Canada off the Gold Standard (1914-26)

Canada, Victory Bond, $100, 1915
This bond issue demonstrated that Canada had come of age financially. It was oversubscribed entirely by Canadians, so that, for the first time, Canada was able to offer Britain a loan for the purchase of war supplies.

World War I

The beginning of World War I marked the end of the classical age of the gold standard.[56] All major countries suspended the convertibility of domestic bank notes into gold and the free movement of gold between countries. This was often done unofficially. For example, in the United Kingdom, private exports and imports of gold remained legal in theory. However, in addition to a number of government-imposed regulations that discouraged the buying and selling of gold, bullion dealers refused to permit gold exports on patriotic grounds (Yeager 1976, 310).

In Canada, convertibility was officially suspended. As tensions mounted in the days immediately prior to the declaration of war on 4 August 1914, there were heavy withdrawals of gold from banks. In an "atmosphere of incipient financial panic" (Macmillan Report 1933, 22), there were concerns about the possibility of bank runs. In the absence of a lender of last resort, this was potentially very serious, since banks were legally required to close if they were not able to meet depositor demand for gold or Dominion notes.

On 3 August 1914, an emergency meeting was held in Ottawa between the government and the Canadian Bankers Association to discuss the crisis. Later that day, an Order-in-Council was issued that provided protection for banks that were threatened by insolvency by making notes issued by the banks legal tender. This allowed the banks to meet their depositor demands with their own bank notes rather than with Dominion notes or gold.

56. Although gold had been used as money since antiquity, a fully fledged international gold standard lasted a surprisingly short time—roughly 40 years. It was not until the 1870s that a gold standard was finally adopted in all major economies (Yeager 1976, 295).

Home Bank, $10, 1917
The Home Bank was one of several chartered banks established in Canada during a period of economic expansion early in the twentieth century. Its operations were suspended in 1923, owing to poor management. Following a Royal Commission into its operations, the Office of the Inspector General of Banks (the forerunner of the Office of the Superintendent of Financial Institutions) was established in 1925.

The government also increased the amount of notes that banks were legally permitted to issue. The government was also empowered to make advances to banks by issuing Dominion notes against securities deposited with the minister of finance. This provision enabled banks to increase the amount of their bank notes in circulation.

A second Order-in-Council, issued on 10 August 1914, suspended the redemption of Dominion notes into gold. This and the previous Order-in-Council were subsequently converted into legislation as "An Act to Conserve the Commercial and Financial Interests of Canada" (the Finance Act), which received royal assent on 22 August 1914.

The Finance Act gave the government the power to act as a lender of last resort to the banking system—one of the powers of a modern central bank. It also provided a means for the government (Treasury Board) to set the Advance Rate, the rate at which it would make loans to the chartered banks. (See Chart C2 in Appendix C.) Advances under the Finance Act were made at the request of banks. The government did not actively manage interest rates, nor was there any board overseeing the conduct of monetary policy (Shearer and Clark 1984, 279).

Chart 2
Canadian Dollar in Terms of the U.S. Dollar
Monthly averages (1914–26)

1. August 1914: Outbreak of World War 1
2. November 1918: End of World War 1
3. July 1926: Return to gold standard
Source: U.S. Board of Governors of the Federal Reserve System (1943)

Dominion of Canada, $2, 1914
The portraits of Canada's Governors General and their wives were commonly featured on Canadian government notes in the late nineteenth and early twentieth centuries. The Duke of Connaught, Governor General from 1911 to 1916, and his wife are shown here.

Dominion of Canada, $1, 1917
This note features Princess Patricia, daughter of the Duke and Duchess of Connaught and patron of the famous Princess Patricia's Canadian Light Infantry.

Throughout the war, the Advance Rate remained at 5 per cent, although a special 3.5 per cent rate was established in 1917 under which the government discounted British treasury bills held by the chartered banks. This facility was designed to assist the British government's war effort. It was complemented by a special $50 million issue of Dominion notes backed by British treasury bills to help finance British purchases of war materials in Canada (Macmillan Report 1933, 22). The government also increased the fiduciary issue of Dominion notes (i.e., notes not backed by gold) in 1915 under an amendment to the Dominion Notes Act.

Despite the suspension of gold convertibility in August 1914, the Canadian dollar traded in a very narrow range close to parity with its U.S. counterpart throughout the war years (Chart 2). In 1918, however, the Canadian dollar began to weaken, and its decline accelerated during the two-year period following the end of hostilities, until it reached a low of roughly US$0.84 in 1920. The weakness of the currency reflected a significant monetary expansion, high inflation, and a deterioration in Canada's balance of payments associated with financing the war effort and the ensuing cost of troop demobilization (Shearer and Clark 1984, 282; Knox 1940).

Setting the stage for a return to the gold standard

There was a general presumption that, after the war, the major industrial countries would return to the gold standard. The United States, which was a late entrant into the war and did not experience the same sort of financial or inflationary pressures as the United Kingdom or Canada, returned to its old fixing in terms of gold in June 1919. The United Kingdom controversially followed suit in 1925 at its old pre-war price in terms of gold, equivalent to US$4.8666.[57]

In Canada, the Finance Act of 1914, which had been adopted as a war measure, was extended in 1919 and revised in 1923. Under the revised act, provision was made for an automatic return to the gold standard after three years unless the government took steps to the contrary.

The revised act also gave the Dominion government greater flexibility to adjust the rate at which banks could obtain funding.[58] However, the Treasury Board, which was responsible for administering the act, did not conduct an active monetary policy.

The Advance Rate remained fixed at 5 per cent, the same level it had been throughout the war. Thus, there appeared to be little overt official effort to tighten monetary policy in anticipation of an eventual return to the gold standard, which would fix the dollar at its pre-war value in terms of gold and at par with its U.S. counterpart.

Despite the apparent lack of action, the money supply did contract significantly during the first half of the 1920s, permitting a return to the gold standard. The maintenance of the Advance Rate at 5 per cent, despite a fall in market interest rates, had deflationary consequences. (See Chart A2 in Appendix A.) Moreover, Britain's repayment of war loans from Canadian banks (which were subsequently discounted under the Finance Act at the special 3.5 per cent rate) and the retirement of the so-called "British Issue" of Dominion notes issued in 1917 against British treasury bills also contributed to the monetary contraction (Shearer and Clark 1984, 291). Expansionary monetary policy in the United States, partly aimed at facilitating the return of European countries to the gold standard, also facilitated Canada's return to the gold standard on 1 July 1926. However, gold reserves were widely viewed as inadequate to the task (Bryce 1986, 36).

57. John Maynard Keynes famously opposed this move in a pamphlet entitled "The Economic Consequences of Mr. Churchill." Given a relatively high rate of inflation in the United Kingdom during and immediately following the war, the old pre-war parity for sterling was seen as being too high. Efforts to sustain the pound at its pre-war rate led to a serious recession and deflation.

58. Under the 1914 act, the Advance Rate could not fall below 5 per cent. This minimum level was removed in the 1923 revision.