EXTRA

BANK OF CANADA

ADDRESS BY THE GOVERNOR AT THE FIRST ANNUAL MEETING OF SHAREHOLDERS OF THE BANK OF CANADA, FEBRUARY 25th, 1936

A balance sheet and profit and loss account as at December 31st, 1935, was sent to all shareholders with the notice calling this meeting. I should like to comment on some of the items in this statement, and also to say something about our activities.

Before doing so, I cannot refrain from a reference to the loss which we have all sustained in the death of His late Majesty, King George V. At the time of the Silver Jubilee, only a short nine months ago, the British Empire joined in expressions of loyalty and good wishes which obviously came from the heart. You will recall that in a minor way we participated in the commemoration of the Jubilee by issuing, with the approval of the Governor-in-Council, a special $25 note which carried engravings of Their Majesties in coronation robes. The symbols of such occasions soon pass from public memory, but the deep feelings of respect and admiration endure.

The Bank of Canada opened its doors for business on the 11th of March last. On the date of opening, we assumed responsibility for the redemption of all Dominion notes issued and outstanding. To cover that liability, which then amounted to $185,455,439, the Dominion Government transferred to the Bank the following assets:—

(*a*)	Gold, valued at	$69,455,439
(*b*)	Silver, valued at	986,363
(*c*)	Dominion of Canada 3% bonds maturing 1940 of a par value of	115,013,637
	TOTAL	$185,455,439

From November, 1932, until March 11th last, the chartered banks had, by arrangement, borrowed under the Finance Act a minimum amount of approximately $35 million, and at the initiation of the transaction had purchased from the Dominion Government, Treasury Bills for approximately the same amount. The Bank of Canada Act provided that on the day on which the Bank was authorized to commence business, the chartered banks should repay all advances then outstanding under the Finance Act. Such repayment resulted in the cancellation of an equal amount of Dominion notes and would have involved a similar reduction in the cash reserves of the chartered banks, if no offsetting action had been taken. We considered it wise to offset this reduction and did so by purchasing $35 million of Treasury Bills from the Dominion Government. The Government used the proceeds of this sale of securities to redeem Treasury Bills held by the banks, with the result that their cash reserves were unchanged.

As a result of the transactions to which I have referred, we commenced our operations with $150 million of Government securities. In July of 1935, certain major changes took place in our holdings. The Exchange Fund Act came into effect on July 5th. Our first statement to be published after this date, namely, that of July 10th, by comparison with the preceding statement, showed an increase of approximately $73,500,000 in our gold holdings, but a decrease in security holdings of $51,492,000. The portion of the gold profit paid to the chartered banks served to augment their cash reserves, but otherwise these transactions did not materially affect their cash position.

As at December 31st, holdings of Dominion Government securities, maturing within two years, were valued at $30,873,168. Those having a maturity longer than two years totalled $83,409,675. All securities were valued on the basis of prices not exceeding the market on December 31st.

GOLD HOLDINGS

The largest item on the Asset side of our balance sheet is gold, valued at $180,509,342. When we commenced operations we acquired gold to the value of $106,584,355, of which $69,455,439 came from the Dominion Government and $37,128,916 from the chartered banks. Settlement for this gold was effected on the basis of the statutory value of $20.67 an ounce. Subsequently, the Exchange Fund Act required us to value the gold at the current market price. The resultant profit of about $73,500,000 did not accrue to the Bank of Canada. Section 30 of the Bank of Canada Act had provided that any profits on gold transferred to the Bank would pertain to the Dominion Government, but it gave the Governor-in-Council power to allow the chartered banks to receive the profit on gold transferred by them, to the extent that such gold was deemed to have been held against liabilities elsewhere than in Canada. The Governor-in-Council determined that 40 per cent of the banks' gold had been so held, and as a result the chartered banks received $10,475,114. The balance of the profit, namely, $63,006,382, was credited to the Exchange Fund of the Dominion Government, and future profits or losses on gold held by us will be credited or debited to that account.

It should be noted that the valuation at which gold is entered on our balance sheet represents the amount which should be obtained in Canada if the gold were to be shipped to London or New York on the date of the statement. In other words, we apply the realizable value instead of an arbitrary one, and are not restricted to the price prevailing in any one particular market.

CAPITAL STOCK AND NOTE ISSUES

On the Liability side of our balance sheet, the item of "Capital" requires no explanation. As at the end of the calendar year our capital stock was owned by 11,021 shareholders, the average holding being 9.07 shares. Notes in circulation totalled $99,677,229; of these $40,497,965 were in the hands of the chartered banks, and $59,179,264 in the hands of the public, including savings banks and other financial institutions. When we commenced business, the amount of notes in public hands was $42,440,981, so that the total has increased $16,738,283 between that time and the end of the year. The increase is partly seasonal in character, partly due to the retirement of chartered bank notes from circulation in anticipation of the $7,275,000 decrease in the banks' issuing power on January 1st, 1936, and partly due, I think, to a greater than seasonal activity in business.

When additional notes are required by the public, they are obtained by withdrawals from the public's accounts with the chartered banks. The banks pay out Bank of Canada notes to the extent that the demand is for $1 and $2 denominations, or if their own note issues are approaching the authorized limit. Thus an increase in the active circulation of Bank of Canada notes serves to reduce the chartered banks' cash reserves, if no offsetting action is taken by the central bank. Such action was taken last year and is reflected in the enlargement of our holdings of Government securities during the latter part of 1935.

The fact that our note issue is so much smaller than the old Dominion note issue has occasioned some misunderstanding. It should be remembered that cash reserves are now being maintained in the form of deposits with the Bank of Canada, as well as notes of the Bank of Canada. The combined total of our notes and chartered banks' deposits with us is the figure which should be used when making a comparison with cash statistics antedating our opening. To give a concrete example, I may say that the amount of Dominion notes in circulation on March 10th, 1935, was $220 million. Gold then held by the chartered banks was valued at approximately $37 million. Legal tender in the hands of the banks and the public therefore totalled $257 million. Compare this figure with $281 million, representing our notes in circulation as at December 31st, 1935, plus chartered bank deposits with us on the same date. In quoting the statistics, I have used round amounts in each case.

DEPOSITS AND CHARTERED BANK CASH RESERVES

Deposits of the Dominion Government require no comment. Deposits of the chartered banks – $181,636,033 – represent the major portion of their cash reserves against deposit liabilities in Canada. Adding to the deposit figure $40,497,965 in Bank of Canada notes, which the banks held in their tills, we find the total cash reserves at December 31st, 1935, were $222,133,998, equal to approximately 10 per cent of the chartered banks' deposit liabilities in Canada.

The amounts shown opposite the headings in our balance sheet entitled "Other Assets" and "Other Liabilities" fluctuate from week to week, sometimes to quite a considerable extent. The main reason for these fluctuations arises from the fact that we include in the category "Other Assets" cheques in course of clearance, and in "Other Liabilities" drafts issued and outstanding.

PROFIT AND LOSS ACCOUNT

The Profit and Loss Account shows that an amount of $764,228.31 was available for distribution in accordance with the terms of the Bank of Canada Act. It will be recalled that our operations covered a period of less than ten months, namely, March 11th, 1935, to December 31st, 1935. Even so, the net earnings are not as large as might have been anticipated. Expenses incurred in connection with a new note issue are necessarily heavy. We had to issue our own notes in exchange for Dominion notes which had been held by the public or as till money by the banks, and also to accumulate in stock an adequate reserve supply. In this respect there was, therefore, a double burden imposed on earnings in 1935.

The decline in silver prices also had a very material effect on profits. On March 11th, we took over from the Dominion Government, at the price then prevailing, 1,671,802 ounces of silver, which the Government had acquired in accordance with the terms of the London silver agreement. Between March 11th and the end of the year, we acquired an additional 1,671,802 ounces, our action in both cases being governed by the terms of the Bank of Canada Act and the instructions which we received from the Minister of Finance. The market price of silver on December 31st last was materially below the quotation of March 11th, and also below the average price between the latter date and the end of the year. The resultant depreciation in the value of our holdings was $489,368, all of which was charged to Profit and Loss Account.

Organization expenses incurred prior to March 11th were also charged to the 1935 account.

While I am on the subject of profit and loss, I would like to refer to our costs of operation, and in doing so to distinguish between what may be termed "new" expenses and "old" expenses. By the latter, I mean expenses which had previously been borne by the Dominion Government in connection with the provision and distribution of Dominion notes, and the maintenance of offices of the Assistant Receivers General as well as the Currency Section of the Department of Finance. The "old" expenses would have been incurred in any event. In saying so, I assume that under any circumstances it would have been found wise and economical to create a new issue of the smaller sized notes. The creation of a central bank organization involves certain new expenses, as well as some new sources of profit. I estimate the net new cost last year at about $275,000. In arriving at that figure, no credit has been taken for any interest earned on investments. The net cost includes all organization expenses. As time goes on, I hope that the net cost of the new régime will tend downwards rather than in the other direction.

THE FUNCTIONS OF A CENTRAL BANK

The functions of a central bank are well set forth in the report of the Royal Commission on Banking and Currency in Canada. The chief functions are to endeavour to regulate the volume of credit; to defend the external value of the national monetary unit; to be a ready source of skilled and impartial advice at the disposal of the Government (in the case of Canada, the Dominion and Provincial Governments); and to afford timely co-operation with the central banks of other countries. I propose to say a few words on each of these functions.

INFLUENCE ON CREDIT

A central bank's influence on the volume of credit arises from its power to affect the volume of commercial banks' cash reserves. When a country is not on the gold standard, the central bank can do more than affect the commercial banks' cash reserves; it determines them. If the central bank increases its assets, by buying gold or securities or making advances, such action will be reflected by an increase in its deposit liabilities. For the most part, in our case, these deposit liabilities are the balances which the chartered banks keep with the Bank of Canada as a part of their cash reserves. An expansion of cash reserves tends to produce an increase in the commercial banks' loans and investments; a contraction of reserves tends to produce a curtailment of these assets.

A policy of cheap and abundant money is the orthodox contribution of a banking system towards recovery from a depression. Such a policy undoubtedly contributes, firstly, to a relaxation of the pressure to liquidate and, secondly, to a recovery of business and to the reëstablishment of Government finances, which are sure to be adversely affected at such times through relief expenditures and other unavoidable commitments; but if the policy is pursued too far the situation may become unmanageable when a revival develops.

In Canada, the present high price level of gilt edged bonds is an indication of the pressure of money looking for employment. The chartered banks' cash reserves on December 31st last were slightly larger than on December 31st, 1929; their deposits at the end of 1935 were less than 2 per cent smaller than deposits on the same date in 1929. If we recall that December, 1929, was the closing month of a year of exceptionally active business, this comparison of figures will serve to remind us that the volume of money is not the cardinal factor which determines the volume of business. The vital matter is not the amount of money in existence; it is the size of people's incomes, in other words, the size of the national income. This can grow, and does grow, without any definite connection between such growth and a growth in bank deposits or note circulation. An increased turnover of existing monetary supplies takes place as prosperity returns, and the total amount of money may be less then than during a depression.

THE EXCHANGE RATE

To turn to the external value of the currency. As you know, the Canadian dollar, like many other currencies, is at present off gold and unstabilized. In these circumstances the Bank of Canada has no specific obligation imposed upon it by the Government. Nevertheless, over a long term, credit policy must necessarily affect the external value of a monetary unit. As the Royal Commission's report says:

> "Control over the external value of the monetary unit is . . . a logical outcome of that of credit regulation. Whatever additional influences may affect the level of the exchanges, such as short term capital movements, external borrowings and indebtedness, and the income from overseas investments, the long term factor of decisive importance is the credit structure of the country . . . "

The Canadian dollar has exhibited a remarkable tendency, when not at parity with the pound or U. S. dollar, to take up an intermediate position. Obviously, in the long run, the purchasing power of our dollar must approximate that of the U. S. dollar and the pound sterling, or there would be a marked divergence in exchange rates. From the point of view of short term movements, it is probable that the large volume of U. S. and U. K. investments in Canada, and the existence of so many Canadian bonds payable in two or three currencies —a feature of our financial economy which is not found to an important degree in any other country—have had a tendency to restrict fluctuations in our exchange rate. A discount on the Canadian dollar in the United States encourages purchases of Canadian securities; a premium encourages selling; and the situation *vis à vis* the United Kingdom is the same. One must add to this statement by pointing out that relative price levels in the security markets of the three countries, and the degree of confidence in our position, are important factors in security transactions. I do not suggest that bonds payable in two or more currencies are desirable. On the contrary, they are often most embarrassing obligations from the borrower's point of view. The extent to which Canadian borrowers incur foreign obligations and later discharge them, and the manner in which such commitments are taken, are matters of public interest affecting our balance of payments and the exchange value of the Canadian dollar. The situation is one which cannot fail to involve close attention on the part of a central bank.

ADVISORY FUNCTIONS

On the subject of our functions as a source of impartial advice, I do not propose to say much. It would be presumptuous to suggest that so inexperienced a central bank could at once be of full value in this respect. Nevertheless, we have every inducement to be impartial. Advice must often, perhaps usually, be the chief form of assistance which we can render to the Governments of Canada, inasmuch as our necessary concern for the cash basis does not permit us to make large advances of a kind which we cannot offset if that policy were requisite. It should not be inferred, however, that we are unable to furnish temporary accommodation at appropriate times. During the year our statements have shown that advances were made to the Dominion Government on various occasions, the largest having been made in October and November in anticipation of new financing.

CENTRAL BANK CO-OPERATION

The desirability of increased co-operation between central banks has been much discussed for a number of years, and has been stressed at various international conferences. There is much that can be done in the way of interchange of information. Business conditions in a country's main markets have an important bearing on domestic trade. A central bank which contented itself with a knowledge of home affairs, and turned a blind eye to developments elsewhere, would not be fulfilling its duty to its own people. The central banks of other countries constitute an excellent source of information. They can often provide facts rather than surmises. Co-operation along these lines is therefore extremely helpful, and can be developed by arrangement between central banks. Obviously, co-operation on any matter of high policy must be dictated or conditioned by the views of the governments of the countries concerned. While I am on this subject, I might mention that one of the Empire central banks, namely, the Bank of England, is supposed by some persons to exercise a universal and malign influence in financial matters the world over. I should like to say that, in my opinion, this is just nonsense, and that in any case one can safely rely upon the central banks and governments of the respective Dominions to see that no undue or pernicious influence is exerted. In these unsettled times, the real problems of central banks are grave enough in all conscience. It would be regrettable if the burden were increased by the addition of imaginary complications.

Co-operation is usually a question of common sense, whether it takes place in the realm of trade or finance. In all the criticism of the existing order which we hear to-day—and I am not a reactionary in this respect—I think that too little weight is given to the fact that the world's business structure has apparently survived a period during which international common sense has been conspicuous by its absence. The structure must possess great inherent strength. In a world designed to live and prosper by the interchange of commodities and services, almost every possible effort has been made to hamper or prohibit such interchange. Few countries are more dependent than Canada upon international trade. In our own interest we must welcome and encourage any loosening of the shackles which have been placed on world business during the years since the War. I hope that the recovery in world trade, of which there is now evidence, can be stimulated by appropriate measures of international co-operation between governments.

BANK RATE

Our bank rate was established at 2½ per cent and remains unchanged. The figure is the same as that which was being charged for advances under the Finance Act, prior to the establishment of the Bank of Canada, and it remains the charge which we would ordinarily make to the banks for advances. It is quite out of touch with Treasury Bill rates, but this fact is not at present of any particular significance. When money is in plentiful supply, the need for loans or rediscount facilities seldom arises. It is in times of greater stringency that accommodation from the central bank is essential. A central bank must be what is known as the lender of last resort, which implies that in times of real need its rediscounting and lending facilities will be freely accorded.

TREASURY BILL MARKET

It is universally recognized that a central bank is hampered in its operations where an active bill market does not exist. Few countries, however, have the bill market they would like. Under present conditions a fairly satisfactory market can be established, if there is a sufficient volume of Treasury Bills, if there is a good institutional distribution of these, and, in particular, if it is the commercial banks' policy to hold Treasury Bills as their secondary reserve. The mere existence of a central bank at once widens and strengthens the market for first-class bills, since the central bank itself will be a large holder and will engage in purchases and sales in pursuance of its open market policy, and for other reasons. In so doing, it is likely to have the effect of steadying the rate. The Bank of Canada can, I feel, claim that it has been of assistance in both these respects.

In times past, New York call loans and bankers' acceptances were, to a large extent, regarded as the secondary reserve of Canadian banks. Fluctuating exchange rates have practically ruled out these items as a means of employment of that portion of a bank's Canadian assets which need not be kept in cash, but which must be convertible into cash, in large volume and without sacrifice, at a moment's notice. Canada has been lacking in facilities of this kind. I hope the deficiency will be remedied. Treasury Bills can be made to play an increasingly important part in our banking life, if further experience and a further widening of the market demonstrate —as I believe they will—the utility of this form of temporary investment. One should not think of such Bills as being merely a means of cheap governmental financing, and nothing more.

Even before we opened our doors in March last, we had occasion to look to the chartered banks for co-operation, so that our operations might be initiated as smoothly and efficiently as possible. Such co-operation was freely accorded at that time and on many subsequent occasions. A central bank does not compete with the commercial banks. The latter depend for their prosperity on the prosperity of the country as a whole. They will benefit if we can contribute to any greater degree of stability and to the more effective operation of our financial system. A central bank—particularly a new one—should be careful not to make any rash claims, but I feel satisfied that any central bank worthy of the name cannot but be of vital importance in the economic life of the country.

It is easy to expect too little or too much from a central bank. There are those who think that the monetary factor is of such great importance that every other factor will fall into its right place, and the whole economy will work smoothly, if only the central bank provides the right amount of cash, at the right rate, at the right time. Other people go to the opposite extreme and consider that a central bank is merely a fifth wheel to the coach (although a fifth wheel to a motor-car is admittedly of service). Neither of these extreme views is, in my opinion, correct. It should also be remembered that some of the most useful actions of a central bank may pass unnoticed or cannot be known, indeed the extent to which beneficial actions are beneficial must necessarily escape the knowledge of a central bank itself. One can imagine—especially if the monetary theorists are right—a boom and the following depression being entirely prevented from happening by sufficiently drastic action of a central bank prior to the boom. Neither the bank nor anyone else would ever know what the country had been saved from. Central banks might claim many such services in the past; but it is their failure to act in time which naturally attracts attention, and rightly so.

I do not wish to close without referring to the work of the staff during the past year. Our organization period was one of less than four months, and within that time we had to prepare ourselves to operate as a full-fledged central bank. That task was accomplished by the exercise of much individual initiative and a disregard of normal working hours. On March 11th, when we commenced operations, our staff was enlarged by those who came to us from the Civil Service, and who participated in full measure in the strenuous activities of our early days. I feel deeply indebted to my immediate colleagues and to the staff as a whole for their energetic and able co-operation during the past twelve months.