Bank of Canada, $25, 1935
This note is the first commemorative note issued by the Bank of Canada. It was issued on 11 May 1935 to mark the 25th anniversary of the reign of King George V.

The Depression Years and the Creation of the Bank of Canada (1930-39)

Despite mounting evidence that a major economic contraction was under way following the stock market crash in October 1929, the federal government took little in the way of monetary action to support the economy.[61] Admittedly, the scope for policy action was constrained, since advances under the Finance Act were made at the initiative of banks, and there was no money market. Also, Canada was, at least notionally, still on the gold standard. Nonetheless, the government set the Advance Rate, and chose to hold it unchanged at 4.5 per cent from September 1928 to October 1931. As a result, questions were widely voiced regarding Treasury Board officials' understanding of monetary issues.

In his 1933 book on central banking in Canada, James Creighton argued that J. C. Saunders, Deputy Minister of Finance during the 1920s and *ex officio* Secretary of the Treasury Board, which administered the Finance Act on behalf of the Minister of Finance, was not competent in monetary matters. Creighton noted that Saunders and other deputy ministers had "neither an academic training in economics nor practical experience in banking." Moreover, the position of deputy minister was left vacant after Saunders' death for an extended and critical period—April 1930 to November 1932—leaving a serious policy vacuum (Creighton 1933, 86–90).

61. At the height of the Depression in 1933, real output in Canada had fallen by roughly 28 per cent from its 1929 level, while prices, as measured by the GDP deflator, had declined by about 15 per cent. Canadian exports had fallen by almost two-thirds from their 1928 peak.

Coincidentally, Benjamin Strong, Governor of the New York Federal Reserve since its establishment in 1914 and dominant personality in the Federal Reserve system during its formative years, died in October 1928. His death also left a policy vacuum in the United States at a critical time.

There is considerable controversy about Strong's policies and what would have happened had he lived. Some argue that his expansionary policies during the mid-1920s encouraged the speculative excesses that led to the stock market crash. Others contend that, had he lived, Strong would have moved quickly to moderate the effects of the Depression (Roberts 2000). Nonetheless, the Federal Reserve Bank of New York acted more quickly and aggressively to cut interest rates than did the Canadian government. The Fed's Discount Rate, the equivalent of the Canadian Advance Rate, was cut from 6 per cent at the time of the stock market crash in 1929 to 2 per cent by December 1930 (Chart C2 in Appendix C).[62]

At the same time that the Canadian government was doing nothing on the monetary front, the chartered banks were repaying their borrowings from the government under the Finance Act.[63] The resulting monetary contraction exacerbated the economic downturn. The banks became increasingly cautious about their own lending activities as the economic environment deteriorated. Banks may have also repaid their borrowings under the Finance Act in response to earlier criticism for having borrowed so extensively prior to the stock market crash (Fullerton 1986, 36).

While the extent of the economic downturn in Canada was undoubtedly made worse by these monetary developments, the monetary contraction helped to strengthen the Canadian dollar, which reached US$0.90 by the spring of 1932.

The government finally reduced the Advance Rate to 3 per cent in October 1931 and to 2.5 per cent in May 1933. (See Chart C2 in Appendix C.)[64] In the autumn of 1932, it also used moral suasion to force the banks to borrow under the Finance Act and reflate the economy (Bryce 1986, 132). This easing in monetary policy led to some temporary weakness in the Canadian dollar, which briefly fell as low as US$0.80. The weakness was short-lived, however. Following the U.S. decision to prohibit the export of gold in April 1933 and similar efforts in the United States to reflate, the Canadian dollar began to strengthen.[65] The Canadian government's decision in 1934 to expand the amount of Dominion

62. The Discount Rate at other Federal Reserve Banks was typically higher than that of the Federal Reserve of New York through the 1930s.
63. Advances under the Finance Act, which had peaked at $112.9 million in November-December 1929, fell to nil by the spring of 1931 (Macmillan Report 1933).
64. The Advance Rate was temporarily increased to 3.5 per cent from May 1932 to May 1933. However, special rates of 2.5 to 3 per cent were available on advances secured by certain securities.
65. The U.S. government subsequently re-fixed the U.S. dollar on 31 January 1934, such that one ounce of gold was worth US$35, compared with the pre-1933 price of US$20.67.

"Rapidly recovering."
Editorial cartoon by Arthur Racey, *Montreal Star*, October 1932

notes in circulation by reducing their gold backing to 25 per cent did not have much impact on the Canadian dollar. In the economic circumstances of the time, and given similar developments in the United States, this move was viewed as appropriate and elicited little market reaction (Bryce 1986, 143). The Canadian dollar returned to rough parity with its U.S. counterpart by 1934 (Chart 3) and, at times, even traded at a small premium. With the U.S. dollar depreciating against gold and the pound sterling, the Canadian dollar returned to its old parity with sterling.

Establishment of a central bank

Not surprisingly, as the 1930s progressed with little sign that the Depression was ending, pressure began to mount on the government to do something. In addition to concerns about the adequacy of the Finance Act, there was also widespread public distrust of the banking system, largely because of the high cost and low availability of credit. Farmers, especially those in western Canada, who were suffering from a sharp fall in both crop yields and prices, were particularly critical of banks and consequently very supportive of the formation of a central bank. They hoped that a central bank would be a source of steady and cheap credit. With effective nominal interest rates on farm loans in excess of 7 per cent, real interest rates were very high—about 17 per cent in 1931 and 1932, owing to sharply declining consumer prices. But interest rates were high for everyone because of the high Advance Rate. The traditional rate for a prime commercial loan was 6 per cent, while the standard deposit rate was 3 per cent, until the latter was reduced to 2.5 per cent in 1933 with the approval of the federal government (MacIntosh 1991, 73–75).

In July 1933, the government set up a commission with a mandate to study the functioning of the Finance Act and to make "a careful consideration of the advisability of establishing in Canada a Central Banking Institution . . . ." (Macmillan Report 1933, 5).[66] Lord Macmillan, a famous British jurist and known supporter of a central bank, was chosen by Prime Minister Bennett to chair the commission. The other members were Sir Charles Addis, a former director of the Bank of England; Sir William T. White, the former wartime Canadian Finance Minister and banker; John Brownlee, Premier of Alberta; and Beaudry Leman, a Montréal banker.[67]

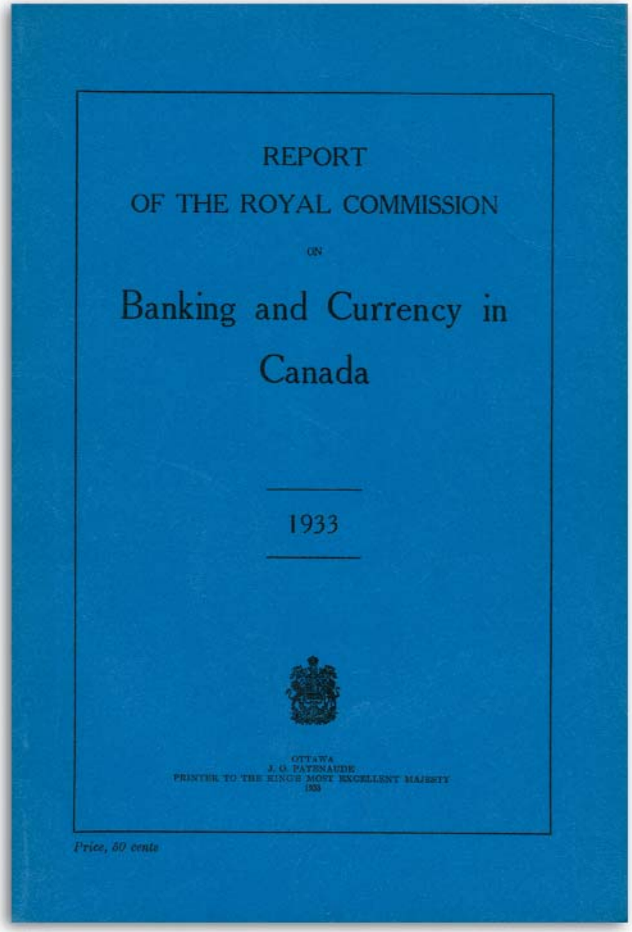
66. Bordo and Redish (1986) argue that the establishment of the Bank of Canada had more to do with political than with economic imperatives. Watts (1993, 9), citing a 7 December 1933 speech by Prime Minister Bennett in London, Ontario, argues that the rationale for establishing a central bank was largely external. In the speech, Bennett stated that for Canada to be "financially independent," it needed a central bank for "determining balances, or settling international accounts." See also MacIntosh (1991).

67. From 1929 to 1931, Lord Macmillan had chaired a British commission called the Committee on Finance and Industry, which examined banking, finance, and credit developments in the United Kingdom. Sir Charles Addis was Chairman of the Hong Kong and Shanghai Banking Corporation and former Vice-Chairman of the Bank for International Settlements. Sir William White was Vice-Chairman of the Canadian Bank of Commerce. Mr. Beaudry Leman was General Manager of the Banque Canadienne Nationale and former president of the Canadian Bankers Association (Stokes 1939).

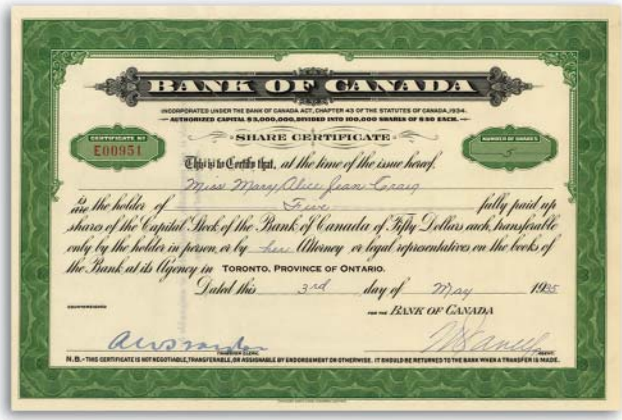
Public hearings began on 8 August 1933, and the final report was presented to the government less than seven weeks later on 28 September. While the commission voted only narrowly in favour of the establishment of a central bank, its conclusion was never really in doubt. The two British members of the committee, joined by Brownlee, voted in favour of a central bank, a position supported by both the Conservative government and the Liberal opposition.

The Canadian bankers on the committee opposed. White dissented from the majority on the grounds that it was unwise to establish a central bank in the prevailing uncertain economic environment. In his view, a newly established and untried central bank might hinder the government. Favouring a return to the gold standard, White contended that Canada's main problem was excessive debt (Macmillan Report 1933, 89). Leman shared this view and also believed that the establishment of a central bank raised constitutional issues that needed exploring (Macmillan Report 1933, 95).

In general, Canadian banks opposed the formation of a central bank. Reasons cited included concerns about the availability of central banking expertise in Canada, the absence of a Canadian money market, the ineffectiveness of the Federal Reserve in countering the Depression in the United States, and the long-time stability of the Canadian banking system. Banks were also unanimously concerned about a reduction in their



Macmillan Report, cover, 1933
The Macmillan Report is a seminal document in the history of the Bank of Canada. It records the recommendations of the Royal Commission, chaired by Lord Macmillan, that considered the feasibility of establishing a central bank in Canada.



Bank of Canada, share certificate, 1935
The Bank of Canada was established as a widely held, privately owned institution, and shares with a par value of $50 were sold to the general public on 17 September 1934; $12.50 payable on application, with the balance due on 2 January 1935. Following a change of government, the Bank was fully nationalized by 1938.

Bank of Canada, $5, 1935 series
These notes were part of the first series issued by the new central bank. It was the only series to feature separate English and French notes. A portrait of Edward, Prince of Wales, appears on the left and the official seal of the Bank of Canada is on the right.

profits associated with the loss of their note-issuing privileges (MacIntosh 1991, 76).

The Bank of Canada Act received royal assent on 3 July 1934, and the central bank officially started operations on 11 March 1935.[68] Graham Towers, who had been assistant general manager of the Royal Bank, became the central bank's first Governor. To provide some practical central banking experience, J. A. C. Osborne, former secretary of the Bank of England, was made deputy governor.

The Dominion Notes Act and the Finance Act were also repealed on 11 March. Dominion notes were quickly replaced by new Bank of Canada notes. A revised Bank Act governing the operations of the chartered banks also took effect in 1934. Revisions to this act initiated a gradual phase-out of private bank notes in favour of Bank of Canada notes.

With the conduct of monetary policy now in the hands of the Bank of Canada, a dedicated monetary institution, there were greater prospects for a more activist monetary policy. However, the

68. The Bank of Canada, like most central banks of the time, was initially privately owned. Bank of Canada shares had to be widely held; no individual could own more than 50 shares. In 1936, following a Liberal victory in the election of 1935, Mackenzie King's government took control of the Bank through the acquisition of a second issue of shares and subsequently nationalized it in 1938.

BANK OF CANADA

STATEMENT OF ASSETS AND LIABILITIES

as at 31st December, 1935

LIABILITIES

CAPITAL:		
Authorized	$ 5,000,000.00	
Issued and Paid Up		$ 5,000,000.00
REST FUND		173,092.16
NOTES IN CIRCULATION		99,677,228.95
DEPOSITS:		
Dominion Government	$ 18,262,843.88	
Chartered Banks	181,636,033.98	
Other Banks	766,255.05	200,665,132.91
DIVIDEND DECLARED–payable 2nd January, 1936		113,000.00
OTHER LIABILITIES		2,026,697.84
		$307,655,151.86

ASSETS

RESERVE–at market values:		
Gold Coin and Bullion	$180,509,342.65	
Silver Bullion	1,638,365.96	
Sterling Funds	219,235.47	
U.S.A. Funds	4,003,866.07	
Funds of other Countries on a Gold Standard	9,215.29	$186,380,025.44
SUBSIDIARY COIN		128,777.87
ADVANCES TO DOMINION GOVERNMENT		3,465,812.50
INVESTMENTS–at not exceeding market values:		
Dominion Government short-term Securities	$ 30,873,168.86	
Other Dominion Government Securities	83,409,675.57	114,282,844.43
BANK PREMISES (Furnishings and Equipment) at cost less amounts written off		111,911.25
OTHER ASSETS		3,285,780.37
		$307,655,151.86

G. F. TOWERS,
Governor.

J. A. C. OSBORNE,
Deputy Governor.

H. R. EXTENCE,
Chief Accountant.

PROFIT AND LOSS ACCOUNT

31st December, 1935

Profits from 11th March, 1935, to 31st December, 1935, after making provision for Contingencies and Reserves		$764,228.31
Appropriated as follows:		
Dividend No. 1 payable 2nd July, 1935, @ 4½% per annum on $12.50 from 21st September, 1934, to 2nd January, 1935, and on $50.00 from 2nd January, 1935, to 30th June, 1935	$126,000.00	
Dividend No. 2 payable 2nd January, 1936, @ 4½% per annum on $50.00 from 1st July, 1935, to 31st December, 1935	113,000.00	
	239,000.00	
Contribution to the Civil Service Superannuation and Retirement Funds	5,951.82	244,951.82
Balance		$519,276.49
Transferred to Rest Fund	$173,092.16	
For credit to Receiver General of Canada–account Consolidated Revenue Fund	346,184.33	
		$519,276.49

AUDITORS' REPORT TO SHAREHOLDERS

We have examined the above Statement of Assets and Liabilities of the Bank of Canada as at 31st December, 1935, and report that, in our opinion, it is properly drawn up so as to exhibit a true and correct view of the state of the Bank's affairs as at that date, according to the best of our information, the explanations given to us, and as shown by the books of the Bank. We have obtained all the information and explanations we have required.

G. T. CLARKSON, F.C.A.,
of the firm of Clarkson, Gordon, Dilworth & Nash.
J. A. LaRUE, C.A.,
of the firm of LaRue & Trudel.
} Auditors

OTTAWA, 15th January, 1936.

Bank of Canada balance sheet
The Bank of Canada's first balance sheet, 31 December 1935

Bank maintained the Bank Rate (which was equivalent to the Advance Rate under the Finance Act) at the same 2.50 per cent rate that it had inherited. It was not until February 1943, in the midst of the war, that the Bank Rate was cut (Chart C2 in Appendix C).

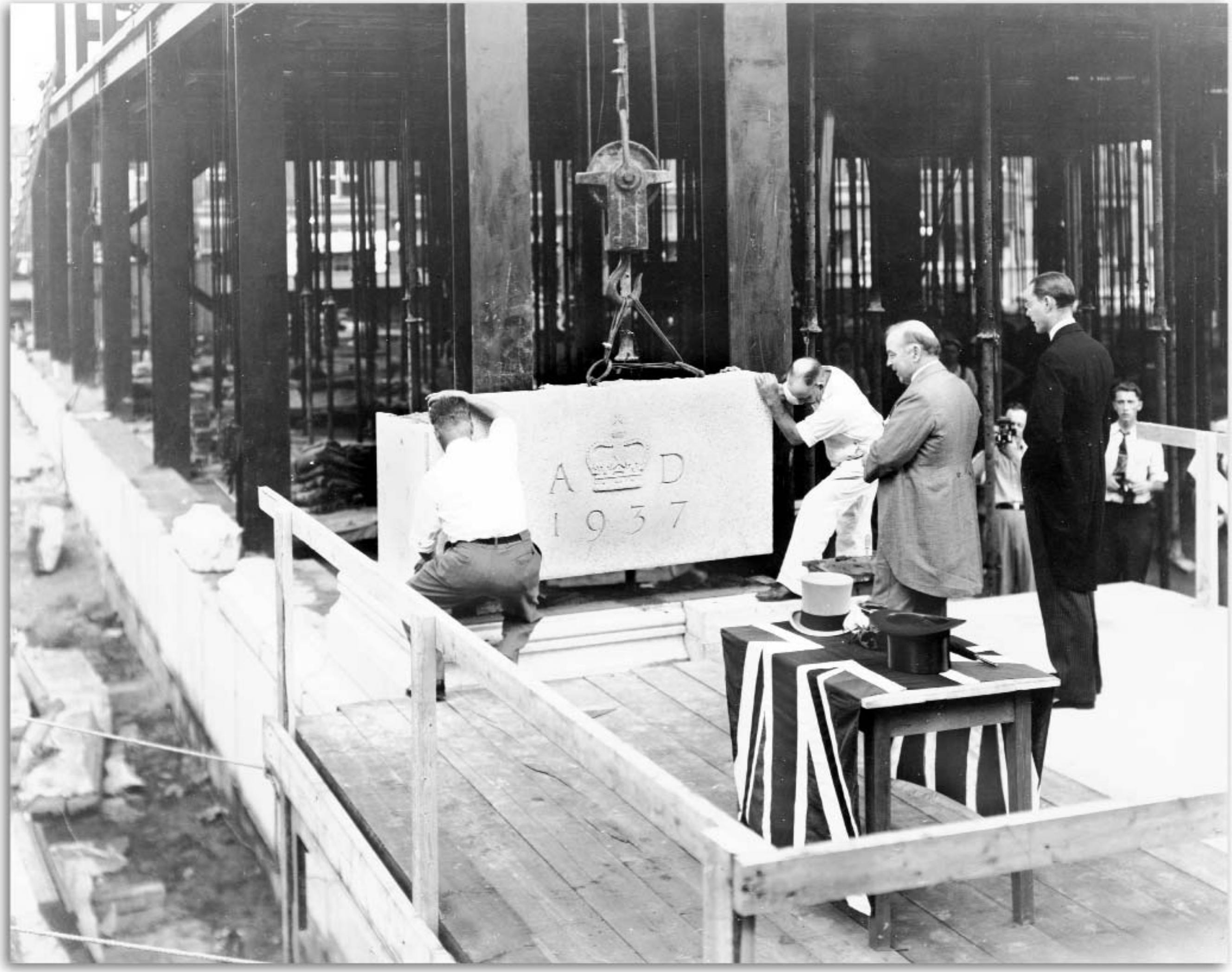
Another important piece of legislation was the Exchange Fund Act, which received royal assent on 5 July 1935. The primary purpose of the act was to provide a fund that could be used to "aid in the control and protection of the external value of the Canadian monetary unit" (*Statutes of Canada* 1935). The resources of the Exchange Fund came from the profits associated with the revaluation of the Bank of Canada's gold holdings from the old statutory price of Can$20.67 per ounce to the prevailing world market price of US$35 per ounce.[69] Although the Exchange Fund Act was passed in 1935, the section of the act dealing with the use of the fund to protect the value of the Canadian dollar was not put into effect until 15 September 1939, following Canada's entry into World War II.

In any event, an Exchange Fund Account was not required to stabilize the Canadian dollar during the mid-1930s. With the currency trading in a relatively narrow range around parity with its U.S. counterpart, little intervention by the Bank of Canada was required.

By late 1938, as the international political climate deteriorated, the Canadian dollar began to slip, falling to a small discount of roughly 1 per cent against the U.S. dollar. The decline was modest, however, compared with that of the pound sterling, which fell by roughly 6 per cent in the second half of 1938, reflecting a considerable shift of funds out of the United Kingdom (Bank of Canada *Annual Report 1939*, 13).

After several months of relative stability, the Canadian dollar came under renewed, and this time significant, pressure in the last days of August 1939, as world tensions increased and funds moved to the safety of the United States. The Canadian dollar fell roughly 6 per cent vis-à-vis the U.S. dollar in the two weeks prior to Canada's declaration of war with Germany on 10 September 1939, and by another 3 per cent by the time the government imposed foreign exchange controls in mid-September (Bank of Canada *Annual Report 1940*, 12). The pound sterling fell even more sharply, declining from US$4.86 to US$4.06, a depreciation of roughly 14 per cent, before the imposition of exchange controls in the United Kingdom in early September.

69. Under the Bank of Canada Act, the government transferred to the Bank of Canada the gold that had backed the old Dominion notes. The gold holdings of the chartered banks that were held against Canadian-dollar liabilities were also transferred to the Bank of Canada. Revaluation proceeds amounted to $73.5 million, of which $10.5 million was returned to the chartered banks and $63 million credited to the Exchange Fund Account (Watts 1993, 23).



Laying the cornerstone for the Bank of Canada, 10 August 1937
Prime Minister Mackenzie King (left) and the Bank's first Governor, Graham Towers (right) watch as the stone is lowered into place.