Canada under Fixed Exchange Rates and Exchange Controls (1939-50)

Bank of Canada, $2, 1937
The 1937 issue differed considerably in design from its 1935 counterpart. The portrait of King George VI appeared in the centre of all but two denominations. The colour of the $2 note in this issue was changed to terra cotta from blue to avoid confusion with the green $1 notes. This was the Bank's first issue to include French and English text on the same note.

The war years (1939-45)

Exchange controls were introduced in Canada through an Order-in-Council passed on 15 September 1939 and took effect the following day, under the authority of the War Measures Act.[70] The Foreign Exchange Control Order established a legal framework for the control of foreign exchange transactions, and the Foreign Exchange Control Board (FECB) began operations on 16 September.[71] The Exchange Fund Account was activated at the same time to hold Canada's gold and foreign exchange reserves. The Board was responsible to the minister of finance, and its chairman was the Governor of the Bank of Canada. Day-to-day operations of the FECB were carried out mainly by Bank of Canada staff.

The Foreign Exchange Control Order authorized the FECB to fix, subject to ministerial approval, the exchange rate of the Canadian dollar vis-à-vis the U.S. dollar and the pound sterling. Accordingly, the FECB fixed the Canadian-dollar value of the U.S. dollar at Can$1.10 (US$0.9091)

70. Parliament did not, in fact, have an opportunity to vote on exchange controls until after the war. The Foreign Exchange Control Act received royal assent on 31 August 1946 and became effective on 1 January 1947. The legislation contained a "sunset" clause, which obliged the government to renew the controls every two years.
71. Preparations for the imposition of exchange controls in the event of war had begun in secret as early as August 1938. See Towers (1940).

War savings stamps booklet, 1940
During World War II, citizens supported the war effort by buying war savings stamps at the post office and at banks. These stamps were glued into booklets and sent to the government for redemption in war savings certificates, which bore low interest and could be cashed in after the war.

Royal Bank of Canada, $5, 1943
In 1944, banks were prohibited from issuing their own notes. This note is from one of the last issues by a chartered bank. The Royal Bank's General Manager, Sydney G. Dobson, appears on the left, and President Morris W. Wilson on the right.

buying and Can$1.11 (US$0.9009) selling. The pound sterling was fixed at Can$4.43 buying and Can$4.47 selling.[72] These rates were roughly consistent with market exchange rates immediately prior to the imposition of controls. Currency rates on futures contracts of up to 90 days were also fixed by the FECB. These exchange rates were maintained for the duration of the war.

To conserve Canada's foreign exchange and effectively support the value of the Canadian dollar, the Board introduced extensive controls. These controls allowed the Board to regulate both current and capital account transactions, although most current account transactions, other than travel, were treated fairly leniently.[73] Permits were required for all payments by residents to non-residents for imports of goods and services. Permits were also required for the purchase of foreign currencies and foreign securities, the export of funds by travellers, and to change one's status from resident to non-resident. Residents were also required to sell all foreign exchange receipts to an authorized dealer. Interbank trading in Canadian dollars ceased.

72. The spreads for both the U.S. dollar and the pound sterling were narrowed slightly in October 1945 by reducing the selling rate for the U.S. dollar to Can$1.1050 (US$0.9046) and Can$4.45 for the pound.

73. The Canadian government placed controls on the importation of goods deemed to be non-essential. Such import controls were administered by other bodies.

On 30 April 1940, the Foreign Exchange Acquisition Order stiffened the controls even further. Canadian residents, including the Bank of Canada, were now required to sell (with minor exceptions) all the foreign exchange they owned to the FECB.

The imposition of exchange controls by the Canadian authorities reflected a number of concerns (Handfield-Jones 1962). First, even though it was expected that Canadian exports to the United Kingdom would increase, there was a concern that the Canadian military buildup would lead to a significant rise in imports from the United States. Second, under U.S. law at the start of the war, loans to "belligerent" countries were forbidden. Hence, U.S. imports had to be paid for in cash; i.e., U.S. dollars or gold. Moreover, given British exchange controls, an increase in sterling assets arising from net Canadian exports to the sterling area could not be converted into U.S. dollars. Finally, there was a concern that Canadians might seek to place funds in a non-belligerent country and that U.S. residents, who held considerable Canadian assets, might seek to repatriate their holdings.

It is interesting to note that while all foreign currency transactions were subject to exchange controls, in practice, the controls centred on transactions involving U.S. dollars. Although permits were required for sterling transactions, there were no restrictions (FECB 1946, 19). Moreover, Canadian residents were not required to sell sterling receipts to the FECB (Wonnacott 1958, 83). This reflected the buildup of sterling balances held by the FECB, which could not be converted into U.S. dollars.[74]

Canada's need for controls during World War II contrasts with its experience during World War I, when exchange controls were not imposed. In 1914, Canada's principal foreign creditor was the United Kingdom, with the bulk of British claims on Canada in the form of direct investment or denominated in sterling. British holdings of U.S. dollars were also substantial at the outbreak of World War I. Consequently, the British authorities were able to pay for their own U.S. imports, maintain a stable and convertible currency, and provide U.S. dollars to Canada in settlement of Canada's trade surplus with the United Kingdom.

The situation had changed by 1939. The United States had become Canada's most important source of foreign capital, and there was concern that neutral U.S. residents would not wish to hold the securities of a belligerent country. British holdings of U.S. dollars were also much diminished. Therefore, Canada could not expect the United Kingdom to provide U.S. dollars in exchange for surplus sterling balances, as it had in 1914. Indeed, the British authorities introduced their own exchange controls at the outbreak of World War II (FECB 1946, 9–10).

74. Efforts to reduce these sterling balances included interest-free loans to the United Kingdom and the repurchase of Government of Canada bonds issued in sterling, including those of the Canadian National Railway.

The revaluation of 1946

By late 1944, pressure on Canada's foreign exchange reserves had eased dramatically. The Hyde Park Agreement of April 1941, the entry of the United States into the war in December 1941, as well as major U.S. infrastructure projects on Canadian soil (such as the construction of the Alaska Highway) contributed to a rebuilding of Canada's foreign exchange reserves. There were also significant capital inflows into Canada, partly from Canadian residents repatriating funds invested in U.S. securities, but also from U.S. residents buying Canadian Victory Bonds. U.S. direct investment in Canada also increased.

The Hyde Park Agreement

The Hyde Park Agreement permitted Canada and the United States to specialize in the production of war material. Canada concentrated on the production of certain types of munitions, aluminum, and ships required by the United States (FECB 1946, 26). This agreement between Mackenzie King and Roosevelt was drafted, in longhand, by James Coyne, later to become Governor of the Bank of Canada, but who was then seconded to Clifford Clark, Deputy Minister of Finance, as Financial Attaché at the Canadian Embassy in Washington D.C.

The rebuilding of reserves allowed a slight easing of exchange controls in 1944 to facilitate travel to the United States and to allow Canadian firms to extend their foreign business activities. By the end of 1945, Canada's holdings of gold and U.S. dollars had increased to US$1,508 million from only US$187.6 million at the end of 1941.

With expectations of continued capital inflows, the Canadian dollar was revalued upwards by roughly 9 per cent against both the U.S. dollar and the pound sterling on 5 July 1946. The new rates were: Can$1.000 buying, Can$1.005 (US$0.9950), selling for the U.S. dollar; and Can$4.02 buying and Can$4.04 selling for the pound sterling. Interestingly, the rationale for the revaluation related more to dampening inflationary pressures emanating from the United States than to the buildup of reserves or to Canada's balance-of-payments situation. In a statement to the House of Commons, the minister of finance noted that the revaluation of the Canadian dollar was one of the measures taken to maintain order, stability, and independence in Canada's economic and financial affairs. He added that

> these measures we feel will go a long way toward insulating Canada against unfavourable external conditions and easing the inflationary pressures which are now so strong (Ilsley 1946, 3181).

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The devaluation of 1949

The new exchange rate did not hold for long. Imports from the United States rose sharply, leading to a marked decline in Canada's holdings of gold and U.S. dollars in the second half of 1946 and through 1947. While Canadian exports to the United Kingdom and other countries remained robust, they were financed largely by Canadian loans. Hence, they did not boost usable reserves.

In November 1947, Canadian authorities reduced travel allowances for Canadians visiting the United States and tightened import controls to restrict the importation of non-essential goods. The provision of U.S. dollars for Canadian direct investment abroad was also virtually suspended. Even with the intensification of exchange controls, Canada's holdings of gold and U.S. dollars declined to US$501.7 million by the end of 1947. These developments led to considerable criticism of the Canadian government for its 1946 decision to revalue the Canadian dollar.

The situation eased somewhat in 1948. Canada's trade deficit with the United States narrowed, a sizable U.S.-dollar line of credit was established with the U.S. Export-Import Bank, and Canada's trade balance with other countries improved (including an increase in actual receipts). In fact, by the end of 1948, Canada's holdings of gold and U.S. dollars had doubled to US$997.8 million.

Nevertheless, following a major realignment of the pound sterling and most other major European currencies vis-à-vis the U.S. dollar, the Canadian dollar was devalued by approximately 9.1 per cent against its U.S. counterpart on

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20 September 1949.[75] The Canadian dollar thus returned to its pre-July 1946 value against the U.S. dollar of Can$1.10 (US$0.9091) buying and Can$1.105 (US$0.9050) selling. The FECB also established new official rates for the pound sterling: Can$3.0725 buying and Can$3.0875 selling.

The main reason cited for the Canadian dollar's devaluation was the possible effect of the substantial devaluations of other currencies on Canada's balance-of-payments position. There were also concerns that Canada's reserves had not recovered sufficiently from their 1947 low (FECB 1949, 7).

However, fast-changing international economic conditions, unleashed by the Korean War, placed the new fixed rate under pressure; this time on the upside. As a consequence, Canadian authorities were once again obliged to reconsider exchange rate policy, ultimately leading to the floating of the Canadian dollar in September 1950, and the lifting of exchange controls late the following year. These issues are explored in "A Floating Canadian Dollar," page 61.

The unofficial exchange market

Shortly after the imposition of exchange controls in 1939 and the official fixing of the Canadian dollar's value in terms of the U.S. dollar by the FECB, an unofficial market for Canadian dollars developed in New York that persisted until the Canadian dollar was floated at the end of September 1950. This was a legal market involving transactions in Canadian dollars between non-residents of Canada. Residents of Canada were prohibited from acquiring foreign exchange through the unofficial market. Similarly, no resident of

75. On 19 September 1949, the pound and the currencies of all other sterling-area countries, excluding Pakistan, were devalued by 30.5 per cent against the U.S. dollar. Concurrently, or shortly thereafter, the currencies of Sweden, Norway, Denmark, and the Netherlands were devalued by roughly 30 per cent. The currencies of other countries were devalued by smaller amounts—France by about 22 per cent, West Germany by 21 per cent, Portugal by 13 per cent, Belgium by 12 per cent, and Italy by 9 per cent.

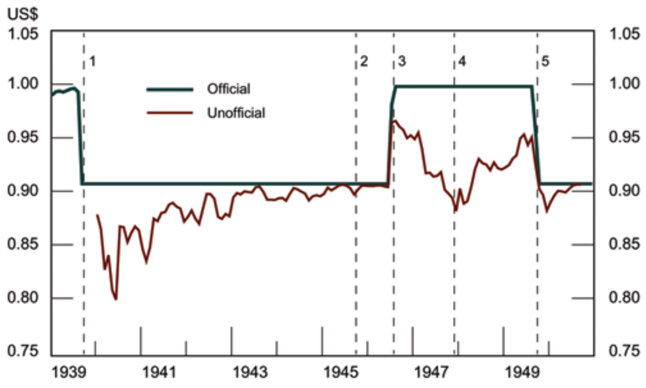
Canada was ever authorized to convert foreign exchange into Canadian dollars through the unofficial market.

The source of "inconvertible" Canadian dollars consisted of Canadian-dollar bank balances held by non-residents when exchange controls were introduced in 1939, sales by U.S. residents of certain types of assets (such as real estate), and the proceeds of maturing Canadian-dollar securities paid to non-residents.

Canadian dollars purchased in the unofficial market could be used only in a very circumscribed manner. For example, they could not be used to purchase Canadian goods and services. In this regard, the purpose of exchange controls was not just to conserve available foreign exchange but also to maximize the receipt of foreign exchange. U.S. residents wishing to buy Canadian securities or real estate were, however, permitted to use Canadian dollars obtained in the unofficial market, as could travellers to Canada.

The unofficial market for Canadian dollars ended with the floating of the Canadian dollar. Throughout most of its existence, the inconvertible Canadian dollar traded at a sizable discount compared with its official counterpart (Chart 4). The spread between the two rates mirrored the pressures on the Canadian economy, widening to more than 10 per cent during the darkest months of 1940 and narrowing as the war progressed and Canadian prospects improved. By 1945, the discount was temporarily eliminated. Indeed, for a few months during 1946, prior to the upward revaluation of the official Canadian dollar back to parity with its U.S. counterpart, the inconvertible Canadian dollar traded at a slight premium in the free market.

Chart 4
Canadian Dollar in Terms of the U.S. Dollar
Monthly averages (1939–50)



1. September 1939: War is declared, the Canadian dollar is fixed, and exchange controls are imposed.
2. September 1945: World War II ends.
3. July 1946: Canadian dollar revalued.
4. November 1947: Exchange controls tightened.
5. September 1949: Canadian dollar devalued.
Source: U.S. Board of Governors of the Federal Reserve System (1943, 1976)

Interestingly, when the official rate was finally revalued on 5 July 1946, the inconvertible Canadian dollar, while also appreciating, did not move up the whole amount. It generally traded between US$0.95 and US$0.96 through the remainder of that year. Clearly, the revaluation was not viewed as completely credible by free-market participants. Indeed, the free rate slowly weakened over the next few years, foreshadowing the eventual devaluation of the official rate in September 1949.[76]

The inconvertible Canadian dollar declined with the devaluation of the official exchange rate in 1949, but to a lesser extent, temporarily eliminating the differential between the two rates. With the inconvertible Canadian dollar continuing to weaken to about US$0.8840 through the winter of 1949–50, a differential of roughly 2.5 per cent temporarily re-emerged. The sudden improvement in Canada's economic prospects, however, and strong capital inflows from the United States, eliminated the differential between the two rates once again by March 1950. Indeed, the unofficial rate actually moved to a marginal premium to the official rate immediately prior to the decision to float the Canadian dollar.

The relevance of the unofficial rate

During the 1940s, there was an active debate over whether the unofficial rate was the "true" value of the Canadian dollar. The Bank of Canada maintained that, given the "limited use" of inconvertible Canadian dollars and the small size of the market, prices were not necessarily an accurate reflection of sentiment towards the Canadian dollar (FECB 1947, 5).[77]

This was disputed by many economists, including then-associate professor of economics, Milton Friedman. In a 1948 University of Chicago debate with Donald Gordon, Deputy Governor of the Bank of Canada, and Dr. W. A. Mackintosh, head of the economics department at Queen's University and wartime economic adviser to the government, Friedman argued that there was no particular reason why a small market should necessarily lead to a distorted price. He also argued strongly that Canada should introduce a flexible exchange rate rather than relying on a system of exchange controls to balance trade. Gordon, on the other hand, contended that a 10 per cent decline in the official Canadian dollar (to roughly the level prevailing in the unofficial market) would have comparatively little impact on trade flows (Friedman et al. 1948).

While there is no evidence directly linking Milton's Friedman's advice to Canada's subsequent decision to float the Canadian dollar, it undoubtedly had an impact on the internal thinking of the Bank of Canada.

76. The unofficial rate, after trading to a low of about US$0.9225 at the beginning of 1949, strengthened modestly to about US$0.9450 during the months immediately prior to the devaluation.

77. The Bank of Canada estimated that, on average, the unofficial market accounted for only 3 per cent of Canada's international transactions (Rasminsky 1946).