THE BANK OF CANADA

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HONOUR POLITICAL ECONOMY

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CHAPTER I

Introduction

One of the most pronounced tendencies in modern banking, noticeable today, is the great increase in the number of central banking systems, and in the power and responsibility lodged with the central banks. The establishment of central Banks of Issue were unanimously recommended in 1920 by the International Financial Conference, held in Brussels, and two years later the same recommendation was made by the International Economic Conference meeting in Genoa. More recently the World Monetary and Economic Conference resolved that--"The Conference considers it to be essential, in order to provide an international gold standard with the necessary mechanism for satisfactory working, that independent Central banks, with the requisite powers and freedom to carry out an appropriate currency and credit policy, should be created in such developed countries as have not at present an adequate central banking institution."

So many sudden changes have been taking place in the currencies and monetary policies of the countries with which Canada trades, that it is necessary for us to overhaul our money and credit machinery. In view of this fact, and the continued recommendations of Economic Conferences, the Royal Commission, which studied the problems of banking and currency in Canada in 1933, carefully considered the advisability of establishing a central bank for the Dominion. The existing banking and credit control mechanism in

Canada has weathered the depression of the past five years exceedingly well and has provided the public with sound banking through a financial crisis as great, if not greater than, any in former times. But in the opinion of a great number of people, the chartered banks did not, in fact could not, provide as sound a monetary policy as a central bank could, under like circumstances. The majority vote of the Royal Commission, after a very careful study of all the briefs submitted to them, was in favour of the immediate establishment of a central bank in Canada.

In order to study central banking we must first define exactly what we mean when we speak of such a system. The main characteristic naturally, is the existence of a central bank, which holds the monetary reserves of the country and stands ready to rediscount commercial paper for, purchase acceptances from and make advances to, the commercial banks. In most instances this bank holds the monopoly of the note issue and may render various services to the government. From a national point of view the central bank should endeavour, to regulate the credit and currency in the best interests of the economic life of the country, and should control, if possible, the external value of the monetary unit. In co-operation with the other central banks of the world, it should attempt to mitigate fluctuations in the general level of economic activity. We may safely say that, the most important function of a central bank is to control the supply of currency, credit and gold in the country by its management of the note issue, rediscounts, and its open market transactions. We must remember that a central bank is primarily a banker's and government's bank and does not usually compete with the commercial banks for private business, to any great extent.

The chief functions of a central bank may therefore be summarized as follows,

(a) control of credit supply and interest rates in the country.

(b) custody of the country's gold reserve for settling debts abroad.

(c) custody of the cash reserves of all other banks.

(d) regulation of the note circulation either by being the sole bank of issue or by being the bank which issues the greater part of the country's circulating notes.

(e) service as the fiscal agent of the government.

(f) co-operation with central banks of other countries, for purposes of financial and economic stabilization.

There are many other functions which a central bank may be called on to perform depending on the economic development of the country; but for the present those named above will suffice.

Such in summary are the main functions of a central bank. It remains for us to glance briefly at each of these in turn.

In the first place, the bank is designed to control the supply of credit, and the interest rates in its own country. The usual method, by which it accomplishes this control, is raising or lowering the rate at which it will discount short date paper.

When the central banks considers that the commercial banks are expanding credit too rapidly, it raises the discount rate. The banks upon finding themselves subjected to a heavier charge when rediscounting, will raise their own discount rates. Now only those customers, who need credit the most, and have the most profitable employment for funds, can afford to borrow. Credit is contracted and business slows down to a more normal rate. Bank loaning does not cease but it becomes more cautious. Expansion of credit is obtained by lowering the discount rate and thus making money cheaper.

The central bank may not perhaps, realize, that credit is being expanded too rapidly, and therefore does not step in and stop it, until too late. Then all the bank can do is cushion the fall a bit. If it is to do anything it must be able to help the other banks in a crisis and it cannot do this unless it holds most of its power in reserve and treats its accommodation to banks as an emergency measure only.

But the market rate of interest cannot always be raised or lowered by the bank raising or lowering its own discount rate. Often open market operation are necessary. In many cases the commercial banks may be holding large reserves and can take care of all their loans without the necessity of rediscounting at the central bank. An increase in the rediscount rate may have a slight moral effect on the banks by showing what they will have to pay if they are forced to rediscount later. If however, the banks do not heed this warning, the central bank must carry on open market operations and attempt some measure of control in this way.

The central bank, at all times, holds a large supply of securities, especially foreign bills, that can be thrown on the market and the sale of these securities absorbs the surplus loanable funds. The commercial banks, if they desire to make further loans, must borrow from the central bank and in this way the discount rate has the desired effect. The banks, finding themselves subjected to a higher rate, will pass this on to its customers and thus credit is contracted. The opposite effect is felt when the banks buys securities. Credit is expanded because the bank has thrown large quantities of money in the market, which flows into the commercial banks. The central bank must endeavour to accumulate a large supply of marketable securities during normal times and be ready for such an emergency. In a later chapter we will deal more fully with the question of open market possibilities in Canada.

The second point with which we deal, namely, the bank as custodian of the gold reserves, need not occupy us very long at this time. Much of the gold reserves of the commercial banks and all of the government are held by the bank. The most useful purpose of a gold reserve lies in its availability for export at times when the ordinary settlement of international payments through the foreign exchange markets has become inadequate to meet the current obligations of trade and governments. The central bank should be able to mobilise all the monetary gold of the country at immediate notice, if the need arises. Centralization of the gold reserves allows the gold to be used, as a stabilizing agent in the foreign exchanges, and as a means of reducing the costs, to governments, of their foreign debt services. It may also be used as security for loans contracted in a foreign country. We must not forget the important place gold holds in the reserves against the central banks note issue.

All commercial banks find it necessary to maintain a certain reserve against their deposit liabilities and their circulating notes. This reserve may not always be held in cash in a bank's own vaults, but may be a deposit with, or a claim upon, another bank. But the reserve must be available at once in case of need. In normal times a bank finds out what percentage its reserves should bear to deposit and note liabilities. But at sometime the creditors of a particular bank may lose confidence in it and start a run. The reserves will soon disappear. [Any cash coming in from borrowers is not of much help because the bank has arranged the maturities of its loans so as to replenish only normally diminishing reserves.] Neighbouring banks may not come to the rescue, for fear that a general bank run may start, and they would need their full reserve to pay off their own creditors. The bank therefore is absolutely helpless unless it can obtain cash from some distant source.

The central bank can provide the needed reserve of cash. Under a central banking reserve plan each bank carries only enough money for its daily transactions and deposits the remainder of its reserve with the central bank. A central reserve such as this may be able to supply enough cash to stop a run on any individual or local group of banks. It is able to make loans to a bank if the bank's deposited reserves are insufficient. Under this reserve plan commercial banks do not need to maintain as large a reserve as when they are doing business as separate units. This lower reserve requirement results in more economical banking and better service to the public.

The central bank in most countries has the monopoly of the note issue. In cases where the bank has not the monopoly, it should at least have a sufficient amount, relative to the total currency supply, to assure an adequate element of elasticity. In the early stages of central banking, control of the note issue meant, in effect, control of the creation of credit. At the present time a deposit with the central bank is the form in which most credit is advanced to the member banks.

It is the duty of the central bank to attempt to stabilise the monetary standard. To accomplish this it must have the monopoly of the note issue. Notes issued by central banks are generally both sound and elastic, soundness being assured by the conditions under which the bank is organized and operated. The circulation is quite elastic because the notes are issued against commercial paper which increases or decreases in volume with the amount of business being done. The best type of central bank notes are those issued in exchange for commercial paper, provided it is backed by adequate gold reserves and by a sound and intelligent policy with regard to rediscounts and loans.

The central bank should act as fiscal agent of the government. In this respect the bank has a wide field of operations but it must be careful to limit the accommodations which it gives. It is the duty of the bank to manage government accounts, business connected with the national debt and act as custodian of the government deposits. These deposits place, at the bank's disposal, large funds usually without interest. The bank will loan or make advances to the government on good security, such as treasury bills, and it is authorized to deal in short term securities issued or guaranteed by the government. In most charters the bank is allowed to make temporary advances to the government as long as they do not exceed a fixed limit of the country's estimated revenue. In short all the financial business of the government is transacted through the central bank.

The bank can assist the government immensely in the matter of loans and bond issues, because of their intimate knowledge of financial conditions in the country. The advice of the central bank is by no means the least of the benefits to be derived from such an institution. The bank should be able to assist the government in planning its monetary policy. A wise management has a great opportunity to assist in many different ways.

We have now arrived at a point which has received, rather is receiving, a great deal of attention, namely that of co-operation between central banks for purposes of financial and economic stabilization. The Genoa Conference and the World Economic Conference had this thought in mind when they recommended that central banks of issue should be established in all countries which did not at present possess such an institution. This aspect of a central bank's activities is new but is developing constantly and promises numerous benefits to national well-being and industry. By working together, the banks can facilitate the great volume of international payments between governments. A thorough knowledge of market conditions allows the banks to arrange these payments with the least disturbance to trade and money markets. If we are to have a restoration of the gold standard, we must have co-operation between countries and central banks can do a great deal in this direction. Until we have concerted action by the banks, there will always be some risk attached in holding stable foreign currencies as the equivalent of gold for purposes of reserve against note issues.

The Bank of International Settlements was created to facilitate the payment of the large war debts but up to the present time very little has been heard about this bank. It was the idea at the time that the B.I.S. would serve as a world clearing house, but it has failed to measure up to expectations.

There is no doubt that a great deal can be accomplished by closer co-operation between banks and it should be the aim of all such institutions to further this idea. Foreign exports could be conducted more easily, and with a greater economy in the use of gold, if central banks held deposits with each other. This is being done to a certain extent in Europe at the present time but it is to be hoped that in the future a greater degree of co-operation will be established among the central banks of the world.

In this chapter we have briefly outlined the principal functions of a central bank, without attempting any arguments for or against it. There is a great deal of business conducted by a bank, that we have not mentioned, some of which apply only to certain countries. The degree of economic advancement plays a great part in the determination of a central Bank's activities. But in a general way the foregoing discussion outlines the main duties of a central bank.

It is the purpose of this work to consider central banking as it concerns Canada in particular. When we consider the effects that a central bank will have on a country such as ours, many difficulties arise. It is very easy to expect too much from our bank and we must be careful not to criticise it too much until we have investigated facilities that Canada can provide for the effective functioning of a central bank. The Bank of Canada is the result of much thought on the subject, and we must consider it as the best solution for our economic problems. The fullest co-operation, on the part of the commercial banks and the country as a whole, is needed to make it a success.

With these few remarks we can proceed to a close study of the Canadian situation, and the possibilities for central banking. In the next chapter we shall study Canadian banking from its beginning to the present day.

CHAPTER II.

The Background of Banking in Canada.

In any study of the Banking System in Canada, the fact must be remembered, that the system was not made but rather has been evolved. It has grown up with the country and through careful decennial revisions, of the banking laws, has been continually in contact with the requirements of Canada's altering conditions.

-The Chartered Banks-

Canadian banking up until 1867 need not receive much attention, but it might be interesting to note briefly its evolution up to that point. The period of one hundred and fifty-five years, when the country was known as New France, was a period of barter for the most part, furs, wheat and tobacco being accepted as the medium of exchange. When the government began issuing obligations in the form of "ordonnances" and card money it was a great relief from the straight barter system. The government however abused this privilege and these obligations depreciated very rapidly. This was Canada's first taste of fiat money issued solely on the credit of the government and thereby the country learned a lesson on the evils of money issued in this way. During the next fifty-four years steps were taken to place the finances of the colony on a stable foundation and the British government did this, by establishing an equitable standard of value, for the various coins which now become current. Spanish money was imported and used for the payment of the army and the purchase of public supplies. Representative government came in 1791 and the first attempts were made to establish banks of issue.

Some years later the British government became involved in the war of 1812 with the United States. As always happens in any war, a great deal of money was needed and steps had to be taken to increase the currency. The Army Bill office was established by Act of Parliament and bills of various denominations were issued. This issue was rapidly absorbed by the people, because it was brought out with a view of prompt redemption. Between 1817 - 1867 these bills were being redeemed and removed from circulation and there was need for some sort of currency. In this period the first banks appeared and in May 1817, the Montreal Bank was founded to relieve the principal business centres, Montreal and Quebec. This bank was shortly followed by others established under charters from the various provinces. Before 1825, five banks had been established, but there was absolutely no attempt made to have the charters uniform and many of the clauses originated in a total misconception of the functions of a bank.

The situation became very unsatisfactory when Parliament began making attempts at banking legislation, such as the "Free Banking Act" and the "Provincial Note Act." The British government stepped in and demanded that all legislation bearing on note issue, banking, and the like should receive the royal assent before it became effective. The young colony naturally resented this restriction but soon learned to appreciate the guidance of riper and more experienced judgment. The wise action on the part of the Colonial office saved Canada from many unsound and dangerous banking theories.

In 1867, the Imperial parliament passed the British North America Act, confederating the provinces into the Dominion of Canada. It was realized, that the banks must be national, rather than provincial in character, if they were to discharge most effectively, their natural functions. The parliament of the new Dominion therefore became the exclusive authority to legislate on all matters pertaining to banks and banking, currency and coinage, and negotiable instruments. The first comprehensive Dominion Bank Act was passed in 1871, embodying the chief features of the Act as we now have it. Under this act, the minimum capital of a bank was fixed at $500,000. of which $100,000 had to be paid in before commencement of business, and a second $100,000 within two years. The note issue was limited to the amount of the paid up capital and stockholders were subject to a double liability continuing to be valid when the shares were disposed of within a month of the suspension of specie payments. The division of profits in any form was limited to eight per cent per annum until the bank had a reserve fund equal to 25% of its capital. Every bank was required to receive its own notes at par, and in any payments due it, but was required to redeem its notes in specie or Dominion Notes only at expressly designated offices. There were no reserve requirements except that the banks were to hold at least 1/3 of the cash reserves in Dominion notes. All bank charters granted or extended were subject to this general act and no charters were to be extended beyond 1881.

The Dominion continued in a period of slow economic progress from 1867 to 1883 and thirty bank charters were issued resulting in the formation of some twenty new banks. In a country such as Canada a system was needed, that would permit the same bank, through its branches, to undertake the complete financing of the distribution of goods from one end of the country to the other. The number of branches operated by the banks increased from 147 in 1868 to 335 in 1884 and their resources increased greatly. Towards the end of this period a general depression occurred which was severely felt in Canada. Several banks failed and the public suffered, especially the note holders. This brought about certain changes in the Bank Act when it was revised in 1880.

The practical question before the country at this time involved the security of the note issue of the banks. The notes of certain suspended banks had not been very promptly redeemed and in the meantime had passed to a considerable discount, involving loss and inconvenience to the holders. In the new Act, bank notes were made the first charge on the general assets of the bank, while the denominations of bank notes were fixed at $5.00 or multiples of that sum. Apart from the amendment with regard to note issue, the act did not embody many important new clauses. Amendments relating to such matters as, giving a person receiving payments from a bank the right to ask for Dominion notes of one or two dollar denominations to the extent of fifty dollars in one payment; increasing the proportion of cash reserves held by the banks in Dominion notes from thirty three and one third to forty per cent; and more detailed monthly returns in order to show more clearly their financial position, were some of the features of the new Act. The sections dealing with loans on warehouse receipts and bills of lading were broadened and the use of the title "bank" was prohibited to other than chartered banks.

The decade between 1880 and 1890 proved to be one of general stagnation, except for a temporary land boom in Manitoba. Some of the banks involved in this speculation suffered severely but the bank failures which damaged the general credit of Canadian banking, mostly took place in the older provinces. Heavy losses were suffered by the shareholders, depositors and noteholders. In the case of the Exchange Bank of Montreal, the note holders were ultimately paid in full, but the depositors and other creditors lost fully one-third of their claims. The Maritime Bank was forced to close its doors in 1887 and little more than 10% of their claims were realized by the general creditors. The list of bank failures towards the end of the decade of 1880-90 produced the usual misgivings with reference to the safety and efficiency of the Canadian banking system. The revision of the Bank Act in 1890 incorporated several new features.

With reference to ensuing the prompt redemption of notes of a suspended or wound-up bank, the American device of a redemption fund, contributed by all the banks in proportion to their outstanding note issue and held by the government, was proposed and adopted. This innovation was included in the new Act and known as the Bank Circulation Redemption Fund. By this provision the banks were required to deposit with the Minister of Finance, five per cent of their average yearly note circulation and if necessary further assessments could be made. If the liquidators of a failed bank did not arrange for the redemption of its notes, they were to be redeemed out of this fund. The minimum capital required to start a bank was left at $500,000 but the amount which had to be paid in was raised to $250,000 and this amount had to be deposited with the Finance Minister before the bank could commence business. Complaint as to inadequate specie reserves held by the banks was once more out in front, but they were able, as usual, to demonstrate the futility of enforcing a minimum reserve under the fluctuating conditions of the note issue, deposits and discounts of Canadian banks. Facilities were granted enabling the banks to aid to a greater extent than formerly in the production and distribution of goods. The sections of the Act pertaining to loans on warehouse receipts and bills of lading were revised and the banks were authorized to lend to manufacturers on security of goods manufactured or procured for manufacture, but advances to the ordinary farmer or agriculturist, on his growing crops were not recommended.

At the next decennial revision of the Act in 1900 the Canadian Banker's Association formed in 1892 was given official recognition. This association has proved to be of great use.

During practically the whole period from 1900 to 1913 Canada enjoyed unprecedented economic development with the result that several changes were made in the act before the next revision. In 1904 the power to issue notes in British Colonies was enlarged and in 1905 the limitation of bank directorates to ten members was removed. During crop-moving season the bank note circulation was not sufficiently elastic to supply currency needs so in 1908 the Act was amended to permit a bank to issue notes in excess of its paid up capital, to the amount of fifteen per cent of its combined rest fund and unimpaired paid up capital, during the period October 1st to January 31st. of the next year. These excess issues were subject to a five per cent per annum tax, so the banks would attempt to call in this issue as soon after January 31st, as possible.

The next bank act revision did not take place until 1913 In addition to a great many minor changes, the chief amendments made in the act at this time were (1) the provision for shareholder's audit; (2) the creation of central gold reserves; (3) the provision of additional facilities for making loans to farmers and (4) making it necessary to secure the consent of the Minister of Finance before a merger could go through.

In 1913 the Dominion issue of currency was backed by a reserve of 25% in gold or guaranteed debentures, for the first $30,000,000. issued. Over this limit all notes issued required a 100% gold reserve. At the beginning of the war in 1914, the partially covered issue was raised to $50,000,000. Later on an issue of $16,000,000 was made, backed by railway securities guaranteed by the Dominion government, and $10,000,000 were issued without any cover. In 1917 an issue of $50,000,000 was made to finance war purchases in Canada but this issue, backed by Imperial Treasury Bills was in due course liquidated by payments from the British Treasury.

But the most important change in monetary structure was the Finance Act passed in 1914. Many 'runs' occurred on the chartered banks at the beginning of the war and much gold was withdrawn. A feeling of financial panic prevailed, throughout the country. And so on August 3rd, an Order in Council was passed whereby the Minister of Finance could make advances to the banks, on receipt of approved securities. The Finance Act was passed a little later in the month making provision for such an issue of notes. The Act also empowered the Governor in Council in times of emergency to authorize the chartered banks to make payments in their own notes, instead of in gold or Dominion notes, and to use the facility of issuing excess notes throughout the year and not merely during the crop moving period.

Throughout the war and early post war period extensive use was made of this Act and in 1919 it was continued for four years. Considerable use was made of the power td issue Dominion notes to the banks against approved securities and in 1923 the Finance Act was made a permanent part of the Canadian Financial System. So Canada, although she has had no central bank, has not been in the dangerous position of being completely without an elastic element to her currency. The Finance Act works similar to the rediscounting of commercial paper by central banks but the analogy ceases here for the Act makes no provision for a gold reserve to be kept against notes issued in this manner.

There were very few otherchanges in the Bank Act except that in 1915 and 1916 amendments were made with respect to lending on cattle and for the purchase of seed grain. The banks followed up the development of the country and established new branches wherever possible. In 1913 the number of branches had grown to 2,847 as compared with 708 in 1900.

Section 88 of the Act requires perhaps a little more study than some of the others. This allows a bank to make loans to a customer on the security of merchandise in his possession. A bank will never lend under section 88 unless it is absolutely certain of the honesty and experience of the customer.

In the Bank Act of 1923, the shareholder's audit provisions were strengthened and annual and monthly returns elaborated with the added requirement that statements, of controlled companies in the names of which any part of a bank's operations are carried on, must be furnished. Regulations regarding loans were amended and advances to any officer or clerk of a bank could not the granted in excess of $10,000. This act with a few small changes is the one under which the chartered banks now operate. With the failure of the Home bank in 1923, provision was made for government inspection by an amendment in 1924. Several changes have been made in the new Bank Act of 1934 necessitated by the establishment of the Bank of Canada. Most important of those changes is the requirement of banks to hold a legal reserve. This is the first time in Canada that commercial banks have been required by statute to hold a legal reserve. The note issue clause is also repealed and the notes of the banks will gradually be taken out of circulation.

The main advantages of the Canadian system of branch banking can be summed up as follows:

(a) Large capital behind each institution. The customers of the smallest branch share in the security which a large capital affords.

(b) Unity of policy on the part of the leading banks during a critical financial period.

(c) Power to equip every branch with ample reserves for maintaining commercial credit by means of note issues. The resources of the branch bank are very quickly and indefinitely extended.

(d) Uniformity of interest rate throughout the whole country which does not vary more than 1 or 2 per cent between the large cities of the East and the newer towns and rapidly expanding cities of the West.

(e) Expert supervision by the central office prevents bad banking.

(f) Branches can be maintained in localities where the profits of the business would not justify the establishment of a separate bank with independent capital.

A New York paper speaking of the Canadian banking system, expressed itself in this manner.

"We know of no system that more closely conforms to the best and broadest economic ideals of banking; none better calculated to afford the largest public accommodations; none better adopted to insure a safe utilization of the surplus balances of the people; and none better qualified to supply the daily fluctuating wants of trade with a safe and convenient circulating medium."

The chartered banks are not the only banking institutions in Canada. There are numerous others with which we can only deal briefly in this chapter.

1. -Dominion Government Savings Bank-

Prior to 1929 there were two classes of these banks namely (a) The Post Office Savings Bank under the Post Office Department and,

(b) -The Dominion Savings Bank-

These two banks were amalgamated in 1929. They receive deposits and pay interest at the rate of 2½% but do not perform the variety of functions that the chartered banks do.

2. -Provincial Government Savings Offices-

These banks are institutions for the deposits of savings and are operated by the Provincial governments of Ontario and Alberta. In Ontario the funds received at these banks are used almost exclusively for financing farm loans under the Agricultural Development Act.

3. -Quebec Savings Banks-

There are two institutions operating under the Quebec Savings Bank Act.

(a) The Montreal City and District.

(b) La Caisse d'Economie de Notre Dame de Quebec.

These banks are brought under practically similar restrictions to those applying to the Chartered banks. Their commercial banking business is quite small and they are essentially "savings" banks.

4. -Caisses Populaises (Co-operative People's Banks)-

The Caisse Populaires are conducted more in the interest of farmers. They generally lend only to shareholders, who have the right of making deposits over and above the amount of their shares. They will make loans on first mortgage on immovable property and in addition will make loans on the personal security of their members.

5. -Loan, Mortgage and Trust Companies.-

The principal function of these companies is the lending of money on real estate. In addition to their capital they obtain their funds by selling debentures and receiving deposits. Trust companies act as executors, trustees and administrators under wills or by appointment. All these companies invest for the account of their clients, in short or long term loans which may or may not be guaranteed by them.

6. -Rural Credit Institutions-

These institutions were organized to facilitate agricultural credit. By 1926 practically all the provinces had established some type of institution to grant all forms of credit, short, intermediate and long term. The majority of the provincial long term lending agencies have been replaced by the Canadian Farm Loan Board established in 1929.

7. -Penny Banks-

Essentially a savings bank designed to encourage school children to save by depositing a certain sum weekly. But their facilities are not entirely limited to children.

8. -Private Bankers - "John Smith Banker"-

There are very few private bankers in Canada at the present time. Loans are available but they are in actual practise only "note shavers".

No attempt has been made to prove the adequacy of the banking facilities to meet economic conditions in Canada. This will be dealt with in the next chapter when we consider why a central bank has become necessary in the Dominion.

CHAPTER III

The Royal Commission.

The Royal Commission was appointed on July 31st,1933, "to study the organization and working of our entire banking and monetary system, to consider the arguments for and against a central institution and to make recommendations for revising or supplementing our existing banking and monetary legislation."

It is not enough to say that the Commission was appointed to study our economic problems, we must consider what brought about this increased interest in central banking. In 1914 D.R. Wilkie, President of the Imperial Bank stated that the time would come when Canada would find it necessary to establish a bank of rediscount and in 1918 E.L. Pease, Vice-President of the Royal Bank made the same statement. So that we see the idea of a central institution for this country is not at all new.

-Reasons for appointment-

In Chapter I it was pointed out that there has been a strong movement in Europe towards the establishment of Central Banks. It is not necessary to repeat the recommendations that were made, suffice it to say that all economic and monetary conferences have advised the setting up of banks of issue in every country. They have found few advocates in Canada, due mainly to the excellent banking system which we possess. These recommendations, although they no doubt created some interest, were not enough to bring on an investigation such as the Royal Commission conducted.

The world has been passing through a period of declining prices and serious unemployment. It seems natural for people to place the blame on existing institutions and a great many complaints have been made against our banking system. Many of the accusations were very unjust, but there is enough truth in them to make the bankers feel uneasy. Our banks have been operated on sound and conservative lines and therefore in bad times, they are considered hard and unjust. Perhaps they have been too cautious but they have given us the security which the United States banks did not afford. The serious banking crisis suffered by the United States caused Canadians to question the soundness of our banks and to inquire what could be done to help better conditions.

One wheel of our monetary machinery received a great deal of attention and abuse, namely, the Finance Act. The opinion in many quarters was that the Act had not worked as satisfactorily as it might have and had not functioned in the manner that a central bank presumably would in protecting the gold reserves and that it did not control or manage credit by raising or lowering its discount rates. The allegation was made that in 1928 the chartered banks were withdrawing gold for export and maintaining their own reserves by borrowing under the terms of the Finance Act. It was claimed that if a central bank had been in existance, this would have been stopped by raising the rate at which the bank would have made advances. As a matter of fact, the chartered banks were not involved in any such operations.

The main opposition to the Finance Act is that it does not control credit. The argument used is that the Treasury Board are not bankers and therefore were not efficient enough to operate effectively in curbing the speculative mania which culminated in the crises of 1929. It is pointed out that under the Act the banks can obtain funds needed by them to meet the demands of business at a lower rate, than the central bank would have to charge in order to conserve its gold reserve. The central bank could curb such excess expansion of business as would if unchecked result in disaster, by increasing the cost of these funds. Thus the Finance Act does not use its discount rate to control credit in the way it should.

But not only is there a demand for credit control, but also for better credit facilities especially for financing agriculture. The farmers claim that they cannot get the credit necessary to carry on, except at an impossibly high rate. If the banks have been strict it is because of the risks attached to financing agriculture and a central bank cannot be expected to make loans that ordinary bankers consider too risky. Such a bank must operate with the aim of providing a source to which the chartered banks may turn in cases of emergency.

It is quite interesting to notice that whereas even the smallest countries in Europe have long had or have recently established, a central bank, there has been no corresponding institution in Canada a country of such financial and economic importance. Within the narrower sphere of the British Commonwealth of Nations, Canada is the last among the Dominions to establish a central bank. No doubt this fact, accompanied by pressure from England, had a great deal of influence on our government. Central Banks have already been established in South Africa, Australia, New Zealand, and just recently a Reserve Bank in India. They have already become an indispensable part of their financial structure and it is expected that with such a bank in Canada, a greater degree of intra-Imperial co-operation can be achieved on economic problems. The Commonwealth Bank of Australia has rendered services of inestimable value, and was the means of helping the country over a period when its ability to provide and to transfer the service of its overseas debt, was seriously in question. The Reserve Bank of South Africa was of great use in helping the commercial banks to negotiate the difficult deflation period following the war.

The final step that we will consider is the alleged confusion in the Dominion note issue. An important part of the Canadian monetary system, is the paper currency issued by the government. Dominion notes are now issued under the authority of three statutes. By the Dominion Notes Act of 1914, the Dominion Government is authorized to issue notes up to $50,000,000. against a reserve in gold equal to twenty-five per cent of that amount. By chapter 4 of the Statutes of 1915 an issue of $26,000,000 is authorized without any reserve of gold, $16,000,000 of the notes to be against certain specified Canadian railway securities guaranteed by the Dominion government. Notes may be issued to any additional amount in excess of $76,000,000, but except as provided in the Finance Act, an amount of gold equal to the excess must be held. The Finance Act provides that the Minister of Finance may make advances to the banks, by the issue of Dominion notes upon the pledge of certain approved securities. Theoretically there is no limit upon the notes that may be so issued except that imposed by the volume of elegible securities in the possession of the banks. It is quite apparent that the nature of Dominion notes which before the war approximated to gold certificates has been greatly changed by the operation of the Finance Act. Perhaps we will get a better picture of the situation by a statement of the Dominion note issue as it stood on June 30th,1933.

STATUTORY AUTHORITY	AMOUNT OF ISSUE
Chapter 4: 1915	$26,000,000.
R.S. 1927;Chap.41 Dominion Notes Act	$106,483,058.
R.S. 1927; Chap.70 Finance Act.	$51,944,000.
TOTAL ISSUED	$184,427,058.

Amount issued under Dominion Notes Act
and special War legislation $132,483,058

No backing necessary..........$26,000,000
25% " "... ....$50,000,000
100% " " $56,483,058

Gold Reserves held...............$69,271,565
Gold Reserves needed

(1) 25% of 50,000,000
(2) 100% of 56,483,058 $68,983,058.

It may be necessary, as Mr. McLeod stated, to establish a definite basis for the Dominion note issue so as to correct the anomalies in the existing legislation. But if the principle of such issue is definitely established by Parliament, the Department of Finance is fully competent to operate the note issue. The public presume that there is a huge profit in bank note issue, and that therefore this function should be turned over to a central bank for the benefit of the state. But as a matter of fact the profit, if any, is very small.

-The Case for the Chartered Banks-

The work of the Commission took them from coast to coast and much valuable evidence was submitted to them. They endeavoured to consider the evidence with the aim of improving and strengthening the Canadian banking and financial structure. As a result of their investigation the Commission by a majority, advised the immediate setting up of a central bank. During the hearings, the majority of the opposition came from the chartered banks. Mr. J.A. McLeod, President of the Canadian Banker's Association, summed up the banker's point of view. Briefly, their arguments are as follows:

With a small number of strong banks operating branch offices Canada, already possesses the advantage of great mobility of loanable funds, highly developed experience in the use of these funds and a bank note currency in conjunction with the Dominion note issue, automatically responsive to the country's requirements.

As to the Finance Act, the bankers support it strongly.

-Finance Act-

The procedure of this act from the standpoint of the banks is admirably convenient. The bankers apply annually to the Treasury Board for a line of credit, against which they pledge securities of the character specified by the Act. The Securities are lodged with the Receiver-General of Canada and the banks are able to obtain Dominion notes whenever they need a temporary enlargement of their cash resources.

Generally speaking the Finance Act has served a most useful purpose to the Dominion, first as a precaution against panic during war years and secondly as an emergency measure during the post war period, during the movement of crops and for government financing.

-Criticisms Raised-

Continuing Mr. McLeod dealt with criticisms raised against the Act.

1. The Finance Act, permits an indefinite increase in the Dominion note issue.

This criticism overlooks the fact that a certain amount of control, of the notes issued in this way, actually exists by reason of the Treasury Board fixing the lines of credit accorded the banks. The Act itself does not place any obligation on the Board to fix such limits, nor to control the total amount of notes outstanding by reason of advances under the Act, but in practise this is done.

2. The potentialities of a possible large increase in Dominion notes outstanding over and above the safeguards in the Dominion Notes Act, were towards inflation of the currency out of regard to the country's actual needs.

The Bankers do not feel that this criticism is justified. It is the natural desire of the banks to limit their Finance Act borrowings to temporary periods and this largely offsets the criticisms referred to.

3. The rate charged the banks for advances under the Act has not been in line with current conditions but at times has been influenced by others.

The bankers deny this charge. They admit that there is no properly constituted body responsible for the supervision of credit or exchange in Canada, but they also say that experience has shown that no central bank was able to control the boom preceding the crisis.

-Central Bank-

The principal new weapon, which a central bank would give Canada, is the means of controlling credit afforded by open market transactions, but we have no money market and it would be very difficult to create one. Outside of the banks there are no portfolios of acceptances or commercial bills, and the issues of Treasury Bills are not continuous enough to afford a supply of short term self liquidating obligations.

It is believed that the co-operation of central banks is necessary, to have an international gold standard. There is certainly a need for co-operation but that does not necessarily mean a central bank.

-Weaknesses of such a Bank.-

1. The public will expect too much from the bank to start with. Our banking system is too strong for the central bank to hold a dominating position at the beginning.

2. The Bankers deny that such a bank can control the level of prices and direction of credit which the public will expect. The Banks of England and Sweden seem to have stabilized the level of commodity prices, but this is due to peculiar conditions, which might not be paralleled in Canada. We have not the money market machinery nor could our bank be backed by government resources even remotely comparable to the Exchange Equitization Account in England.

-Credit Control-

The bank is expected to be able to control fluctuations in credit in four ways.

1. The exercise, in public and private, of its moral authority. This requires a directorate of the highest calibre and a prestige which must inevitably be a product of slow growth.

2. The purchase and sale of bonds in the open market. We have discussed the difficulties attached to this function. There is the added danger that any attempt to create conditions of "easy" money in Canada, might lead to heavy importations of bonds from the

United States, cause a pressure on the foreign exchange market and an outward drain of gold.

3. The purchase and sale of foreign exchange. These operations would have a more immediate effect than the purchase and sale of securities in the open market and would present no difficulties not parallelled in other markets.

4. Raising or lowering of the rate charged on advances to the commercial banks. Contraction of credit may be brought, about but expansion would be more difficult. It would be hard to force our strong banks to advance credit.

-Note Issue-

The Bankers are strongly opposed to giving the central bank the sole right of note issue. "The note issuing privilege is one of the features of our system upon which the economic structure is based and the benefits to be derived from the creation of a central bank would be dearly purchased if they involved any weakening of the existing structure as resulted in the banks being able to give the public less adequate banking services."

1. Small branches:

The banks claim that if they lose their note issue, they cannot maintain some of their unprofitable branches and small communities might suffer. The banks unissued notes are used as the cash reserves of smaller brandes.

2. Earnings:

Loss of the note issue would seriously lessen the banks earnings. If any constructive purposes were being served by taking this privilege away ie., if it would give a central bank a better control of the reservoir of credit than it would otherwise possess, the question would be arguable, but no such purpose would be served.

-Banker's suggestion for Amendment-

If the assumption is made, that the Treasury Board is not fitted to exercise the supervisory and control powers necessary, when dealing with the extension of credit to the banks under the Finance Act; it is suggested that an Administrative Board composed of experts in finance and currency, should be appointed to administer the functions under the Act, now delegated to the Treasury Board. Such a body should have the authority to see that the total amount of credits granted to the chartered banks was in keeping with the requirements of the country, and that the rates charged on such advances fluctuate in accordance with current conditions. The members should be free from all political bias and chosen only by their technical knowledge and equipment for the task.

The only practical measure, of control of the reservoir of credit, that could be applied in Canada, is through the regulation of the advances to the chartered banks under the Finance Act and the rate of interest charged. The Administrative Board should be fully competent to deal with this phase of the problem. As to stabilizing the external purchasing power of the dollar, no insuperable difficulty should be anticipated either with the existing machinery or under the Board proposed, provided the government supplies the necessary funds.

-Conclusion-

As a result of this study of the question the bankers consider that in the present extremely disturbed state of business it would be most unwise to experiment with an organization entirely new to this country, namely, a central bank.

-Report of the Royal Commission-

In presenting the majority report the Commission, considered the adequacy of the existing equipment of the banking system, to play its part in the national economy. Insofar as the ordinary functions of the commercial banks are concerned, they have been performed admirably. With regard to the Finance Act although it furnishes means of increasing the credit base, the method which it embodies, regarded as part of the normal financial machinery of the country, is unsatisfactory. At a time when a deterioration in Canada's balance of payments led to an outflow of gold, the banks could keep up their reserves with Dominion notes obtained under the Finance Act. In this way the normal working out of the corrective measures was missing.

The powers of the Act are entrusted to a Board which is in effect a committee of the cabinet, a system with many disadvantages because of political interference. Moreover the Act does not require the Department of Finance to hold any gold reserve against the notes issued to the banks. A co-ordinating element is necessary in the banking system because there is no body at present, which has the responsibility of supervising credit or exchange.

An Administrative Board, as suggested by the bankers, in the opinion of the Commission could not adequately perform the functions that the present system fails to perform, unless it had powers and organization so similar to a central bank, that a bank might as well be established at the start.

-Recommendation of the Commission-

In view of the weaknesses in our existing system, the Commission recommended the establishment of a central bank.

There is no reason to suppose that a directorate of the necessary quality cannot be found in Canada. Even if we have no highly developed money market, some sort of control could undoubtedly be achieved.

A well managed bank, through its discount rate, purchase and sale of securities, and operations in the foreign exchange market, would have a decisive influence on the credit situation. Its holding of gold and foreign exchange could become a factor in carrying out the external value of the currency. In the opinion of the Commission the time was very opportune for its establishment and there should be very little disturbance to the existing system. With respect to the cost, it cannot be regarded as of major importance in a country like Canada.

"A central bank would substitute for the present undeveloped and anomalous system, a more rational and unified control over the credit structure; it would provide a suitable instrument for the execution of a national policy in regard to the external value of the currency; it would be increasingly a source of skilled financial advice for the Dominion and possibly the Provincial Governments; and finally it would provide a central body which could maintain relations with similar institutions in other countries, which find at present no counterpart in Canada with which to maintain contact."

Sir Thomas White and Mr. Beaudry Leman dissented from the arguments and conclusions of the Commission as to the need for a central bank at the present time.

We will consider briefly their views on these questions.

-Finance Act-

Sir Thomas White states very clearly his views on the Finance Act, as follows:

1. The statement was made that the Finance Act was the efficient agent which made effective the policy of inflation which Canada followed in common with all belligerent countries. The Act, instead of being an instrument promoting a policy of credit inflation, served with the highest efficiency the purpose of providing, in conjunction with the note issues of the banks, adequate currency facilities for the financing of the rapidly mounting volume of

production and trade. No central bank in the world during the war period or post-war period functioned more smoothly and efficiently or was better adopted to national needs, than the Finance Act.

2. The Finance Act was in no wise responsible for the fall in the Canadian dollar in the immediate post-war period. During this period our dollar stood at a higher gold exchange than the currency of Britain or any other Dominion of the Empire.

3. It is alleged that the rates charged from time to time on Finance Act advances were not used as an instrument of credit expansion and contraction but were mainly varied to meet the exigencies of the Dominion Governments finances. The rates of the Finance Act were practically similar to the rates charged by central banks which presumably were employed as instruments of credit expansion and contraction. As to meeting the exigencies of Government financing this is done in all countries. It is central bank practise to regard Government exigencies as a factor in fixing the discount rate when occasion so requires.

4. With regard to political influence affecting the administration of the act, no evidence came before the Commission in support of such a suggestion. The administration of the Act under all governments has been wholly free from any such influence. If it was thought necessary to limit the aggregate amount which may be borrowed by banks under the Act or that expert assistance were needed in the Treasury Board, legislation could be readily enacted. It may be of interest to know that since 1914 the Dominion Govern-

ment has received $22,782,602 by way of interest charged on Finance Act advances, and this at practically no additional cost to the Department of Finance.

-Central Bank-

Sir Thomas White and Mr. Beaudry Leman both dissent from the recommendation made by the Commission that a central bank should be established.

1. The time is inopportune for organizing a central bank in Canada because:

(a) In a time of great economic difficulties the fullest co-operation is needed with the financial institutions of a country.

(b) Under present conditions, a monetary policy cannot be placed beyond political influence.

(c) Developments may come which might necessitate fundamental changes in central banking.

2. It must be ascertained beforehand that a central bank would be assured of the goodwill and co-operation of each and every one of the Provinces of Canada.

3. Features of the proposed constitution which appear unacceptable.

(a) No differentiation is made between notice and demand deposits.

(b) The power of the Board to carry their cash reserves either in gold or foreign exchange.

(c) The provision authorizing the Bank to become the banker for Provincial Governments might lead to undesirable friction and ill-feeling.

(d) Vacancies in the directorate from time to time should be filled by the Governor General in Council, to avoid active canvassing by candidates seeking election.

4. Sufficient stress has not been laid upon the factors of national recovery, far more dependable and permanent than the temporary advantages of export trade of raw materials or foodstuffs.

5. A bank newly established and entrusted with the ownership of the entire cash reserves of Canadian banks and administered by an untried and independent Board of Directors with the power of controlling currency, credit and security issues and charged with the conduct of negotiations respecting our external public finance, would be only an impediment to the Government in this trying period.

6. Co-operation necessary for an international gold standard can be achieved better by direct negotiations of Governments with Governments.

With respect to some of the specific reasons put forward by a majority of the Commission in favour of a Central Bank Sir Thomas White summarizes his observations as follows:-

1. The fact that central banks have been created by numerous other countries is not a valid reason.

2. Expressions of opinion by international conferences no longer, carry weight with the public in any part of the world.

3. No Board of Directors no matter how eminent its personnel,

would be wise enough to be entrusted with the duty of influencing the levels of economic activity and prices.

4. The establishment of relationships between a central bank in Canada and other central banks, does not warrant the expense.

In conclusion the determination of the question of the advisability of establishing a Central Bank for Canada lies with the Government and Parliament of Canada. There may be considerations of policy relating to the promotion of intra-Imperial and international trade which may materially influence that determination, of which, the members of the Commission have no immediate knowledge.

In the next chapter a summary of the new Bank of Canada Act is submitted. The Act follows quite closely the constitution proposed by the Royal Commission.

CHAPTER IV

The Bank of Canada Act.

The Bank of Canada was incorporated on July 3rd, 1934, to "regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence, fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action and generally to promote the economic and financial welfare of the Dominion."

For ease of reference a synopsis of the new Bank of Canada Act, embodying the main features, is included at this point.

-Constitution of the Bank-

The new Bank with head office in Ottawa is under the management of a Board of Directors composed of a Governor, Deputy Governor, Assistant Deputy Governor, and seven directors. The Governors must be men of tested banking experience and the Directors men of diversified occupations; none of the latter can be bankers or bank directors and no member of the Board can be a member of the Dominion Parliament or any Provincial Legislature, or a Civil Servant.

The Governor of the Bank is the chief executive officer and has the direction and control of the business of the bank, with full authority to act in all matters, which are not specifically reserved to be done by the Board or by the Executive Committee composed of the Governor, Deputy Governor and one director selected by the Board.

-Capital and Shares-

The capital of the bank is five million dollars but may be increased from time to time. It is divided up into shares of fifty dollars each, not more than fifteen to be held by any individual. None can be held by any chartered bank or any officer of a bank. The liability of every shareholder is limited to the amount for the time being unpaid. There is no double liability such as was formerly in the chartered banks. It is not necessary for a central bank to have a large capital. The smaller the capital, within reason, the less is the necessity to make profits for dividend purposes. Since the Bank of Canada is a comparatively small bank it is not wise to allow any large holdings by any certain interests. A chartered bank might be able to exert too much pressure if they were allowed to hold shares.

-Business and Powers of the Bank-

The central bank's powers are defined so that it can only do the very highest class of business, invest only in the most liquid types of securities, and maintain a strong position that will enable it to tide the country over periods of strain.

-The Bank of Canada is empowered to:-

(a) buy and sell gold, silver, nickel and bronze coin and gold and silver bullion.

(b) transfer funds by telegram, letter or other means of communication, buy and sell trade and banker's acceptances, banker's drafts and bills of exchange drawn in or on places outside of Canada, for a term of not more than three months.

(c) buy or sell or rediscount short term securities, issued or guaranteed by the Dominion of Canada or any Provincial Government maturing in not more than two years.

(d) buy and sell securities issued or guaranteed by the Dominion of Canada or any province, maturing in over two years. The amount of such securities must not exceed three times the paid up capital of the bank.

Section 'c' refers to securities on which banks may secure advances.

Section 'd' refers to permanent investments of the Bank, not held for quick turnover.

(e) buy and sell short term securities of the United Kingdom, any British Dominion, the United States of America, or France having a maturity not exceeding six months.

(f) buy and sell securities issued by the United Kingdom or the United States maturing in over six months but the amount of such securities must not be in excess of one-half of the paid up capital of the Bank.

(g) buy, sell or rediscount bills of exchange and promissory notes endorsed by a chartered bank drawn or issued in connection with the production or marketing of goods, and having a maturity of not more than three months.

(h) buy, sell or rediscount notes and bills of exchange drawn under section 88 of the Bank Act maturing under six months, provided the Bank may itself limit the amount of such paper it is ready to rediscount, to a percentage of its total assets, which mature in under six months.

(i) make loans or advances for not more than three months, to the chartered banks on the pledge of the foregoing classes of securities, bills of exchange, promissory notes, Canadian municipal securities, gold and silver coins and bullion, or documents of title relating thereto. This replaces the advances made by the Minister under the Finance Act.

(j) make loans or advances to any Dominion or Provincial Governments on the pledge of readily marketable securities issued or guarenteed by these governments. There is a great need of control on the part of the management in respect to this section. Advances must not be for periods exceeding six months.

(k) make loans to the Dominion or Provincial Governments, such loans at any one time, in the case of the Dominion government must not exceed one third of the estimated revenue of its fiscal year. In the case of the provincial governments the loans must not exceed one-quarter of their estimated revenue for the fiscal year. Such loans must be repaid before the end of the first quarter, after the end of the fiscal year of such governments. These are short term advances made in the ordinary course of business in anticipation of tax receipts.

(l) buy and sell in the open market, for the purpose of open market transactions, securities, cable transfers, banker's acceptances, and bills of exchange with or without the endorsement of a chartered bank.

(m) accept from the Dominion or any Provincial government or from any chartered bank, deposits, which shall not bear interest. No deposits are accepted from the general public.

(n) open accounts in a central bank in any country or in the Bank for International Settlements and act as agent in Canada for such accounts.

(o) acquire real estate for the use of the bank.

(p) do any financial operation necessary to carry out the above purposes.

The Bank may acquire from any chartered bank and hold, any warehouse receipt, bill of lading and other security as collateral and may sue for repayment of any bill of exchange or promissory note acquired by the bank.

<u>The Bank can not:</u>

(a) engage or have a direct interest in any trade or business whatsoever.

(b) purchase its own stock or the shares of any other bank except the Bank for International Settlements, or make loans on the security of bank shares.

(c) make loans on the security of any real or immovable property except when its funds are endangered it may secure itself by acquiring such property, but this must be resold as soon as practicable.

(d) make loans or advances without security.

(e) accept deposits for a fixed term or pay interest on any deposits.

(f) allow the renewal of maturing bills of exchange, promissory notes or similar documents purchased or discounted by or pledged to the Bank; provided that under special circumstances the directors may in their discretion renew for not more than one more time.

-Business for the Government-

The Bank acts as the fiscal agent for the Dominion Government without charge and by agreement may also act as banker or fiscal agent of any Provincial government.

If the Minister requires, the Bank must act as the agent of the Dominion Government in payment of interest and principal of the public debt in Canada.

The Bank must cash all government cheques at par.

-Note Issue-

The Bank has the predominant right of note issue.

75%, the chartered bank's issue is to be redeemed over a specified period. A central Bank is responsible for the countrol of the volume of credit and the maintenance of the stability of the value of the currency, therefore it must have the sole right of issue. The Bank's notes are legal tender and the first charge on the assets of the Bank. Subject to the provisions of the section on reserves, the Bank can issue notes to any amount. These notes are redeemable in bars of gold containing approximately four hundred ounces of fine gold but the governor in Council may suspend this redemption at any time.

The Minister of Finance must transfer to the Bank

(a) Gold held for the redemption of Dominion notes.

(b) Silver held for redemption purposes, valued at the market price.

(c) Securities of the Dominion bearing interest at 3 % payable half-yearly, maturing in not more than five years, to the amount of Dominion notes outstanding, except notes issued under the authority of the Finance Act.

The Bank is responsible for the redemption of all Dominion notes and the chartered banks must repay all advances outstanding under the Finance Act.

-Reserves-

The Bank must always maintain a reserve as security against the outstanding notes and deposit liabilities.

The reserve consists of:

(a) gold coin and bullion to an amount equal to 25% of the notes issued and its deposit liabilities.

(b) silver bullion valued at the market price.

(c) foreign exchange which means balances with the Bank of England, the Bank for International settlements, the Federal Reserve Bank of New York and the central bank of any gold paying country; treasury bills or other obligations of the United Kingdom or the United States of America, having a maturity of not more than three months; and bills of exchange maturing in not more than three months, payable in London or New York or any gold paying country, less any liabilities of the Bank payable in currency in the United Kingdom, United States or any gold paying country.

-Reserves of the Chartered Banks-

Every chartered bank must keep a reserve of not less than 5% of its deposit liabilities in Canada, consisting of a deposit with the Bank and of notes of the Bank held by such a bank.

This deposit shall be used in the event that any chartered bank's property and assets are insufficient to pay its debts and liabilities.

All gold coin and bullion owned and held by banks, in Canada must be transferred to the Bank on the day it begins business at the mint price of gold. Any gold transferred by the banks, which was being held against liabilities elsewhere than in Canada, when sold, the profit thereon shall belong to the banks.

-Profits of the Bank-

The Bank must establish a rest fund and after making provision for bad debts, depreciation in assets, pension funds and payment of a four and one-half per cent dividend, the remaining profits are to be applied as follows:

(a) If the rest fund is less than the paid up capital, one third of surplus goes to the rest and two-thirds to the Receiver-General.

(b) If the rest fund is more than the paid-up capital but less than twice that amount, one-tenth of the surplus goes to the rest and nine tenths to the Receiver-General.

(c) If the rest fund is not less than twice the paid-up capital, the whole surplus goes to the Receiver-General.

-Audit and Returns-

The Minister appoints two auditors and the shareholders at each annual meeting appoint an additional two. The Minister can require the auditors to make a report at any time.

The Bank must submit a statement of its assets and liabilities each week and each month. The return must state the amount of its notes in circulation on each business day. Yearly statements must be transmitted six weeks after the end of each fiscal year, which is the calendar year.

It remains for us to examine very critically the possibilities of the Bank, its working and future.

CHAPTER V.

We have already outlined in Chapter III the main objections raised to the establishment of a central bank, when we studied the evidence submitted by Mr. McLeod before the Royal Commission. There are, however, several points which require further study before we can decide whether such an institution will better conditions in this country. Are the benefits to be derived from a central bank in Canada sufficient to warrant its establishment?

-Credit Control-

The main difficulty that the bank will have to face is, how far will it be able to function as a serious controller of credit? Will it be able to conduct sufficiently large open market transactions to make its credit policy effective?

When we approach the topic of the part a central bank could play in controlling the expansion and contraction of credit in this country, it is essential to note that, under the provisions of the Finance Act, Canada has already part of the machinery of a central bank. It must be admitted, however, that there has been a definite weakness in this system. Under the Finance Act, as we will recall, the commercial banks may take certain securities to the

Department of Finance and thus obtain Dominion Notes which can be used either as a reserve or as backing for additional bank note issue. But there has been no conscious effort on the part of the Treasury Board to control the amount of borrowing by commercial banks, through adjustment of the discount rate. The Dominion has had no definite policy of currency and credit control.

We have already mentioned sufficiently the means by which a central bank is expected to be able to control credit, but it remains for us to consider how far the Bank of Canada will be able to function in this respect. The most important consideration, of course, is that Canada does not possess a money market in the sense in which we use that term. And because of special circumstances it would be quite difficult to create the mechanism of control which exists elsewhere. It may be pointed out that when the Federal Reserve System came into effect in the United States it was found that the creation of a bill market was absolutely necessary. Even so this bill market has never functioned as smoothly as that of London, which was the product of natural growth. In Canada we see no facilities for open market transactions corresponding to the arrangement in Britain and the United States.

In the case of the Bank of England, its control is, in normal times, almost perfect. These means of control can be exercised with precision and sureness, for three reasons.

1. Because of the conventions which, over a long period of years, have grown up in the London money market.

2. Because London is a creditor on a large scale, by reason

of long term investments abroad in the past.

3. Because Londin is at all times a depository of short term funds from abroad, of such a kind that it was possible in normal times within limits to decrease or increase the short-term indebtedness of London to the rest of the world, practically at will.

These conditions are not closely parallelled anywhere on this continent. New York is the only place that occupies a creditor position on foreign account, and serves as a repository of short term funds from abroad, in the sense that London does. This has been a recent development and has only lately been of prime importance. Even with the existing machinery in the New York market it cannot be kept in close control by the Federal Reserve Banks, as can the London money market.

One of the most important classes of marketable short term obligations in any country of course, is the government's issue of Treasury Bills. In London and New York these bills are actively dealt in and there is always a large supply available for the banks to buy or sell. Even though the Treasury Bill is quite familiar in Canadian financial circles, they are only issued at very irregular intervals and as a rule are not negotiated after purchase, by the bank that buys them.

Apart from the types of short term obligations available in each of these great money markets, and the mechanism with which each conducts its technical operations, the fact that both Britain and United States are creditor countries on a large scale, permits them to strengthen their position on international account by retaining balances accruing in their favour abroad, instead of re-lending these balances immediately, by the purchase of long term securities in other countries.

We have seen the difficulties which arise in the case of operations in short-term government obligations, similarly the facilities are missing for operations in short-term self liquidating commercial obligations. Canada has no market for banker's acceptances and outside of the banks there are no portfolios of acceptances or commercial bills. The Canadian exchange broker is an intermediary, pure and simple, between the banks.

We will turn now to a consideration of the possibilities of purchasing and selling bonds in the open market. As a procedure this would be very simple and a central bank might increase or diminish the cash resources of the commercial banks in this manner; subject to the qualification that changes might occur in their assets abroad, independent of those being brought about in Canada, which would perhaps affect the situation materially. There are several other difficulties which also arise at this point.

1. Before a central bank could, with any reasonable degree of confidence, go about the procedure of buying and selling, an intricate technique would have to be learned on the basis of experience. Seasonal movements in general business and in the public accounts would have an unsettling influence on credit and it

would be the task of the central bank to mitigate these fluctuations as far as possible.

2. We must remember that the Canadian security markets are of a very limited character. Depending on the trend of the market it is easy at times to sell in volume, or at other times to purchase in volume without seriously disturbing prices. But if the market was unreceptive and the central bank desired to sell, the process might be exceedingly slow. Another difficulty involved is that a large number of the security issues in which a central bank could deal, are so largely held in the United States as well as Canada that a strong buying policy by the bank might only prompt an importation of Canadian bonds held in the United States. The Canadian market is overshadowed so much by that of the United States, that a central bank's powers in the direction of contraction or expansion would be limited unless any action taken in this country was parallelled by similar action in the United States. It would be extremely difficult to pursue a course different from that pursued by the neighboring country.

3. Even if such open market transactions could be conducted by a central bank in Canada without ulterior consequences, there is reason to doubt whether they would have positive effects of much importance.

The bank rate, is of course, the lever by which it would be expected that the central bank could regulate advances to the commercial banks and thus affect the credit situation.

In theory, borrowing should be checked as the bank rate is raised and stimulated as it is lowered. But it is very doubtful whether a bank could hope by rate reductions alone to effect an expansion of loans by the commercial banks.

If the central bank commanded great prestige in the country, manipulations of the rediscount rate charged upon advances would have a certain moral effect. If the bank made the public announcement that the rate was changed, it would be a sign that the bank considered the financial or rather economic condition of the country to warrant it. Now, whether the rate is raised or lowered, if the public trusted the advice of the central bank, changes would take place in the demand of the public for credit, in the direction desired by the central bank. The rate therefore is an additional means of exercising a certain moral authority.

We may sum up the question of credit control by saying that the mechanism which a central bank in Canada will possess, will be quite crude. It would be very hard for a directorate, no matter how efficient and far sighted, to enforce its will merely by means of open market operations and the discount rate. We must not forget however the possibility that under certain circumstances and by manipulating the rate of exchange, a central bank might effectively produce the desired results which direct action in the domestic market alone could not secure. This presupposes that we should remain off the gold standard.

-Weaknesses-

Another point to which we must give serious attention is the fact that the bank will raise hopes that may not be fulfilled. The public may expect too much in the line of easy credit. We must remember that the effectiveness of central banks is governed everywhere by local conditions. The executives of central banks do not possess, as the public seems to think, the power to control the level of prices and the direction of credit. Several central banks it is true have met with slight success along these lines but it is not a certain fact that a Canadian central bank will be successful. Conditions prevailing in the Canadian banking system are not such as will allow the bank to hold a dominating position. Of course it is to be hoped that our banks will co-operate with the Bank in its attempts to better conditions.

To begin with the Bank of Canada, a small bank, does not possess the resources to allow it to attempt to control any situation that might develop. Central banking is something new in this country and the men in control may possess neither the experience in central banking nor the prestige with the public necessary to permit them to use with confidence even the small resources of such a bank.

The arguments used by the faction in opposition to the Bank of Canada are:

1. The chartered banks which are old well established and powerful institutions might pay very little attention to the central bank authorities if they attempted to give advice.

2. The chartered banks have large resources quite ample

to meet the financial needs of Canada for many years to come and therefore would not be obliged to resort to the central bank for additional reserve. In this way any attempt at control of credit through adjustments of the discount rate, would be rendered ineffective.

3. The old argument of the absence of a money market is brought up again. If the central bank attempted to force the member banks to rediscount through open market transactions, it would find itself seriously hampered by the absence of suitable market. Without recourse to a ready money market a central bank is in a very weak position when it desires to control credit movements.

At first glance these seem to be very convincing arguments but let us consider them for a moment. In the first place the chartered banks although they are well established and powerful they are not in qiite as strong a position as this argument tries to point out. After all they are under the jurisdiction of the government to a certain extent being dependent on it for a renewal of their charters. It is not reasonable to suppose that the banks are going to work against the central bank in everything. Anything that promotes the economic welfare of the Dominion is certainly advantageous to the banks.

Secondly when it is stated that the commercial banks have ample resources to meet any financial needs, the facts are not truly stated. During the boom period 1927 to 1929 the banks found it necessary to borrow under the Finance Act. We must not forget that the member banks must keep a certain reserve with the central bank.

The third argument of course is the most convincing one of those raised. There is no doubt that the absence of a suitable money market does restrict the bank in its attempts to control credit. This can of course be altered by establishing such a market as did the United States. The difficulties associated with this task are not insuperable.

The conclusion we arrive at is that the bank will not occupy as weak a position as some people are prone to think. No doubt there are weaknesses such as prestige, inexperienced directorate etc., but these can be overcome. In all fairness to the men responsible for the establishment of the bank we must say that it is not as hopeless an attempt as certain people try to make out.

-International Relations-

A central bank has been urged, in Canada, because of the possibility of international co-operation. A strong argument in the bank's favour in this respect is that it would be in a position to co-operate with the central banks of other countries much more effectively than our ten competing chartered banks. There is, to a certain extent, uniformity of policy among our chartered banks but a central bank at the head of our financial system would be able to decide on a course of action much more promptly than the members of a competing system acting jointly. A central bank furthermore would command more respect and prestige than a number of independent banks.

Of course to the claim of the proponents of a central bank, that Canada would be able to take part in the joint enterprise of gold management if and when the gold standard is restored internationally, it may be stated that the co-operation necessary to maintain the standard could have been accomplished without the creation of a central bank.

There is one important thing that the Bank of Canada could perhaps assist in overcoming and that is the so-called "international dilemma" in central banking. Suppose a central bank in one country decides to curtail the expansion of credit by raising its rediscount rate, it finds that the increase in the rate causes a flow of funds from abroad, which result nullifies the central bank's action. Conversely if the rate is lowered in order to encourage the internal expansion of credit, funds tend to flow abroad where earnings are higher. Co-operation between the central banks of leading countries is the only possible way of controlling such situations in the absence of a world bank. It is quite safe to say that the Bank of Canada will be of considerable help in the international field. As to the argument that it will enable Canada to do more financing abroad, may we state, Canada has never experienced any difficulties in this direction.

-National Relations-

Owing to the overgrowing burden of public debts and the increasing complexity of the governments financing, we need some form of permanent organization, able to give expert advice in matters of finance. The central bank's duty is to act as the fiscal agent of the government and in this respect our bank should be able to accomplish much. The bank is in constant touch with all economic matters in the country and should be of great assistance in planning the economic policy of the government. Such a system of economic planning might do much to avert a repetition of the depression experienced during the past few years. The officers of the Bank of Canada should have, in a short time, considerable knowledge of financial conditions both nationally and internationally and should be able to perform the task of fiscal agent more satisfactorily than any other body. Less important but yet of great use to a country is the opportunity for economic research supplied by the bank. In this way much valuable information can be furnished not only to the government and the member banks but to the public as well. A central bank certainly has its advantages in this field.

There are one or two clauses in the Bank of Canada Act which require a closer study, namely, the problem of control, reserves and the revaluation of gold with its possibilities of inflation.

The problem of control is not of very great importance, because in times of serious financial crises the state will if necessary dictate the policy of the Bank of Canada. But the bank stands in a peculiar position in relation to the country first with regards to its discount policy. The central bank controls the purchasing power through the action of its discount policy on credit, gold reserves and note issue. This is so important that in some countries the bank is conducted under a government guarantee. Secondly, the bank is responsible for safe-guarding the currency standard established by law. And thirdly the failure of a central bank would have such an effort on a country's credit, that a government cannot be indifferent to the Bank's policy. Therefore it must have a great interest in the efficiency of the bank and most countries have in their bank acts, certain clauses, giving the government some influence with regard to the constitution of the bank's governing body. This is particularly noticeable in times of war etc.

The theory underlying a state controlled bank is that because a wise central banking policy is the basis of a sound economic life, the national government should control the bank. But there are distinct disadvantages and dangers to this system.

1. The bank's decisions should be as unbiased and continuous as humanly practical. The policy of the bank may not be continuous if it is under government supervision especially when governments change, as often they do.

2. The government is the largest customer in our equivalent of a money market and if it controlled the discount rate and money market policy there might be serious results.

3. The bank could be wrecked by politics and undue governmental influence.

4. If the control lies with the government it becomes fatally easy for it to finance itself by short loans and book entries from the bank. This is a sure step towards currency depreciation and inconvertibility.

The only satisfactory conclusion we can arrive at is that in starting a central bank it is better to make it an independent bank, as has been done in Canada, and then give specific and limited powers to the government. The reverse method is not to be advocated. The divorce of the government from direct responsibility for the monetary policy of the bank is now the accepted policy.

It is interesting to notice that in practically all countries, the governors of the bank are appointed by the government. In Canada Mr. Graham Towers was appointed by the Federal Government, in order to organise the Bank of Canada. We must point out however that all subsequent governors are to be appointed by the directors with the approval of the Governor in Council. England is a notable exception to this procedure. The governor of the Bank of England is not a government appointee.

We will now consider very briefly the question of reserves. The central bank must consider the state of its reserves against its notes and deposits, in determining how freely it will lend and create credit. It is not necessary to deal with the need for such reserves but rather with the nature of them. The older line of thought was that reserves should be actual gold in the vaults. However in newer bank charters, foreign claims in gold may be held and reckoned as part of the legal reserve. The Bank of Canada is also authorized to hold foreign exchange as reserve. This is something new in Canada and may be very dangerous to the country holding such deposits as was seen when the Bank of England was forced to suspend gold payments. The Bank in Canada may count in its reserve, Bills of Exchange or balances in London, New York or the Bank for International Settlements. It really amounts to holding reserves out of the country. It should be noticed that the minimum reserve against notes and deposit liabilities must be 25% of their amount in gold. This follows on the recommendation of the gold delegation of the League of Nations and the further recommendation of the Economic Conference.

In conclusion we must consider the question of note issue and the great possibilities of inflation under the new Act. The gold held by the Chartered Banks and the Finance Minister is to be handed over to the bank and revalued at the open market rate. To grasp the situation better, it might help to examine the actual figures.

In summary it is as follows,

Gold held by Chartered Banks	$44,534,000
Revalued at $35.00 per ounce	75,350,000
Gold held by Finance Minister	71,966,000
Revalued at $35.00 per ounce	121,850,000
Total gold at the new value	$197,200,000
Under the 25% reserve, it is possible to issue	$788,800,000
Subtract the present note issue of the Dominion Government	182,644,000
Therefore the net possible increase of note issues is	$606,156,000.

We can easily see that there is a possibility for a very large increase in the currency. This power of the Bank of Canada is very great and the management must conduct itself with care.

We may sum up our whole discussion on the problem of Central Banking in Canada by saying that the bank cannot be better than its directorate. There are great possibilities in Canada, for improvements and it is with great interest that the Country looks forward to the early commencement of business. The bank may find it advisable to follow British practise and concern itself with the internal price level alone, but whatever it attempts it must try to function for the benefit of the country at large: We must not expect the Bank to perform miracles. At best the success of the bank will be a product of gradual growth.

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