

A CENTRAL BANK FOR CANADA

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WE as Canadians must have been regarded as something more than human if, during the banking *débaclé* experienced last spring by our wealthy neighbour to the south, we had not secretly given thanks in the manner of the Pharisee. We may perhaps be pardoned a measure of smugness and complacency as the more obvious virtues of our banking system are editorially extolled to a disillusioned and somewhat bewildered American public. But while expanding with legitimate pride in the soundness of our banking structure *per se*, it would be folly to blind ourselves to the palpable inadequacies of the present legal frame-work within which it operates. In our own cupboard lurks a skeleton which in recent years has been rattling in a most disconcerting fashion. Our banks, it is true, have maintained solvency in our own Canadian dollars, but in exchange with foreign currencies these dollars repeatedly have been found wanting.

Nor can this instability in the "external value" of the Canadian dollar be dismissed as a product of the Depression. The unenviable record goes back to the happier days of expanding business activity when budgets used to balance. Although the *official* embargo on the export of gold was not proclaimed until late in 1931, yet it is fair to say that the history of the operation of the gold standard in Canada since its readoption in 1926 has been a deplorable record of successive suspensions. As early as March, 1927, there was evidence of irregularity in the foreign exchange quotations, suggesting that the free movement of gold, which is the *sine qua non* of the gold standard, was not being maintained. During 1928 a discrepancy between *de jure* and *de facto* conditions became increasingly obvious. That is to say, although there was no official embargo on the purchase and export of gold, yet at times during January, February, June, July, and December the premium on United States dollars was such as to establish beyond question the fact of an effective restriction on the outward movement of gold. This does not mean that none at all was released for export during the entire year. It does mean, however, that at times the metal was not obtainable in unlimited amounts. The Finance Department was obviously exercising "discretion".

Early in 1929 the Finance Department definitely suspended convertibility of Dominion Notes in order to protect the remaining gold reserve. Accordingly, the Canadian link in the golden chain

which binds the currencies of the world together was broken, and our country took her place along with Russia and Spain, beyond the pale. It is true that the gold standard was still staunchly "maintained" with delightful ambiguity on the floor of the House of Commons, but unfortunately such support was not of the stuff of which legal reserves are made. In the foreign exchange market the Canadian dollar still suffered depreciation.

In view of the chronic nature of Canada's trouble in maintaining the value of the dollar in the foreign exchanges since the readoption of the gold standard in 1926, it is not surprising that there should have arisen prophets of a new order. Among the various remedial measures suggested which, in the opinion of the writer, are particularly worthy of serious consideration is that of a Central Bank. This issue has claimed a position of increasing importance on the economic and political forums of the Dominion, and has recently become the subject for the deliberations of a Royal Commission. The major prophet and chief exponent of this new departure for Canada is Professor C. A. Curtis, of Queen's University, whose able analysis and presentation of the case for a Central Bank was given before the Political Science Association in 1930.¹ Since that time, various aspects of the problem have been subjected to critical review. It is the purpose of this article to discuss the adequacy of some of the arguments thus far offered in favour of the project, and to explore the possibilities of an alternative solution.

Let us consider, first of all, the purpose of the Central Bank and the nature of the conditions under which, in various countries, it has come to occupy so important a place. Primarily, its function is that of ensuring a sound currency system. In no part of our economic structure has the policy of *laissez-faire* turned out to be more woefully inadequate than here—the field of money and banking. The problem arises in connection with the right of the banks to create "means of payment". For although the privilege of issuing legal tender has, historically, been jealously guarded as a prerogative of the State, there has developed, with the evolution of modern banking systems, a wide field within which private institutions may supply, in the form of credit, an alternative means of making payments and settling debts. In this way bank notes have become an important part of our circulating medium. And experience has proved that the banks, under the guidance of private profit, may exercise this privilege "not wisely but too well".

Although a perusal of the charters of the many Central Banks existing to-day reveals that they were granted primarily for the

1. C. A. Curtis, "Credit Control in Canada", *Papers and Proceedings of the Canadian Political Science Association*, 1930.

purpose of regulating the currencies of the respective countries, some state their functions to include, as well, the control of credit. The declared purpose of the Federal Reserve Act, for example, is, "To provide for the establishment of Federal Reserve Banks, to furnish an elastic currency, to afford a means of rediscounting commercial paper, to establish a more effective system of banking in the United States, and for other purposes". Here, it is noticed, we find not merely the reference to currency improvement, but also explicit provision of credit facilities for the member banks.

Undoubtedly, this preamble of the Federal Reserve Act indicates more nearly than do most other charters the extent of the duties undertaken by modern Central Banks. Ability to control credit, indeed, may be regarded as the real test of the bank's efficiency in the field of currency regulation. But it would be highly incorrect to regard currency management as the sole end, and credit control as simply the means toward that end. Policies are based on criteria other than gold reserves. In recent times, Central Banks have attempted a rôle which embraces stabilization of the internal price level, and general control over business activity. While originally the power of control was directed primarily toward maintaining an equality of value between paper money and the standard money (usually gold), modern central banking aspires not merely to maintain convertibility, but also, by influencing the credit structure, to exercise a degree of control over the *value* of the standard money itself.

For example, the United States may be said to have exercised a determining influence over the value of her currency and of gold during the period following the world war. Undoubtedly cooperation among the Central Banks of the four leading commercial nations of the world might lead to an effective control over the value of gold such that the independent action of any other remaining country would, in this respect, be insignificant. In general, the extent to which the Central Bank of a country can regulate the value of its currency, while still maintaining convertibility into the world standard, depends on the economic importance of that country relative to all others on the same standard.

The important inference from this set of conditions is that the majority of the Central Banks of the world, in so far as their policies are directed toward any end other than that of maintaining convertibility, are doomed to play the game of "Follow the leader". That is to say, in view of the relative unimportance of Canada in the world economy, a central banking institution in this country would find its sphere of effective action limited to that of ensuring

parity between gold and the means of payment. It is, of course, open to any nation, in the interest of internal regulation of prices, to abandon the attempt to maintain its currency at a parity with the world standard money. In that event the Central Bank of such a country most decidedly would have functions and, indeed, responsibilities far exceeding those which most Central Banks to-day will admit.

Central Banks have come into being either through a relatively slow process of evolution, taking form and assuming functions as expediency required; or by direct and conscious creation, being an integral part of a comprehensive reorganization of a decentralized system which had proved intolerable. The widespread havoc wrought by the world war on currency systems, both of the belligerent and of the neutral nations, gave a strong impetus to the creation of Central Banks. The International Financial Conference which met in Brussels in 1920 specifically recommended that "in countries where there is no Central Bank of Issue, one should be established." It thus appears that expert modern counsel, as well as the lessons of history, suggests the importance of a Central Bank in any country which aspires to a sound currency system. It is scarcely surprising, therefore, that the proposal to bring the Dominion into line with the practice of other nations should be seriously entertained.

It is most important to remember in this connection, however, that there is great diversity in financial structure and banking practice among the various nations. And furthermore, it is to be noted that the recommendation of the International Financial Conference found its setting in a period of world chaos following the rather widespread intemperate use of the printing-press as a means of balancing national budgets. It follows, therefore, that any existing Central Bank may be the product of entirely unique conditions, and justified only by a situation peculiar to the time or the place. In view of this fact, it is by no means logical to prescribe for general applicability a specific set of functions as definitely falling within the province of Central Bank action. Much less is it possible to state with any confidence that such a system of control would be superior to an alternative solution adapted to conditions in the country concerned.

Assuming that a central institution may usefully act as guardian of the "external" stability of the country's currency, let us now analyse briefly the principles of currency regulation and the mechanism by which control is usually effected.

In view of the general disappearance of "hard money" from hand to hand circulation, the currency problem has become primarily

the determination of conditions surrounding the issue of paper money. This must be kept at a parity with the standard money, and the conditions of its issue should be appropriately elastic, so as to allow it to expand and contract with the volume of credit granted by the banking system. Given the general habits of the people in regard to the use of paper money in business transactions, the demand for such currency will be a function of the volume of credit outstanding. Accordingly, the issue of paper money should be closely related to the credit mechanism. Thus the Bank of England, in that country, in addition to its regulative power over the money market, has been given a monopoly of the note issue. In the United States, although a more or less fixed amount of the paper in circulation is issued by the Government and the National Banks, the variable element emanates from the Federal Reserve Banks—the bankers' banks.

In modern communities, paper money comprises a relatively insignificant part of the total means of payment—the greater part of our business being conducted by means of cheques on demand deposits. It is the means of payment which must be kept at parity with gold. Paper money, generally a minor part of the banks' liabilities to the public, furnishes only one of the means whereby solvency and the operation of the gold standard are tested. Liabilities in the form of demand deposits, as the Bank of England early discovered, are the major source of danger when convertibility is being tested. Recent experience in the United States merely confirms a long established fact.

One principle, then, clearly emerges. If the Central Bank is to administer effectively the currency system, it must have a definite measure of control over total means of payment. It follows, in view of the relative importance of demand deposits as a means of payment, that if control over credit is established, the conditions surrounding the issue of paper money are of lesser importance.

In the light of these conclusions, the operation of the Canadian currency and banking system will now be very briefly examined, especially with regard to the way in which the gold standard operated in normal times, and in respect of the control over credit.

It may be said that prior to the world war the maintenance of the gold standard and control over credit in Canada rested entirely with the chartered banks. They operated within a *milieu* of comparatively moderate legal restriction. Generally, there was an unused margin of note-issue privilege, and in the matter of reserves they were (and still are) at liberty to keep only such amounts as they might deem expedient. These reserves were kept in the form

of gold or Dominion Notes, and credit policy was related directly to the volume of cash thus on hand. Since the Dominion Notes held by the banks were practically equivalent to "gold certificates", and readily convertible into the metal at any time, it follows that the banks in maintaining solvency automatically maintained the gold standard, and, so long as this condition was preserved, the exchanges could never go beyond the "gold points".

Then came the War and the Finance Act. By virtue of this measure the banks, in addition to being relieved of the obligation to redeem their notes in legal tender, were granted the privilege of borrowing from the Minister of Finance on approved securities. The proceeds of these loans were advanced in the form of Dominion Notes. Although introduced merely as an emergency measure, this provision was given permanent form in the Finance Act of 1923.

Whether or not the legislators realized the full implications and possibilities of this new departure in the banking and currency system, is a matter of some doubt. The fact remains that, under the operation of the Act, Dominion Notes in circulation in excess of a fixed amount are or are not covered by gold according to whether they are issued under the Dominion Notes Act or under the provisions of the Finance Act; and furthermore, all, no matter how issued, are legal tender and redeemable in gold by the Minister of Finance.¹ In effect, the Minister of Finance may with one hand (Dominion Notes Act) issue notes in exchange for gold, while with the other (Finance Act) he may advance identical notes whereby the gold may again be obtained from him. It is equivalent to locking up the gold and then lending out the key. Here, indeed, is a situation pregnant with possibilities for the embarrassment of any Finance Minister, particularly if he lets not his right hand know what his left hand doeth.

The introduction of this new feature of borrowing under the Finance Act is of utmost importance in regard to the maintenance of the gold standard. It has had the effect of shifting the whole of the responsibility for maintaining the standard from the chartered banks to the Treasury Department. Prior to 1914, the duties of the Minister of Finance in respect of the Dominion Note issue were simple and clearly defined. Without having to exercise any discretion, he merely maintained a safety deposit business with the banks as customers. Upon demand, notes were issued in exchange for gold, or gold for notes, dollar for dollar.

Under the operation of the Finance Act, the banks, of course, still have to maintain such reserves in legal tender as they deem

1. This, of course, applies only when the gold standard is in operation.

expedient, but they are now in the position of being able to *borrow* Dominion Notes for this purpose. Furthermore, if the exchange situation is such as to make it profitable, they may present these borrowed Dominion Notes to the Minister of Finance and demand gold in exchange, for export. Refusal to redeem in gold Dominion Notes outstanding is, in effect, abandoning the gold standard, while continued redemption of borrowed notes means the exhaustion of the gold reserve. It becomes evident, therefore, that the Department of Finance, by virtue of the Finance Act of 1923, possesses powers of the utmost significance, the indiscreet exercise of which may bring consequences of far-reaching importance to the currency and credit structure of the Dominion.

The irregularities which occasionally appeared in the foreign exchange quotations of the Canadian dollar during 1928, and the continuous record of depreciation throughout the whole of 1929, is sufficient evidence either of highly inexperienced hands at the helm, or of an astonishingly light-hearted disregard for the integrity of the gold standard. Clearly the "rediscount rate" (the rate of interest charged by the Finance Department on advances to the banks) was not being used as a means of regulating the volume of borrowing with a view to protecting the gold reserve. It was this lack of effective policy, with the attendant misbehavior of the exchange rates, which led Professor Curtis to favor the creation of a Central Bank as a means of obtaining at least some passive control over the credit situation in Canada. The following extract from his paper "Credit Control in Canada" reveals clearly his position:

To sum up the situation, it has been shown that the present control of credit in Canada is not satisfactory, and that some agency other than a governmental department should be in authority on this matter. Despite the problems which arise in its establishment, a Central Bank appears to be the logical step. Such a bank could act as fiscal agent for the Government, and should be able to exercise, in a passive way, and with respect at least to its reserves, and the maintenance of the gold standard, a control of credit much superior to that which now exists. As an agency for the general control of business, it must be proceeded with cautiously and with the clear understanding that, on the surface at least, its power in this direction appears to be definitely limited. However, as a banking institution to manage the reserves of the banking system, and to avoid a repetition of the happenings of 1929, the establishment of a Central Bank seems to be highly desirable.

Professor Curtis sees clearly that difficulties would attend an effort on the part of a Central Bank actively to control credit

because of the absence of a highly-organized money market in Canada, and the proximity of unlimited credit facilities in New York. He admits that "a Central Bank in Canada would to a great extent be tied to the policies of the New York money market, which in itself is not necessarily a bad thing, but which would restrict the independent action of the Canadian Central Bank".¹ It appears, therefore, that the chief function of the proposed institution would be that of passive control of credit by managing the reserves of the banking system.

Let us examine more closely the nature of this control, and the sphere within which it might be expected to operate. First of all, if the Canadian rediscount rate were below the call loan rate in New York by more than one-fifth of one per cent. (the approximate cost incidental to shipping gold to that market), profits could be realized by borrowing in Canada and relending in New York, and, in the absence of any restriction on borrowing, this might lead to a flow of gold out of Canada to the point of exhaustion. It appears, therefore, that the Canadian rate would *always* have to be above the New York rate, and anyone who has observed the dizzy course which this latter rate may take upon occasion—for example, during the years 1928 and 1929—would be impressed with the frequency and extent to which the proposed Canadian institution would be compelled to alter its lending rate.

If, on the other hand, the rate in Canada were kept above the New York rate, the banks in Canada, instead of borrowing at this higher figure, would find it profitable to withdraw funds from abroad, or lacking these, might possibly borrow abroad. It is, of course, recognized that this is a problem which all Central Banks have to face, owing to the increased internationalization of funds. The proximity of our financial centres on this continent, with the attending ease of communication and access, suggests, however, that for Canada this problem would present itself in a very acute form. Under such conditions a Central Bank would be in the unenviable position of having to accept the responsibility of maintaining the gold standard without possessing the power of control ordinarily associated with it.

In order to have the monetary system effectively managed, it is undoubtedly true that the chartered banks would have to work in complete accord with the lead indicated by the Central Bank. Although there are definite advantages in having the banking resources of the country concentrated in the hands of a few, yet it must be admitted that the problem of Central Bank control

1. *Ibid.*, page 122.

becomes, in consequence, a much more delicate matter. In the face of collusion among the few leaders, it is highly doubtful how far a high rate would act as a deterrent to continued rediscounting. With our four large banks doing the major part of the banking business, it is obvious that borrowed Dominion Notes would almost immediately provide the basis for loans many times the volume of the original rediscount. Under these circumstances it would be profitable for the banks to continue borrowing reserves even though the rate charged by the Central Bank were considerably above the market rate.

Professor Curtis refers to this contingency, and admits that "A rediscount rate which might be very effective in New York might, for this very reason (that is, the small number of banks), be much less effective in Canada".¹

J. M. Keynes, in his *Treatise, on Money* considers this general problem at some length. That he also recognizes that a large number of member banks may be essential to effective Central Bank control is evident in the following summary of his conclusions:

We conclude, therefore, that *where there is a multiplicity of member banks*, borrowing from the Central Bank at a rate appreciably above the rate in the market for precisely similar loans is not likely to occur; not, that is to say, unless there is deliberate agreement between the member banks as a whole to operate in a concerted manner contrary to the wishes of the Central Bank—and a concerted insurrection of member banks against the deliberate policy of the Central Bank is a purely academic risk which does not materialize in practice.²

Clearly this is a case of safety in numbers. Can we be so sanguine about the outcome in Canada, where the few leaders may be easily gathered together? Surely it is too much to expect that the banks will not realize that the power of coercion over them of a high rediscount rate is a somewhat feeble thing. A realistic consideration of the circumstances suggests that a Central Bank in Canada, in order to "control" the situation, may, in each case, first of all, have to consult and convince the chartered banks that a certain line of policy is desirable. Having accomplished this, it would be a matter of complete indifference whether the rediscount rate were subsequently lowered to zero or raised to one hundred per cent. per day. While it may not be an impossible task to secure the necessary co-operation of the banks in Canada, it is well to realize clearly that the success of the proposed institution depends on that fragile basis—the willingness to be coerced.

1. Ibid, page 121.

2. J. M. Keynes, *A Treatise on Money*, Vol. II, page 250 (italics are mine).

Professor Curtis has, it seems, adequate support for the thesis that a Central Bank could administer the existing Finance Act to much greater advantage than the Finance Department is able to do. He has, however, completely evaded the main issue, namely, is the Finance Act itself necessary? He has clearly revealed the operation of this Act as the thorn in the flesh of our currency system. Why not consider removing the thorn, instead of applying emollients to the sting?

The question at issue is plain. Is it necessary in normal times that our chartered banks be provided with an opportunity to become borrowers? An affirmative answer to this question appears to be the only substantial ground on which the Finance Act may be justified.

The Act, as stated above, was originally an emergency measure passed in 1914 to allay the fears of the banks in the uncertain financial situation which developed at the outbreak of war. It was, in the meantime, freely utilized by the banks, but owing to the general embargo on the export of gold its significance was not appreciated. Accordingly, the original provisions, with some modifications adding further to the discretionary power of the Minister of Finance, were given permanent form in the Finance Act of 1923. Thus was a purely emergency measure, incorporated into and accepted as part of the "normal" system.

Prior to 1914 our banks did not find it necessary to borrow from the Government. In England to-day the commercial banks do not borrow from the Bank of England; rather they lend to it by keeping deposits there. Again, they lend to the money market by retaining portfolios of bills purchased from the brokers. In the United States, however, as it was noted above, the Federal Reserve System was designed, in part, to afford the member banks a means of rediscounting commercial paper. Fundamentally, the banking problem involved was that of obtaining, in a competitive system comprising thousands of small banks operating within a framework of *rigid reserve requirements*, an appreciable elasticity of credit. Such were the conditions in the United States which culminated in the provision of bankers' banks. It is difficult to see how the situation could otherwise have been corrected.

Our banking system offers a striking contrast. There are only ten chartered banks in the Dominion, four of which dominate the field, doing about eighty per cent. of the business. In a very real sense these institutions may themselves be regarded as Central Banks controlling the policies and resources of thousands of small banks. Furthermore, and this is of utmost importance, there have

been imposed no legal requirements as to the amount of reserves to be maintained against deposits. This permits an elasticity of credit in time of emergency. It appears, therefore, that the conditions in the United States which made imperative some provision for the credit needs of the banks themselves find no parallel in Canadian experience.

Rather than having felt the need of borrowing from other institutions, Canadian bank presidents have frequently pointed out to their stockholders that, after meeting the domestic demands for credit accommodation, *surplus* funds have been employed profitably abroad, chiefly in the New York call loan market.

A very important question arises in connection with the maintenance of this fund of liquid assets abroad. Would the establishment of a Central Bank have any bearing on the policy of the banks in this respect? Professor Curtis has considered the point and has concluded that "...it is fair to assume that they would continue to do so (maintain substantial amounts at call in New York) even if a Central Bank were established".¹ This assumption is worthy of further analysis.

From the point of view of the banks, this fund held abroad serves two purposes. It provides profitable employment for funds not needed in the domestic market, and, at the same time, it acts as a reserve against demand liabilities in Canada. Presumably, the banks would, upon the creation of a Central Bank, keep their reserves with that institution, and consequently would be under no obligation to maintain a fund of liquid assets abroad. In fact, the drastic fall of the Canadian dollar under the pressure which developed during the latter half of 1931 was clearly in consequence of the banks having allowed this reserve to run down to very meagre proportions. That is, since the Department of Finance, playing the role of Central Bank, had relieved them of the necessity of maintaining the gold standard, they shifted their funds from the relatively unprofitable New York money market over into Canadian public securities, leaving demand liabilities in Canada protected only by the "first line" reserves. Solvency could, of course, be preserved by borrowing legal tender from the Finance Department, if occasion demanded.

These "secondary reserves" have been taken more or less for granted by writers who have analyzed the Canadian banking system. Nor can it be said that the maintenance of this fund abroad has, in the past, generally been a matter of serious concern to the banks. During the pre-war period, when Canada was importing capital

1. C. A. Curtis, "Credit Control in Canada", *Proceedings of the Canadian Political Science Association*, 1930, page 121.

on a grand scale, the banks were able to obtain unlimited funds abroad in exchange for deposits in Canada. Such additional gold as was needed for reserve purposes was allowed to flow in. Under these conditions there was a constant tendency for assets to accumulate abroad.

During the war the banks were relieved of the liability of maintaining convertibility of their notes into gold, so that the existence of secondary reserves lost its immediate significance. The Finance Act was available for emergency use. Furthermore, at times since the war, and particularly during the period 1923-1926, the Canadian balance of payments has annually provided substantial surpluses, thus favoring the accumulation of balances abroad. From the beginning of 1927, however, there have generally been demands for foreign funds considerably in excess of the supply afforded by exports of goods and services and the import of capital. Consequently, the banks' fund of net assets abroad has suffered a more or less steady depletion, and this in spite of the high rate of return afforded on balances employed in New York during the boom years.

Canada has reached a stage of economic development such that predictions regarding net capital movements of the future are decidedly uncertain. It is highly probable, however, that net interest payments abroad, repayment of principal of previous borrowings, together with new Canadian investments abroad will usually exceed the inward flow of capital. That is to say, conditions may well be such as to result in pressure on this holding of foreign assets.

One other post-war development in the Canadian banking situation merits some attention in connection with this problem of the maintenance of outside reserves. In recent years our banks have been making extensive use of short term collateral loans in Canada. Although these loans may not be so readily "callable" as those made in the New York market, yet they do provide an asset far more liquid than the ordinary current loan, and also furnish an important element of elasticity in the domestic market for the employment of funds. In view of this fact, it becomes highly questionable whether the banks will find it profitable in the future to send funds abroad, at least to anything like the same extent as in the past.

It is evident, then, that it is unwise to assume that the maintenance by our banks of a secondary reserve of foreign exchange will be automatic. The behaviour of the banks under the Finance Act suggests rather the opposite, and the outlook for the Canadian

balance of payments does likewise. Yet the maintenance of this fund and its size are of the utmost importance to Canadian monetary stability.

After assuming that the chartered banks would probably continue to use the New York money market as a field for short term investments, Professor Curtis turned to the question of the size of the reserves which the banks might be required to keep with the Central Bank against their liabilities to the public. Ten per cent. is the figure which he used as a basis for calculating the probable extent to which the banks would have to convert earning into non-earning assets upon the transfer of a reserve to this extent to the Central Bank.

Would this ten per cent. reserve be sufficient in the *absence of outside reserves*? In this connection it is worth noting that the estimates made by Professor Viner, for the period 1900-1913, show that this secondary reserve was never less than ten per cent. of the liabilities to the public in Canada, except in the year 1907 when the average was about eight per cent. The amount of this outside reserve for the period as a whole averaged over thirteen per cent.¹ During the same period the average volume of cash at home was slightly over nine per cent. On this basis, total reserves immediately convertible into gold averaged over *twenty-two per cent.* of the banks' liabilities to the Canadian public.

The writer has not at hand the statistics for the intervening years up to 1926, but for the period 1926-1931 the percentage reserves were as follows:

Net Assets Abroad and Domestic Cash Reserves
Held by Canadian Banks, 1926-1931²

(Percentage of Liabilities in Canada)

	1926	1927	1928	1929	1930	1931
Net Assets Abroad	10.6	10.3	7.3	4.8	3.5	1.7
Cash at Home	7.9	7.2	7.0	7.1	7.2	7.0
Total Reserve	<u>18.5</u>	<u>17.5</u>	<u>14.3</u>	<u>11.9</u>	<u>10.7</u>	<u>8.7</u>

The above table shows clearly the decline in outside reserves which set in during 1927. The banks continually disposed of foreign funds to meet the demand for foreign exchange, and did not accumulate balances abroad during the years 1928 and 1929 when interest rates were high in New York. In 1930, cash at home, together with net assets abroad, amounted to about ten per cent.

1. Jacob Viner, "Canada's Balance of International Indebtedness, 1900-1913." Pp. 166-167.

2. Computed from "Monthly Return of Chartered Banks to Minister of Finance," published in Canada Gazette.

of liabilities to the public in Canada. It is pertinent to inquire whether it is probable that a Central Bank with the above percentage reserve at its command could have maintained convertibility of its notes and deposits during the subsequent situation. It seems highly unlikely that it could have done so. It may be fairly claimed that world conditions since that time have provided an unusual and extreme test—one which has caused the majority of the Central Banks of the world to suspend gold payments. The figures do suggest, however, that the determination of what shall constitute a safe reserve in the case of Canada is a highly uncertain matter. A percentage reserve perhaps twice as high as that suggested by Professor Curtis probably would have to be adopted, at least until it could be shown that a lesser reserve would prove adequate.

It does not follow, however, that this would necessitate the piling up of non-earning assets in the form of gold to be held in Canada in excess of the amount now held idle under the present system. A large part of it might well be held in the form of earning assets in gold standard countries. With such an arrangement, the Central Bank could afford to pay a low rate of interest on the reserves deposited with it. This is a possible solution of the reserve problem.

If, however, it is granted that, in the interests of safety and economy, a large portion of the reserves of the Canadian banking system should be held abroad in the form of liquid assets readily convertible into gold, the question of the most efficient management and administration of this fund destined for employment abroad becomes a matter of considerable importance. To create a special institution to administer abroad such a large proportion of the assets of the Canadian banking system would appear to be depriving the banks of a function which they themselves, with their foreign branches already in the field, and their years of experience in placing funds abroad, are better fitted to perform.

Furthermore, it is as yet unknown to what extent and how readily the Canadian balance of payments may be expected to respond to changes in credit policy. This, be it noted, is not a problem which arises through the creation of a Central Bank, but is one which, in any case, will have to be faced. It is doubtful if a newly created institution could meet this uncertain situation so well as those bodies most immediately affected thereby, and through which policy will, in any event, have to find impact on the situation to be corrected.

■ The above analysis has attempted to provide the basis for an answer to a question of vital importance in Canada to-day. Will

this problem find its solution in the creation of a Central Bank, or will a less drastic modification of the existing system lead to the desired currency stability? The following summary of conclusions developed above give support to the latter alternative.

The sphere within which a Central Bank could usefully act in Canada is extremely limited. Its chief task would, of necessity, be that of maintaining convertibility of the means of payment into the world standard money and, in the absence of a highly organized money market, it is difficult to discover any mechanism whereby policy could be enforced. Such an institution would not possess powers commensurate with its responsibilities.

Furthermore, there appear to be no grounds for the assumption that the chartered banks of Canada, with their nation-wide system of branches and extensive international contacts, should be provided with an opportunity to borrow from the Minister of Finance or from a Central Bank. Banking resources of the country are already economically concentrated to a considerable extent in the "Big Four", and the absence of legal requirements as to the amount of reserve to be kept against deposits allows, in the credit structure, the necessary elasticity. It follows from these conclusions that *the Finance Act should be repealed*. The banks in maintaining solvency would then automatically ensure the convertibility of the currency.

In the matter of reserves for the system as a whole, recent experience suggests that an amount considerably in excess of ten per cent. of liabilities to the public should be maintained. Since it would be uneconomical to keep such a sum in the form of gold, either the Central Bank or the members of the system must administer the investment abroad of a large part of this fund. It seems reasonable to assume that the chartered banks, with their wide experience and foreign facilities, are better equipped to manage this secondary reserve of gold exchange than a newly created institution would be. They would have all possible incentive to maintain it—the penalty of neglect being bankruptcy, not to mention the constant threat of "Government control".

Having restored to the banks the control over credit, with the accompanying responsibility for convertibility, there is no obvious reason why they should not be favored with a more elastic note-issue privilege. Recent restriction on bank-note issue, it is noted, is a departure from the policy under which our banking system developed. Prior to the war, the banks generally operated with an unused margin of note issue privilege.

The final conclusion drawn in consideration of Canada's change of status in respect of international indebtedness, and of the develop-

ment of an internal call-loan market, is that the maintenance of outside reserves will probably no longer be in any sense automatic. That such a fund should be consciously maintained, has been clearly indicated in recent experience. The proportions of this secondary reserve should bear some close relationship to deposit liabilities in Canada; but, since it is a matter of considerable uncertainty how readily our balance of payments will respond to changes in credit policy, it is impossible to predict how large this foreign fund of gold exchange must be to ensure safety. Undoubtedly, the successful operation of the gold standard in Canada will depend largely upon the effectiveness of credit policy in controlling the net demand for foreign exchange in relation to a reserve supply consciously maintained abroad. This stands out as the fundamental problem of the future, regardless of whether control over credit is delegated to a central institution or returned to the chartered banks.