BANK OF CANADA

ANNUAL REPORT TO
MINISTER OF FINANCE
AND
STATEMENT OF ACCOUNTS

1938

FEBRUARY 6TH, 1939

BANK OF CANADA

INCORPORATED UNDER THE BANK OF CANADA ACT, 1934

HEAD OFFICE—OTTAWA

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R. MCQUEEN	WINNIPEG, MAN.
T. BRADSHAW *Member of the Executive Committee*	TORONTO, ONT.
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A. C. PICARD	QUEBEC, QUE.
R. A. WRIGHT	DRINKWATER, SASK.
W. D. BLACK	HAMILTON, ONT.
LT. COL. C. BROWN	LONDON, ONT.
G. G. COOTE	NANTON, ALTA.
W. K. MCKEAN	HALIFAX, N.S.
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Ex Officio Member of the Board

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OFFICERS

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Assistant Deputy Governor

D. GORDON
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K. A. HENDERSON
Securities Advisor

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Secretary

L. P. J. ROY
Deputy Secretary

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Chief

W. A. CAMERON
Deputy Chief

CURRENCY DIVISION

C. E. CAMPBELL
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J. P. MELVIN
Deputy Chief

RESEARCH DEPARTMENT

D. A. SKELTON
Chief

CHIEF ACCOUNTANT'S DEPARTMENT

H. R. EXTENCE
Chief Accountant

PUBLIC DEBT DIVISION

M. G. ANDERSON
Chief

F. M. PETERS
Deputy Chief

SECURITIES DEPARTMENT

W. B. WATSON
Chief

W. H. BUDDEN
Deputy Chief

H. G. GAMMELL
Toronto Representative

C. DE V. WELSFORD
Montreal Representative

AUDIT DEPARTMENT

E. FRICKER
Auditor

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CHARLOTTETOWN, P.E.I.	D. A. MACKINNON	"
HALIFAX, N.S.	S. A. STADEN	"
MONTREAL, QUE.	J. H. C. DESMARAIS	"
	E. METCALFE, *Assistant*	"
OTTAWA, ONT.	S. J. PERKINS	"
REGINA, SASK.	G. A. IVEY	"
SAINT JOHN, N.B.	E. H. CAMERON	"
TORONTO, ONT.	K. FREDERICKSON	"
	A. W. S. TAYLOR, *Assistant*	"
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WINNIPEG, MAN.	W. MORTON	"

BANK OF CANADA

Ottawa, February 6th, 1939.

The Hon. C. A. Dunning,
Minister of Finance,
Ottawa.

Dear Sir,

In accordance with the provisions of the Bank of Canada Act Amendment Act, 1938, I am enclosing herewith, in duplicate, a statement of the Bank's accounts for the fiscal year 1938, signed by the Governor and Chief Accountant, and certified by the Auditors in the form prescribed by the By-laws of the Bank.

The statute provides that this statement should be accompanied by such summary or report by the Governor as he may deem desirable, or as may be required by the Minister. In the report which follows I propose to comment on the principal items in our Balance Sheet and Profit and Loss Account as at December 31st, 1938, and also to refer to certain other matters which are either directly related to our activities or are of special interest from the point of view of a central bank.

Figures to the nearest thousand dollars will be used in making comparisons between our Balance Sheet as at December 31st last and the statement for the preceding year.

ASSETS

RESERVES

Our holdings of gold coin and bullion were valued at $185,912,000, an increase of $6,148,000. Of this increase, $4,325,000 is attributable to the addition of 122,890 ounces to our stock of gold, and the balance is largely accounted for by the fact that the premium on the U. S. dollar as at December 31st last was 31/32 of 1 per cent, compared with 3/32 of 1 per cent on December 31st, 1937. The Exchange Fund Act provides that all gold held as reserve by the Bank of Canada shall be valued at the current market price, namely, the amount realizable from the sale of gold in London or New York converted into Canadian dollars at the current rate of exchange.

Silver bullion, valued at $2,993,000 in our Balance Sheet of December 31st, 1937, was sold during the year.

The growth of approximately $95 millions in our note and deposit liabilities since December 31st, 1935, and some increase in Canadian dollar deposits in chartered banks, owned by persons resident elsewhere than in Canada, have made it desirable to add to our reserves from time to time. We have felt it essential that such reserves should be maintained in a form which would ensure their immediate availability in case of need, and which would not (so far as could be judged) expose the Bank to risk of loss. The increase in our gold holdings during 1938, to an extent that more than offset the sale of our silver bullion, is in line with the policy to which I have just referred.

In comparing our holdings of pounds sterling and U. S. A. dollars with those of December 31st, 1937, account must be taken of the change in the item "Other Securities". These "Other Securities" may consist of obligations of the United Kingdom, any British Dominion, the United States of America or France, subject to the restrictions in respect to dates of maturity set forth in paragraphs (e) and (f), subsection 1, section 21 of the Bank of Canada Act as amended. A decrease of $12,212,000 in "Other Securities" during 1938 is a little more than offset by an increase of $13,470,000 in the item entitled "Sterling and U. S. A. dollars".

INVESTMENTS

Our holdings of Dominion and Provincial Government securities, valued at $185,516,000, show an increase of $11,607,000 on the year. The substantial increase in short term obligations, and decrease in investments having a maturity in excess of two years, is largely due to the fact that the Dominion Government issue of 3 per cent bonds, due March 1st, 1940, fell in the short term classification on March 1st last. This issue of $115,013,636 was initially held in its entirety by the Bank of Canada, which received it from the Dominion Government in part settlement of the liability assumed by the Bank for redemption of Dominion notes outstanding on March 11th, 1935, the date on which we commenced our operations.

BANK PREMISES

You will observe that the total amount for Bank Premises shown in our statement is $1,647,580.14. This figure includes the total cost of all land and buildings owned by the Bank, together with the cost of furnishings and equipment, less the amounts which have been written off for depreciation. In addition to its Head Office building in Ottawa, the Bank owns its Agency premises at Vancouver, Calgary, Regina and Toronto, while rented premises are occupied by the Agencies at Winnipeg, Montreal, Halifax, Saint John and Charlottetown.

The Head Office building of the Bank in Ottawa was completed, and the transfer of all Head Office Departments was accomplished during the last week of April, 1938. At the same time, an Ottawa Agency of the Bank was opened in the new building. We have been particularly well pleased to find since that time that the planning of the building, which was, of course, designed to meet rather special needs, has proven satisfactory.

LIABILITIES

CAPITAL

In accordance with the provisions of the Bank of Canada Act Amendment Act, 1938, $5,100,000 par value of the capital stock of the Bank was redeemed on August 15th, 1938. Our capital is now represented by 100,000 shares of the par value of $50 each, all of which are held by the Minister of Finance on behalf of the Dominion of Canada.

NOTES IN CIRCULATION

At the end of December, 1938, our note issue stood at $175,260,000, up $9,929,000 on the year. An increase of $6,992,000 in the amount of our notes in the hands of the public was more than offset by a reduction of $7,696,000 in the note issues of the chartered banks. Thus the net active circulation at the end of the year was $704,000 less than at the end of 1937. Using annual daily averages, there was an increase in 1938 of $5,200,000, or 2.6 per cent, as compared with 10 per cent between 1936 and 1937, and 7.2 per cent between 1935 and 1936. The increase in active note circulation in 1938, when industrial activity was reduced, may be explained in part by the lag in the decline of payrolls and retail trade, and by the increased demand for notes in the West during the marketing of the much larger 1938 wheat crop.

DEPOSITS

The main item under this heading, namely, "Deposits of Chartered Banks", increased $4,606,000 on the year. Notes of the Bank of Canada held by the chartered banks as at December 31st last were $2,937,000 higher than the year before, so that the total increase in the cash reserves of the chartered banks was $7,543,000. This change can be accounted for as follows:—

(Millions of dollars)

	Changes producing a decrease in chartered banks' cash	Changes producing an increase in chartered banks' cash
Increase in gold coin and bullion		6.1
Decrease in silver bullion	3.0	
Increase in sterling and U. S. A. dollars		13.5
Decrease in "Other Securities"	12.2	
Net decrease in Capital and Rest Fund		4.5
Increase in investments in Dominion and Provincial Government securities		11.6
Increase in active circulation	7.0	
Increase in Dominion Government balances	5.6	
Other net changes	.4	
	28.2	35.7
Deduct		28.2
Increase in chartered banks' cash reserves (notes of and deposits with Bank of Canada)		7.5

PROFIT AND LOSS

The amount available for distribution in 1938, after providing for Contingencies and Reserves, was $2,033,100.97. Deducting dividend requirements of $367,800, the balance to be apportioned between the Rest Fund and the Dominion Government was $1,665,300.97, compared with

$1,814,096.36 in 1937. During 1938 our investments averaged $17,107,000 more than in 1937, but the average yield declined sufficiently to cause a slight falling off in earnings. Another factor affecting our Profit and Loss Account was a loss on silver amounting to $135,740.18 compared with $13,847.41 in 1937.

PUBLIC DEBT DIVISION

Acting under powers conferred by section 23 (2) of the Bank of Canada Act, you required the Bank, as from April 1st, 1938, to act as Agent for the Government in the payment of interest and principal and generally in respect to the management of the public debt of Canada. The public Debt Division of the Bank was constituted for this purpose, and on April 1st last the staff of the Loans and Interest Branch of the Department of Finance entered our service. In view of the fact that so much of the work of the former Loans and Interest Branch had been interwoven with work performed by the Bank in its capacity as fiscal agent of the Dominion Government, we believe that the amalgamation will be in the interests of efficiency and economical operation.

STAFF

At the meeting of the Board of Directors held on September 12th, 1938, the Deputy Governor, Mr. J. A. C. Osborne, informed the Board that personal considerations required his return to England, and submitted his resignation, to take effect on September 14th. In regretfully accepting this resignation, the Board recorded its deep appreciation of the value of the service rendered by Mr. Osborne, and recalled that he had interrupted his career for a period of nearly four years to come to this country and aid in the work of organizing and operating the Bank of Canada. Mr. Osborne brought to this task a knowledge of central banking matters born of long experience, and the Bank of Canada will be permanently in his debt.

The Board of Directors appointed Mr. Donald Gordon to the office of Deputy Governor, for a period of seven years commencing September 15th, 1938. This appointment was approved by the Governor in Council. Since becoming Secretary of the Bank in February, 1935, Mr. Gordon has played a major part in our activities. May I say that I feel very fortunate in having him as a colleague in the position of Deputy Governor.

The permanent employees of the Bank number 359, an increase of 139 since last year, reflecting for the most part the establishment of the Public Debt Division of the Bank, as referred to in a preceding paragraph. The incorporation of this Division in our organization, the creation of an Ottawa Agency, and the move to our new quarters, called for special efforts on the part of the staff, so that the daily activities of the Bank could go forward without interruption. I should like to record a special acknowledgment of the work done by our staff during that period.

BANK RATE

Bank Rate has remained unchanged throughout the year at 2½ per cent. As in previous years, there has been very little need for banks to borrow.

CHARTERED BANKS' CASH RESERVES

The ratio of cash held by the chartered banks to their deposits in Canadian dollars averaged 10.5 per cent in 1938. An increase in the banks' cash reserves usually takes place in the last few months of each year. Thus, in 1937, the ratio of cash to deposits in Canadian dollars rose from 9.9 per cent in September to 11.4 per cent in November. In 1938 the rise was from 10 per cent in July to 11.2 per cent in November. The increase in the cash base takes place mainly through a reduction in the chartered banks' holdings of Dominion Government Treasury Bills, and an increase in our investment in these obligations. We estimate that between the end of July and the end of November the holdings of the banks were reduced by approximately $21 millions. During that period our investments in all forms of Dominion and Provincial Government securities increased by some $27 millions.

The desire of the banks to build up their cash reserves during the closing months of each year is based on demands in connection with the movement of crops, and the practice of showing a strong cash position at fiscal year-ends. It is probable that last year the disturbed conditions which prevailed in September were also a factor in the situation.

SECURITY MARKETS

It will be recalled that the prices of high grade bonds suffered a sharp fall in the early months of 1937. At that time, the market evidently anticipated that interest rates would rise as a result of the enlarged demand for credit which increasing business activity and buoyant commodity prices could be expected to produce. The subsequent recession in business caused the market to amend its views in respect to the outlook for gilt-edged securities; and the rise in prices of Government obligations which was initiated in the second quarter of 1937 continued in 1938. Thus, the average price of two typical long term issues in Canada moved from 104.34 in January, 1938, to 106.08 in December last. I should add that the recovery was interrupted by a very sharp fall in prices at the time of the European crisis, exemplified in the case of the two issues mentioned above by a low price of 98.94 in September. The net decrease in the yield of high grade long term bonds over the year was about one-fifth of one per cent. Approximately the same change took place in the United States, while in the United Kingdom yields rose by about one-fifth of one per cent.

Apart from the influence exerted on the bond market by changed business conditions, there was the further factor that the total amount of new issues in Canada by Governments and corporations in 1937 and 1938 remained very much below the level of any other year since 1930. The ability of the high grade market to absorb new offerings has, therefore, not been exposed to any severe test during the last two years. I am appending a table * showing the net amount of new issues by Canadian governments and corporations for the years 1936-38 inclusive. The figures on this subject—at least in the form in which they are shown on the attached statement—were not available until our Research Department commenced to assemble the information in 1936; and this is the reason why the table does not cover a longer period of years.

The year 1938 witnessed a further reduction in borrowings of members of the Toronto and Montreal Stock Exchanges. Borrowings on Canadian collateral were approximately $39 millions at December 31st last, compared with $45 millions a year earlier. And during the twelve months ended October 31st, 1938, Canadian bank loans to individuals against stocks and bonds were reduced by about $22 millions. The market value of all listed stocks increased some nine per cent during the twelve months. Thus the decline in member borrowings and in bank loans to individuals must reflect a further curtailment in speculative activities, and an increase in the proportion of securities which have been paid for in cash.

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In my address to shareholders at the last annual general meeting, I referred to the fact that the Dominion Government was allowing a longer period to elapse between the announcement of the offering of its loans, either direct or guaranteed, and the opening of the books for receipt of subscriptions. I believe that, as anticipated, the procedure now being followed has given small investors, particularly those who are distant from the large centres, a better chance of participating in new issues. Other changes in procedure were adopted recently in an effort to promote a more orderly distribution of such issues. Before these changes were decided upon, representatives of banks and dealers who participate in the distribution of Dominion Government Direct and Guaranteed Loans were asked to make suggestions, and I wish to record the fact that we received very helpful co-operation from those concerned.

THE FOREIGN EXCHANGE SITUATION

Fluctuations in the relationship between sterling and the U. S. dollar were more extensive in 1938 than in any year since 1933. After irregular weakness earlier in the year, sterling commenced a major decline in July which continued until December. On a monthly average basis, it moved from a premium over the U. S. dollar of 1.88 per cent in June to a discount of 4.03 per cent in December. During the year the daily rate ranged between a premium of 3.52 per cent and a discount of 5.27 per cent.

The Canadian dollar was naturally influenced to some extent by the uncertainties of the European situation during the spring and autumn. After remaining near par until early in March, it declined to an average discount in terms of U. S. funds of 1.09 per cent in June. It rose somewhat during July and August, but during the last four months of the year fell again to an average discount of .82 per cent. The range for the year of the Canadian dollar in New York was about 3½ per cent as compared with a little more than ½ of 1 per cent in the preceding year. Using noon rates, which eliminate the major fluctuations on September 28th, the range is only 2.19 per cent, between .06 per cent premium and 2.13 per cent discount.

It will be seen that the decline of the Canadian dollar in New York during 1938 was small in comparison with that of the pound sterling. The main cause of the drop in sterling, namely, a heavy movement of funds out of the United Kingdom, found no counterpart in Canada. On the contrary, there was an increase in foreign purchases of Canadian securities, and an inward movement (probably of relatively moderate proportions) of funds for deposit in Canadian banks. These factors, and the continued strength of our balance of international payments on current account—to which I refer in the next section of this report—make the relative strength of the Canadian dollar during 1938 easily understandable.

GENERAL

Preliminary estimates of Canada's balance of international payments for 1938 indicate that the reduction in our net surplus on current account, consequent upon unfavourable developments abroad, was relatively small. Exports of merchandise other than gold were down by $160 millions, or 16 per cent from 1937; including gold, they were $150 millions lower. Net tourist receipts declined by about $25 millions, or 15 per cent; there was virtually no decrease in net interest and dividend payments abroad; and reductions in other invisible debits were small. The sharp contraction in net available foreign income thus indicated was, however, largely offset by an unusually rapid adjustment of merchandise imports. These fell by $130 millions or 16 per cent, leaving the net active balance on current account at $185 millions, as compared with $218 millions in 1937.

The balances of the last three years have, in fact, averaged more than double those of the 1926-28 period, but have taken place on a substantially lower volume of turnover. Total Canadian exports during 1936, 1937 and 1938 averaged 17 per cent, or $220 millions a year less than in the earlier period. A direct effect of this decline was, of course, to reduce the aggregate national income, of which export receipts are a part, by a corresponding absolute amount. Its indirect effect upon national income, that is, the influence of the reduction of exporters' purchasing power upon the activity of those engaged in secondary industries and in the provision of services, is more difficult to trace. In point of fact, the national income as a whole, in terms of money, fell by about the same percentage as exports. This is also roughly true of national income per capita in terms of goods and services, the correction for their lower prices in the second period being approximately offset by the 15 per cent increase in population which had taken place.

It would appear that this substantial decline in average "real" income per capita was not accompanied by any net improvement in its distribution, at any rate in relation to the present structure of our economy. For instance, according to the most complete estimates yet made—those of the Dominion Bureau of Statistics—the average number of employed wage-earners during the years 1936-38 was, in round figures, only 110,000 more than it had been a decade before, while the average number unemployed was about 320,000 greater. Again, foods and food-stuffs, which constituted half our total exports during the years 1926-28, were, over the last three years, in spite of liquidation of surplus wheat stocks, only 29 per cent of the reduced total; while non-ferrous metal exports (including non-monetary gold), rose from 7 per cent to 30 per cent of the whole. It is possible that this change in the distribution of export income has in itself had appreciable repercussions upon the other components of our aggregate national income.

Changes in the volume and the character or distribution of national income have been reflected on the import side of our balance of international payments. Proportionally, merchandise imports fell much more than either exports or national income, averaging in the years 1936-38 36 per cent or $400 millions a year less than they had in the earlier period. In other words, the proportion of available income being devoted to the import of consumption and capital goods was substantially curtailed. And this had the effect of leaving unusually large credit balances on current account to be devoted to the repayment of foreign debt.

To an important degree the changes which were noted at the beginning of the last paragraph have had as their proximate or perhaps even as their ultimate cause the prevailing low level of investment in capital goods. One has only to recall the magnitude of the expansion which took place in the latter twenties in Canada's productive, distributive and housing equipment to realize how different is the present situation in this regard. There are some grounds for expecting an increase in residential construction in 1939, but at best it could do little to close the very large gap which still exists, in the case of industries connected with the production and installation of durable goods, between present levels of activity and those of ten years ago. Whatever may be the basic causes of this situation (and it is common to many countries), it seems safe to say that in the present state of international relationships broad recovery in the section of the economy to which I have referred is unlikely to be rapid. It therefore seems obvious that unemployment in its existing proportions cannot be regarded as entirely, or even chiefly, a short-term problem.

I am,

Dear Sir,

Yours faithfully,

G. F. TOWERS

Governor.

ESTIMATED

NET NEW ISSUES OR RETIREMENTS

(Par Values in Millions of Dollars)

Calendar Years	*BONDS OF:— Domin- ion (1) and C.N.R.	Prov- inces (2)	Private Corpora- tions	(3) TOTAL	PAYABLE:— In Canada Only	†Abroad
1936	86	41	51	178	372	194
1937	11	59	10	60	181	121
1938	70	53	4	119	188	69

* Treasury Bills are excluded. In the case of the Dominion, corresponding figures for Treasury Bills would be net issues of 57, 0 and 5 in 1936, 1937 and 1938 respectively.

(1) Includes all guaranteed issues. Retirement of the $40 mm. issue which was due in New York on January 1st, 1939, and which was refunded in November 1938, is, for the purposes of this table, taken as having occured in 1938.

(2) Includes guaranteed issues other than those of the C. N. R., which are covered in the previous heading.

(3) Available information concerning retirements by municipalities and religious institutions was not sufficiently comprehensive to justify including such classifications of bonds in this table.

† Only or optionally.

BANK OF
STATEMENT OF ASSETS
as at 31st

LIABILITIES

Capital:		
Authorized, 100,000 shares par value $50.00 each	$ 5,000,000.00	
Issued and Paid Up		$ 5,000,000.00
Rest Fund		1,903,514.79
Notes in Circulation		175,259,572.56
Deposits:		
Dominion Government . . .	17,783,300.40	
Chartered Banks	200,645,826.03	
Other	3,086,372.51	221,515,498.94
Dividend Declared:		
Payable 3rd January, 1939 . .		85,000.00
Other Liabilities		1,172,015.79
		$404,935,602.08

AUDITORS' REPORT

We have examined the above Statement of Assets and Liabilities of the Bank of Canada as at 31st December, 1938, 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 received all the information and explanations we have required.

GORDON W. SCOTT, C.A.,
of the firm P. S. Ross & Sons

MAURICE SAMSON, C.A.,
of the firm Samson, Knight & Co.
Auditors.

OTTAWA, 31st January, 1939.

CANADA

AND LIABILITIES

December, 1938

ASSETS

RESERVE—at market value:		
Gold Coin and Bullion . . .	$185,912,016.63	
Sterling and U.S.A. Dollars .	28,354,420.52	
Other Currencies of countries on a gold standard . . .	2,004.92	$214,268,442.07
SUBSIDIARY COIN		220,151.92
INVESTMENTS—at not exceeding market values:		
Dominion and Provincial Government short term Securities	144,620,866.07	
Other Dominion and Provincial Government Securities . .	40,894,975.88	185,515,841.95
BANK PREMISES:		
Land, Buildings and Equipment —at cost less amounts written off		1,647,580.14
OTHER ASSETS		3,283,586.00
		$404,935,602.08

G. F. TOWERS,
Governor.

H. R. EXTENCE,
Chief Accountant.

PROFIT AND LOSS ACCOUNT

31st December, 1938

Profits for year ended 31st December, 1938, after making provision for Contingencies and Reserves . .		$2,033,100.97
Appropriated as follows:		
Dividend No. 7 payable 2nd July, 1938, at 4½% per annum on $10,100,000.00 for six months to 30th June, 1938	$ 226,240.00	
Dividend No. 8 payable 15th August, 1938 at 4½% per annum on $10,100,000.00 for the period from 1st July, 1938 to 15th August, 1938	56,560.00	
Dividend No. 9 payable 3rd January, 1939 at 4½% per annum on $5,000,000.00 for the period from 16th August, 1938 to 31st December, 1938	85,000.00	367,800.00
Balance		$1,665,300.97
Transferred to Rest Fund	$ 555,100.32	
For credit of Receiver General of Canada, account Consolidated Revenue Fund	1,110,200.65	$1,665,300.97

REST FUND

Balance as at 31st December, 1937 . .	$1,348,414.47
Amount transferred at 31st December, 1938, as above	555,100.32
Balance as at 31st December, 1938 . .	$1,903,514.79