BANK OF CANADA

ANNUAL REPORT TO
MINISTER OF FINANCE
AND
STATEMENT OF ACCOUNTS

FEBRUARY 10TH, 1940

BANK OF CANADA

INCORPORATED UNDER THE BANK OF CANADA ACT, 1934

HEAD OFFICE—OTTAWA

BOARD OF DIRECTORS

G. F. TOWERS
Governor

D. GORDON
Deputy Governor

J. L. HOLMAN	SUMMERSIDE, P.E.I.
A. STEWART McNICHOLS	MONTREAL, QUE.
R. MCQUEEN	WINNIPEG, MAN.
F. MAGEE	PORT ELGIN, N.B.
A. C. PICARD	QUEBEC, QUE.
R. A. WRIGHT	DRINKWATER, SASK.
W. D. BLACK *Member of the Executive Committee*	HAMILTON, ONT.
LT. COL. C. BROWN	LONDON, ONT.
G. G. COOTE	NANTON, ALTA.
W. K. MCKEAN	HALIFAX, N.S.

Ex Officio Member of the Board

W. C. CLARK — OTTAWA, ONT.
Deputy Minister of Finance

OFFICERS

G. F. TOWERS
Governor

D. GORDON
Deputy Governor

L. P. SAINT-AMOUR
Assistant Deputy Governor

K. A. HENDERSON
Securities Advisor

SECRETARY'S DEPARTMENT

D. G. MARBLE
Secretary

L. P. J. ROY
Deputy Secretary

FOREIGN EXCHANGE DIVISION

S. TURK
Chief

W. A. CAMERON
Deputy Chief

CURRENCY DIVISION

C. E. CAMPBELL
Chief

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

J. W. GRANT
Toronto Representative

C. DE V. WELSFORD
Montreal Representative

AUDIT DEPARTMENT

E. FRICKER
Auditor

AGENCIES

CALGARY, ALTA.	J. PARRY	AGENT
CHARLOTTETOWN, P.E.I.	D. A. MACKINNON	"
HALIFAX, N.S.	S. A. STADEN	"
MONTREAL, QUE.	J. H. C. DESMARAIS	"
OTTAWA, ONT.	S. J. PERKINS	"
REGINA, SASK.	G. A. IVEY	"
SAINT JOHN, N.B.	E. H. CAMERON	"
TORONTO, ONT.	K. FREDERICKSON	"
VANCOUVER, B.C.	W. WINSBY	"
WINNIPEG, MAN.	W. MORTON	"

BANK OF CANADA

Ottawa, February 10th, 1940.

Col. the Hon. J. L. Ralston,
Minister of Finance,
Ottawa.

Dear Sir,

In accordance with the provisions of the Bank of Canada Act Amendment Act, I am enclosing herewith in duplicate a statement of the Bank's accounts for the fiscal year 1939, signed by the Governor and Chief Accountant, and certified by the Auditors in the form prescribed by the by-laws of the Bank.

Before proceeding with the report which must accompany this statement, I wish to refer to the loss suffered by the Bank in the death of Mr. Thomas Bradshaw, which took place on November 10th. Mr. Bradshaw had been a member of our Executive Committee since the Bank commenced operations in 1935. Thus we had the benefit of his advice for nearly five years, including the all-important period when the organization was being developed. On behalf of the Board of Directors, I would like to pay tribute to the great value of the services rendered to the Bank by Mr. Bradshaw. In spite of the many claims on his time, he did not spare himself in carrying out his duties as a member of the Board and of the Executive Committee. Perhaps I may be permitted to add, as a simple reminder of one factor involved in this task, that during his term of office Mr. Bradshaw attended well over one hundred meetings of the Board and the Executive Committee, every one of which necessitated a trip from Toronto to Ottawa.

At a meeting of the Board of Directors held on November 20th, Mr. W. D. Black was selected by the Board to act as a member of the Executive Committee. I would like to record the Board's appreciation of Mr. Black's willingness to assume this additional responsibility.

In dealing with the statement of accounts for the year 1939, I propose to show the major changes on the year in the form of a table indicating the effect of these changes on the chartered banks' cash reserves, to comment on certain of the individual items, and then to refer to the reasons underlying the policy which has been followed.

	Changes producing a decrease in chartered banks' cash	Changes producing an increase in chartered banks' cash
	(Millions of dollars)	
Increase in Gold Coin and Bullion		39.8
Increase in Sterling and U. S .A. dollars		36.0
Increase in Dominion and Provincial Government securities		46.3
Increase in active circulation	43.8	
Increase in Dominion Government balances	29.6	
Increase in Other Deposits	14.8	
Increase in Rest Fund	.5	
Other net changes	3.3	
	92.0	122.1
Deduct		92.0
Increase in chartered banks' cash reserves (Notes of and deposits with Bank of Canada)		30.1

NOTES IN CIRCULATION

Our note issue at the end of December was $232,779,000, up $57,520,000 from the previous year. Of this increase $13,736,000 was held by the chartered banks. The remainder, $43,784,000, represented larger holdings on the part of the general public. A decline of $3,696,000 in the note issues of the chartered banks offset to that extent the increase in the public's holdings of Bank of Canada notes, leaving the net increase in active note circulation $40,088,000 on the year. On the basis of daily averages, the increase was $11,600,000 or 5.7 per cent as compared with 2.6 per cent between 1937 and 1938, and 10 per cent between 1936 and 1937.

Much the largest part of the increase in active note circulation took place during the latter part of the year, when normal seasonal expansion was considerably exceeded. The large wheat crop and higher farm income undoubtedly contributed to this rise, as also would rising business activity, increasing payrolls and stimulation of retail trade during the last few months of 1939. In addition, it is probable that some of the increase was required to replace United States bills which were returned to that country because of the premium on U. S. funds.

RESERVES

Gold coin and bullion held by the Bank at the year end were valued at $225,677,000, an increase of $39,765,000. The addition of 603,431 ounces to our stock of gold accounts for $21,152,000 of this increase. The remainder is attributable to the change in the premium on U. S. dollars, since our gold stock under the Exchange Fund Act of 1935 is valued at market price in Canadian funds. The premium was

31/32 of 1 per cent on December 31st, 1938 and 10 per cent at the end of 1939.

During the last three years, we have increased our gold and foreign exchange holdings from time to time, partly because of a desire to maintain a liquid reserve appropriate to our growing note and deposit liabilities, and partly because of the prospect that we would stand in need of such additional foreign resources as could conveniently be accumulated, if war broke out. It was the latter consideration which prompted the increase in our gold holdings during the first four months of 1939. Sterling and U.S. dollar exchange holdings of the Bank as at December 30th last were $64,325,000, an increase of $35,970,000 over the preceding year.

INVESTMENTS

The remainder of the increase in our assets during 1939 was in holdings of Dominion and Provincial Government securities, which on December 30th were $231,773,000. This represented an increase of $46,257,000 for the year, of which $37,276,000 was in securities maturing in less than two years, and $8,981,000 in securities of a maturity longer than two years. On the basis of the Wednesday figures published in our weekly statement, total investments averaged only $4½ millions more in 1939 than in the year 1938.

PROFIT AND LOSS

The net profit available, after allowing for contingencies and reserves, was $1,863,725.20. Deducting dividend requirements of $225,000 on the $5,000,000 capital stock held by the Minister of Finance, leaves $1,638,725.20, as compared with $1,665,300.97 in 1938. Of this amount, in accordance with the Bank of Canada Act, $546,241.73 was

added to our Rest Fund and $1,092,483.47 was paid to the Dominion Government.

STAFF

During the summer months, we were asked to lend the services of certain of our officers to the Central Mortgage Bank, to assist in the work of organizing that institution. These officers were released—temporarily—by the Central Mortgage Bank when the crisis developed towards the end of August, and the release was confirmed in November when the Government reached a decision not to put the Central Mortgage Bank into operation at this time.

The Foreign Exchange Control Order of September 15th last named the Bank of Canada as technical advisor and agent of the Foreign Exchange Control Board. In this capacity, we have occasion to do a substantial volume of work on behalf of the Board, and we have also loaned them the services of twenty-five members of our staff. Of these, six had been engaged in foreign exchange work of a character which is now performed by the Board, seven were replaced by temporary employees, and the gap left by transfer of the remaining twelve has been filled by the contribution of extra work by others.

Since commencing operations in 1935, we have had the opportunity of developing an organization which could provide a nucleus of experienced men for work of an emergency character. Under modern conditions, whether of war or peace, it seems essential that a central bank should be able to respond to such demands.

The permanent employees of the Bank number 361, an increase of two since last year.

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

As I have indicated in the table on page 5, our transactions during the year had the effect of increasing the cash reserves of the chartered banks by $30.1 millions. During 1939, the banks' Canadian dollar deposits rose by $352 millions, and at the year-end their ratio of cash to deposits was 10.1 per cent, as compared with 10.3 per cent at the end of 1938. The increase in deposits, and the need for additional cash resources, were related to certain major developments to which I am referring below.

Most of the increase in the assets and liabilities of the banks took place during the last four months of the year, and was caused by an expansion of loans to finance the 1939 wheat crop—the second largest on record—and by the purchase of $200 millions of securities from the Dominion Government. The securities took the form of 2 per cent obligations, which mature on October 16th, 1941, but are callable by the Dominion Government on or after October 16th, 1940, on thirty days' notice.

This short term financing conformed to the programme outlined in the Budget Speech at the Emergency Session of Parliament. While it was recognized that Canada's war expenditure as a whole should be met by taxation and borrowing of savings, it was thought desirable that, in the initial stage, financing by the Dominion Government should take a form which would not in any way hamper the process of ad-

justment necessitated by war. I am referring to this subject again in the last section of my report.

SECURITY MARKETS

In my last annual report, I referred to the fact that high grade bond prices had risen appreciably in 1938. The year-end level was maintained during the first seven and a half months of 1939, in spite of disturbing events abroad, and in spite of a total volume of new bond issues which was much greater than in the same period of 1938 or 1937, and comparable with that of 1936. A considerable inflow of foreign funds during the early part of the year contributed to the firmness of the Canadian market.

The outbreak of war brought a severe decline, and despite sharp recovery in the latter part of September and October, two typical long term Dominion issues averaged 96 in December as compared with 100-7/8 in the same month a year before. Further recovery during January, following the issue of the First War Loan, left yields about one quarter of one per cent higher than they had been at the beginning of 1939.

In the United States, over the same period, there was a net reduction in long term high-grade yields of about one quarter of one per cent. In the United Kingdom there was no net change; this followed a rise in yields during 1938.

Apart from the Dominion's October Loan, the amount of new government issues in the latter part of 1939 was appreciably below recent levels. New corporate financing, however, continued to be in somewhat greater volume than in 1937 or 1938. A table summarizing net new bond issues by Canadian governments and corporations over the past four years is appended. The table shows that these issuers as a group have in that period effected a net reduction of $551 millions in the amount of their bonds outstanding which are payable solely or optionally in a foreign currency. As shown in the more detailed figures which are given in the Bank's Statistical Summary for January, 1940, the reduction in the case of bonds payable optionally in New York was $493 millions. Comparable statistics are not available for the years immediately preceding 1936; otherwise somewhat greater totals could be quoted.

The very substantial reduction in the foreign currency obligations of Canadian debtors has obviously lessened their vulnerability to exchange fluctuations. Also, in so far as it has been accompanied by a reduction in the volume of Canadian bonds actually held by non-residents, the international position of the country as a whole has been strengthened. Including municipal bonds, which are not included in the appended table, it is estimated by the Dominion Bureau of Statistics that net repatriations have totalled about $650 millions since 1932, some $400 millions of the total having occurred since 1935.

FOREIGN EXCHANGE

Despite the pressure of substantial capital movements, the sterling-U. S. dollar rate remained steady during the first part of 1939, in the neighbourhood of $4.68. Late in August, the rate fell sharply, and after exchange control was instituted in the United Kingdom early in September, the official buying and selling rates on New York established a middle rate of $4.03.

The Canadian dollar was also stable during the earlier period, the premium on U. S. dollars remaining less than one

per cent. Foreign purchases of Canadian securities continued in considerable volume, and our current account balance of payments remained strong. It is, therefore, not surprising that the Canadian dollar held at only a small discount in New York, in spite of the position of sterling.

In the last days of August, however, it dropped sharply, and by the time Canada had declared war, the premium on U. S. funds was 7½ per cent. By the end of the following week, the premium had risen to about 11 per cent, with an appreciable outflow of capital coming into evidence. On September 16th, the Dominion Government established foreign exchange control. Since that time, the premium on U. S. funds in Canada has been 10 per cent buying and 11 per cent selling. The corresponding rates on sterling have been $4.43 and $4.47.

BALANCE OF PAYMENTS

Preliminary calculations of Canada's balance of international payments in 1939, made by the Dominion Bureau of Statistics, indicate that the net surplus on current account was appreciably greater than the revised 1938 figure of $189 millions. Exports of merchandise other than gold rose by $85 millions, and net non-monetary gold exports by $25 millions. A $65 millions increase in imports left the favourable trade balance about $45 millions greater than in 1938, and our net receipts on tourist account showed little change. On the other hand it is estimated that net interest and dividend payments to non-residents were slightly higher, and that net payments on account of freight and other service items also rose.

During the first part of the year it appeared probable that an even stronger total current account position would be shown, for the whole of the net rise in imports took place in the last four months.

The small increase in net interest and dividend payments, which has been mentioned above, deserves further comment. Chiefly as a result of repatriation, net interest payments to non-residents followed the trend of recent years, and recorded a further decline. This is after allowing for the effect of the premium on U. S. funds in the latter part of the year, as all items in the balance of payments are expressed in terms of Canadian dollars. The increase in net dividend payments to non-residents which has taken place since the depth of the depression has, of course, been closely associated with, and in its effect upon the balance of payments offset by, expanding mineral exports.

GENERAL

Last spring, I was present at the meetings of the Banking and Commerce Committee of the House of Commons, when certain aspects of monetary and fiscal policy were discussed at length. By order of the Committee, certain memoranda and tables which were presented in this connection have been published in the form of a booklet.

At that time, discussion centered upon the problems of depression, and I had occasion to emphasize the special limitations which are imposed upon monetary policy in Canada by the character of the Canadian economy. More than one-third of the total real income of Canadians in terms of goods and services is earned directly from sales to other countries. In the absence of structural changes, which lessen our dependence on export trade, it is clear that no amount of internal monetary stimulus can fully offset the effect upon Canada

of a low level of foreign demand for Canadian goods and services.

War, on the other hand, gives rise to such a demand for goods and services of certain types, that monetary action to stimulate production becomes unnecessary. It is true that, in the initial period of shock and transition, credit expansion may help to prevent liquidation which is not required by underlying conditions, and may ease the process of adjustment to the new situation. This was the case in the latter part of 1939. But, as was pointed out in the Budget Speech of last September, credit expansion should be confined to this initial phase.

If production for war purposes is expanded in any given period by more than the amount by which production of all kinds can be physically increased, then it must encroach upon the volume of goods and services which can be made available for other purposes. To the extent that Government expenditure is not financed by taxes or loans which correspondingly reduce private expenditure, it is necessarily financed by an increase in the effective money supply. Beyond a certain point, this latter method curtails real private expenditure in terms of goods and services just as surely as if private spending had been reduced directly by tax or loan. It does so by means of an inflationary rise in prices.

Recollecting the effect of developments of this character during and after the war of 1914-18, various countries have expressed the intention of doing everything possible to avoid a repetition of inflation during the present struggle. The success of such an effort in any country where it is made will, no doubt, largely depend upon the degree of public understanding and acceptance of the fact that the direct form of sacrifice is more equitable, and in the long run less costly, than any other method of dealing with the financial problems of a war.

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:			TOTAL (3)	PAYABLE:	
	Dominion and C.N.R. (1)	Provinces (2)	Private Corporations		In Canada Only	Abroad (4)
1936	86	39	52	177	371	194
1937	11	58	10	59	187	128
1938	70	49	11	108	179	71
1939	177	81	15	273	431	158

* Treasury Bills are excluded. In the case of the Dominion, corresponding figures for Treasury Bills would be net issues of 57, 0, 5, and 0 in 1936, 1937, 1938, and 1939, 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 occurred 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.

(4) Only or optionally.

BANK OF CANADA

STATEMENT OF ASSETS AND LIABILITIES

as at 30th December, 1939

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		2,449,756.52
NOTES IN CIRCULATION		232,779,327.47
DEPOSITS:		
Dominion Government . . .	47,362,964.19	
Chartered Banks	216,996,200.45	
Other	17,851,577.90	282,210,742.54
DIVIDEND DECLARED:		
Payable 2nd January, 1940 . .		112,500.00
OTHER LIABILITIES		4,678,505.39
		$527,230,831.92

AUDITORS' REPORT

We have examined the above Statement of Assets and Liabilities of the Bank of Canada as at 30th December, 1939, 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.

E. J. HOWSON, F.C.A.,
of the firm Thorne, Mulholland,
Howson & McPherson.

JEAN VALIQUETTE, C.A.,
of the firm Anderson & Valiquette.
Auditors.

Ottawa, 31st January, 1940.

ASSETS

RESERVE—at market value:		
Gold Coin and Bullion . . .	$225,677,320.37	
Sterling and U.S.A. Dollars .	64,324,717.55	
Other Currencies of countries on a gold standard . . .	46.89	$290,002,084.81
SUBSIDIARY COIN		90,272.81
INVESTMENTS—at not exceeding market values:		
Dominion and Provincial Government short term Securities	181,896,819.41	
Other Dominion and Provincial Government Securities . .	49,875,738.20	231,772,557.61
BANK PREMISES:		
Land, Buildings and Equipment —at cost less amounts written off		1,635,158.62
OTHER ASSETS		3,730,758.07
		$527,230,831.92

G. F. TOWERS,
Governor,

E. METCALFE,
Acting Chief Accountant.

PROFIT AND LOSS ACCOUNT

30th December, 1939

Profits for year ended 30th December, 1939, after making provision for Contingencies and Reserves . .		$1,863,725.20
Appropriated as follows:		
Dividend No. 10 payable 2nd July, 1939, at 4½% per annum on $5,000,000.00 for six months to 30th June, 1939	$ 112,500.00	
Dividend No. 11 payable 2nd January, 1940 at 4½% per annum on $5,000,000.00 for six months to 31st December, 1939 . . .	112,500.00	225,000.00
Balance		$1,638,725.20
Transferred to Rest Fund	$ 546,241.73	
For credit of Receiver General of Canada, account Consolidated Revenue Fund	1,092,483.47	$1,638,725.20

REST FUND

Balance as at 31st December, 1938 . .	$1,903,514.79
Amount transferred at 30th December, 1939, as above	546,241.73
Balance as at 30th December, 1939 . .	$2,449,756.52

BANK OF CANADA

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FEBRUARY 11TH, 1941