is it like a bankers' bank? In Chapter 2, when the general functions of a central bank as a bankers' bank were being discussed, it was stated that such a bank had as its customers the commercial banks, that it made loans to the banks, that it supplied them with emergency currency and acted as a rediscounting agency for them, that it usually issued notes and sometimes had a monopoly of the note issue, that it acted as a clearing house for them, that it was the depository of the cash reserves of the banks, and finally, that it was responsible for the solvency of the whole banking system.

There is no doubt of the ten commercial banks being the customers of the Finance Act. Not only that, they are the sole customers. Even the Federal Government cannot borrow from its "central bank". The nation's credit is not considered to be "sound" or "healthy" as backing for the issuance of currency until it has been "disinfected" by passing through the hands of the banks and until it has been tested in the fire of profit-making. Thus the "central bank" may not loan directly to its creator, the nation, on the latter's own credit. On the other hand a bank may take some of the nation's credit (in the form of

a victory bond, shall we say?) to the Minister of Finance and Receiver General at Ottawa (or to an Assistant Receiver General Office at Halifax, Charlottetown, St. John, Montreal, Toronto, Winnipeg, Regina, Calgary, or Victoria), deposit it there, and receive legal tender Dominion notes dollar for dollar on the deposited credit (bond) as security, paying  $3\frac{1}{2}$  per cent. on the money so borrowed. If the Government is in need, the bank may turn around and loan these same notes back to it at, say, 4 per cent. or five per cent. Or the Bank of Montreal may secure a quantity of these Dominion notes in this way at  $3\frac{1}{2}$  per cent. and loan them to the needy city of Vancouver at 6 per cent., thus charging  $2\frac{1}{2}$  per cent. for the cost of transferring the funds from Ottawa by telegraph or mail, and for the other services of an "honest broker" and middleman. The city of Vancouver may not borrow directly from the "central bank", (the Finance Act); it must borrow through the "middleman" in order that the transaction may be "sound". In fairness to the banks it should be pointed out that as "middlemen" they sometimes perform a service that might easily be overlooked. For instance, if the Bank of Montreal accepted Vancouver city bonds as security for a loan to that city and then deposited those bonds with the Department of Finance as collateral security for an advance

under the Finance Act, it would bear the risk of Vancouver's default. On the other hand, if it accepted from Vancouver securities other than the city's own bonds, it would assume two risks. Hence part of the interest charged in such cases is to compensate the bank for risks assumed. More often than not, however, the bank will not reloan the Dominion notes themselves, that it has secured in the above way. Instead, it may take the Dominion notes so obtained to the Central Gold Reserves, deposit them there instead of gold as backing on which to issue its own bank notes dollar for dollar. It costs the bank something to print its own notes, but it considers that the prestige and advertising resulting therefrom will more than repay the additional cost. Then it may loan its own bank notes to the Government or to the city of Vancouver as suggested above.

No more than what has just been said above and what was stated in our discussion of the history of the Finance Act is needed to show that this Act does serve as a bankers' bank to the extent that the banks are its customers, that it makes loans to them, and that it supplies them with emergency currency. The main bulwark of the defence of the Finance Act as a bankers' bank, however, is supposed to be found in the claim that it serves as an



adequate rediscounting agency. Most of our bankers have made this claim in recent months. One statement will be sufficient to indicate their general view. Mr. S. H. Logan, General Manager of the Canadian Bank of Commerce at the bank's annual meeting in Toronto, on January 10, 1933, spoke as follows:

"It may be noted that the Act provides for freer rediscounting than is permitted in the United States, a country with the largest central bank in the world."<sup>81</sup>

It is quite true that advances may be and are obtained quite readily by the banks through the operation of the Act. For instance, according to the monthly returns<sup>82</sup> of the banks to the Minister of Finance, we find that on December 31, 1932, every one of the ten banks had advances outstanding, that one bank had advances to the amount of \$25,000,000, that the bank with the smallest amount had \$84,000, and that all of them together had \$56,988,000. As listed in a previous section the securities or paper made eligible by law for such advances show quite a variety--from Dominion treasury bills and bonds to promissory notes and bills of exchange. Very little trade

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81. The Vancouver Daily Province, Jan. 10, 1933.

82. The Financial Post, Feb. 11, 1933.

paper is so used, however. In most cases the securities deposited are bonds. According to a Treasury Board Minute<sup>83</sup> of May 30, 1923, the margins by which the different classes of securities deposited should exceed in value the amount of the loans range from nothing, on Dominion Treasury Bills and Bonds, to 25 per cent. on assignments secured by documents covering grain, flour, cereals and feed.

From what has been stated above it can readily be seen that this so-called "rediscounting" is not really rediscounting at all, but just an ordinary process of making loans on deposited collateral. The words "loan" and "advances" are used in the Act, but the word "rediscount" does not appear at all. When securities or trade paper are really rediscounted they are negotiated and the purchaser may negotiate them again or hold them till maturity. Although the first bank that has them rediscounted remains liable, it has endorsed them in favor of the new holder. On the other hand, when loans are made on securities, these securities remain the property of the borrower and are redeemed on the loan maturity date. The very facts that the Department of Finance requires margin, and that the maximum period for which the advances are made is one

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83. Beckhart, B. H. The Banking System of Canada, p. 391.

year, are in themselves proof that the operations of the Act are not rediscounting. In fact one banker<sup>84</sup> puts it clearly when he says:

".... we are well satisfied with the present simple and effective machinery by which we are able to borrow<sup>85</sup> under the Finance Act for our needs during the peak periods of business, by putting up ample security with our Government."

Central banks, on the other hand, both rediscount in the real sense and make loans on deposited collateral. That there is a distinction between the two transactions is shown in the fact that the rates differ. The rate on loans is usually higher than the discount rate. Of the two transactions rediscounting by the central bank for the commercial banks is much the more important.

The Finance Act (as a "central bank") does issue notes as we have already seen, but it does not possess a monopoly of the note issue, since the banks themselves may and do issue bank notes.

It cannot be said that the Act serves as a central bank by acting as a clearing house for the commercial banks. They provide their own clearing house facilities. The Act does, however, provide them with legal tender notes which

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84. Henwood, H. G., General Manager of the Bank of Toronto, as reported in the Financial Post of Jan. 21, 1933, p. 5.

85. Underlining by writer.

they use as a medium of exchange in settling clearing house balances.

Unlike a bankers' bank the Finance Act is not the depository of the cash reserves of the banks. They hold their own reserves. If they have a greater quantity of gold and Dominion notes deposited in the Central Gold Reserves than they have used as backing for notes of their own, the difference constitutes a part of their cash reserves, but the Central Gold Reserves are distinct in location and administrative personnel from the Department of Finance. Since, therefore, the cash reserves are decentralized in that they are held in part by each of the ten banks and the Central Gold Reserves, they are not used as economically and efficiently as they would be if they were concentrated in one place such as in a real central bank.

Like a bankers' bank, on the other hand, the Finance Act does ensure the solvency of the whole banking system. The fewness of the chartered banks (10) leads almost inevitably to a kind of Government guarantee of banking. As Beckhart<sup>86</sup> says:

"The Canadian Government could not allow any of the larger banks to fail, for such would be most disastrous to the entire economic structure of the country. The Government would have to

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86. Beckhart, B. H. The Banking System of Canada. p. 328.

"lend support if such an institution were approaching insolvency, as indeed it was called upon to do on one occasion before the war."

As we have already seen, when the Great War broke out the Government met the danger of insolvency of the banks by passing the Finance Act. Made permanent in 1923, this Act is to-day the medium through which a threatened bank insolvency would be prevented from occurring. In the sense, then, that it assumes responsibility for the solvency of the whole banking system, the Finance Act serves as a bankers' bank and in part plays the rôle of a central bank.

Carrying further the idea that the Finance Act is a good substitute for a bankers' bank, some of its supporters go so far as to compare our whole banking system with the Federal Reserve System of the United States. They point out that this system consists of twelve regional Federal Reserve Banks and a Federal Reserve Board. Then they say that our Finance Act corresponds with the Federal Reserve Board and our ten banks with the Federal Reserve Banks. In numbers it is true there is only the difference between 11 and 13, but in other ways there is a vast difference. Later on, when we come to consider the Finance Act as a "people's" bank, we shall see that the administrators of the Act have, in the past at least, exercised no conscious control over the chartered banks or over money and credit.

The Federal Reserve Board, on the other hand, does exercise direct and very real control over the Federal Reserve Banks, and does pursue a definite policy of monetary control. The head office of each of our banks, it is said, discounts for the branches, and in other ways acts as a central bank, while the branches are the unit banks. Though it has little to do with the argument, it may be interesting to point out here that the head office of a Canadian bank is not itself a bank. It does, however, discount for the branches, and this is one of the strongest points made by those who oppose the creation of a central bank for Canada. If each head office is a central bank, then we have in effect ten central banks. But it is hardly logical to say that because one central bank is a good thing, ten would be still better. In fact, of course, the opposite is true. If it is a good thing that the control of all our branch, or "unit" banks, should be concentrated in the hands of ten institutions it is logical to argue that still further centralization in one real central bank would be still better. Though control of the ramifications of all the branches of one chartered bank is concentrated in the head office, as has been said before, a branch may be three or more thousands of miles from the discounting agency of the head office. Hence in comparing our ten head offices

with the twelve Federal Reserve Banks of the United States we must remember that the latter are regional while the former are not. Then, too, we should realize that our ten "central banks" are not unified under a Federal Reserve Board. As we have seen, the Finance Act does not co-ordinate them. True there is a Canadian Bankers' Association, but it does not perform the ordinary functions of a central bank.

Another argument put forth in support of the adequacy of the head office plus the Finance Act as a bankers' bank is the comparative security of deposits in Canada. When we realize that there have been only twenty-six bank failures<sup>87</sup> in Canada since Confederation, that there have only been nine since 1900, and that the last occurred in 1923<sup>88</sup>, while in the United States failures have reached four figures<sup>89</sup> in the last three years, as many as sixty-six<sup>90</sup> having failed during one week, we are inclined to agree that our banks have given us a high degree of security for our deposits. In further condemnation of the banking system of the United States it may be stated

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87. Beckhart, B. H. The Banking System of Canada. p. 480.

88. The Home Bank.

89 and 90. Saturday Night, Toronto, Article on the Glass-Steagall Bill by John McLean, about March 1, 1932.

that in 1929 there were in all 25,110 banks, while in December, 1932, there were only 19,046, a decrease of 6,064 in three years, most of them having closed their doors owing to insolvency. But condemnation of one system does not necessarily defend another. A great many branches of our banks have been closed since 1929. Since these were branches and not unit banks we do not class them as failures. Nor were they true failures. They meant simply the voluntary winding up of branches of a solvent bank. Nevertheless in the United States, where there is little branch banking, each of these closings would have constituted a bank failure for each would have been an involuntary closing of an insolvent unit bank. Sixty per cent. of the failures in the United States were of banks under \$25,000 capitalization, and 60 per cent. of the commercial banks (not 60 per cent. of the nation's commercial banking power) were non-members of the Federal Reserve System, made up of state banks and trust companies, preponderantly small institutions in rural districts.<sup>91</sup> On the other hand, in view of the fact that the minimum capitalization of a bank in Canada is \$500,000, that each chartered bank

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91. The information given above relative to American bank failures was taken from an article on "United States Banks" by Francis H. Sisson, President of American Bankers' Association, in the Review of Reviews and World Work for Dec., 1932.



has a great many branches, and that the facilities of the Finance Act exist, it would be a disgrace for one of our ten banks to fail. So calamitous would it be that, to recall the words of Beckhart<sup>92</sup> again:

"The Canadian Government could not allow any of the larger banks to fail,....."

It will be well to note the stress laid upon what is said to be the great security of deposits under our Canadian banking system. Speaking at the last annual meeting of the Canadian Bankers' Association on November 10, 1932, the President<sup>93</sup> said:

"They (the Canadian banks)<sup>94</sup> are to be regarded, first and foremost, as guardians of the people's money. In the total of our banking assets the shareholders' equity forms a very small proportion. Most of the vast sum for which the banks are responsible has been left in their safe-keeping by the people of Canada..

"To the people they discharge two primary responsible duties; firstly, that of providing currency for the daily conduct of business, as and when required, and in adequate amounts; and secondly, that of holding in safe custody the balances entrusted to them by ten million people in Canada.

"It is unnecessary to state that both of these functions have been performed with complete smoothness and certainty throughout the depression.

"....The safety of deposits has never been in any doubt, nor has there been a moment's hesitation in the meeting of all lawful demands."

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92. Beckhart, B. H. The Banking System of Canada. p. 328.

93. McLeod, J. A. Address to the Annual General Meeting of the Canadian Bankers' Association, Nov. 10, 1932.

94. Parenthesis by the writer.

In a previous chapter it was mentioned that in the last three months annual meetings of almost all the banks have been held. In nearly every case either the president or the general manager spoke against the idea of a central bank being instituted. One of the methods used almost invariably was not to show that a central bank would be bad, but to laud the existing system, particularly with respect to the safety of deposits. The President of the Bankers' Association as quoted above, however, covers their point fully, so none of the others need be quoted here.

It would be well to state here, perhaps, in neither criticism nor approval, the status of the depositor as a claimant against the assets of a failed bank. The law does not give him a prior lien on these assets. In the matter of priority, the notes constitute the first lien on these assets; the claims of the Dominion Government, the second; of the Provincial Governments, the third; the depositors' claims, the fourth.<sup>95</sup>

On December 24, 1932, "A Canadian Banker", writing to give the viewpoint of Canadian chartered banks on the question of a central bank for Canada, says with reference to deposits:

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95. Beckhart, B. H. The Banking System of Canada. p. 403.

"Long experience has indicated that if approximately 10 per cent. of the amount of the deposits is held in cash or in balance due by other banks, 10 per cent. in call loans (New York) and 25 per cent. in securities, the requirements of safety are sufficiently met."<sup>96</sup>

The fact that the banks have made a practice of holding in reserve against demand only 10 per cent. of the amount of deposits has usually been acknowledged in the past without criticism from the public. Conditions resulting from depression, however, have caused more people to become interested in banking affairs, and many have been recently criticizing this "pyramiding" of credit, and have been pointing out that it constitutes a method of very extreme inflation.

Let us quote one popular writer as an illustration:

"Are the Banks Gambling With Their Depositors' Money?"

Total amount of cash admitted by the banks to be on deposit with them on April 30, 1931.....	\$2,049,002,583.00
Total amount of cash in the form of legal tender throughout the entire Dominion out of which to pay these deposits.....	\$ 214,814,046.00

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Balance not covered by legal tender in cash.....	\$1,834,188,537.00
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How could they pay their depositors even 11 per cent. of what they show they owe them....? Can this be considered a safe and conservative policy to pursue

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96. The Financial Post, Dec. 24, 1932, p. 15.

"in our banking system; particularly if we should be approaching a period of panic?"<sup>97</sup>

And now we come to the last, but by no means the least, consideration relative to the argument that the Finance Act constitutes a satisfactory substitute for a bankers' bank--the question of administration. In its administration, more than in any other way, the Finance Act fails to exhibit the symptoms of a central bank. The vital factor, the real key to the success of a central bank, is to be found in its administrative personnel. Speaking about monetary control Lionel D. Edie says:

"Its success depends upon the discrimination and judgment of central bank officials in analyzing complex situations of finance and trade."<sup>98</sup>

And again:

"Financial statesmanship of a high order is the cardinal requirement."<sup>99</sup>

In other words, as Bagehot once said:

"Good banking is made by good bankers and not by good laws."

Or, as one of our most enlightened Canadian bank economists says:

97. Bank of Canada, Why Not? p. 7.

98. Money, Bank Credit, and Prices. p. 475.

99. Ibid., p. 483.

"The degree of success they will achieve will depend upon their skill in interpreting the various criteria, and the promptitude with which they exercise the expedients at their command."<sup>100</sup>

It is above all important, then, that the administration of a central bank should be in the hands of experts of unquestioned intelligence and professional qualification who will be able to interpret economic and financial situations and see ahead far enough to "apply the brakes" before the danger spot is reached.

The administration of the Finance Act is in the hands of the Treasury Board. This Board is presided over by the Minister of Finance. The Deputy Minister of Finance is Secretary, ex-officio.<sup>101</sup> With these two officials are five members of His Majesty's Privy Council who are appointed by the Governor-General-in-Council.

Canada has usually enjoyed the good fortune of having very able and trustworthy men as Ministers of Finance. Their qualifications have been such as to fit them very well for the position of head of the Department of Finance. However, rarely if ever, has one of them been a professional economist or an experienced banker. Hence it is too much to expect that such ministers should give expert direction

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100. Monthly Letter of the Royal Bank of Canada, May, 1932.

101. Proceedings of the Select Standing Committee on Banking and Commerce, 1924, pp. 344 and 347.

to the administration of the Finance Act.

The five Privy Councillors are Cabinet Ministers. As heads of various departments they have other heavy duties. They are able, therefore, to devote little time or thought to matters relative to the Finance Act. Besides, they and the Finance Minister form a political body subject to change in personnel with shifts within the Cabinet and with changes of governments. Unlike the administrators of most central banks, the members of the Treasury Board are not aided by expert advice, except in the case of the valuation of the securities deposited by banks as collateral for a loan, when the Trustees of the Central Gold Reserves may be requested to lend their advice.

In view of the fact that the head of a central bank admittedly should be almost an "expert of experts" in all things financial, it is somewhat amusing to find that the administrators of our "central bank" (the Finance Act) have to go to the Trustees of the Central Gold Reserves for advice on the quality of commercial paper. There are four of these Trustees. One is appointed by the Minister of Finance. The other three are appointed by the Canadian Bankers' Association, with the approval of the Minister. Referring to the Trustees Beckhart says;

"In 1924 the Trustees were the Royal Trust Company, the Bank of Montreal, the Canadian

"Bank of Commerce and the Royal Bank.."102

It is stated to be the custom that when one of the trustees, or his bank, is interested in the securities under consideration, he is not consulted. Since it is the banks that are interested in the transactions, however, advice obtained elsewhere would be less open to suspicion than that obtained from Trustees who are members of the Bankers' Association. As Mr. Donald Watson<sup>103</sup> says, the Trustees of the Central Gold Reserves are a body that, "does not possess the ultimate in impartiality and disinterestedness."

Thus we see that the Minister of Finance and the five Privy Councillors are not trained for the duties of central banking and are too busy with other duties to give much thought or attention to administration of the Finance Act. They probably accept with little questioning the suggestions of the Deputy Minister. Their conception of the responsibilities devolving upon them as a Treasury Board in charge of the Act's administration is probably accurately indicated by the casual nature of the remarks of one of them before the Banking Committee when he said they "try to meet once a week".<sup>104</sup>

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102. Beckhart, B. H. The Banking System of Canada. p. 385.

103. Watson, Donald, Essay on "The Finance Act".

104. Proceedings of the Select Standing Committee on Banking and Commerce, 1924, p. 392.

The Deputy Minister of a department of government is usually regarded as the expert of that department, and is, generally speaking, a permanent civil servant. It is natural that the Minister should leave details of administration to him. It is therefore the Deputy Minister of Finance who is the real administrator of the Finance Act in practice. In fact one such Deputy said he was "supposed to be the adviser".<sup>105</sup> Most Deputies have been very efficient and faithful civil servants. It is no criticism of them as such, therefore, to say that they have not, in the past at least, been fitted as central banking experts to administer the Finance Act. Rather, any criticism should be directed against the system by which there have been imposed upon a civil service department duties which rightly belong to a specialized institution. The Deputies have had neither an academic training in economics nor practical experience in banking. The same may be said of the Comptroller of the Currency who looks after some of the details of the operations of the Act. There are in fact no statutory requirements as to the qualifications of any official responsible for the administration of the Act.

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105. Ibid., p. 388.



In a later section, when the Act will be judged as a "people's" bank, it will be shown fully that the administration exerts no control over monetary matters in the social sense. Suffice it to say here that, in the past at least, it has not been the policy of the administrators to vary the interest rate for the purpose of controlling credit, or regulating commodity prices, or foreign exchange. Just one or two excerpts<sup>106</sup> from the Proceedings of the Banking Committee will be given here in passing as evidence of the fact that the Deputy has not even been conscious that such control could be exerted.

"Question: Can you tell me whether or not the interest rate might be used as a means of assisting in the process of deflation, or as a weapon which might be used against inflation?

Answer: I do not quite get that.

Question: Do you recognize the interest rate, that is, the raising and lowering of the interest rate, as an effective instrument, not perhaps thorough, but an effective instrument, to cause deflation or to assist inflation?

Answer: I do not think so."

It is interesting to note that there was no Deputy Minister of Finance for more than two years. The late Mr.

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106. The Proceedings of the Select Standing Committee on Banking and Commerce, 1924, p. 393.

J. C. Saunders, who had become Deputy Minister in 1920, died on April 1, 1930. His successor was not appointed until November, 1932. Now if we were correct in our previous assumption that the Deputy Minister is the real administrator of the Finance Act, then there existed an anomalous situation during these two and a half years. The assistant, a civil servant, who did the work of the Deputy, was no doubt a very capable man (for another position). That he was not considered qualified sufficiently as an expert to administer the Act is evidenced by the fact that he did not become the new Deputy when the appointment was finally made. It is also very unlikely that the Minister was able to assume any greater share of the work then than usual. During the greater part of the time the Minister of Finance was also Prime Minister and Minister of External Affairs. For a period of two and a half years, then, when Canada was off the gold standard and therefore did not have even that semblance of so-called "automatic" control, our would-be "central bank" was administered by a civil servant who was tacitly acknowledged to be unsuited for the task. And this was a period that saw the Hoover moratorium on debts, the fall of Britain from the gold standard, a financial panic in the United States, the Imperial Economic Conference at Ottawa, and our Canadian dollar at an unprecedented discount--a period, in fact,

unparalleled in the number of crises that shook the financial and economic structure of the world.

As stated above, a new Deputy Minister was finally appointed to the Department of Finance in November, 1932. In the light of what has already been said it will be interesting to note the qualifications of this new official. He is Dr. W. C. Clark, recently of the Department of Economics of Queen's University. Before joining the staff of Queen's University he had considerable "practical" experience in the business and financial world. For the first time, then, in the history of the Finance Act the administrator is an expert seemingly well qualified to direct central bank policy.

Dr. Clark was adviser to the Canadian representatives on monetary matters at the Imperial Economic Conference in Ottawa in 1932. At almost the exact moment that he was being appointed Deputy, Canada was taking her first taste of "reflation" (to the extent of some \$35,000,000 in newly issued Dominion notes). This created \$35,000,000 in new bank deposits, for the Government received bank advances to that amount. It also created the possibility of a \$350,000,000 extension of bank credit, when and if the outlet, backed by adequate collateral, is found for it, because the \$35,000,000 becomes an addition to

the cash reserves of the banks, and banks make a practice of permitting their deposits to grow up to approximately ten times their cash reserves.

It is not the purpose of this thesis to speculate, but in view of the fact that the present Prime Minister has so frequently expressed himself as being in favor of "sound" money, one is inclined to conclude that the new Deputy advised and convinced him that a measure of inflation was necessary. The Financial Post<sup>107</sup> thinks that the Premier was also influenced by the fact that "the rise in our dollar was damming up the export flow of Canadian wheat". Whatever the influence, the interesting fact remains that for the first time in Canada's history we have witnessed an experiment in seemingly conscious monetary management. The qualifications of Dr. Clark and the initiation into monetary management which we have already experienced would give us reason to anticipate under the regime of the new Deputy Minister of Finance an attempt to regularize our monetary and banking control and the operations of the department generally.

It will be of interest then to learn something of Dr. Clark's views. There has been something of the nature

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107. The Financial Post, Toronto, Nov. 26, 1932.

of a controversy as to whether or not Canada is still on the gold standard. The Prime Minister declared when Great Britain abandoned gold that Canada would not do so, and up to the present declares his intention to adhere to "sound" money. Of our position with respect to gold the new Deputy says:

"....Prohibition of gold export is tantamount to suspension of the gold standard, though the niceties of formal logic would also require the substitution of a DE JURE for a DE FACTO prohibition of the conversion of Dominion notes into gold for domestic as well as export purposes."108

In the same article he says:

"Sept. 21, 1931, marked the end of an epoch in the financial history of the world."109  
(It will be remembered that this was during the period when Canada had no Deputy Minister of Finance--no one directing our "central banking" machinery.)

Again he states:

"We would be in a sounder position, however, if we had central banking machinery properly equipped and definitely responsible for the control of credit in an emergency of this character instead of the anomalous condition of division of responsibility between the banks and the government and lack of special equipment or traditions in the Department of Finance."110

108. "The Flight from the Gold Standard", Queen's Quarterly, Autumn, 1931, p. 760.

109. Ibid.

110. Ibid., p. 761.

Are we, then, to have "traditions" built up around our Finance Act? Certainly no such traditions exist yet. In fact the lack of such traditions constitutes an argument against the theory that the Finance Act is in effect a central bank. Traditions are a great asset to a central bank. The vast prestige of the Bank of England, for instance, is to a large extent due to its traditions. If the new Deputy is able to convince the Government that we should have deliberate management of our monetary system, and if he succeeds in building up traditions around our central banking machinery, November, 1932, will mark the beginning of a new epoch in the financial history of Canada.

Dr. Clark speaks of "the anomalous condition of division of responsibility between the banks and the government". Certainly the administration of our so-called central banking machinery illustrates admirably the economists phrase "division of Labor". If we are to consider that the Finance Act and our banking system together constitute in effect a central bank we have the powers of administration divided among the following:

- (1) The banks -- 10 central banks working independently-- or a decentralized central bank.
- (2) The Finance Act -- administered by the Treasury

Board--grants loans to banks.

- (3) The Trustees of the Central Gold Reserves --in their capacity as experts advising the Treasury Board as to the values of commercial paper on which loans are sought.
- (4) The Governor-in-Council - responsible for the issue of legal tender (Dominion notes).
- (5) The Central Gold Reserves - administered by four trustees, one appointed by the Minister of Finance and three by the Bankers' Association - responsible for the gold and Dominion notes deposited by the banks as backing for the issue of bank notes in excess of the amount of their paid-up capital.
- (6) The Minister of Finance in his capacity as supervisor of the Circulation Redemption Fund.
- (7) The Canadian Bankers' Association in its capacity as supervisor over -
  - (a) clearing houses.
  - (b) the printing and distributing of notes to the banks and their destruction.
  - (c) the appointment of a curator to assume supervision of the affairs of suspended banks.
- (8) The Postal Savings Banks - state institutions.

- (9) The Inspector General of Banks --makes external inspection, at least one a year, of each chartered bank.

When one surveys this medley of powers that share the administration of our "central banking" machinery he is not surprised that Kisch and Elkin<sup>111</sup>, authorities on central banks, should speak of "the serious draw-backs to the Canadian system", under the following heads:

- (1) Divided responsibility.
- (2) Lack of leadership.
- (3) Gold standard not an automatic system.

Following is their comment in part:

"Whether there is a gold standard or not the control of the credit and the monetary system involves the solution of many difficult problems of policy and detailed administration. But if there are many issuing authorities there cannot be one controlling force to direct the monetary policy of the country, and this is bound to be a source of weakness, especially at a time of serious crisis, when a well-devised and coherent plan of action vigorously applied is essential."<sup>112</sup>

While on the subject of administration we must give consideration to the political factor, and the general relationship between the "central bank" and the Government. This is a subject on which there is room for much honest

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111. Kisch and Elkin. Central Banks. p. 6.

112. Ibid.



difference of opinion. Bankers in particular, and opponents of the central bank idea generally, in Canada, give voice to their apprehension lest the creation of a central bank might mark the entry of politics into the monetary and banking machinery of our country. The desirability of keeping politics (in the evil sense) out of such matters is so self-evident that there is no difference of opinion on that point. Kisch and Elkin<sup>113</sup> in effect say that it is of the utmost importance that monetary matters should be kept clear "from the exigencies of party politics and controversy", and that it is desirable that the central bank should be "independent or quasi independent". It is the degree and kind of independence that gives rise to difference of opinion. Some believe that the central bank should be privately owned and completely independent of government control like the Reichsbank of Germany and the Bank of England. Others insist that it should be a real state bank like the Norges Bank of Norway, the Riksbank of Sweden and the Commonwealth Bank of Australia. Then in between these two types there are almost as many varieties and degrees of independence as there are central banks.

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113. Kisch and Elkin. Central Banks. p. 27.

What now of the Finance Act as a central bank? If it be a central bank it is indisputably a more completely state bank than any other bank in the world, with the possible exception of the state bank of Russia, governed by the "People's Commissary of Finances". It will be remembered that the Finance Act is administered completely by a political body--the Treasury Board. At its head is the Minister of Finance, generally a leading party light, immersed as completely as anyone could be in the thick of partisan party controversy. The Deputy to whom falls the real work of administering the Act is appointed by and is responsible to the Minister. The five Privy Councillors are party men. All, with the exception of the Deputy, are members of the Government, and their term of office is dependent upon the fortunes of party. In addition, if one may conceive of an act being "owned", then our "central bank", the Finance Act, is completely state owned.

The fact that the administration of the Finance Act is so completely political and that our "central bank" is so incontrovertibly a state "bank" should give rise to considerable amusement in view of the opposition shown towards the institution of a real central bank for Canada. The voices of the bankers compose a symphony in praise of the virtues of the Finance Act. Yet they utter a

dire warning against the danger of political interference should a central bank be created. If political control of banking is dangerous, then the Finance Act is a most dangerous instrument. If the Finance Act has as many virtues as we are told, then state ownership and control are not necessarily evil. Opponents of a central bank cannot hold to two opposites and be logical. They must "cleave to the one and despise the other". As indicated in previous paragraphs there are many faults to be found in the Finance Act. One of these is that its administration is left too open to the danger of the political factor. Yet the writer has searched in vain for any suggestion of political interference (in the evil sense) in connection with the administration of the Act from the time it was passed in 1914 to the present. Mistakes there no doubt have been. Yet, although not properly qualified for this special work, our Ministers and civil servants at least have not allowed the evil of politics to show itself to the slightest degree in the administration of the Act. As Mr. A. F. W. Plumptre says:

"....political interference with the credit and money system is not a problem in Canada at present."<sup>114</sup>

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<sup>114</sup>. A Central Bank for Canada, p. 3.

That is not to say, however, that the dangers of the political factor should not be guarded against. Here in passing it may be suggested, however, that if under unguarded, "wide open" conditions the political evil has not appeared, supporters of a state owned central bank may be encouraged to believe that in a Canadian central bank with proper safeguards there need not necessarily be any great danger from the political angle.

A very important objection that may be offered against the Finance Act as a bankers' bank is that it operates on the initiative of the banks only. When the banks desire advances they may apply for them under the provisions of the Act, and presumably, if the securities which they offer are acceptable, the Department of Finance has no option but to make the advances sought. On the other hand our "central bank" has not the power to force its "member" banks to accept advances when it wishes to initiate an "easy money" policy with the idea of encouraging investment. No doubt this explains why the banks prefer the Finance Act to a real central bank.

And now we may summarize the arguments for and against the Finance Act as a bankers' bank:

It is like a bankers' bank in that -

- (1) It makes provision for loans to the banks, and in this general operation of making advances it bears some semblance to a central bank.
- (2) It provides emergency currency for the banks.
- (3) In a loose way it may be said to have ten "member banks" that do rediscounting, for the head offices of the chartered banks do rediscounting for the branches.
- (4) Its customers are the commercial banks.
- (5) It issues notes (if in a broad way you think of the Department of Finance as being a part of the "central bank"), but does not possess a monopoly of the note issue.
- (6) It might be said to be responsible for the solvency of the whole banking system, for through it the Government comes to the rescue of the banks.

It is unlike a bankers' bank in that -

- (1) It is not the depository of the cash reserves of the banks.
- (2) It is therefore unable to economize the cash reserves by concentration.
- (3) It does not act as a clearing house for inter-bank settlements.

- (4) It has not a monopoly of the note issue  
(though not all central banks have).
- (5) It does not rediscount for the banks in the  
real sense; it merely makes loans to them on  
deposited securities.
- (6) Its administration is faulty in that -
  - (a) the official with final responsibility is  
the Minister of Finance who has neither  
the time nor the qualifications for these  
duties.
  - (b) the officials who do the real work are  
civil servants who have in the past at  
least been incompetent for this special  
work.
  - (c) the Treasury Board nominally responsible  
is entirely unfit for the work.
  - (d) there is division of the responsibility.
  - (e) there is lack of leadership.
  - (f) it is open to the dangers of the political  
factor.
  - (g) aside from the personnel there is a complete  
lack of central banking machinery and equip-  
ment.
  - (h) it operates at the option of the banks only.

In Chapter 2 the functions of a central bank were discussed under three headings--(1) a bankers' bank, (2) a government's bank, and (3) a "people's" bank. The Finance Act has already been considered in the light of a bankers' bank. We shall now consider it as a government's bank.

Where there is a real central bank one of the chief customers of that bank is the government. The central bank holds the account of the government; it is the depository of the government's funds and of the nation's reserves. In fact the tasks which the government imposes on the bank make it imperative that it should hold the government's funds. As was shown in a previous section the Canadian Government has not the privilege of being a "customer" of the Finance Act; the banks are its only customers. They may receive advances through it, but as a "central bank" it does not make advances to the Government. It provides the means whereby banks may secure loans of unstated amounts, without limit, and without any gold reserve whatever. The Act gives no such accommodation to the Government, however. An act of 1914 gives the Dominion Government authority to issue notes up to 115 and including \$50,000,000 against which a gold reserve of

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115. Statutes of Canada, 5 George V, Chapter 4.

25 per cent. has to be maintained. An act of 1915 permitted the Government to issue notes up to \$26,000,000<sup>116</sup> without any reserve of gold. Of these \$16,000,000<sup>117</sup> were to be backed by Canadian Northern and Grand Trunk Pacific Railway securities, and \$10,000,000 were uncovered notes issued for general governmental purposes.<sup>118</sup> The same act required that Dominion notes in excess of \$76,000,000 were to be secured dollar for dollar by gold, except as provided in the Finance Act of 1914. Thus we see that in the issue of notes for its own purposes the Government is very definitely restricted as to the quantity, by act of Parliament. In the issue of notes for the convenience of the banks, on the other hand, the Government is limited only by the judgment of inexperienced members of the Treasury Board, as advised by the four Trustees of the Gold Reserves, three of whom are appointed by the Bankers' Association. In the issue of notes for its own purposes the Government must have \$50,000,000 backed to the extent of 25 per cent. by gold, and all over \$76,000,000 must be backed dollar for dollar by gold. In the issue of notes for the convenience of the banks, through the Finance Act, no gold

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116. Statutes of Canada, 5 George V, Chapter 4.

117. Ibid.

118. Ibid.



backing is required at all.

Hence we see that the Finance Act certainly does not serve as a government's bank in the sense of making loans to the Government or of having the Government as a customer. It would be absurd, too, to suggest that an "act" could be the depository of the Government. Most central banks are the fiscal agents of their governments. The financial operations of governments are conducted on a scale so great that not many private banks could handle them. Where there is a central bank it receives tax funds for the government, advances short term loans in times of temporary shortage, and in general acts as an intermediary between the Department of Finance and business. None of these functions, of course, can be performed by the Finance Act for the Government of Canada. Again, as has been said before, where there are central banks, the central bank experts often represent the country at financial and economic conferences of various kinds. Certainly the Finance Act performs no such service for Canada. When the Imperial Economic Conference was held at Ottawa in the summer of 1932 the Canadian Government had no central bank experts to call upon for advice on financial or monetary matters. We even had no Deputy Minister of Finance at the time. The Government called

upon a Queen's University professor, Dr. Clark, for such advice. Dr. Clark was later appointed Deputy Minister, as previously stated. The appointment of this expert should very greatly improve the administration of the Finance Act, but without proper central bank facilities and equipment he cannot hope to give Canada the advantages of a real central bank.

When summing up the argument for and against the Finance Act as a bankers' bank we found many points in support of each side. We may, however, sum up the argument with reference to the Act being a government's bank by saying that in no single respect does it perform the function of such a bank.

And now we come to a consideration of the Finance Act as a "people's" bank. In this light a central bank is regarded as having a "social" function. As stated in Chapter 2, it is the opinion of many that the control of money and credit is a matter of such vital importance in the lives of a people that it should be a prime function of government--that it should be in the hands of disinterested experts exercising their powers in the general interest rather than being in the hands of a private institution organized for the pursuit of private gain.

In Chapter 3 the theory of monetary control in

general was studied. The objectives of this control were outlined under the headings--(a) control of foreign exchange, (b) control of the price level. Evidence for and against the possibilities of such control was examined.

As a result the following conclusions were arrived at:

- (1) Balancing the evidence available it would seem that control of money and credit is quite possible.
- (2) That the variations in foreign exchange can be kept within reasonable limits, or
- (3) That a very worth-while degree of control over the price level can be exercised, and
- (4) That a reasonable measure of control of both exchange and prices can be attained in normal times at least.
- (5) That the responsible governmental officials have never seriously attempted monetary control in Canada, and have at times, at least, been entirely unaware of its possibility.
- (6) That Canadian banks have pursued no conscious, positive policy with respect to the volume of money and credit, and are skeptical of any attempts at deliberate control of exchange and the price level.

In Chapter 4 particular attention was given to monetary control in Canada previous to 1914. Resulting conclusions were to the effect that:

- (1) A fairly orthodox gold standard was maintained up to that date.
- (2) The Government's duties with respect to the monetary system were practically automatic--the exchange of gold for notes, and notes for gold.
- (3) The year 1907 brought the first evidence of insufficient elasticity of the bank note issue, resulting in the Government coming to the assistance of the banks with the "crop-moving" provision.
- (4) Previous to 1914 all responsibility for credit control rested entirely with the banks.

The passing of the Finance Act, however, completely altered the whole structure of the Canadian monetary system. Previous to 1914 the banks could only increase their reserves by borrowing abroad, by withdrawing call loans from abroad, or by selling securities. There were no facilities in Canada for increasing their reserves. The Finance Act provided these facilities, however. Now that the banks could easily and quickly increase their reserves, their ability to expand credit was also greatly

increased. This ability was all the greater by reason of the fact that Canada has so few banks. The significance of the change wrought by the Finance Act can thus scarcely be over-emphasized. As Mr. C. A. Curtis says:

"Previously, the control of bank credit rested solely with the banks themselves, but not it was transferred to the agency which had the power to add to the reserves of the banks, that is the Department of Finance."119

Certainly it would seem that neither the governments of 1914 and 1923, nor the public ever fully realized the true significance of this Act. We may now ask whether or not the Department of Finance has been meeting the new responsibility which it tacitly assumed when the Finance Act was passed.

The best-known method of monetary control in the social sense is that of manipulating the discount rate. In support of this statement the MacMillan Committee may be quoted:

"Thus variations in the rate of interest charged appear to be the appropriate instrument to bring about harmony."120

"There can be no doubt, in our judgment, that 'bank rate policy' is an absolute necessity for

119. The Journal of Political Economy, June, 1932, p. 319.

120. The Report of the Committee on Finance and Industry. (The MacMillan Report) London, June, 1931, p. 15.

"the sound management of a monetary system, and that it is a most delicate and beautiful instrument for the purpose."<sup>121</sup>

A summary of the description by Mr. Lionel D. Edie<sup>122</sup> of the operation of the discount rate will explain how manipulation of the rate may be made to effect control. As he points out, the discount rate should be raised to prevent prices from rising excessively during booms and lowered to prevent prices from falling excessively during depressions. An advance in the discount rate should restrict the volume of borrowing during a wave of business expansion, and this restriction should curtail the means of payment and so curtail the ability of traders and of the public to bid up the prices of goods. A reduction in the discount rate would aim to stimulate the volume of borrowing during a wave of receding business, thus augmenting the means of payment and so sustaining the ability of the public to bid up prices of goods. The raising of the rate should be a danger signal. If success is to be attained, however, the central bank policy must be directed by the discrimination and judgment of experts. As stated in a previous paragraph, these experts must be able to judge the various criteria and see ahead so that

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121. Ibid.

122. Money, Bank Credit and Prices, p. 474.

they may be able to "apply the brakes" before reaching the danger spot.

Now let us see how the "discount" rate, or interest rate, has been used in connection with the operation of the Finance Act. When the Act of 1914 was being introduced the Minister said nothing to indicate that the rates were to be manipulated to control credit or prices. Nor was anything said about this by the Minister in 1923. When asked whether the Act would merely provide loans when required by the banks, or whether it would in a broader way do central bank re-discounting like the Federal Reserve Banks of the United States, the Minister in 1923 said:

"There is no doubt this measure serves to some extent the same purpose as the national reserve system of the United States. But as we are not likely at this session to adopt the national reserve system generally, we might have this bill as a piece of it, possibly."<sup>123</sup>

It is quite evident that the Act was not intended by the Minister to do real rediscounting involving conscious credit control. At best the Act is only "a piece of a central bank".

Nor is there anything in the Act itself to suggest

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<sup>123</sup>. Debates of the House of Commons, 1923, p. 4405.

"that the rates charged by the Treasury Board should be altered with a view affecting the business situation, of preventing inflation or deflation, or ironing out cyclical sweeps in business, of preventing or checking speculation, or of performing the functions expected of the rate of discount of a central bank."124

Evidence<sup>125</sup> of the Deputy Minister of Finance in 1924 shows that he, the official chiefly concerned with the administration of the Act, knew nothing of "management" of the rates for the purpose of controlling credit:

"Question. You think that the interest rate would have no relation to that matter at all?

Answer. I do not think so.

Question. And consequently it would be wholly unnecessary to have either an increase or decrease in the interest rate for that purpose under the provisions of the War Finance Act?

Answer. We have never looked at it in that way, nor considered it in that way.

Question. Then it would be fair to say that as an instrument for the purpose I have mentioned, the Treasury Board does not consider it, and has never considered it?

Answer. Not in that light, no. It has always been considered as meeting the needs of the banks in their commercial business, and work outside in the business world."

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124. Beckhart, B. H. The Banking System of Canada. p. 392.

125. Proceedings of the Select Standing Committee on Banking and Commerce, 1924, p. 343.



Then again, in testifying in 1924, Mr. George Edwards, a chartered accountant, very definitely stated that any changes in the rates charged were not made with a view to checking inflation or deflation, or for the purpose of stabilizing economic conditions.<sup>126</sup> Let us now see what changes in the rates have been made since 1914.

From 1914 until November 1, 1924, the rate was 5 per cent. except that from October 20, 1917, the rate on advances against Imperial Treasury Bills was  $3\frac{1}{2}$  per cent. From November 1, 1924, until November 1, 1927, the rate was  $4\frac{1}{2}$  per cent., from that date until December 1, 1927, the rate was 4 per cent., and from the latter date until June 8, 1928, the rate was  $3\frac{3}{4}$  per cent. From that date until September 1, 1928, the rate was 5 per cent., except for advances against 4 per cent. Treasury Notes when the authorized rate was  $3\frac{3}{4}$  per cent. From September 1, 1928, to October 26, 1931, the general rate was  $4\frac{1}{2}$  per cent., except on advances against Treasury Notes when the rate was  $3\frac{3}{4}$  per cent. From October 26, 1931, to May 2, 1932, the rate was 3 per cent., and from that date the general rate remained at  $3\frac{1}{2}$  per cent. till the date these figures were obtained--November 19, 1932.

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126. Proceedings of the Select Standing Committee on Banking and Commerce, 1924, pp. 46, 349 and 375.

No wonder a witness said in 1928 (without intending to be humorous), "there is a steadiness about the rate here".<sup>127</sup>

For ten years, from 1914 to November 1, 1924, the rate was kept calmly at 5 per cent. And this was a period in which the central banks of the world made many and drastic changes in their rediscount rates--a period of almost unparalleled and sweeping changes in all phases of business, finance, and banking. No wonder, then, that Beckhart says:

"The lack of change during this period when interest rates through the world soared skyward, when the discount rate at the Federal Reserve Bank of New York ruled at 7 per cent. for nearly a year, is sufficient evidence in itself that the Treasury Board did not look upon the rate as a central bank would upon its rate of discount. That this was not the case was an error in administration. The rate should have fluctuated with economic and financial conditions."<sup>128</sup>

In this period in Canada we experienced rapid and high inflation followed by drastic deflation. Prices rose rapidly until 1920 and then fell precipitously in 1921. Advances under the Act rose from \$12,767,500 in 1914 to \$123,689,025 in 1920.<sup>129</sup> Yet in spite of all this the interest remained unchanged at 5 per cent. According to the then Deputy Minister of Finance the rate was lowered in

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127. Ibid., 1928, p. 384.

128. Beckhart, B. H. The Banking System of Canada. p. 392.

129. Ibid., p. 397.

1927 to  $3\frac{3}{4}$ <sup>130</sup> per cent. because the money rates were lower in New York and it was desired that the banks should borrow at home rather than in New York. From September 1, 1928, to October 26, 1931, the general rate stood still at  $4\frac{1}{2}$  per cent. Yet the Bank of England in 1929 alone changed its rate four times and the Federal Reserve Bank changed its rate three times.<sup>131</sup> Since England abandoned the gold standard on September 21, 1931, Canada's rate has been changed three times. In the same time the discount rate of the Riksbank of Sweden<sup>132</sup> has been raised first from 4 to 5 per cent., later to 8 per cent. (at the time of Sweden's departure from the gold standard), then down to 6, in October, 1931. By the beginning of June a fourth successive reduction had taken place in the rate, bringing it down to 4 per cent., and at September 1, 1932, it was lowered to  $3\frac{1}{2}$  per cent.

It would seem, then, that no very definite reasoning, except perhaps for the general position of the New York money rates, has been the cause of the few changes that have been made by the Treasury Board. Seemingly the Board has

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130. Proceedings of Select Standing Committee on Banking and Commerce, 1928, p. 53.

131. The Monetary Times Annual for 1930, p. 38.

132. The Financial Post, Dec. 31, 1932.

not yet discovered that the rate is "a delicate and beautiful instrument" to restrict flows of gold or to control credit conditions. Certainly we may say that the Finance Act has never been administered in the past to control money and credit in the social sense by means of the interest or discount rate.

In its attempt at monetary control the central bank finds that manipulation of the discount rate requires various supplementary devices if the official rate is to be made effective. One of these devices is moral suasion. It must be remembered that experts of the central bank have to be able to see ahead and anticipate dangers before they are reached in order that preventive measures may be taken. They are doing this with the interest of the whole people in mind. Commercial bankers, on the other hand, are interested in making profits and in the middle of a boom are not disposed to sacrifice easily won profits for the sake of the future welfare of the people generally. Hence the central bank commences to warn the banking fraternity that inflation has gone far enough and tries to secure their co-operation in restricting credit. It may go further and try to engender an attitude of caution and conservatism on the part of the general public by public statements and personal conferences. As said before the mere raising of the discount rate should be regarded by the people as a

danger signal. It generally has a psychological effect upon both bankers and business men and creates an atmosphere of hesitation and retrenchment. The lowering of the rate, on the other hand, should have just the opposite effect. It would be foolish to suggest that the Finance Act as a central bank has in the past used moral suasion. If, however, we were to take the broad view that as a central bank the Finance Act is merely the "Federal Reserve Board", and the ten chartered banks are the "Reserve Banks", we might be able to discover something in the nature of moral suasion being used at times. The Act is administered by a department of the Government, and in war time there is generally a common and close understanding between the banks and the Government. It might be added also that Canadian banks are undoubtedly influenced by the policies of the Bank of England and the Federal Reserve Bank of the United States. While these influences fortunately are generally for good, there is the possibility that at some time our banks might be thereby influenced by a foreign monetary policy conflicting with the interests of our own people.

Another supplementary device for making the discount rate more effective is found in open-market transactions. When the rate is raised, the central bank may sell some of

its commercial paper or securities. In this way money will be drawn out of the market, and this will tend to tighten up the market and discourage further expansion of business transactions. On the other hand the central bank may buy commercial paper and securities in the open market and thereby inject new funds into it. The result should be easy money, lower rates, and greater encouragement to business. It can scarcely be said that the Finance Act as a central bank carries on open-market transactions. As we have seen already in previous sections the transactions performed through the Act amount to nothing more than the making of loans to the banks. In fact, as we shall see in the next chapter, one of the arguments put forth against the creation of a central bank for Canada is that such a bank could not control money and credit because there is no such thing as a money market in Canada in which a central bank could operate.

If central bank control is to be effective, it is generally admitted that the reserves of the commercial banks should be held by it. As the MacMillan Committee has said:

"....once the commercial banks of a country hold their reserves in the shape of deposits at the central bank, the possibility of control by the central bank arises."<sup>133</sup>

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133. The Report of the Committee on Finance and Industry. (The MacMillan Report.) London, June, 1931, p. 16.

When we were dealing with the Finance Act as a bankers' bank, it was shown that this Act was not the depository of the reserves of our chartered banks. Hence the Act has not this means to assist it in any measure of control that its administrators might try to exercise.

It is usually considered that to make possible the greatest measure of control the central bank should possess a monopoly of the note issue. Freedom of issue of paper money might easily, under the influence of the desire for profits, lead each issuing body to expand its issue to the extent that the reserve of gold would be inadequate (in the case of a country on the gold standard). When a country is not on the gold standard the need for effective management is even greater. As has already been stated in a previous paragraph, the Finance Act as a central bank has no monopoly of the note issue in Canada. Hence it lacks this, another, means of control.

We shall now consider the Finance Act with respect to control of exchange. In dealing with the history of the Act in an earlier part of this present chapter it has already been noted that it was this Act that permitted the war-time inflation<sup>134</sup>. This inflation was part of the

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134. See Beckhart, B. H. The Banking System of Canada. p. 400.

cause of the disturbed condition of our foreign exchange at that time. Since exchange was affected by war conditions generally, however, we need not dwell on that period further. The Act was continued in force until 1923, when, as already explained, certain features were made permanent, and others were permitted to continue for three years more. Then in 1926 Canada officially returned to the gold standard. We may now consider the operation and management of the Act, therefore, under gold standard conditions, particularly in relation to the foreign exchanges.

As noted previously, Dominion notes issued under the authority of the Act are not required to have any gold reserves behind them at all. Yet when these notes go out into circulation there is nothing to distinguish them from the Dominion notes issued under the Dominion Notes Act and having definite gold backing. They become, in fact, an inseparable part of the total Dominion issue. As such they are legally redeemable in gold upon demand. Hence if it is considered desirable to be on a gold standard there is here a very real danger to that standard. Should the banks secure through the Finance Act a very large quantity of Dominion notes (with no gold reserve), then the gold reserves of the notes that were issued on a gold basis might be so diluted that the percentage of gold backing



to the total body of notes would become almost infinitesimal. In fact, as we shall see later, this "dilution" was what caused Canada to slip off the gold standard in 1929. Such a danger did not exist from 1914 to 1926 because Canada was not then on the gold standard. When the provision of the 1914 Act for making advances to the banks on collateral was being made permanent by the Act of 1923 apparently the danger was not realized. The reason is not difficult to see. The whole experience in the operation of the Act, both before and after the war, was gained when Canada was on paper money. Apparently the framers of the 1923 Act did not realize that when Canada went back on the gold standard, as she did in 1926, the effects of the operations of the Act would be vitally different from what they were during the paper money period. As has previously been stated, after 1926 the Government's policy was to adhere to the gold standard while her monetary machinery in the form of the Finance Act was going the opposite way--pushing her off the gold standard.

From our point of view in Canada exchange rates represent the price in our money at which the currency unit of any other country may be bought or sold. While Canada and other countries were on the gold standard the prices which we had to pay for their currencies varied only very slightly. Otherwise if, say, the cost of the United States

dollar rose above or fell below the cost of shipping gold from Canada to the United States, or vice versa, obligations would be settled by transfer of gold instead of by the purchase or sale of exchange. In other words, when exchange rates rise or fall beyond the gold points (between Canada and the United States the gold points are approximately  $5/32$  of one per cent. from parity<sup>135</sup>) gold will be shipped in settlement of balances. Thus when the orthodox gold standard works "automatically", without interference, this movement of gold tends to correct abnormal exchange situations. When Canada was on the gold standard she promised to give on demand a stated sum in gold for any and all of her paper currency. It was implied also that she would permit the export and import of gold without restriction.

From the time Canada returned to the gold standard in 1926 until the end of 1928 Canadian-United States exchange rates remained pretty steadily within the gold points. Towards the end of 1928, however, the premium on United States funds began to rise, and from then until 1930 it remained considerably above the gold export point. Almost no gold was exported, however. Our Department of Finance

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135. Curtis, C. A. The Canadian Monetary Situation. p.320.

had practically suspended redemption of Dominion notes in gold. Hence gold could not be obtained freely for export. According to our definition of the gold standard, then, Canada had in effect abandoned that standard in 1929.

As previously stated, advances under the Finance Act rose from \$12,767,500 in 1914 to \$123,689,025 in 1920. After that the tendency was downward until 1927 when they began to increase again. They rose rapidly in 1928 and 1929. As American funds were at a premium, our Canadian banks were securing loans of Dominion notes on deposited securities under the provisions of the Finance Act. These notes they were then presenting to the Department of Finance for redemption in gold, which in turn they were shipping to the United States to avoid paying the premium which they would have had to do if they had bought United States exchange. The effect of this process was soon seen. The average ratio of gold to Dominion notes outstanding dropped from 57  $\frac{1}{3}$  per cent. in 1926 to 29  $\frac{1}{6}$  per cent. in 1929.<sup>136</sup> It will be remembered that this result was possible because of the fact that while the issue of Dominion notes under the Dominion Notes Act is rigidly limited, the issue of such notes under the Finance Act is unlimited and requires

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136. Computed from the monthly returns made on "Circulation and Specie" as published in the Canada Gazette.

no gold backing. As the Government saw its gold reserves becoming depleted it was forced to suspend redemption of its notes in gold and in effect to prohibit the export of gold. Hence we see that the operations of the Finance Act forced Canada off the gold standard in 1929.

Under circumstances such as those described an ordinary central bank would have used its discount rate as a weapon to protect its gold reserves. No such use of the interest rate, or discount rate, was made by the administrators of the Finance Act. From September 1, 1928, to October 26, 1931, the general rate was  $4\frac{1}{2}$  per cent., except on advances against Treasury Notes, when the rate was  $3\frac{3}{4}$  per cent. The administrators of the Act therefore watched the country being forced off the gold standard by its operations without even once raising the rate in an attempt to halt the process. The foreign exchanges were thus allowed to act as they would. Certainly the Finance Act proved to be a poor substitute for a central bank at that time.

Whether or not Canadian banks during 1928 and 1929 borrowed money under the Finance Act to use on call loans in New York or for investment in stocks is hard to determine.

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Part 2., Section 14, of the Act says:

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137. The Finance Act, Part 2, Sec. 5.

"No advances shall be made against the pledge of promissory notes or bills of exchange issued or drawn for the purpose of carrying on trading in stocks, bonds, or other securities....., and the Minister may direct the trustees to make enquiry and report as to whether any notes or bills offered in pledge fall within the prohibition of this section."

On first appearance this clause of the Act would seem to provide an adequate safeguard. It must be borne in mind, however, that transactions giving rise to an advance under the Act do not necessarily have any connection with the character of the securities or paper deposited as collateral. Hence there is at least a hole in the woodpile big enough to house the celebrated nigger. In addition, one is again reminded of the fact that the experts called upon to advise as to the wisdom of making the proposed advances are the Trustees of the Central Gold Reserves, four in number, of whom three are bankers appointed by the Canadian Bankers' Association. In any case, whether or not the provisions of the Act have been abused in the ways suggested above as possible, the fact is that, as Mr. W. H. Budden says,<sup>138</sup> "this state of affairs is dangerous not only in theory but in practice...." It would seem to be expecting too much of any banker to resist borrowing

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138. Budden, W. H. "Finance", p. 7--private copy.

under the Finance Act at  $4\frac{1}{2}$  per cent. at a time when money could be put out on call loans in New York at as high a rate as 20 per cent. To say the least the existence of such possibilities as those above suggested renders control of the exchanges most precarious.

However, the premium on New York exchange was never more than  $2\frac{1}{2}$  per cent. until September, 1931. After that date it almost reached 25 per cent. At date of writing (March 2, 1933) it is 19.76 per cent. The sudden drop in the value of the Canadian dollar abroad followed Great Britain's fall from the gold standard on September 21, 1931. The balance of trade and international payments generally does not seem to offer an adequate explanation of our exchange situation. From 1921 to 1928 we had an excess of exports over imports. In the latter year the so-called "favorable" balance of trade amounted to \$152,000,000. It is true that we had an "unfavorable" trade balance of \$91,000,000 in 1929 and \$103,000,000 in 1930, but accompanied with a drastic fall in our total trade we find a growing decrease in our adverse balance until in 1932 we had a net merchandise credit balance of \$82,000,000 and a credit balance on all international payments of \$61,000,000.<sup>139</sup> Yet our dollar is still at a

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139. Data obtained from the Financial Post, Feb. 18, 1933.

big discount in the United States.

Undoubtedly the shock given to the faith of all nations in foreign investments generally by England's fall from the gold standard in September 1, 1931, caused foreign demand (particularly American) for Canadian securities to cease almost altogether. Never before, probably, have the money markets of the world been so completely closed to even first-class foreign borrowings.

Then again this general state of lack of confidence led to a closer examination of Canada's financial condition. The fact of our having played with the gold standard from 1929 to the present, the weakened condition of our gold reserves, and the extent of our funded debt probably all tended to make prospective investors even more nervous.

As stated above, foreign markets were practically closed. Bond issues could not be floated, short-term loans could not be refinanced, and Canadian borrowing abroad ceased. This cessation of borrowing had an unfavorable effect on our exchange situation. Then of course we had heavy interest payments to make on Canadian securities held in the United States and the unfavorable exchange added greatly to this burden. The burden of the high premium on American funds was evidenced in another way. Many Canadian securities held in Canada are payable in

either Canadian or United States funds at the holder's option. Many owners of such securities held in Canada sent them to New York for payment to get the advantage of payment in United States funds. This added to the payer's burden. In addition, if the full amount of these payments was not brought back to Canada there was a net additional demand for United States exchange which in turn further depressed our dollar. Undoubtedly, too, the general feeling of insecurity after Britain's fall from the gold standard caused the repatriation of United States funds in Canada and this affected Canada's exchange situation unfavorably.

Had the Canadian Government been concerned solely with its own financial obligations and had it not felt it necessary to assist the banks it would very likely not have been led to play as it did with the gold standard. As we have seen, during 1929 we were definitely off the gold standard, and after 1929 till October, 1931, we were "on and off". Then on the latter date gold export was officially prohibited, except under license, and we were admittedly off the gold standard again. But just previous to this the Government's reserve position was sound.<sup>140</sup>

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140. The material here used is a summary of Mr. C. A. Curtis' treatment of the question in his article on "The Canadian Monetary Situation" in the June, 1932, issue of the Journal of Political Economy.



Dominion notes outstanding amounted to \$150,000,000 of which \$28,000,000 was in the hands of the public. The banks had \$12,000,000 of the rest on deposit in the Central Gold Reserves and \$110,000,000 in their possession, and the Government had \$67,000,000 in specie. By law 40 per cent. of the reserves of the banks must be in the form of Dominion notes. It is altogether unlikely that the banks could have reduced their reserves to an extent great enough to endanger the Government's gold position. Therefore, had the Government concerned itself solely with its own position, it need not have been worried about its gold reserves. But it had come to the rescue of the banks in 1914 with the Finance Act. They had become accustomed to rely on this Government assistance provided by the terms of that Act. In other words, the passing of the Finance Act in 1914 marked the transfer of responsibility for monetary control from the banks to the administrators of the Act. The Government had supported the banks up to this time. It admittedly could not permit any of the banks to fail. It could not, therefore, abandon them now. The price of its assistance to them was the abandonment of the gold standard.

It would appear to be beyond question, then, that there is a serious weakness in our Canadian monetary system. It

may be that there are enough minor defects to make a general overhauling of the whole structure desirable. The really vital defect, however, is to be found in the Finance Act. It not only does not control, it at times is a positive force working in the opposite direction. The writer has no inclination to uphold the gold standard, but would point out that if such a standard is to be maintained in Canada the Finance Act will be a constant source of danger to its stability. On the other hand if some other standard is adopted, a greater degree of intelligent control will be necessary than under gold standard conditions.

In this chapter we have examined the Finance Act to see if it constitutes an adequate substitute for a central bank. After weighing the evidence with respect to its operation we found that in some respects it is like a bankers' bank, particularly in that it provides loans for the banks, supplies emergency currency, and has the commercial banks as its only customers. On the other hand we found that as a bankers' bank it is very inadequate in that it does not hold the reserve funds of the banks, that it does not act as a clearing house for the banks, that its loaning function does not constitute real rediscounting, and that its administration has been hopelessly inefficient from the point of view of central banking. As a bankers'

bank, then, it is only a "piece of a bank". We have previously seen that in no sense does it serve as a government's bank. Now we may add that it is even worse as a "people's" bank than as a government's bank, for it not only fails to provide any social control whatever, but actually is a dangerous source of instability in our monetary structure.

In concluding this chapter we may observe that an institution which does no real rediscounting, which performs no direct service for the Government, which exercises no control over the commercial banks, which pursues no credit policy, which is unconscious of a possibility of price control, which makes no attempt at exchange control, which in short provides not even a modicum of control in the social sense, and which is responsible for its country being driven off its adopted monetary standard, may be one of a number of things, but most certainly it is not a central bank.

## Chapter 6.

Arguments for and against a Central  
Bank for Canada.

Since the question of a central bank for Canada has reached the stage of serious consideration its opponents have been trying to show first, that it is unnecessary, and then that there would be many difficulties in the way of creating an institution that could render effective service. The argument most frequently put forth in opposition is that in the Finance Act we have all that we need in the way of a central bank. Another argument is that the head offices of the chartered banks provide adequate discounting facilities for the branches. With these two arguments we have already dealt at length in the previous chapter.

When the argument is advanced that a central bank is required for the purpose of controlling credit, opponents claim that the chartered banks themselves practise credit control to an adequate degree. It is true that they do have certain more or less mechanical rules to guide them. For instance, they feel constrained to keep cash holdings about equal to 10 per cent. of their liabilities. Then

again they are inclined to have a "balance sheet concept". They watch one another's statements to see whether their own position is relatively favorable or not. They are no doubt to a considerable extent influenced by the Bank of England and the Federal Reserve Banks. In addition, it is true that the larger banks, at least, have, at certain times, a common understanding with the Government on credit policy. This is particularly true in time of war. In the broader sense of credit control as a social function, however, as seen in Chapters 3 and 5, practically nothing is done by the chartered banks in Canada.

One of the first reactions of Canadian bankers to the suggestion that we should have a central bank is to express anxiety lest the present banking system be disturbed. They look upon this system as tried, proven, and efficient. Why then should we tinker with it? Why endanger it with an innovation? Mr. C. A. Bogert, Vice President and General Manager of the Dominion Bank, says:

"Throughout this depression, the Canadian banking system has functioned so quietly and efficiently as to win praise from many other countries, and competent observers in the United States do not hesitate to pronounce it much superior to their own."<sup>141</sup>

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141. The Daily Province, Vancouver, B. C., Jan. 31, 1933, p. 3.

Mr. J. A. McLeod, President of the Canadian Bankers' Association, says:

"I have, perhaps, said enough to make it clear that the projected establishment of a central bank in Canada raises some exceedingly difficult problems, and is not without elements of danger."142

"A Canadian Banker", writing to give the view-point of Canadian chartered banks, expresses himself in part as follows:

"....I believe that the establishment of a central bank in Canada is unnecessary and that its organization and operation in the manner outlined in Mr. Plumptre's articles will involve a drastic and dangerous change in Canada's banking structure which may vitally affect the interests and well-being of every Canadian..."143

No doubt the above quotations express the sincere convictions of the great majority of our bankers. It is perhaps natural that they should view with anxiety any projected change in a system which, from their point of view, appears to be excellent. Nevertheless, when the question is given consideration free from bias, there would seem to be little valid reason for their opposition. A central bank need not interfere with their ordinary privileges nor lead to uncontrolled inflation, which they

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142. McLeod, J. A. Address to the Annual General Meeting of the Canadian Bankers' Association, Toronto, Nov. 10, 1932, p. 13.

143. The Financial Post, Dec. 10, 1932.

fear. In fact a genuine central bank would assist the bankers to solve many of their problems and would limit them only in-so-far as it would be necessary to prevent abuses. The situation of our Canadian bankers might best be summed up in the words of Kisch and Elkin:

"In some instances when the Central Bank is superimposed on an existing banking system the commercial banks which have maintained themselves previously without it may perhaps not fully appreciate its advantages and, jealous of their position, may question the expediency of the innovation."144

Our Canadian bankers are for the most part skeptical of the efficacy of central banks generally. In the first place they have little faith in the general theory of monetary control in the social sense. They are inclined to shy at the suggestion of control of foreign exchange and of the price level. The arguments on this question were presented in Chapter 3, however, so that phase of the broader question of central bank efficacy will not be labored further here.

When we look at the mistakes and failures of central banks to date, however, it must be admitted that there is considerable ground for our bankers' doubts. They point, for instance, to the Bank of England, the most famous

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144. Kisch and Elkin. Central Banks. p. 117

central bank in the world, and remind us that this great bank was powerless to prevent the financial crisis of 1931 in that country. Certainly the writer does not think that the Bank of England is by any means perfect. It is not a government bank. It is really a private corporation owned and controlled by its shareholders. These shareholders elect a board of twenty-four directors who choose one of their number as Governor and one as Deputy Governor. It is quite true that the Bank's policy usually indicates a high sense of duty to the nation on the part of the directorate. There can be no doubt that the directors often place their moral obligations to the country above the profit motive. Nevertheless, it would appear that very often the directorate's idea of what is the best policy for the nation is really what is the best policy for "the city". Whether consciously or otherwise, the directors seem all too often to be too much influenced by "the city". Unfortunately the interests of "the city" and of the nation as a whole are not always one and the same. An illustration of this may be seen in the events of the crisis of 1931. From whatever motive it may have been pursued, the fact remains that the policy of "the city", and not any policy of the government of the day, resulted in frozen assets and in a financial crisis. It was not



necessarily in the interests of the people generally that wages should be reduced, that the dole should be cut, that the standard of living should be lowered, and that the gold standard should be glorified one day and despised the next in order that "the city's" chestnut might be pulled from the fire. Yet the financial policy of "the city", led by the Bank of England, forced the downfall of one government and the creation of another to do these things. Had the Bank of England been a real government's bank, had its policy been formulated by a directorate having an enlightened social consciousness, uninfluenced by special interests, these things would not likely have happened.

One illustration alone seems to be proof enough that the personnel of the management of the Bank of England is not all that it might be, in spite of the fact that undoubtedly there are many splendid and able men on its directorate. The Governor, Mr. Montagu Norman, is quoted as saying last autumn:

"The difficulties of the present economic situation are so vast and so unlimited that I approach the subject not only in ignorance but in humility. It is too much for me ..... I hope we may all see the approach of light at the end of the tunnel. Some people have been able to point out that light to us. I myself see it somewhat indistinctly but I admit that for the moment the way is not clear."145

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145. The Financial Post, Oct. 29, 1932.

The frankness of this utterance is indeed to be commended. For humility there is great need. For ignorance, however, there should be no place in the governorship of the Bank of England. Respected as he must be for his candour, the Governor would have been much more respected had he, following this frank utterance, resigned and given place to some one who could "see the light at the end of the tunnel" less indistinctly.

Turning now to the Federal Reserve System of the United States we may again find imperfections. Before the Federal Reserve Act of 1913 was passed, the American banking system was particularly deficient in social control of the monetary structure. The thousands of banks were unable to cope with inflation and speculation. As a matter of fact their influence was often exerted in the direction of aggravating the instability that existed. United action was impossible. Each bank followed its own policy, which was usually to expand its credit in competition with the other banks at a time when concerted restriction should have been used as a brake on the inflation of a boom period. The weakness of the system was seen clearly in the panic of 1907.

The United States now has a Federal Reserve System with twelve regional banks headed by a Federal Reserve

Board. The Reserve Banks are expected to follow business developments closely and to vary their discount and open market operations accordingly. It is perhaps not surprising that they have not always done this. In the first place the Federal Reserve System is very young, having been established as recently as 1913. During the first few years, till 1916, shall we say, it was not strong enough to carry out a very ambitious policy. The period of the participation of the United States in the war witnessed the subordination of the Reserve Board's policies to the mistaken ideas of the Secretary of the Treasury.<sup>146</sup>

The Federal Reserve Board's policy has never been very definitely stated.<sup>147</sup> The Board has officially acknowledged the price level as one guide to discount policy, but only one among many. "Stability" has not been defined. What index or indexes are used is not clear. The Strong Bill, which would definitely have committed the Board and the Reserve Banks to "promoting a stable price level for commodities in general", was opposed by them. Both Board and Banks in 1927 disowned any responsibility

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146. Beckhart, B. H. The Banking System of Canada. p. 485.

147. The information here given is largely a summary of the views of Lionel D. Edie in "Money, Bank Credit and Prices", pp. 491-92.

for the drastic decline of commodity prices which had started in 1925. In 1929 the growth of the speculative boom caused great concern on the part of both the Federal Reserve Bank of New York and the Board.<sup>148</sup> Unfortunately the two could not agree upon remedial measures to be taken, the former wishing to raise the discount rates, the latter desiring to rely upon direct action and warnings. Consequent lack of co-operation naturally weakened their efforts to bring about stability.

Early in the present depression the Federal Reserve System was found to be too rigid, hence the organization of the Reconstruction Finance Corporation and the passing of the Glass-Steagall Bill. The policy of open market operations inaugurated in 1932 seems to have been successful in arresting bank failures and in reversing the hoarding movement<sup>149</sup> for a time. The success was only temporary, however, and the real bank crisis came on March 4, 1933.

The worst feature of the Federal Reserve System seems to be that the personnel are apparently unable to decide

148. Bopp, Karl R. Two Notes on the Federal Reserve System. The Journal of Political Economy, June, 1932, p. 388.

149. See Chase Economic Bulletin of May 16, 1932, p. 18.

readily upon the policy to be carried out and consequently they have not made definite declarations as to what their policy is. The cause of this condition of affairs can perhaps be found in the structure of the Reserve System.<sup>150</sup> Its complicated nature renders it difficult to obtain a consistent long-run policy. The Federal Reserve Act sets up many agencies having either direct or indirect influence on policy. There is first the Federal Reserve Board of eight members. Then there are the boards of directors of each Federal Reserve Bank having in all 108 directors. There is also the Federal Advisory Council of 12 members made up of one from each Reserve district. There are in addition the 12 governors of the several regional banks. These 12 governors in turn constitute an open market policy conference. In all, then, there are at least 140 individuals concerned with policy development. Policy is therefore often the result of compromise or balance of power. Add to this the fact that of the 25,110 banks in operation in the United States in 1929<sup>151</sup> more than 60 per cent. of the commercial banks were non-members made

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150. See Bopp, Karl R. Two Notes on the Federal Reserve System. The Journal of Political Economy, June, 1932, p. 379.

151. Sisson, Francis H. United States Banks. Review of Reviews and World's Work, Dec., 1932.

up of state banks and trust companies, preponderantly small institutions, and you see the difficulty of enforcing a unified banking policy.

Nevertheless the Federal Reserve System in its brief existence has already been of untold benefit to the country--in the financing of the Great War, in making possible at least some degree of concerted action, and in helping to meet the present critical financial situation.

Neither time, space, nor purpose permits a further examination into the general efficacy, or lack of it, of the various central banks. In the light of what has been said of two of these banks, however, it is not altogether surprising that the President of the Canadian Bankers' Association should say:

"May I say, with regard to central banks, that there has been a great deal of misapprehension as to what they can do: that even today there exists a great deal of misapprehension as to what they have been able to do elsewhere."

When "Christian" met "Atheist", in Pilgrim's Progress, trudging along with his back to the Celestial City, the following conversation is supposed to have taken place:

"Where are you going?" asked Atheist, laughing at Christian.

"To the Celestial City", replied Christian, his face all aglow with heavenly light.

"You fool!" said Atheist, laughing as he trudged

on into the darkness. "I've been hunting for that place for twenty years and have seen nothing of it yet. Plainly it does not exist."

Heaven was behind him.

The bankers of Canada can see no "heaven" in a central bank for our country. Their backs are turned against it. But even if central banks in existence elsewhere have not been all that they might have been, even if the creation of a central bank in Canada would not immediately usher us into a financial or monetary heaven, it would at least be a consolation to know that we were walking in the right direction. At the same time if we are to have a central bank in Canada it will be vitally important to remember that the mere erecting of a central bank of "some kind" would be futile and a waste of time and money. We do not want to copy any particular central bank in existence. We should have one that would fit our particular needs and one that will be free from the faults of the present central banks. We should adopt the view that no single central bank yet in existence is quite good enough for us.

Another objection that our bankers raise against the proposal of a central bank for Canada is that the political factor may thereby come to have an evil influence upon the banking system. In the previous chapter this point was dealt with rather fully and need not be considered at

length here. It will be recalled that we found the Finance Act "wide open" to possible political influence, yet there was no evidence of any evil in this regard. Speaking recently in favor of a central bank and denying that such a bank would be subject to political influence, the Hon. Vincent Massey said:

"The need is to take the banks out of politics, and if there is one agency which would keep all the delicate mechanism of financial policy out of political debate it is a central bank."<sup>152</sup>

In agreement with Mr. Massey one may observe that a properly constituted central bank would at least leave our banking system less open to the political factor than it is at present with the existing substitute for a central bank in the form of the Finance Act.

It is contended also that it would be difficult to secure efficient management for the projected central bank. This objection can scarcely be taken seriously, however. In fact, "A Canadian Banker", with the very breath in which he is strenuously opposing a central bank, unintentionally implies that there would be no difficulty in securing the needed experts. In recommending a permanent economic advisory committee instead of a central bank, he says in part:

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152. The Financial Post, Feb. 4, 1933.



"This committee should be composed of the most intelligent, experienced and practical men it is possible to secure. Consideration might be given to obtaining as chairman an outstanding British economist who would bring to the deliberations of the committee a broad international point of view."153

This is indeed a good description of what experts administering a central bank should be. It cannot too often or too strongly be stressed that the personnel of a central bank is the vital factor. A mere bank and a high sounding constitution are not enough. In agreement with "A Canadian Banker" one may well admit that our central bank experts could not be too intelligent or too experienced. There is a danger, however, of over-emphasis on the word "practical". It is possible for so-called eminent business men and bankers to be so "practical" that they cannot see the forest for the trees. Consideration of the social function of a central bank in Canada should be paramount. Hence it would seem advisable to have in the key position with respect to central bank policy formation a person with professional academic training--a person whose knowledge of money and banking has been gained as a result of disinterested study--an economist who is an expert in the field of money and banking in some university. Then, if

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153. The Financial Post, final article by "A Canadian Banker".

necessary, surely the very able bankers that we have in Canada could supply us with some of the management personnel.

A more serious contention is that a central bank could not function effectively in Canada because of our lack of a money market. The President of the Canadian Bankers' Association says:

"It may be questioned whether in any country that is a debtor country the central bank can possess power. For a central bank that does possess power, to bring its influence to bear without shock to the financial and business structure, it should be functioning in a sensitive money market and, if possible, a market which creates bills of exchange in its own currency. Where these conditions are not fulfilled a central bank is apt to resemble an impressive facade with a small and rather flimsy building behind it."154

As outlined in the previous chapter, when the Finance Act was being appraised as a "people's" bank, the discount rate of the central bank is the primary device for the control of money and credit. One of the means of making this device effective is found in open market operations. The central bank uses this method of making money "tight", or dear, "easy", or cheap. If money is too plentiful, the discount rate will be raised and commercial paper or securities will be sold in the open market. Money is thereby taken out of the market, and this tends to tighten

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154. McLeod, J. A. Address to the Annual General Meeting of the Canadian Bankers' Association, Toronto, Nov. 10, 1932.

the market. The commercial banks will not then have as liberal a supply of funds with which to make new loans to customers. If they go to the central bank they will be confronted with the high discount rate which will dampen their enthusiasm for further expansion of credit. On the other hand, if money is too scarce, the central bank will buy securities in the open market. It may do so by issuing new notes, or simply by crediting the sellers with "deposits". The sellers may then transfer these new notes or deposits to their own banks. The commercial banks thus receive added reserves, and on these new reserves they may make new and profitable loans to their customers. In this way, the bank credit of the whole country may be increased by central bank open market transactions.

But Canada has no sensitive market in which such open market transactions could be carried out. Business men do discount their bills with their bankers, but we have no adequate market for dealing in bills of exchange. Neither have we the machinery for dealing with them, such as is to be found in financial centres like New York and London. When one of our banks discounts a bill, it usually retains it until the date of maturity. Very often, too, such bills are drawn in terms of sterling or American dollars rather than in Canadian money.

It is usually desirable that there should be, for central bank operations, a plentiful supply of investment media in the form of short-term commercial paper and short-term Government treasury bills. In Canada the supply of treasury bills is usually neither large nor constant, although the supply was augmented to the extent of \$35,000,000 last autumn. As for the supply of commercial paper, while it totals up to an immense sum, the individual items are small and are not concentrated to any extent in any one or in a few centres.

In considering the possibilities of a central bank in Canada, then, this drawback of a lack of a money market must not be minimized. Nevertheless this undoubtedly potent obstacle should not be over-emphasized either. Other means of control are possible. The discount rate itself is the primary device for such control. Moral suasion is also often more effective than anything else. The psychological effect on the banking fraternity and on the general public, when a central bank announces a change of policy, may be greater in checking unsound developments than any other device.

In Sweden there is no short-term money market nor bill market, yet that country has a very effective central bank, the Sveriges Riksbank. Sweden followed Great Britain in

going off the gold standard in 1931. Since that time the central bank has been following a policy of regulating the internal price level and more or less ignoring the foreign exchanges. This policy has been remarkably successful<sup>155</sup> to date in stabilizing the internal purchasing power of the krona. As in the case of Canada, Sweden's foreign trade is transacted in terms of foreign currency, and as stated above she has no money or bill market. Her central bank operations are therefore largely confined to discount and exchange rate manipulation supplemented by moral suasion, just as would largely be the case with a central bank in Canada.

In New Zealand also we find there is no money or bill market, yet the Minister of Finance, Mr. Coates, has announced officially that the Government is going to establish a central reserve bank there.<sup>156</sup>

Finally, we may ask to what extent our lack of a money market, or bills of exchange, or short-term commercial paper and treasury bills, etc., should be regarded as a result of having no central bank, rather than as a good cause for not creating one. Is it not to be expected also

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155. See Financial Post, Dec. 31, 1932.

156. See Financial Post, Dec. 17, 1932.

that our foreign transactions will be in terms of sterling, or of American dollars, instead of in terms of Canadian dollars, as long as we have no central bank facilities?

At all events we should not permit the lack of a money market alone to discourage the idea of a central bank, for as Kisch and Elkin say:

"....the risk of prematurity in the creation of a central banking system should not necessarily be regarded as a decisive factor, because there is no influence so potent in the way of developing the credit system on sound and progressive lines as a well-founded Central Bank."157

Canadian bankers are very sensitive to the criticism that they do not meet the needs of the public in the matter of credit. Practically every one of them who has in recent months spoken against the proposed central bank, seems to have assumed that the uppermost thought in the minds of the advocates of such a bank is that it would greatly increase credit. One of the arguments most frequently put forth by them, therefore, is that a central bank would not increase credit. For instance we find "A Canadian Banker" saying:

"The establishment of a central bank cannot, therefore, increase by one dollar the supply of commercial credit now available in this country."158

157. Kisch and Elkin. Central Banks. p. 12.

158. The Financial Post. Final Article by "A Canadian Banker".

In similar vein Mr. M. W. Wilson, Vice-President and General Manager of the Royal Bank, says:

"Too often, I fear, it is thought that a central bank would furnish increased credit facilities to farmers and others. This is not the case. At no time during the present depression has it been necessary to withhold bank credit for agricultural or commercial purposes when proper security was offered."159

We might consider briefly the question of availability of credits. Whether there is any real foundation for it or not the fact remains that the criticism of our banks most commonly voiced is that they are not accommodating enough in the matter of credit. The West in particular keeps up an almost continual cry against inadequate credit facilities. Some of the people there think that unit banks would serve local needs better than the present banks. They feel that with the branch banking system money is concentrated too much in the large financial centres of the East, such as Montreal and Toronto, and that the West is discriminated against. It is no doubt harder to interest a bank official of the East in a loan in the West than it would be to interest the official of a local unit bank. However, if the West had unit banks it is doubtful if credit would be any "cheaper". The West

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159. Ibid., Jan. 21, 1933.

is an area of excess of loans over deposits, and credit would have to come from the "surplus fund" areas. With unit banks such an area as the Maritime Provinces, however, with an excess of deposits, might expect to obtain larger amounts of credit at lower rates.

The criticism of the moment, however, is that the chartered banks, being private institutions quite naturally and rightly concerned primarily with profit-making and their own safety, give credit all too freely in prosperous times and restrict it too rigidly in times of depression like the present. The idea of the central bank advocate, on the other hand, is that such a bank would be more far-seeing in its policy, would not be concerned with profits but rather with the general well-being of the nation, and would tend to restrict credit in boom times and be more accommodating in depression periods.

A good sample of the type of criticism heard is to be found in an editorial entitled "Money and Credit" in an issue of the Vancouver Daily Province of March 3, 1932. Quoted in part we have:

"The credit situation has become a serious one in the Dominion. There is no lack of wealth in the country, but a very serious lack of the means of developing that wealth.....

"Confidence and no money! The two don't go together. While the men of money whisper of their confidence, their actions in denying



"credit to construction and industry and in rushing to over-subscribe government issues at 6 and  $6\frac{1}{2}$  per cent. fairly shout the opposite. Where is the money to meet these 6 and  $6\frac{1}{2}$  per cent. issues to come from? It can only come, ultimately, from industry. And industry is being throttled for lack of credit. Undoubtedly the system needs investigating."

In the same editorial Mr. Reginald McKenna is quoted as saying:

"The amount of money in existence varies only with the action of the banks in increasing or diminishing deposits. We know how this is effected. Every bank loan creates a deposit, and every repayment of a bank loan destroys one."

Bankers maintain that they loan to borrowers the savings of depositors. This of course is true, but it is not the whole truth. They are really "merchants of credit" rather than "merchants of money". When they regard conditions as favorable they make a practice of loaning to customers ten times the amount of the money actually placed on deposit with them. This practice gives birth to the currently popular statement that banks "loan what they haven't got".

As Mr. Plumptre says:

"The fallacy that bankers as a body receive and re-loan the 'savings' of the public dies hard; and that not only among the bankers. But it is a fallacy."160

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160. Plumptre, A. F. W. The Point of View of a Central Bank. p. 132.

The amount of real money in Canada at any given time is extremely small compared with "money" in the form of bank deposits. These deposits are nothing more than book entries, and surely it is reasonable to say that the bankers can exercise considerable control over these entries. Hence it is logical to assume that our bankers can increase credit if they desire, and if the chartered bank can do this, surely a central bank could. It is utterly unreasonable, then, for "A Canadian Banker" to say that a central bank could not increase by one dollar the supply of commercial credit.

It will be noted from the quotation given above from Mr. M. W. Wilson of the Royal Bank, that it is the contention of bankers that even today in the midst of depression there is no lack of credit for 'sound' borrowers. They maintain that decreased loans are a result of the lack of borrowers with adequate security. They are unwilling to admit that a stringency of credit may have contributed to the 'unsoundness' of prospective borrowers. To them there appears to be no relation between the abundance of credit in 1929, for instance, and the 'soundness' of borrowers at that time. It is hard to understand, however, their persistence in the theory that restricted credit and abundant credit are not even contributory causes of

the 'solvency' and 'insolvency', respectively, of borrowers.

As Mr. Plumptre very aptly says:

"The main difference (between a central bank and a private bank) is really extraordinarily elusive--for it is a difference in point of view."161

The point of view of our chartered banks primarily is that profits should be made for their shareholders and that the banking institutions must naturally be guarded against insolvency. So far as is consistent with this primary objective credit accommodation and general services may be given to the public. This, of course, is the natural and reasonable point of view for the banks to take.

The point of view of a central bank would be very different. It would not be concerned primarily with profits. Profits it might, and likely would, make, but they would be of secondary consideration. Transactions might often be undertaken deliberately at a loss in order to serve a greater purpose. Not the security of a bank, or of a banking system alone, but the 'security' of a whole people, would be the objective.

Another obstacle in the way of the creation of a

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161. Plumptre, A. F. W. The Point of View of a Central Bank. p. 132.

central bank for Canada, say its opponents, is the matter of costs. This is a question which of course demands serious consideration. Let us hear first from banker opponents. Mr. A. E. Phipps, General Manager of the Imperial Bank of Canada, says:

"A central bank cannot be established without heavy expenses--no doubt its sponsors will say otherwise, but once it is launched expenses will be hard to control."162

Mr. H. B. Henwood, General Manager of the Bank of Toronto, says:

"....I am satisfied that if this additional frill to our present banking system were added, it would mean a heavy increase in expense with little or no offsetting benefits to the banking facilities of the country...."163

The bankers, in fact, seem to be pretty unanimous in their support of the general statement that the costs of a central bank would be too great. Not many of them go into details, but Mr. Phipps says:

"It is not difficult to visualize the agitation for an imposing head office, expensive branch offices for every province, highly paid Managers and staff at the Head Office and the Branches with no benefits to the country,..."164

It is of course obvious that there would be an initial

162. Saturday Night, Dec. 3, 1932, p. 27.

163. The Financial Post, Jan. 21, 1933, p. 5.

164. Saturday Night, Dec. 3, 1932, p. 27.

organizing cost, but this would not be a recurring item. Nor need it be the spectre that Mr. Phipps imagines. It is to be feared that Mr. Phipps envisions a central bank edifice as imposing as, say, the main branch of one of the chartered banks in the city of Montreal or Toronto. One of these in the city of Toronto is thirty-eight storeys high--the tallest building in the British Empire--and all its appointments are in keeping with its height. Only two or three blocks away the same bank has another branch building at least about half as large. But it would be entirely unnecessary for a central bank to be housed in such a palatial building. It would not aim to make profits enough to invest in real estate to such an extent. Besides, in most of our large cities the Government spends a great deal on rentals for office space. Should the central bank, or a branch office, have space to spare, it could be used for Government offices. This would work particularly well if the central bank were entirely state-owned.

A matter of greater importance would be the operating costs. Mr. Phipps says:

"A central bank once established is established for all time, and the expense goes on forever."165

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165. Saturday Night, Dec. 3, 1932, p. 27.

If it is established for all time, then presumably the initial organizing cost is paid for all time. Undoubtedly operating costs would go on indefinitely. But do not the costs of Mr. Phipps' bank "go on forever"? His statement obviously is meaningless as an argument against a central bank.

Six of the United States Federal Reserve banks had current expenses of less than \$2,000,000 in 1929.<sup>166</sup> In the same year the smallest one, the Reserve Bank in Minneapolis, kept its current expenses under \$1,000,000.<sup>167</sup>

It would seem fair to assume that the costs of a Canadian central bank would be lower than those costs in the United States.

Then there is the question of capital for the central bank. "A Canadian Banker" says:

"There are sound political reasons why the institution should not be government-owned and since it is to be a "bank for bankers" the chartered banks would probably be called upon to subscribe for the greater part, if not all, the capital stock."<sup>168</sup>

166. See Curtis, C.A., in Proceedings of the Canadian Political Science Association, 1930, p. 111.

167. Ibid.

168. The Financial Post, Jan. 28, 1933.

This banker is taking a good deal for granted. The Finance Act which bankers laud as a perfect substitute for a central bank is, as we saw previously, entirely "government-owned", yet the banker sees no "sound political reasons" for objecting to it. It might be that if a central bank were set up in Canada the banks here, as in the United States, would be asked to subscribe some or all of the capital. The writer can see no valid reason, however, why the bank should not be completely state-owned. He can, on the other hand, see several very vital reasons why it should be so owned. The central bank should be more than a mere bankers' bank. It should be a government's bank, and above all a "people's" bank in the manner described in previous chapters. As a government-owned institution completely independent of the other banks it would be in a position to act as the guardian of public welfare to a greater degree than if partly or entirely owned by the chartered banks. The writer feels that the political factor has been met with so repeatedly in history as a "bogey" raised in defence of vested interests whenever it has been suggested that the state should operate a service in the interests of the people generally, that it has largely lost its effect.

The Atlanta Reserve Bank has a capitalization of about

\$5,000,000.<sup>169</sup> At the beginning of 1930 it had \$138,000,000<sup>170</sup> of Federal Reserve Notes in circulation. The Central Reserve Bank of South Africa has a capital of \$5,000,000.<sup>171</sup> Six of the Federal Reserve Banks of the United States have capital of \$6,000,000 or less. The ten chartered banks<sup>172</sup> of Canada on December 31, 1932, had a total paid-up capital of \$144,500,000. The average number of branches of all these ten banks for the year 1931 was 3,506. One bank with 141 branches has a paid-up capital of \$4,000,000. Three other banks with a combined capital of \$27,000,000 have together 636 branches. It would seem reasonable to suggest, then, that the capital of the proposed central bank for Canada need not exceed \$10,000,000 at most.

With the establishment of a central bank the Central Gold Reserves would no longer be required. If an entirely state-owned bank were created, the Government's supply of gold could be used as capital and reserves and would be more than adequate as such. On October 31, 1932, gold held by the Minister of Finance<sup>173</sup> was as follows:

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169-171 Curtis, C. A. Proceedings of the Canadian Political Science Association, 1930, p. 111.

172. The above information on capital of Canadian Banks was obtained from the Financial Post of Jan. 28, 1933, while information as to their branches was taken from "Canada, 1933", p. 156.

173. Statement from the Department of Finance of Nov. 10, 1932, and published in the Canada Gazette.



Against Savings Bank deposits.....	\$ 2,312,316.06
Against Dominion Notes.....	70,301,955.69
In excess of Statutory requirements..	874,231.33
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	\$73,488,503.08
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Mr. A. E. Phipps<sup>174</sup> wonders where the deposits required to build up the central bank would be obtained. This would not seem to be a very great difficulty. The Government's account would naturally be transferred from the chartered banks to the central bank. "A Canadian Banker" gives figures to show that in 1931 the average balance carried by the Dominion with the banks was \$49,000,000.<sup>175</sup> Monthly returns to the Minister of Finance show under the heading, "Balance Due to Dominion Government", the sum of \$53,107,707 as at December 31, 1932. Such funds would seem to be ample as deposits for the central bank to start with.

"A Canadian Banker"<sup>176</sup> also says that with the appearance of the central bank the Dominion Government would

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174. See Address of Mr. Phipps in "Saturday Night", Dec. 3, 1932, p. 27.

175. The Financial Post, Jan. 28, 1933.

176. Ibid.

lose the interest paid by the chartered banks on loans under the Finance Act. The average annual revenue received by the Government from this source during the past five years has been \$1,250,000. This is of course quite true, but what the Government would lose directly in this way the central bank would gain because the central bank would replace the Finance Act. If the bank were entirely state-owned the Government would presumably receive the equivalent sum through it in the form of profits, assuming that the bank is not to be operated on a service-cost basis. In fact, even if the central bank were entirely privately owned, it would be reasonable to assume that it would turn over to the Government the equivalent of the net profit on what is now the Dominion note issue. If the bank were run purely on a service basis, then the chartered banks, business, and the general public would benefit accordingly, and would be the better able to pay taxes to the Government to make up for its initial loss.

The very fact that the operations of the Finance Act are profitable tends to prove that the central bank would be profitable. It is true that the expenses of administering the Finance Act are slight,<sup>177</sup> much less, no doubt, than

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177. House of Commons Debates (Can., 1923, Vol. 5, p. 4408).

would be the case with the central bank. On the other hand rediscounts would not be the only source of revenue for the central bank.

The maximum gross earnings<sup>178</sup> under the Finance Act occurred in 1920-21, amounting to \$3,568,000. We find that the minimum yearly earnings since 1917 appeared in 1925-26 and amounted to \$313,000. The year 1929-30 brought earnings of \$2,235,000, and the average annual earnings from 1914 to 1930 were approximately \$1,300,000. From this it will be seen that the central bank would have an exceedingly lucrative business to start with. With the added facilities which it would provide true rediscounting would be increased and would not be confined largely to government bonds, as at present under the Finance Act, but would extend to commercial paper generally. This would of course swell the income of the central bank far beyond that of the present Finance Act.

Central banking in any case is generally profitable. The prestige of a properly run central bank rarely suffers from financial losses. A large amount of absolutely safe

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178. Figures which follow were largely obtained from C. A. Curtis, Proceedings of the Canadian Political Science Association, 1930, p. 113.

business is brought to it by its customers. Interest is not usually paid on deposits which it holds. Its assets, on the other hand, except for cash holdings and real estate, are usually very productive. Additional profits could be made by the central bank taking over the monopoly of the note issue and by entering into competition with the commercial banks in the realm of business and finance generally, but these points will be dealt with in later paragraphs.

It can scarcely be too often repeated, however, that profit-making should be of only very secondary concern to the central bank. If the bank is entirely, or in part, owned privately, it is desirable that payment of a reasonable rate of interest to the shareholders should be ensured. But it is of supreme importance that the earning of dividends should not be made the prime consideration. For this additional reason it would appear that a state-owned institution would be best, for then there would be less tendency to become concerned over profits. As Kisch and Elkin say:

"The activities of a Central Bank have such far-reaching effects on the economic welfare of the whole nation that no inducement must be allowed to divert the Bank from the pursuit of the public interest with the object of earning increased profits."179

With Professor Moffitt<sup>180</sup> of Wesley College, Winnipeg, however, we can say that "a central bank would undoubtedly yield a profit to the treasury", and, whether the Government were part or whole owner of the institution, its profits from the bank would be a most welcome addition to revenue.

Our Canadian bankers are naturally rather apprehensive of the possibility of competition from the projected central bank in the ordinary field of commercial banking. It is the view of the writer that there should be no such competition. There are many and substantial reasons why it might be desirable to nationalize the banking system completely. In that case, however, there would be no competition, because banking would be a Government monopoly. If, however, our present commercial banks are to be allowed to continue after the creation of a central bank very much as before, it would seem to be better that the central bank should stay out of the commercial field. A central bank should be set up to do its own particular job. It has a very special mission to perform. It would be very apt to fail in the performance of its true functions if it attempted as well to perform the functions of competitive commercial

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180. See Financial Post, Feb. 14, 1933.

banking.

A further subject of concern to Canadian bankers, growing out of the proposal of a central bank, is to be found in the note issue. They fear that the central bank would ultimately if not originally be given a monopoly of the note issue. "A Canadian Banker" says:

"I have little doubt that, were a central bank formed, it would in due course be given a monopoly of the note issue, even were this monopoly denied to it at the time of its organization."181

In his rather superficial treatment of the note issue question in his writings on "A Central Bank for Canada"

Mr. A. F. W. Plumptre says:

"But there seems no reason why, at the same time, the chartered banks should not be allowed to continue to issue notes under strict regulations similar if not identical to those already laid down in the Bank Act."182

It is quite true that continuance of the note issue might not prevent the central bank from being a useful institution, but it seems to the writer that "A Canadian Banker" has faced the realities of the situation more frankly than Mr. Plumptre. To deny the central bank a monopoly of the note issue would mean that we would be but playing with central banking. It is well that the issue

181. Financial Post, Jan. 28, 1933, p. 11.

182. Plumptre, A. F. W. A Central Bank for Canada. p. 3.

should be met honestly, cold-bloodedly, without compromise, without any attempt to placate those who oppose a central bank, by pretending that they would not lose the note issue privilege.

Mr. C. A. Curtis showed a keen appreciation of the note issue problem in his address given to the Canadian Political Science Association in 1930.<sup>183</sup> There he estimated the losses that the chartered banks might suffer in the cancelling of their note issue privilege, and then stated:

"The conclusion would appear to be that while the banks might lose slightly by having their note issue privilege cancelled, the loss would not be as great as is ordinarily believed."

It is not easy to estimate accurately what the loss of note issue would mean to the chartered banks. Recently a number of questions were addressed to the officials of the head offices of several of our Canadian banks. Among these questions was the following:

"Do banks to-day depend very much upon their right of note issue as a profit-making branch of their business?"

One official answered that "it would be contrary to our policy to give you information along the lines asked

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183. Proceedings of Canadian Political Science Association, 1930, p. 115.

in your questionnaire". The officials of two of the banks were kind enough to answer the above question. One of these was good enough to give permission to quote what he said. Following is his complete answer:

"No. The profit on note circulation is largely eaten up, first by the Government circulation tax (1%)<sup>184</sup>, and then by the expense of providing facilities for daily redemption, the interest cost of maintaining revenues against possible adverse balances in the daily clearings, shipping notes from point to point, the printing of new and destruction of old notes, and the employment of staff whose duties are exclusively or largely in connection with the note issue and its handling.

"The note issues, however, represent a form of publicity and would be continued even at a loss for reasons of prestige. A consideration which has always been important in Canada is that our note system enables branches to be established in pioneer districts, and to be maintained in many localities, only or mainly because of the fact that such branches can hold the cash reserves necessary for their business in the form of the bank's own notes, which involve no interest loss. Should it become necessary for branches to carry their working cash reserves in any other form of currency, the resultant burden of interest loss would make the operation of many existing branches too unprofitable to permit continuance of banking service."

The matter of till money is no doubt important. As the above quoted banker says, it is desirable that the reserves of notes needed for business purposes by the branches should not entail a heavy cost. It might be

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184. Parenthesis by the writer.



pointed out, however, that the existence of a central bank would enable the branches to do with less till money than under the present system. Presumably the central bank would have agencies either in each of the provinces or in each of several geographical areas. Every branch of the chartered banks would be within a few hours of the supply of reserve bank currency. Then again, since this currency would not be the commercial bank's own currency, it would not have to worry about the redemption of it. Redemption would be the concern of the central bank.

To avoid discount for geographical reasons, each bank at present must provide for the redemption of its notes in specified centres throughout Canada.<sup>185</sup> The notes are redeemed daily. Each bank keeps all the notes of other banks and pays out its own notes. The other bank's notes are presented for redemption at the end of the day. This practice increases the quantity of the notes required by the branches. With a central bank this extra quantity would not be required.

Sir Edmund Walker<sup>186</sup> has pointed out that against the note issue must be charged the entire cost of maintaining

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185. Walker, Sir Edmund. Canadian Banking. p. 23.

186. Ibid., p. 26.

the Central Gold Reserve fund. In addition 5 per cent. interest is charged by the Government on all emergency notes. Sir Edmund estimated in 1922<sup>187</sup> that 71 per cent. of the notes in circulation returned a profit and 29 per cent. a loss.

Another question addressed to the bankers at the same time as the one quoted above was as follows:

"Approximately what per cent. of profit can a bank make on notes issued?"

Only one answered this question. His answer in full was as follows:

"The determining factor here is the interest value to the bank of its circulation, which is similar to the interest value or earning power of the funds it receives on deposit, and hence is continually varying. Some of the cost factors have been indicated above. We could not give any strict estimate of the net profit, but, taking into consideration the low levels of interest rates now prevailing; we should not be surprised if a careful analysis showed that there was a net loss on circulation at the present time. To the best of our knowledge no estimates that have been made in the past have indicated a net profit on circulation above 3%."

In 1923 Sir Edmund Walker estimated the net profits from the note issue to be between 1 per cent. and  $1\frac{1}{2}$  per cent.<sup>188</sup> On December 31, 1933, the ten chartered

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187. Walker, Sir Edmund. Canadian Banking. p. 26.

188. Proceedings of Committee on Banking and Commerce, 1923, p. 528.

banks had more than \$127,000,000 worth of notes in circulation. To the lay mind one to three per cent. on that amount should not be despised. Moreover, it is the view of the writer that in estimating the profit on the note issue neither the above quoted banker nor Sir Edmund Walker gave adequate weight to the possibilities of profits on notes issued as a result of the facilities provided by the Finance Act. Under the provisions of that Act a bank may take, for instance, a Dominion Victory Bond of \$100 in value, deposit it with the Minister of Finance, receive in return a \$100 Dominion note, deposit the note in the Central Gold Reserves and on it as backing issue one of its own bank notes for \$100. At the present time the bank would have to pay  $3\frac{1}{2}$  per cent. to the Government on the \$100 Dominion note. If it should then loan its own bank note for \$100 to a customer at 7 per cent. it would be making a very considerable profit. At the present time banks are charging municipalities as high a rate as 6 per cent. on advances. If the money so loaned were obtained from the Government under the Finance Act at  $3\frac{1}{2}$  per cent. the transaction would be a most lucrative one.

All three bankers quoted above, then, Sir Edmund Walker, "A Canadian Banker" writing in the Financial Post, and the banker (not to be named) who answered the two

questions quoted above, minimize the profits gained by the banks on their note issue. If they are right, then the banks should not object to a central bank on the score that it will deprive them of profits on the note issue. On the other hand there is no doubt that they would suffer some loss in the way of publicity and prestige. But this should not be too great a sacrifice for the benefits that would be derived from a central bank.

It is true that in a few cases where there are central banks there is still more than one note issuing authority. In Germany, for instance, four banks other than the Reichsbank may still issue notes. Their total permissible issue is only 194 million marks, however, and is only a very small proportion of the total note issue. Therefore the central bank has control over the issue of paper money.<sup>189</sup>

In the United States the National Banks still issue notes, but these are very inelastic. Hence the responsibility for the expansion and contraction of the currency rests predominantly with the Federal Reserve Banks.<sup>190</sup> As an illustration of this fact we may note that in the

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189. Kisch and Elkin. Central Banks. p. 79.

190. Ibid., p. 77.

present financial crisis in the United States it is Federal Reserve Bank notes that are being issued as emergency currency. In fact the disadvantage in the United States of having more than one issuing body is more apparent than real.

Here we might quote Kisch and Elkin<sup>191</sup> with profit:

"With multiple banks of issue there can be no single directing impulse."

"No central banking system can really be the controlling force it should be if its policy can be stultified by uncorrelated action on the part of numerous commercial banks of issue."

Undoubtedly the greatest authority that could be quoted on this question is the MacMillan Committee. In their report we find this statement:

"Since freedom of issue of paper money may easily, under the stimulus of the desire to make profits, lead each issuer to expand until the total amount in circulation is inconsistent with the retention of a sufficient reserve of gold, it is clear that the Central Bank should possess a monopoly of note issue, and this is indeed the almost universal practice of the modern world."<sup>192</sup>

The same MacMillan Committee says that there are four rights<sup>193</sup> that are essential to a central bank--(1)

191. Ibid., p. 76.

192. The Report of the Committee on Finance and Industry. (The MacMillan Report.) London, June, 1931, p. 15.

193. Ibid., p. 16.

the right of note issue (2) the right to hold the reserves of commercial banks (3) the right to buy and sell securities, and (4) the right to discount.

In cases we noted, where authorities, or banks other than the central bank, have the right of note issue we saw that the "independent" issue, additional to the central bank issue, was small in comparison with the total note issue. In Canada that is not the case under the present system. The number of Dominion notes actually in circulation is extremely small in proportion to the total note circulation. Hence there can be no predominant central controlling authority.

In view of this fact, then, and in the face of the opinions expressed by the outstanding authorities above quoted, it is scarcely conceivable that retention by the chartered banks of the note issue privilege, after the creation of a central bank in Canada, could be justified.

So far in this chapter we have been concerned almost entirely with stating and answering the objections to the creation of a central bank in Canada. In the process of answering objections and in previous chapters, arguments in favor of such a bank have been advanced. In addition to these, however, we might here point out some further advantages that might be expected.

In Chapter 5 we noted the profusion of administrative bodies concerned with our financial structure. There were the chartered banks, the Finance Act administrators, the Trustees of the Central Gold Reserves in their capacity as advisers, the Central Gold Reserves administration, the Circulation Redemption Fund supervision, the Canadian Bankers' Association, the Inspector General of Banks, and the Postal Savings Banks. A central bank could co-ordinate most of these and take over their duties. It would take over the banking duties of the Minister of Finance, the Deputy Minister and the Treasury Board as a whole--in short, the work that now comes under the administration of the Finance Act. It would not require advisers, as its own management would consist of experts. The Central Gold Reserves, most of the duties of the Bankers' Association (supervision over clearing houses, note printing, the appointment of curator for suspended banks, etc.), the Dominion note issue, rediscounting operations, publication of financial data, and inspection of banks would all be handled or replaced by the central bank.

Much has already been made of the importance of the social function of a central bank in controlling the monetary and banking structure in the common good. A problem of current interest in Canada might be cited here

as a case in point. Owing to the length to which the present depression has gone the burden of debt and interest has been greatly intensified. While commodity prices and the wages of labor have gone down, the "wages of money" has not decreased in proportion. It is very generally admitted that interest rates should be lowered. If governmental authorities believe that the rates should be lowered they have not as yet proclaimed any plan for bringing about the desired result.

In England, on the other hand, rates have been lowered generally, and the Government was successful in refunding a large part of its debt at a very much lower rate. This was brought about by deliberately planned financial policy. First the Bank of England lowered the discount rate to 2 per cent. and kept it low. Then the Government imposed an embargo on the issue of new securities, and this prohibition was maintained until just recently. In addition the banks, under the leadership of the Bank of England, reduced the interest rate on deposits to  $\frac{1}{2}$  per cent. As a result of these measures taken by the Government and the Bank of England in close co-operation, the demand for funds was greatly reduced, and the reduced demand caused a reduction in the "price", or the interest. Thus the intelligently planned, deliberate, "central banking" policy of England



forced a situation where the investor was willing to take a lower rate of interest on his money. Fortunately, in addition, many of the Government securities were callable on short notice. Hence when the Government gave the holders the choice of renewing their holdings at a reduced rate of interest or of turning them in for redemption they were glad to exchange them for bonds bearing a lower rate of interest.

In Canada, if we had a central bank managed by an intelligent board of monetary and financial experts working in co-operation with (or perhaps inspiring) an enlightened Government policy, some such result might have been achieved. Unfortunately, however, the great majority of our Government bonds are of long term issue and not redeemable at the choice of the Government. This fact but emphasizes further the great need of a central bank or its equivalent. If we had had a wise central bank board in the past it would have been one of its duties to advise against the issue of uncallable securities.

Indeed there is a faint flicker of a suggestion that there may recently have been a conscious monetary policy in operation in Canada. Or is there? It might not even be a flicker, but the possibility is at least intriguing. Much has been heard at large, and something has been said.

here already, of the \$35,000,000 advance to the banks of last November under the provisions of the Finance Act.

It has been suggested that this transaction may have been carried out on the advice of the present Deputy Minister of Finance who was appointed just about the same time that the advance was made. And now we hear rumors<sup>194</sup> to the effect that the interest rate on savings deposits may be lowered. It is suggested that the banks, having no need for the \$35,000,000 were forced to employ these extra funds in adding to their already huge investment in Government securities. (In December, 1932, they held over \$562,000,000 worth.<sup>195</sup>) But the banks find that they are able to earn only  $3\frac{1}{2}$  to  $4\frac{1}{2}$  per cent. on prime Government securities. Hence they would perhaps be greatly relieved at having to pay less than the present 3 per cent. on savings deposits. Then if the interest on savings deposits were lowered, funds now idle might be induced to seek more profitable employment in high grade bonds, then in second grade bonds, and finally in more speculative business enterprises. This would make it easier for the Government to do the great amount of financing that will shortly be necessary.

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194. Financial Post, Feb. 18, 1933., p. 16.

195. Ibid., Feb. 11, 1933, p. 12.

If one were to venture further in the subjunctive mood he might even see a relation between possible business revival and the now famous \$35,000,000 transaction. Even if the "flicker" should prove to have been a myth, however, the suggestion at least will tend to indicate something of "what might have been" under intelligent central banking leadership.

## Chapter 7.

### Summary and Conclusions.

A careful examination of the monetary and banking structure of Canada leaves these three facts firmly impressed upon the mind--firstly that in the past there has been a relatively efficient system, secondly that the events of 1907, 1914 and 1923 marked stages in a transition period, and thirdly that the cross-roads where it is essential that a deliberate, intelligently planned policy should be decided upon, have been reached.

In the existing disorder of a world of financial anarchy Canada has been possessed of a monetary and banking structure somewhat less chaotic and incompetent than the average. Its relative stability and efficiency have been due to a number of factors, such as the branch banking system; the small number of large banks; a considerable degree of co-operation, unity, and solidarity fostered by the Canadian Bankers' Association; and the comparative elasticity of the system.

This elasticity, due in part to the lack of formal reserve requirements, the comparative concentration of reserves in a few large banks, and the degree of general

unity of the system, was more particularly effected by the note issue provisions. The bank notes were originally elastic because they were asset issues based on paid-up capital. Paid-up capital did not increase, however, as rapidly as did the need for notes. Hence, as we have seen, bank notes having reached the limits of their original elasticity in 1907, the Government came to the rescue of the banks with an emergency provision for extra Dominion notes, and the crop-moving provision for bank notes was inaugurated in 1908. But very shortly, with the general increase in business throughout Canada, the banks found themselves in the position where they were using even this emergency note issue privilege to the limit.

It is not to be wondered at, then, that the first serious shock should vitally affect our banking structure. This shock came with the outbreak of the Great War in 1914. The result was, as related in Chapter 6, the passing of the Finance Act. The advent of this Act marked the most profoundly significant change in our banking and monetary structure since the passing of the Bank Act of 1871. As a war-time emergency expedient the Act no doubt served a useful purpose even though it may be criticized as the instrument of the inflation of that period. Tested only under abnormal conditions and in a paper money period, the

main provisions of this Act were made permanent in 1923. Operating in normal times, under gold standard conditions, this Act, by permitting our monetary and credit system to get out of control, resulted in Canada's defection from the gold standard and the depreciation of our dollar.

Previous to the passing of the Act the responsibility for the solvency of the banking system and for the social control of money and credit rested entirely with the banks themselves. The passing of the Act transferred this responsibility to the Department of Finance. Unfortunately the Government was not aware of its new responsibility. Cast off by its former owners, unclaimed by its new masters, our monetary ship has drifted aimlessly in the currents of world finance. It is high time, then, that consideration should be given to directing it into the course most suited to our national welfare.

Canada has departed from the gold standard. In the opinion of the writer that is well. We do not seem, however, to have gone off the gold mentality. Having departed from gold only in a halting, half-hearted way, we are still thinking in terms of gold. Like Lot's wife we are hazarding our position by the backward look. Going off the gold standard was merely a negative act. We must now make a positive move. The greatest care should be

taken that this positive move should be the wisest one possible. But the need for courage is no less than the need for caution. It is essential that a deliberate, definite policy be intelligently planned and boldly declared. If we allow ourselves to drift until we are forced into a certain action, the very fact that our action was forced and not deliberately planned will of itself generate a lack of confidence. We must not be forced into action, we must force action into our system. A bold declaration that we are deliberately adopting a policy which is the result of calm and intelligent consideration will of itself beget confidence.

International concerted action in monetary policy would be ideal assistance for us. Perhaps the next greatest help could come from a declaration of the adoption of a positive monetary policy by Great Britain. American monetary policy has been such as to make her currency the least stable of all in purchasing power, and it seems likely that 'gold' currencies will continue to fluctuate in purchasing power whether deflation continues or a policy of inflation is adopted. Hence it would seem unwise for Canada to try to follow the course of the American dollar. On the other hand if Great Britain were to make a bold declaration of

positive policy, if she were to adopt a definite standard, and if she resolved to manage that standard deliberately and intelligently, membership in the sterling bloc would be of great benefit to Canada. The internal purchasing power of sterling is already relatively stable. A declaration of positive policy would have a further stabilizing effect. The majority of the nations are now off the gold standard, and, under the leadership of Great Britain, would form a stable sterling bloc. By joining such a group Canada would be greatly helped.

But Great Britain and the other nations have not done these things. International co-operation holds out little immediate hope. Yet Canada has taken no constructive action of her own. She cannot afford longer merely to await that action on the part of others which does not come. Neglect by those who have the greatest responsibility does not relieve Canada of the share of responsibility that is her own.

The entire process of abandoning the gold standard and of watching our dollar fluctuate in terms of foreign currencies has probably caused us to think too much of the exchange side of our money problem. True, Canada is a great exporting nation, and as such, in normal times, she should



probably be more concerned about exchange control than most nations. However, the present depression has already gone so far, foreign exchange as a whole is so unstable, and foreign trade has decreased so greatly that a state of emergency exists, and in that state of emergency it would seem that Canada's first duty is to set her house in order. At the present time, then, it would appear that we should concern ourselves less with the external value of our dollar and give our first attention to management of our internal price level. Undoubtedly we have a very great problem in the repayment of debts which we owe abroad. But if present conditions are allowed to continue, we shall not much longer be able to meet our foreign obligations regardless of what the exchange rates may be. We should therefore boldly take the responsibility of declaring that we are going to raise the internal price level to a determined level, say that of 1926. Having so determined and declared we should resolutely administer our money and credit to that end.

But who will do this? Where is the machinery for carrying out such a policy? In the past, as we have seen, both the Government and the chartered banks have disowned responsibility for social control of money and credit. None of the required machinery exists. What, then, can be

done to remedy our situation?

As we have seen in Chapter 5, Canadian bankers claim that the Finance Act provides all that is necessary in the way of a central bank. On the other hand critics have roundly condemned the Act and have pointed to the need for a real central bank. It is not unnatural, therefore, that a compromise, in the form of amendments to the Finance Act, should be proposed by some as the remedy. The amounts that could be advanced under the Finance Act against securities alone might be limited and provision made for a measure of gold backing as additional security for amounts exceeding the specified limit. Or, a definite minimum percentage of gold reserves for the total Dominion note issue might be set and advances made only to an extent consistent with the safety of that minimum.

No doubt these amendments would tend to safeguard the gold standard in a situation like that which existed in Canada in 1929. But these proposals are based on the assumption that Canada will go back to the gold standard, and Canada may never return to that standard. It is true of course that other amendments could be devised as a safeguard if the Act were operated under paper money conditions. Admittedly the Act could be so changed as to remove the dangers inherent in it under any and all

conditions, but even in a harmless form it would not be a central bank. Governments and civil servants, as such, would have neither the time, the inclination, the machinery, nor the qualifications to operate the Act as a central bank. On the other hand, if properly qualified administrators and the necessary central banking equipment have to be provided to make the Act effective, it would be more reasonable to take the final step of creating a genuine central bank.

A more valuable proposal is that made by "A Canadian Banker" writing to give the point of view of Canadian chartered banks on the question of a central bank for Canada.<sup>196</sup> Instead of a central bank he advocates the setting up of a permanent economic advisory committee. "This committee", he says, "should be composed of the most intelligent, experienced and practical men it is possible to secure."<sup>197</sup> He would go outside of Canada, to Great Britain--presumably anywhere--to get a suitable personnel. Summarized are his main ideas as to what such a committee would do:

1. Concentrate its efforts upon finding the best

196. Financial Post--final article by "A Canadian Banker".

197. Ibid.

way through the maze of troubles in which we are entangled.

2. Examine and pass judgment dispassionately upon various plans advocated, and experiments being tried elsewhere.
3. Advise the Government re manipulation of the rate of interest on loans under the Finance Act.
4. Make possible an intelligent attempt at exchange rate stabilization.
5. Make for general stability by creating an enlightened public opinion.
6. Represent Canada at international economic conferences or act as advisers to official delegates to such conferences.

With the greater part of this proposal the writer is in hearty agreement. The general nature of the personnel which "Canadian Banker" proposes for his committee is just what is required for a central bank. Of such duties as he would assign to the committee, as far as they go, one would heartily approve. Moreover, a committee of this character could perform those duties admirably and to the very great advantage of Canada. To create such a committee would be to take a big step in the right direction. It

would mean a vast improvement over the existing system.

The committee would be a veritable physician for our sick monetary and banking system, yet as a physician it would have no surgical instruments. It could prescribe but it could not operate. Before ten banks and the Government could be prevailed upon to act in an emergency it is to be feared the patient would die. Nevertheless, if we cannot have a complete remedy for our situation, let us have a partial one.

The proposal that is currently the most popular with the general public is that our banks should be nationalized. This means that all banks should be owned and operated as a public service. Commercial banking and the control of money and credit would be a state monopoly.

To the writer this is the logical and almost the inevitable ultimate course. To the thread-bare and discredited argument that state institutions cannot be operated as efficiently as those that are privately owned one may reply that this is the stock argument that has been used down through the centuries every time it has been proposed that the state should remove from vested interests and perform in the social interest any additional function. The occurrences during the course of the present depression should be sufficient to give this argument its final

quietus. Through its own incompetence individual enterprise has failed. Private business failed first. Then, throwing the responsibility for its employees as an extra burden upon governments, and running to governments for succor and a dole for itself, private business has been gradually dragging these governments down to bankruptcy after it.

Moreover, there is a "worldizing", socializing movement afoot that is gaining impetus with the march of time. To the writer general state ownership and socialization of industries and services is merely a matter of time, and banking is not likely to be the last to experience this change. Therefore, if we do not nationalize our Canadian banking system now, it will likely mean that we shall merely be postponing the event.

It would be entirely feasible for the Canadian Government to take over all the banks and not do anyone an injustice. The total paid-up capital<sup>198</sup> of the ten chartered banks amounts to \$144,500,000 and the total reserves<sup>199</sup> amount to \$162,000,000. Of the last paid dividends<sup>200</sup> one was at the rate of 7 per cent., one at

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198-200 Financial Post, Feb. 11, 1933.

14 per cent., and eight at 10 per cent. This rate is based on paid-up capital. "A Canadian Banker" states that on the basis of combined capital and reserves Canadian bank shareholders received in 1932 a return slightly less than  $5\frac{1}{4}$  per cent.<sup>201</sup> If the Government issued bonds to the shareholders to the amount of the combined paid-up capital and reserves, and guaranteed, say, even 6 per cent. on them, the shareholders could not justly complain of any unfairness, particularly in view of the fact that they would be relieved of the "double liability" to which bank shares are subject. Neither should there be any difficulty for the Government in meeting the interest guarantee. Hundreds of bank offices could be closed as needless, facing one another across the street as they do in so many places under the present expensive, competitive system. Neither would it be necessary in future to erect the palatial buildings that it is the custom of the banks to build in competition with one another. With these and other savings, with practically the same efficient staff of employees, and with the demonstrated ability of the banks to pay handsome dividends in these times of depression, it should not be difficult for a centralized, unified system to pay the interest guaranteed.

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201. Ibid., Jan. 28, 1933.

The writer labors under no delusion as to the difficulty of bringing about the complete nationalization of the banking system immediately. Quite naturally the bankers would strenuously resist such a proposal. Against it also would be the older people and the more conservative-minded persons who have little faith in public enterprise generally. It may be, therefore, that the spirit of youth, which alone would appear to be capable of lifting us out of our present despondency, may have to await the reform which will come with the natural removal of the procrastination, indecision, and lack of resolution inherent in the apparent senility that now guides the hands of government and finance.

Of all the proposals relating to the regeneration of our monetary and banking system the one most generally acceptable is the suggested creation of a central bank.

In the first place, as we have seen, informed, disinterested opinion supports the efficacy of such an institution properly constituted. Secondly, neither a privately owned nor a state owned central bank need antagonize the protagonists of individual enterprise because it would not likely be expected to compete with the chartered banks in the commercial banking business. Its interest would be in the "money business" rather than in the banking



business, and if nationalization of the whole banking system were later determined upon, the organization necessary for the complete integration of the financial structure would be in readiness in the form of the central bank.

It would be most inept of us, however, to organize a central bank just because it might represent a convenient compromise between more contentious proposals. Canada must have a central bank. She must institute such a bank on no basis of compromise, however. She must create it because it could be of tremendous benefit to her people. Here is a summary of what our proposed central bank could do:

1. Act as the depository of the cash reserves of the commercial banks.
2. Perform the duties of a clearing house agency.
3. Do rediscounting.
4. Assume the duties performed at present by the Trustees of the Central Gold Reserves.
5. Take over the supervision of the Circulation Redemption Fund.
6. Carry out the work of bank inspection.
7. Assume responsibility for the solvency of the whole banking structure.
8. Relieve the Department of Finance of the duty

of administration of the Finance Act.

9. Encourage the growth of money and bill markets in Canada.
10. Act as the depository of Government funds.
11. Act as the fiscal agent of the Government.
12. Represent the Government at financial conferences.
13. Assume the monopoly of the note issue.
14. Act in the capacity of expert financial adviser to Governments--federal, provincial, and municipal--such as in the matter of foreign borrowing.
15. Determine all currency and credit problems.
16. Exercise control over foreign exchange.
17. Exercise control over the price level.
18. Publish financial data.
19. Guard the money and banking system from the dangers of the political factor and the manipulations of private self interests.
20. Exercise complete control over money and credit in the general interest rather than in the interest of profit.

A few of these duties deserve special emphasis. It is a widely recognized fact, and it has been repeated herein, that one of the leading functions of a central

bank is that of rediscounting. There is a great danger that this function might be over-emphasized. Our Canadian central bank must be a bank of rediscount, but it must be more than that. A central bank that would be a bank of rediscount and little more would be a lasting monument to the ineptitude of its political progenitor.

The last item in the list of duties--that of controlling money and credit for the general welfare--is by far the most important. The influence of the workings of money and credit on the lives of the people to-day is so profound that its direction and control should be one of the prime functions of government--though not necessarily a direct one. In Canada we have delegated this vital function to institutions organized for the pursuit of private profit. It should be removed from such institutions and intrusted to a central bank whose monetary experts would exercise it in the interest of the people as a whole.

If the proposed central bank is to be the institution of service that it ought to be, it must be properly constituted and empowered. In the first place it must be a NATIONAL central bank. It is not the purpose of this paragraph to repeat the arguments for and against public ownership of the central bank, but to reiterate the fact

that the proposed bank should be "national" in the sense that it will be state owned. To make it otherwise would be, in the opinion of the writer, but to play with the question--to attack the problem in a superficial way.

The question of the details of the constitution of the central bank must be left to experts, but it cannot be too often repeated that the type of the personnel of its administration is all-important. As stated in Chapter 6, it would appear advisable to have in the key position determining policy, a man with professional academic training--a man whose knowledge of monetary and banking matters has been gained as a result of disinterested study--a professional economist who is, say, an expert in the field of money and banking in some university. With him on the board of directors should be at least one outstanding man of practical banking experience. Consideration should be given to the question as to whether or not certain special interests might be represented in minor rôles on the board, such as Agriculture, Commerce, Labor, the Canadian Bankers' Association, etc. The majority of the members of the board and the dominating officials, at least, should be appointed by the Government. Each should be assured of relatively long and secure tenure of office.

Even under state ownership and with an able personnel, however, the central bank could not attain results without the proper powers. It should be granted the monopoly of the note issue, control of the reserves of the commercial banks, and the right to do rediscounting. In addition it should be empowered to buy and sell securities in the open market when necessary, and to deal in precious metals and foreign exchange. In short, it must be given every power necessary to ensure complete mastery of the country's entire money and credit system.

While it is no criticism of a central banking system to point out that in countries where central banks are established bank failures, and financial and business crises still occur, yet too much may easily be expected of a central bank. As Kisch and Elkin say:

"Advocacy of a central banking system rests not on the view that it is a panacea or a substitute for prudent banking, but on the view that it affords the best basis for a sound banking and business economy and the surest safeguard for the stability of the currency."<sup>202</sup>

A central bank would not be a cure-all and end-all for our troubles, but it would be of very real value. It would at least mean the control of money and credit in the

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202. Kisch and Elkin. Central Banks. p. 112.

interest of the people as a whole rather than in the interest of private profit. Admittedly, we are but a part of a world economic unit. Owing to the world-wide influences the central bank could not guarantee even our own economic welfare. Nevertheless, by establishing such an institution to act in co-operation with other central banks and an effective world bank (which the Bank of International Settlements may become), we would at least be contributing our share towards ending the present anarchy in international finance.

Our monetary and banking system is in a state of flux. The passing of the Finance Act commenced the transition from the old to a new financial era. To make certain that the foundations of the new order should be wisely laid it would seem advisable that we should have a "MacMillan Committee" to investigate every phase of our monetary and banking problem. Here again the vital point would be the personnel of the committee. Professional economists--experts in money and banking--would be required, not merely financiers, "big business" men and bankers.

The time for action is upon us. Are we going to be any longer content with the ideal of an order in which social good is nothing more than the inadvertent and

precarious by-product of an inglorious competition for private gain? In the wise words on the passing hours, that Sir Christopher Wren wrote under his sundial in All Souls College, we would say: "Pereunt et Imputantur"--they pass away and are counted against us.

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