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THE POLICY SIGNIFICANCE OF THE FOUNDING OF THE BANK OF CANADA

by

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Introduction

The point to be made is that the Bank of Canada was established as an 'instrument' to achieve a 'target'. The 'target' was 'internal and external price stability'.

In this initial statement, the terms 'instrument' and 'target' are taken from the technical language of current central banking theorists, and are intended to have the meaning ascribed to them there. The phrase, 'practical monetary policy leading to the founding of the Bank of Canada', which is the phrase used in the bulk of the following discussion, is intended to convey the same general ideas.

The 'target', that is, the practical policy, was not simply price stability, but 'internal and external price stability'. The point that comes out of the citations that are to follow is that the Bank of Canada was intended to achieve, in the environment of the 1930s, what the Gold Standard and the Real Bills Mechanism, properly functioning, were supposed to have achieved in the environment that prevailed up to the First World War. That is to say, the citations point to the conclusion that, because Canada was an extremely open economy, a nineteenth century, laissez-faire, international trade oriented approach to monetary policy was favoured over the interventionist, domestic output and employment approach of mid-twentieth century general equilibrium theory.

Question and Presumed Answer

The question is, What was the practical monetary policy leading to the founding of the Bank of Canada in 1935?

'Practical', here, designates the immediate motivation of those who
accomplished the act: not what their motivation should have been on
the basis of some monetary theory which they may have had in mind,
or what it might have been in the light of some theory towards which
they may have been groping, but what it was in view of whatever
immediate, practical exigency was to be met.

The question rises in the context of an attempt to discern, through
their consequences in monetary policies and institutions, long-run fac-
tors in Canadian economic development. So, the underlying, substan-
tive questions are, (1) If there has been one at all, what has been the
characteristic Canadian position with respect to monetary policy, and
(2) what has been its consequence in the institutionalization of the
monetary aspect of the Canadian economy? These questions are to
be answered here in the single case of practical policy underlying the
founding of the Bank of Canada in 1935.

The expected answer is that the characteristic Canadian position
has been that of the Banking School, with respect to domestic policy,
and that of the Gold Standard, with respect to external policy. What
this indicates is that, over the long-run, the Canadian government
has attempted, permitted or encouraged control of the volume of the
domestic means of payment to keep it in line with the volume of
viable enterprise within the economy, and to keep the exchange rate
stable. The two are consistent, and, indeed, complementary. Both are
reactive and accommodating, rather than initiating and directive. Both
reflect the openness of the Canadian economy. Given the open nature
of the Canadian economy over its entire history, a stable exchange
rate has been necessary for internal stability, and stable domestic
prices have been necessary for a stable exchange rate. That is to say,
given the need to maintain a manageable relationship with external
commodity and capital markets, purely domestic monetary goals have
been secondary and derivative. The hypothesis is, then, that the
practical policy embodied in the founding of the Bank of Canada was
exchange rate and internal price stability, the latter assuming price
stability in Canada's major external markets.

Grounds for the Answer Presumed

The presumed answer, that the characteristic Canadian position
has been that of the Banking School and of the Gold Standard, inso-
far as it is presumed for the nineteenth and early twentieth centuries,
finds grounds in Adam Shortt's History of Canadian Currency and
Banking: 1600-1880. Shortt's history concludes in the nineteenth
century, but it was written with the conditions of the first two decades
of the twentieth century in view. For the second half of the twentieth century the presumed answer is grounded in the complaints of Keynesians and Monetarists that their positions were not the positions taken in Canadian policy as it issued from the central bank. In this later period it is not the theories held by the complainants that is of importance, so much as their allegations with respect to the policy they say was actually, though, in their view, erroneously, followed.

Adam Shortt did not claim that the Banking School position and the Gold Standard automatic mechanism (the Real Bills Doctrine and exchange rate stability) were the full blown stuff of Canadian monetary policy from 1820 until 1914. Rather, his is an account of the eventual triumph of these positions over what he considered to be an incorrect and damaging, even immoral, incursion of United States, ‘populist’, paper money inflationism. His point was, precisely, that, through a kind of Darwinian, evolutionary process, long-run factors in the development of the Canadian economy gradually forged a characteristic position.

Owing to the character of the experiences which gave it shape, the Canadian system has been distinguished for remarkable economy in operation, and for an unusual capacity for adjustment in the expansion and contraction of the issues of the banks, and in meeting the varying needs of the older and newer parts of the country (p. 726.).

With respect to the possibility of using an issue of paper money to generate prosperity when the needed markets and sources of supply were external, and the additional currency would lose value through a concomitant decline in the exchange rate, Shortt stated that

The conception was as happy as that of putting in an extra pump to prevent a well from going dry (p. 376.).

With respect to variability of the volume of the means of payment, stability of the exchange rate, and the process of accommodating the long run characteristics of the economy, He recounted that,

The banks, more as the result of their everyday experience than as the outcome of a thorough understanding of the situation, followed the fluctuations of trade and exchange with a close eye, and by a rapid curtailment of their discounts, amounting sometimes almost to a suspension of accommodation, endeavored to protect themselves in times of stringency (p. 407.).

The point is, of course, not that Shortt was correct in all of this,
but that this is the position of the outstanding authority on monetary policy and institutions in nineteenth and early twentieth century Canada. Whether he was correct has to be shown, but that he was correct is the presumption upon which the answer to the question asked here is hypothesized.

The best of post-Second World War evidence, with respect to the presumed answer, is to be found in the work of H.S. Gordon. Gordon took a clear cut, 1960s, Keynesian position with respect to internal and external monetary policy, but, and more to the point here, he documented in some detail what non-Keynesian considerations led the Bank of Canada into specific non-Keynesian policies during the high period of the Keynesian paradigm in Canada. With respect to Keynesian economics in general he said,

Three decades have gone since Keynes' General Theory of Employment, Interest, and Money was first published, and two since our own White Paper on policy; and it must be confessed that Keynesian economics has made virtually no impact on the Canadian public mind or on the business community (1965, p. 46.).

Instead, policy focused on two things,

the structural characteristics of the unemployment problem, and the dominating significance of the international sector of the economy (1965, p. 40.).

With respect to monetary policy in particular, he alleged that the Bank of Canada considered that,

. . . not only is price stability one of the major economic objectives of a modern state but that it must be recognized as the paramount objective (1961, p. 38.). . . he [the Governor of the Bank of Canada] has placed most of his emphasis on the large amount of the deficit in Canada's balance of payments (1961, p. 42.).

These brief citations are not intended to show that it was the Bank of Canada's policy to maintain internal and external price stability. The point is that it is a justifiable assumption that, even in the high period of Keynesian monetary theory, long-run factors associated with the continuing open character of the economy, moved policy in the direction accommodated by Banking School theory and the Gold Standard at an earlier date.

In the following period, after 1970, when Monetarist critics charged the Bank of Canada with too much creation of money and with re-
sponsibility for the resulting high rate of inflation, it would seem that the forces impinging on the Canadian economy had changed, and that internal price stability was no longer a goal. It is true that internal price stability was no longer a goal, in a certain sense, but the force of external markets had not diminished. Price stability had to be maintained in relation to prices in the United States. With that major external market inflating, exchange rate stability became associated with controlled, parallel inflation in domestic markets. Thomas Courchene, the outstanding Monetarist critic, described the situation.

The point of all this is simply that the dollar 'overhang' probably put considerable downward pressure on the U.S. dollar after the world moved towards flexible rates. In order to avoid the expected appreciation relative to the U.S. dollar, the Canadian authorities had to chart monetary policy in a manner that was considerably more expansionary than that followed in the United States (1976, p. 214.) . . . no country was more reluctant than Canada to face exchange rate appreciation (1976, p. 229.).

These sparse citations from Shortt, Gordon and Courchene, I repeat, are not intended to prove that internal and external price stability always have been the explicit policies of Canadian monetary authorities, even though other opinion could be cited to support the contention that that has been the case (Shearer, 1977, p. 41.). The point is, simply, that there are fair grounds for accepting as a viable hypothesis the proposition that long-run factors in Canadian economic development, factors related to the openness of the economy, have fairly consistently pushed monetary authorities in that direction.

Grounds for Presumption: the Inter-Bellum Period

It is one thing to assert the possibility that over the long-run, and in general, a certain hypothesis is a reasonable subject for testing. It is another to state that, in a particular, relatively short period the possibility is to be respected. The 1919–1938, inter-bellum period cannot be described as one of quiet, normal development, for the world economy, for the Canadian economy, or for the structure of monetary institutions in Canada. So, a further question must be answered. Is the presumption that Canadian monetary authorities were driven by circumstances into a policy of internal and external price stability (what in the early inter-bellum period would have been encompassed by the Real Bills Doctrine and the Gold Standard System) a reasonable presumption for the years from 1919 to 1938?

To establish the reasonableness of the presumption evidence can be
taken from works devoted to the period; indeed, from works devoted to the founding of the Bank of Canada during the period, by Stokes, Plumptre, Neufeld and Watts. They can be considered in that order, which is the chronological order of their appearance.

Stokes is clear about his perception of monetary policy in Canada prior to the First World War.

In the pre-war period the only monetary objective thought of in Canada was the maintenance of the exchanges. (p. 8.). . . .Adherents of the banking principle rather than the currency principle, Canadian bankers disclaimed any control or degree of management over the volume of credit. . . .They placed an exaggerated and unwarranted emphasis on the automatic action of the gold standard in regulating the volume of currency (p. 10.).

Stokes is also clear about the difficulties facing the proponents of internal and external price stability after the First World War. The world had abandoned the Gold Standard during the war, and so had Canada. The Finance Act of 1914 allowed the government to advance funds without gold backing. This Act was continued by legislation in 1923, thereby continuing subvention of the Gold Standard System. But this was only one of the disturbing elements. A movement of monetary radicalism, with strong roots in western Canada, clamoured for the ‘equalization’ of wheat prices, some degree of inflation, and for a central bank similar to the Federal Reserve Board in the United States (Stokes, pp. 44–57.).

Both sides, according to Stokes, those favouring price stability and those favouring inflation, could see a solution to their liking in the establishment of a central bank. E.L. Pease, one time President of the Royal Bank of Canada, suggested that a central bank would eliminate government interference in banking, along with consequent inflation and distortions in the allocation of capital (Stokes, p. 31.). A resolution passed by the World Economic Conference in 1933 stated,

...in order to provide for an international gold standard with the necessary mechanism for working that independent central banks...should be created... (Stokes, p. 71.).

W.C. Clark of Queen’s University, while quite opposed to the goals of the monetary radicals in Parliament, ‘furnished a good deal of the inspiration for the western Members... who a few years later began advocating a central bank for credit control’ (Stokes, p. 34.).

Stokes noted that the political opportunity was not lost on the
leaders of either of the two major parties.

A farmer-labour party of the extremely radical variety, the Co-operative Commonwealth Federation, had developed considerable strength in the West and was spreading rapidly as far eastward as Ontario. It threatened for a time to hold the balance of power between the two old parties, and even to come into power itself. The views of this party, consequently, carried considerable weight. This party, like its friends in the United States, advocated the "socialization of credit". It criticized severely what it called the "money power". In Canada the emotional appeal was strong, for there had been in fact a concentration of commercial banking power in fewer and fewer banks (Stokes, p. 62-63.).

The impulse that moved the two older parties to change their views relative to the establishment of a central bank of Canada was probably twofold: a gradually formed conviction that such an institution would be desirable, and a desire to meet public opinion (Stokes, p. 63.).

Mr. King inferred that the recent conversion of Mr. Bennett was founded on political expediency. This would seem to be true. The same thing could be said with equal truth about Mr. King and most of the Liberals. The establishment of a central bank would effectively spike the guns of the third party (Stokes, p. 66.).

What is evident in Stokes's account is not so much that the Canadian government was under pressure to maintain the external and internal value of the Canadian dollar, because, clearly, in Stokes's account there were also pressures for devaluation and inflation; but that, if the goal was external and internal stabilization, a central bank was perceived as a means to that end. It was a means to that end with the great advantage that it could be put in place without a clear statement condemning the opposing policy. After reading Stokes, one can state, at the very least, that there was no incompatibility between a central bank and a policy of internal and external monetary stability.

Plumptre attempted to place the formation of the Bank of Canada in an Imperial, if not a generally international context. He added to the possibility that a central bank could serve either inflationists or 'sound money' advocates, the possibility that it could serve either nationalists or Imperialists.

Central banking was attractive to political leaders, and particularly to the fairly conservative leaders who were in all the Dominions responsible for its introduction. For this there were several reasons. A glance
abroad showed that it was what was being done in other new countries (which were, of course, getting foreign advice from the same sources as the Dominions). Moreover, and this paradox was most important, accepted central banking supplied a departure from the status quo enshrined in a form of orthodoxy. If the time for monetary intervention was ripe, here was an innovation which might steal the thunder of radical reformers but which might also, in the name of the Bank of England, rally the forces of conservatism and imperialism. A central bank of accepted form could, so the experts said, exercise a regulatory influence over currency, credit, and the foreign exchange rate; but an institution of the English model could surely be relied upon not to engage in rash experiments, not to plunge the country into the débâcle of the French assignats or the German Mark (Plumptre, p. 162.).

Popular demand was for a general measure of monetary control without any clear conception of the form it should take. The specific form of central banking was recommended by economists, by civil servants and probably most important, by English authorities. Appreciating the political advantages attaching to its introduction, political leaders took it up . . . (Plumptre, p. 162.).

Without clearly specifying that internal and external price stability was traditional policy in Canada, Plumptre is quite clear in his assertion that it was ‘conservative’ forces that controlled the formation of the Bank of Canada. That, however, is not yet the point here. The point is simply that the founding of the Bank of Canada was not inconsistent with a policy of internal and external price stability, and that it is reasonable to assume that that policy was the practical policy of those responsible for founding the bank.

Neufeld’s account of the early years of the Bank of Canada is of an entirely different order. Written some twenty years after the fact, when the full implications of Keynesianism finally broke upon the minds of Canadian economists (Brecher, p. 108.), Neufeld’s account attempts to make the case that the Bank of Canada was groping toward full Keynesian monetary policies in the period immediately after its founding. It has to work hard to make the case, however, and, in the process, supplies evidence that a contrary hypothesis would not be unreasonable. Citing the Governor in 1939, Neufeld gives the reasons for the Bank’s wariness with respect Keynesian monetary policies.

Canadian interest rates cannot break through the floor set by American rates, so that monetary expansion will lead finally to the export