The Canadian Dollar under the Gold Standard (1854-1914)

Canada, \$10, 1912

Although Newfoundland issued gold coins as early as 1865, the Dominion of Canada did not do so until 1912–14, when the recently established Royal Mint in Ottawa struck \$5 and \$10 pieces. When the redemption of Dominion notes into gold was suspended at the beginning of the First World War, the production of Canadian gold coins ceased.

Operation of the gold standard

From 1 August 1854 when the Currency Act was proclaimed, until the outbreak of World War I in 1914, the Province of Canada, and subsequently the Dominion of Canada, was continuously on a gold standard. Under this standard, the value of the Canadian dollar was fixed in terms of gold and was convertible upon demand. It was also valued at par with the U.S. dollar, with a British sovereign valued at Can\$4.8666. As noted earlier, both U.S. and British gold coins were legal tender in Canada.

With the gold standard in place, monetary policy was largely "on automatic pilot." Paper money was freely convertible into gold without restriction, and there were no controls on the export or import of gold. This implied that there was virtually no scope for the authorities to manage the exchange rate or to conduct an independent monetary policy.⁵²

Fluctuations in market exchange rates between the Canadian dollar and the U.S. dollar and the pound sterling, respectively, around their official values were generally limited by the gold "export" and "import" points. These points marked the exchange rates at which it was profitable for individuals to take advantage of price differences between the market and official exchange rates through the export and import of gold from the United States or the United Kingdom. The difference between the export and import points and the official rates reflected the cost of

^{52.} Note, however, that following Confederation, the amount of Dominion notes issued without 100 per cent gold backing was increased over time from \$8 million in 1868 to \$30 million by 1913 (Beckhart 1929, 294). Rich (1988) argues that the marked expansion of the uncovered note issue through the 1867–85 period suggests that the government relied extensively on discretionary monetary policy during this time. After 1885, however, although the amount of Dominion notes in circulation continued to rise, there was a matching increase in gold reserves. Consequently, the percentage of gold reserves to Dominion notes in circulation rose from only 21 per cent in 1890 to 81 per cent at the outbreak of World War I (Rich, 71–73 and Beckhart, 296).

insuring and shipping gold to and from New York or London and Montréal. Canada's financial centre at that time. Given the proximity of New York, the margins against the U.S. dollar were very narrow around parity with a gold export point of Can\$1.0008 and a gold import point of Can\$0.9992. The margins around the \$4.8666 par value of the pound sterling were somewhat wider, ± 1 per cent, given the greater distance to be travelled (Rich 1988). On rare occasions, the Canadian dollar traded outside the gold points for periods of several weeks, much longer than one would have expected if arbitrageurs were efficient. This suggests that obstacles, probably imposed by governments in an effort to protect their gold reserves, might have impeded their activities (Turk 1962). While not a particularly significant phenomenon prior to 1914, government-erected impediments to the cross-border flow of gold became common during World War I and even more so through the late 1920s and early 1930s in order to conserve the country's gold reserves.

With monetary policy essentially on autopilot and little in the way of active fiscal policy, there was nothing to buffer economic swings and the impact of large international capital movements. In his 1867 pamphlet arguing in favour of government-issued fiat currency, Robert Davis contended,

Such a currency, moreover, freed from the constraint of convertibility at the bank counter, would not be subject to the fluctuations to which our present circulation is constantly liable, and the injury to trade from its contraction, at the time its extension was most needed, would no longer exist . . . (Davis 1867, 32).

The price-specie flow

Classical economists explained international economic adjustment under the gold standard using a theory developed in part by David Hume-the price-specie flow. Under this theory, an economic shock that led to increased demand in one country, and rising prices, would trigger an increase in imports and a countervailing outflow of specie to the rest of the world. The drain in gold from the country experiencing the shock would reduce the quantity of money in that country, leading to higher domestic interest rates (which, in turn, would slow demand), lower prices (relative to those elsewhere), and higher exports. Increased net exports and capital inflows attracted by relatively high domestic interest rates would restore equilibrium to the balance of payments. The opposite process would happen simultaneously in the rest of the world. The successful functioning of this adjustment mechanism depends critically, however, on the sensitivity of demand to price changes in the countries affected. If the "price-elasticity of demand" was low, it would be possible under the fractional gold standard that prevailed during this period for a country's reserves of specie to be exhausted before adjustment was completed. See Yeager (1976). This opposition remained a minority position, however, with the weight of orthodox economic views and conventions in support of the gold standard prevailing until the 1930s. Accordingly, Canada experienced booms and busts during the gold-standard years. For example, between 1870 and 1900, Canada suffered several economic contractions with falling prices. In contrast, between 1900 and 1913, Canada grew rapidly, and inflationary pressures mounted as huge amounts of foreign capital (as a percentage of Canadian GDP) entered the country. (See also Appendix A.)⁵³

The Canadian dollar and the U.S. greenback (1862–79)

In 1862, the American Civil War began to affect currency in the United States. As the finances of the Union government deteriorated, U.S. banks suspended the convertibility of their notes into gold, and the government suspended the right to convert U.S. Treasury notes (government-issued paper money) into gold. Shortly afterwards, the U.S. Congress authorized the government to issue non-convertible legal tender currency, which became popularly known as "greenbacks." While little was said officially regarding the future convertibility of greenbacks into gold, it was widely assumed that convertibility would be restored when the war was won (Willard et al. 1995). Trading in the greenback vis-à-vis gold commenced in mid-January 1862 in New York and continued with





United States, \$1, 1862 Known as the "greenback" and produced during the Civil War, this was part of a note issue that re-established a government (paper) currency in the United States.

only one short interruption until the United States returned to the gold standard on 1 January 1879.

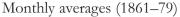
Almost from the start of trading, the greenback depreciated relative to gold and against other currencies, including the Canadian dollar, which remained on the gold standard. The weakness in the greenback undoubtedly reflected the rapid expansion of the U.S. note issue from \$150 million in early 1862 to \$450 million by March 1863. Fluctuations in its value also reflected the military and political fortunes of the Union government and, hence, the expected likelihood

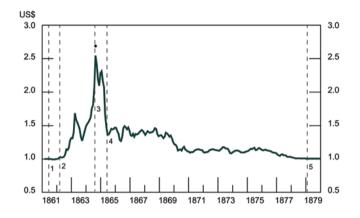
^{53.} Net capital inflows into Canada reached a record 18 per cent of GDP in 1912 (Urquhart 1986).

that the government would eventually be able to redeem the greenbacks in gold. The greenback tended to strengthen on news of Union victories, such as the Battle of Gettysburg in 1863, and weakened on Union reversals. It reached its nadir during the summer of 1864, when the Union government, in a move against speculators, temporarily shut down gold trading for two weeks in late June, followed in early July by Confederate advances towards Baltimore and Washington and raiding operations in Pennsylvania.⁵⁴ Based on available information, the U.S. greenback fell from close to parity against the Canadian dollar in early 1862 to less than 36 Canadian cents (or Can\$1=US\$2.78) on Monday, 11 July 1864 (Chart 1).⁵⁵ This represents the all-time peak for the Canadian dollar in terms of its U.S. counterpart.

The greenback subsequently began to recover, almost doubling in value by the end of the Civil War in April 1865. After the war, it continued to strengthen, albeit at a slower pace, as the government retired a significant amount of greenbacks during the 1866–68 period. Deflation after the Civil War enabled the United States to return to the gold standard on 1 January 1879, with the greenback convertible into gold at the old pre-war rate of 23.22 grains of gold (Yeager 1976). Once again, the Canadian dollar traded at par with its U.S. counterpart. This exchange rate held until the outbreak of World War I.

Chart 1 Canadian Dollar in Terms of the U.S. Dollar





- *11 July 1864: Can\$1=US\$2.78
- 1. April 1861: Outbreak of U.S. Civil War
- 2. January 1862: U.S. suspends gold convertibility.
- 3. June, July 1864: Closure of Gold Room, Confederate army approaches Washington.
- 4. April 1865: U.S. Civil War ends.
- 5. January 1879: U.S. returns to gold standard.
- Source: Turk (1962), Montreal Gazette

^{54.} Confederate troops led by Jubal Early came within five miles of the White House on 11 July 1864 before breaking off the raid and returning to Virginia (Willard et al. 1995, 17).

^{55.} Exchange rate data were obtained from the Montreal Gazette on file at Library and Archives Canada.