2004

Private Banknotes in Canada From 1867 (and Before) to 1950

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This article outlines the legal and historical experience of the rise and fall of privately issued paper money in Canada against the backdrop of the development of paper currency in Europe, and it reviews the reasons why the right to issue currency was ultimately transferred from private banks to the Bank of Canada. The article opens with a discussion of the monetary regime that developed in Europe and was imported into Canada well before Confederation. The value of medieval coins was based on the value of the precious metals in them, and fluctuations in the price of those metals led to a chronic shortage of small-denomination coins. Expanding commerce required a reliable money supply, and that need was gradually met by private notes issued by goldsmiths and banks. In pre-Confederation Canada, problems with the supply of money also led to the issuing of private notes, first by merchants and then by newly established banks. From Confederation to the 1930s, federal banking and finance legislation tried to come to grips with the need for a secure currency and for the expansion of credit, but with only limited success. The financial system's failure to respond adequately to the challenges of the Depression led to the establishment of the Bank of Canada in 1935, over the objections of many private bankers. The legislation that set up the Bank of Canada provided for the gradual phasing out of private banknotes and their replacement by notes issued by the Bank of Canada. The events that led to the move away from privately issued currency, and to the advent of a central bank, played an important role in helping to shape the economy of the young country. A review of the historical record casts doubt on the views of economists who have argued for a return to a system of privately issued currency, and it can provide guidance to those responsible for formulating policies to meet our currency needs in the future.

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* Ph.D. Candidate, Osgoode Hall Law School, York University. I would like to express my tremendous gratitude to Professor Benjamin Geva for all of his valuable insights and suggestions. I would also like to thank Professor Balfour Halevy, Craig M. Wilson, Soren D. Frederiksen, David Yarrow, and Alberto Salazar for their thought-provoking questions and comments.

Introduction

Canadians today take for granted the fact that this country's official currency is the dollar, as manifested in the familiar banknotes of the Bank of Canada—our central bank. Yet not so long ago, Canada's monetary system was based on banknotes issued by the chartered banks. Each chartered bank issued notes that could be redeemed for coins or precious metal in various centres across the country. From 1867 to 1950, these notes competed with each other and complemented the officially issued governmental currency, the Dominion Note.

Periodically, one finds proposals for the elimination of the governmental monopoly over currency issuance, in the hope that the monetary system might be restored to what it was before that monopoly came about. The most famous of those proposals, perhaps, was that of the Austrian economist Friedrich Hayek in his 1976 book, *Denationalisation of Money*.[1] Hayek argued that the economic system would be much more efficient, and the political system less totalitarian, if currencies were to be supplied by the private sector rather than by government.[2] Historical experience suggests that such theories bring with them an element of risk. I have commented elsewhere on the

1. Friedrich A. Hayek, *Denationalisation of Money: An Analysis of the Theory and Practice of Concurrent Currencies* (Lancing, U.K.: Institute of Economic Affairs, 1976).
2. *Ibid.*

wisdom of similar theories with respect to Internet currencies, which in many ways are similar to private banknotes.[3] The purpose of this paper is to examine the historical record on the Canadian experience with private banknotes, and the circumstances surrounding the abandonment of that experience.

Part One of this paper will discuss the operation of the monetary system as a function of the gold standard and the standard formula. Part Two will focus on the operations of the money supply mechanism from Confederation to the establishment of the Bank of Canada, when the issuing of private notes reached its zenith. Part Three will discuss events surrounding the Bank's establishment, and Part Four will describe the impact of the nationalization of the money supply mechanism on subsequent events.

I. The Money Supply as a Function of the Standard Formula and the Gold Standard

During the medieval era, states and individuals throughout Europe believed in a system of full-bodied coinage.[4] Under that system, the denominations of coins were based on their intrinsic value, which would fluctuate with the value of the metal from which they were minted and also with the exchange rate between different denominations. While today the value of a quarter is fixed relative to the value of a nickel despite the present valuation of the dollar, under a full-bodied coinage system the purchasing power of a coin would vary vis-à-vis that of other denominations as well. For instance, under the present system, a quarter is the equivalent of five nickels, but under a full-bodied coinage system, it could be worth six nickels if its purchasing power were to increase or if the purchasing power of the nickel were to decrease. One of the perceived benefits of a full-bodied coinage system was that price levels could be anchored to the value of precious metals.

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3. Muharem Kianieff, "Show Me the Money! A Critical Evaluation of Laissez-Faire Internet Currencies" (2002) 17 B.F.L.R. 215.

4. Thomas J. Sargent & François R. Velde, *The Big Problem of Small Change* (Princeton: Princeton University Press, 2002) at 5.

The medieval solution to providing a workable medium of exchange was to emphasize the role of money as a standard of value and as a metallic store of value. Money was both a means of facilitating transactions and a means of investment. The supply of coins of each denomination would be determined by private citizens, who would use precious metals to purchase coins from the mints at prices set by government.[5] Government would not mandate the quantity of each denomination that was to be minted. On the contrary, individuals could bring or purchase specie (in the form of bullion, or old or worn coins) to or at a mint and have it coined in whatever denomination they wished. In doing so, they would have to think carefully of the rate of return to be derived from minting a particular denomination of a coin.

Mints were private operations which, in exchange for *brassage*[6] and *seigniorage*[7] fees, stood ready to mint coins that were demanded by the public. The propensity to mint a particular coin was determined by the general price level and the value of a precious metal. Thus, when the price level was low with respect to a particular denomination of a coin, the officially declared value of the coin (and hence its rate of return) would be high enough that people would bring metal to the mints to be coined. Analogously, the mint price (that is, the cost of the metal plus the mint fees) would be low for an individual, so it would be profitable to have a coin minted. Conversely, a high price level would diminish the mint price of a coin, so it would bring a higher rate of return as bullion or as some other denomination. Individuals would thus decrease their holdings of coins in a manner that minimized transaction costs. The end result was that individuals melted, exported or hoarded coins as the cheapest way of obtaining the metal.[8]

The system ultimately proved to be problematic, since it suffered from persistent shortages of smaller denominations throughout most of

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5. *Ibid.*

6. Sargent and Velde define *brassage* as a "[f]ee charged by the mint operator to cover production costs (excluding the price of metal)." *Ibid.* at 375.

7. Sargent and Velde define *seigniorage* as a "[f]ee charged on the coining of money to cover production costs and to provide revenue to the King. Also, profit earned by the monetary authority from the issue of currency." *Ibid.* at 376.

8. Leland B. Yeager, Book Review of *The Big Problem of Small Change* [*supra* note 4], (2002) 22 Cato J. 188 at 189.

Europe. People would only wish to convert metal into coins if it was profitable for them to do so.[9] This in turn was a function of the price level, which was determined by the aggregate stock of currency and not just that of small denominations.[10] As stocks of precious metals gradually grew through increased mining activity, so would the price level. The increase in the stocks of metal did not affect the mint price of small coins in such a way as to make it profitable to mint them. In other words, their scarcity still did not result in a rate that made it advantageous for individuals to mint them in small denominations.[11] As a result, the relative purchasing power of small coins would result in their depreciation vis-à-vis larger coins (and hence in their rate of return as well). Small coins would thus become more valuable as metal than as coins, and they would eventually be melted, which of course made the situation even worse.[12] The initial solution of the medieval monetary authorities was to debase[13] smaller coins in an effort to reverse this trend, albeit temporarily. Over time, as prices continued to rise, an increasing number of smaller denominations would be hoarded and would eventually fall into disuse.

The economist Carlo Cipolla described this phenomenon, which persisted from 1300 to 1850, as "the big problem of the petty coins,"[14] or in Sargent and Velde's words, "the big problem of small change." The solution to it emerged in the form of what Cipolla termed the "standard formula,"[15] which worked as follows. Small change was issued on government account, with small coins having a commodity value lower than their monetary value. Thus, unlike full-bodied coinage, those coins were intrinsically of a token nature. The quantity of small coins in

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9. Sargent & Velde, *supra* note 4 at 10.

10. *Ibid.*

11. *Ibid.*

12. *Ibid.*

13. Sargent and Velde define debasement as a "lowering of the intrinsic content of a coin or currency." *Ibid.* at 375.

14. Carlo M. Cipolla, *Money, Prices and Civilization in the Mediterranean World: Fifth to Seventeenth Century* (New York: Gordian Press, 1956).

15. This formula found its first formal expression in a memorandum from Sir Henry Sligsby, Master of the London Mint, to King Charles II in 1661. Sargent & Velde, *supra* note 4 at 13.

circulation was limited, and they were kept convertible with one another at fixed rates with the definitive money (which was to be full-bodied gold coins that would emerge under the gold standard discussed below).[16] To use a current example, one can be confident that although a quarter is of little intrinsic value, it will remain freely exchangeable for two dimes and a nickel regardless of the value of the dollar. Thus while full-bodiedness was eliminated for all purposes with respect to small change, prices were still anchored to commodities while the gold standard was in operation.

A. Banks of Deposit, Goldsmiths and Banks of Circulation

Before we examine the implementation of the standard formula, it may be helpful to pause and examine some of the other attempts to address the "big problem of small change." Such solutions manifested themselves in the development of institutions that were the precursors to the modern banking system. In the twelfth century, the City of Venice founded its first "bank of deposit,"[17] a bank whose sole task was to accept the gold and silver deposited with it for safekeeping, subject to a fee.[18] The Bank of Venice attained such credibility in the eyes of its customers that many of the local merchants began to settle their mutual claims through transfers on its books.[19] Its operations eventually came to encompass accepting deposits and effecting payment of bills of exchange and contracts between individuals.[20] A remarkable facet of the Bank of Venice was that although it was an institution without capital, its bank credits commanded a premium in current money.[21] It continued in existence until 1797, when invading French armies overthrew the

16. Cipolla, *supra* note 14 at 27.
17. George Tucker, *The Theory of Money and Banks Investigated* (New York: A.M. Kelley, 1964) at 145. The text was first published in 1839.
18. *Ibid.*
19. *Ibid.* at 146.
20. *Ibid.*
21. *Ibid.*

government, extinguished the debt of the state and annihilated the bank.[22]

After Holland's independence, Dutch merchants founded a similar bank in Amsterdam in 1609 for commercial purposes.[23] Like the Bank of Venice, it was a bank of deposit. The problem of small change had frustrated the attempts of local merchants to pay bills of exchange drawn on them in good coin, so the value of those bills was depreciated in the market.[24] The Amsterdam bank operated under the guarantee of the city, as was also the case in Venice. The bank would receive light and worn coins then in circulation, and would give a credit on the bank's books at or near their intrinsic value (approximately 95 percent of their current value).[25]

This meant that the bank would absorb the risk in settling transactions in underweight or clipped coins.[26] Citizens could now settle transactions between them by going to the bank together, presenting a deposit receipt (or *recepipe*, as they were called), and ordering the bank to transfer an amount from the debtor's to the creditor's account. Amounts paid in this way were said to have been paid in "bank money."[27] Depositors were authorized to make withdrawals within six months for the amount of the coins deposited, if they had transferred to the bank as much bank money as the depositor had received and if they paid the costs for the keeping of specie.[28] The rates charged were one fourth of one percent for silver and one half of one percent for gold. This provided an incentive for individuals not to convert their bank credits back into coin, and the end result was that all of the money deposited became the property of the bank.[29]

Eventually, the Amsterdam bank extended its deposit-taking activities to include accepting deposits of bullion.[30] Over time, receipts for these

22. *Ibid.*
23. *Ibid.*
24. *Ibid.* at 147.
25. *Ibid.*
26. William A. Scott, *Money and Banking*, 4th ed. (New York: Henry Holt, 1910) at 106.
27. Tucker, *supra* note 17 at 148.
28. *Ibid.*
29. *Ibid.*
30. *Ibid.* at 149.

deposits began to circulate as money, becoming a *de facto* paper currency that could shield merchants from the risks of coins. Much of the success of the bank has been attributed to the high levels of public confidence that it inspired, because of the fact that all deposits were backed by one hundred percent reserves of coins and bullion. By the 1790's, however, the public's confidence was shaken when the bank's directors admitted to lending the Dutch East India Company funds that it would not repay.[31] The bank's operations were thus curtailed, and in 1814 a bank of circulation replaced it.[32]

In seventeenth century England, paper money became prominent because it allowed debtors to avoid the physical delivery of coins to creditors.[33] Goldsmiths are said to have pioneered paper money. They would issue receipts in favour of a payee or bearer for funds deposited with them.[34] These receipts, known as goldsmiths' or bankers' notes, were the precursor to the promissory note.[35] Depositors were also permitted to draw upon the goldsmith amounts up to the total amount of the deposit.[36] Drafts of this sort, which were payable on demand and made out to a payee or bearer, were the first cheques.[37] As Benjamin Geva has observed, they came to serve as money themselves, with their acceptability being based upon the credit of the issuer, irrespective of the form of the instrument.[38] The development of goldsmiths' notes may have served as the impetus for banks to attempt to provide another solution to the problem of small change.

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31. *Ibid.* at 154.
32. *Ibid.* at 155.
33. Benjamin Geva, "From Commodity to Currency in Ancient History—On Commerce, Tyranny, and the Modern Law of Money" (1987) 25 Osgoode Hall L.J. 115 at 146.
34. Richard David Richards, *The Early History of Banking in England* (New York: A.M. Kelley, 1965) at 40-43. The text was first published in 1929
35. James Milnes Holden, *The History of Negotiable Instruments in English Law* (London: Athlone Press, 1955) at 70.
36. Geva, *supra* note 33 at 146.
37. Holden, *supra* note 35 at 204.
38. Geva, *supra* note 33 at 146.

"Banks of circulation" first gained prominence in the United States, having originally been based on a model developed in Britain.[39] Unlike banks of deposit, they issued paper that was used as a circulating medium.[40] The principal operations of a bank of circulation consisted of lending money on the credit of promissory notes and bills of exchange not yet due, after deducting or "discounting" the interest.[41] When a holder of a negotiable paper that was not yet due wished to cash the instrument, the holder would be offered specie or the notes of the bank, less interest. Banks of circulation would freely offer to convert their notes for specie, so as to maintain public confidence in their issue. Such confidence was crucial for these banks, as their profitability depended on the extent of their loans, for which the substitution of paper for coin was essential. They also maintained deposit facilities, and offered all of the advantages of a bank of deposit.[42]

Banks of circulation had to be careful to retain enough specie to meet public demands for redemption. Any initial endowments of specie that constituted their reserves were often provided by the capital that was paid into the bank by the original promoters, as specified in the bank's charter.[43] Banks of circulation had an incentive to ensure that their notes enjoyed wide circulation, so that they would take a long time to return to the bank.[44] Preference was thus given to customers who would accept the bank's notes rather than specie in exchange for their negotiable instruments.[45] A positive balance of trade led to freer discounting by the banks, since it brought an influx of specie into the economy, which could be used to secure outstanding notes.[46]

Throughout the eighteenth century, the use of banknotes as a form of freely negotiable currency gained wide acceptance as a primary feature of a bank of circulation. As early as 1758 in the United Kingdom, courts began to treat private banknotes as a widely accepted form of money. In

39. Scott, *supra* note 26 at 160.
40. *Ibid.*
41. *Ibid.* at 161.
42. *Ibid.*
43. *Ibid.* at 165.
44. *Ibid.* at 163.
45. *Ibid.*
46. *Ibid.*

the famous case of *Miller v. Race*,[47] Lord Mansfield stated the following with respect to banknotes:

> Now they are not goods, not securities, nor documents for debts, nor are so esteemed: but are treated as money, as cash, in the ordinary course and transaction of business, by the general consent of mankind; which gives them the credit and currency of money, to all intents and purposes. They are as much money, as guineas themselves are; or any other current coin, that is used in common payments, as money or cash.[48]

An Irish case suggested that, in addition to the accepting of deposits and the honouring of cheques, the issuing of notes was one of the primary components of the business of banking, although it did not in itself give rise to a banker-customer relationship.[49] The extension of banknotes was a sub-function of lending, as it was the primary way for a bank to place credit in the hands of individuals.

The establishment of banks of circulation was thought to bring considerable economic gain to the colonial economies of North America. For much of its early history, North America had a trade deficit with Europe, as it had to import many necessities. Thus, what little currency there was in a colony was frequently sent back to the mother country to pay for imports. A bank of circulation brought with it the ability to supplement the money supply by offering credit.[50] Through prudently managed reserve banking, this credit could be used to stimulate industry and meet consumer demand by employing the "idle capital" of an economy. This was a precursor to what we today refer to as expansionary monetary policy. The fact that banks had to maintain public confidence in their issues, and thus had to anchor them to specie, was seen as a beneficial check on the growth of the money supply. The system was seen to provide a "flexible" means of adjusting the money supply to the needs of the economy.

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47. *Miller v. Race* (1758), 1 Burr. 452, 97 E.R. 398 (K.B.).
48. *Ibid.* at 457.
49. *Shields and Others v. The Governor and Company of the Bank of Ireland*, [1901] 1 I.R. 172 (Ch.).
50. Scott, *supra* note 26 at 181.

B. Monetary Conditions in Canada before the Development of a Banking System and the Emergence of the Bank of Montreal

Throughout the late eighteenth and early nineteenth centuries, Canada also suffered from a persistent lack of coinage. [51] As explained above, an adverse balance of trade meant that specie would not stay in Canada for long. Numerous solutions were devised by the colonial authorities, including the famous example of playing card money that was issued in New France.[52] The presence of foreign coins alleviated some of the difficulties, but did not adequately augment the money supply. British coins used in Canada were imported from London or Birmingham, as Canada had not been allowed to mint coins in its own right from the bullion it possessed.[53] The Ottawa branch of the Royal Mint did not open until 1908.[54]

The lack of a viable means of exchange, and the disadvantages of the barter economy, led to the development of new forms of payment.[55] In Canada, merchants began to issue their own paper notes, or "bons" as they were called in Lower Canada, to their customers.[56] The name came from the fact that the notes would state that they would be "bon pour"—specifying the amount of the note.[57] They could be redeemed in goods from the store of issue, and would also pass from hand to hand.[58] They provided a crucial means of exchange between merchants and their suppliers. The War of 1812 brought a governmental currency (the

51. R. Craig McIvor, *Canadian Monetary, Banking and Fiscal Development* (Toronto: MacMillan, 1961) at 17.

52. *Ibid.* at 1-11.

53. Emilio S. Binavince & H. Scott Fairley, "Banking and the Constitution: Untested Limits of Federal Jurisdiction" (1986) 65 Can. Bar Rev. 328 at 335.

54. Ottawa, *Report of the Royal Commission on Banking and Currency in Canada* (Ottawa: King's Printer, 1933) (Chair: Lord Macmillan) [Macmillan Commission Report] at 23. The Mint in Ottawa continued in operation as a branch of the Royal Mint until 1931, when it was taken over by the Canadian government and became a branch of the Department of Finance.

55. Geva, *supra* note 33 at 122-123.

56. McIvor, *supra* note 521 at 15.

57. *Ibid.*

58. *Ibid.*

Army Bills),[59] which also provided relief. Although those bills were taken out of circulation after the war,[60] the experience with them was positive because it did much to dispel prejudice against paper money.[61]

In the years after the War of 1812, the lack of adequate money supplies coupled with the lack of banking facilities meant that the extension of credit in Canada was largely in the hands of merchants.[62] Although bons were gaining widespread use, barter was still quite prominent, with whisky often serving as a means of exchange.[63] As a result, in 1817, nine Montreal merchants signed Articles of Association to conduct (without statutory authority) a banking business that would come to be known as the Bank of Montreal.[64] Largely modelled on the First Bank of the United States,[65] the Bank of Montreal was envisaged as a bank of discount, deposit and issue—a *de facto* bank of circulation.[66] It obtained its Charter in 1822,[67] and its Articles of Association served as a template for subsequent banking institutions in Canada.[68]

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59. One of the legacies of these experiences is that common parlance now refers to paper money as "dollar bills." See Binavince & Fairley, *supra* note 53 at 335.

60. McIvor, *supra* note 51 at 19-21.

61. *Ibid.* at 25.

62. *Ibid.*

63. *Ibid.* at 17.

64. *Ibid.* at 25.

65. This was the United States' first attempt to set up a central bank to perform the same functions carried out by the Bank of England at the time. The Bank was the result of a proposal made by Alexander Hamilton in 1791, the first Secretary of the Treasury. Political opposition eventually resulted in its demise in 1811. A second Bank of the United States, founded in 1817, met the same fate as its predecessor in 1837. The U.S. Federal Reserve System, a third attempt at a central banking institution, was founded in 1914. See generally A. Barton Hepburn, *A History of Currency in the United States*, rev. ed. (New York: A.M. Kelley, 1967).

66. McIvor, *supra* note 51 at 25-26.

67. *Ibid.* at 26. The Charter was obtained from the Crown, although it was in essence an act of incorporation by the legislature. The granting of a charter would change the official status of the bank from a private to a public company, impose legally enforceable obligations on its directors and greatly enhance its prestige as a centre for deposits and the issuing of notes. Merrill Denison, *Canada's First Bank: A History of the Bank of Montreal* (Toronto: McClelland and Stewart, 1966) vol. 1 at 136.

68. *Ibid.*

Shortly after its founding, the Bank of Montreal sent one of its first officers to New York to study the operations of the Bank of the United States,[69] which was held in high esteem throughout the world as a stable institution that furthered the commercial interests of its constituency.[70] The Bank of Montreal's first banknotes and the plates used to print them also came from the United States.[71]

To build goodwill among the population, the Bank of Montreal had to convince prospective customers that its activities would be beneficial to the economy as a whole. The bank's directors were particularly keen to obtain a charter, as that would reassure the public of the "beneficial purposes contemplated by the Bank's establishment."[72] A central feature of the Charter of the Bank of Montreal was its explicit reference to the public interest: "Whereas the establishment of a Bank at the City of Montreal, by legislative authority, would be conducive to the advancement of Agriculture and Commerce, and promote the prosperity of this Province."[73]

The extension of bank charters came to be seen as a powerful regulatory tool to ensure that banks established in Canada met certain liquidity standards and protected the interests of noteholders. The public nature of the bank charter was manifested in subsequent versions of the *Bank Act*, and helped to entrench the state's interest in the business of banking. To obtain a charter, other banks would have to meet legislatively mandated standards designed to safeguard the public interest.[74]

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69. Adam Shortt, *Adam Shortt's History of Canadian Currency and Banking 1600-1880* (Toronto: Canadian Bankers' Association, 1986) [Shortt, *Adam Shortt's History*] at 73.

70. Adam Shortt, "Origin of the Canadian Banking System" in E.P. Neufeld, ed., *Money and Banking in Canada* (Toronto: McClelland and Stewart, 1964) 77 at 83.

71. Shortt, *Adam Shortt's History*, *supra* note 69 at 73.

72. Roeliff Morton Brackenridge, *The Canadian Banking System 1817–1890* (Baltimore: Guggenheimer, Weil, 1895) at 26.

73. E.P. Neufeld, "Charter of the Bank of Montreal" in Neufeld, *supra* note 70 at 53.

74. Speaking of conditions some years later, an American writer said: "The provisions of the *Bank Act* with respect to the organization of new banks are intended to guard against the entry of unfit or inexperienced persons into the banking business." Joseph French Johnson, *The Canadian Banking System* (Washington: Government Printing Office, 1910) at 18.

The Bank of Montreal proved to be successful, and gave rise to the establishment of other banks throughout the country. As well as providing for the extension of credit, the advent of banks of circulation and the subsequent emergence of the banknote system conferred other benefits. The convenience of no longer having to deliver specie to pay debts helped to facilitate commerce. Perhaps more important, the banknote system brought increased stability, since banknotes were more widely accepted than merchant-issued bons. A bank's financial standing was seen as more certain than that of a merchant or an individual. For the same reason, banknotes gained more acceptance than cheques;[75] a banknote is a promise to pay, whereas a cheque is merely an order.[76] The emergence of banknotes ultimately led to a preference for chartered banks over free banks, and thus to increased efforts to obtain governmental charters by banks throughout British North America.

C. *Implementation of the Standard Formula*

While the issuance of paper money did much to facilitate mercantile transactions, the big problem of small change persisted for consumers until the standard formula was implemented. Before the adoption of that formula, many jurisdictions were on a bimetallic standard of coinage, silver and gold being the two most commonly used metals. In Britain, the eighteenth century would begin with a small silver coin—the shilling—as the unit of account. However, by the end of that century, a gold coin—the guinea—would assume that role.[77] This was due in part to the government's efforts in 1717 to set a ceiling on value at 21 shillings per guinea, which went on to become the definition of the unit of account in Britain.[78] As Sargent and Velde observed, accepting this unit of account put Britain on a *de facto* gold standard.[79] The government's

75. Geva, *supra* note 33 at 146.
76. Scott, *supra* note 26 at 111.
77. Sargent & Velde, *supra* note 4 at 293.
78. *Ibid.*
79. *Ibid.*

main purpose in placing a ceiling on the value of the guinea was to protect the tax revenue it received when it accepted gold at a high rate.[80]

Monetary authorities in Britain began to neglect the supply of small change during the eighteenth century, because of the prevalence of privately issued tokens that were made possible by advances in minting technologies. By stabilizing the exchange rate between the guinea and subsidiary coinage, the British government set the stage for private firms to issue token coinage that would be redeemable in gold—the single standard of account.

The issuance of convertible token coinage displaced the notion of full-bodied coinage based on intrinsic value, and it made fiat money more acceptable in the eyes of the public. It also served to end coin shortages;[81] exchange rates between denominations were no longer a consideration in the eyes of the public. This set the stage for the government to nationalize private token coin production and fully implement the standard formula along with the classical gold standard. The *Coinage Act of 1816*[82] (also known as *Liverpool's Act*) proclaimed gold coins to be the sole standard of value, and made silver coins representative. Private coinage was made illegal one year later through the *Act of Suppression of 1817*.[83] By the end of the nineteenth century, the standard formula had been implemented in all of the world's major economies.[84]

In the nineteenth century, Canada also anchored its monetary system to gold.[85] As in England, this was done by making the various forms of currency convertible into the monetary standard, which in turn was defined as a given quantity of gold of specified fineness.[86] In 1871, the

80. *Ibid.*

81. *Ibid.* at 303.

82. *An Act to provide for a New Silver Coinage, and to regulate the currency of the Gold and Silver Coin of this Realm*, 1816 (U.K.), 56 Geo. III, c. 68.

83. *An Act to prevent the issuing and circulating of Pieces of Copper or other Metal, usually called Tokens*, 1817 (U.K.), 57 Geo. III, c. 46.

84. Sargent & Velde, *supra* note 4 at 318.

85. James Holladay, *The Canadian Banking System* (Boston: Bankers Publishing, 1938) at 1.

86. *Ibid.*

Uniform Currency Act[87] officially authorized a decimal currency for the entire Dominion and made the sovereign of England and the eagle of the United States legal tender, in addition to providing for a five-dollar Canadian piece.[88] That Act established the standard of value, which consisted of 25.8 grains of gold that was nine-tenths fine and came to be known as the dollar. It also proclaimed that the Currency of Canada would consist of "dollars, cents and mills."[89]

While the issuing of coinage was fully nationalized by the implementation of the standard formula, the issuing of banknotes remained in private hands. This was the situation in Canada in the years immediately after Confederation. Private banks issued notes in the form of promissory notes made to the bearer. Those notes promised to deliver, upon redemption, the face amount in coins or precious metal. However, even under this regime, precious metals in the form of coins continued to be the basis which underlay the money supply, and private banks had to maintain a reserve of precious metals to meet the demands of customers who wanted to redeem their notes. The same was true for government mints.

II. The Canadian Money Supply in the Years Following Confederation

A. Bank Regulation and Dominion Notes

It is important to observe that in the nineteenth century, note issuance was considered to be one of the primary functions of banking.[90] It was the one certain resource for obtaining credit.[91] Deposit taking as an

87. *An Act to establish one Uniform Currency for the Dominion of Canada*, S.C. 1871, 34 Vict., c. 4, ss. 1, 2, 6, 9.
88. Holladay, *supra* note 85 at 1.
89. *Supra* note 87, s. 2. A mill is one-tenth of a cent.
90. In 1833, the New York State Bank Commissioner said: "The legitimate use of banks is not for the purpose of loaning capital, but for the purpose of furnishing currency to be used instead of specie." Thomas Wilson, *The Power "to Coin" Money: The Exercise of Monetary Powers by the Congress* (Armonk, N.Y.: M.E. Sharpe, 1992) at 127.
91. Hepburn, *supra* note 65 at 145.

instrument for extending loans became more prominent during the nineteenth century. However, it had not yet totally displaced the use of banknotes,[92] since individuals still preferred them as the most convenient means of using loans in the circumscribed limits of trade at that time.[93]

Issuing banknotes was a lucrative business for banks. They could profit from the *seigniorage* that was derived from having what was in effect an interest-free loan on coin and specie that their customers exchanged for notes, a portion of which could then be lent out at a profit. This was similar to their present-day use of funds deposited by customers.[94] As the standard formula was put into place and stability was brought to smaller denominations, people began to shift their attention to their savings in the form of larger denominations of banknotes and deposits.

Banking in the United States proved to be very tumultuous, both in terms of its viability and its role in larger debates on the role of government intervention in general. However, the history of Canadian bank regulation was very different.[95] For instance, Canadian authorities did not have the anti-centralist tendencies displayed by U.S. authorities, who preferred to discourage the establishment of large financial

92. *Ibid.* at 148.

93. *Ibid.* at 149.

94. Modern *seigniorage* has been explained as follows:

> When an individual holds cash that he/she is not investing but rather is intending to keep liquid so that he/she can meet their daily expenditure requirements, they are obviously not earning any income on the cash they hold. The effect of this development is that the holder is effectively lending money to the government at zero interest, which is the economic equivalent of the government earning interest on the cash it issues.

Thomas P. Vartanian, Robert Ledig & Lynn Bruneau, *21st Century Money, Banking and Commerce* (Washington: Fried, Frank, Harris, Shriver and Jacobson, 1998) at 492.

95. For a summary of U.S. banking and currency law history, see Ali Khan, "The Evolution of Money: A Story of Constitutional Nullification" (1999) 67 U. Cin. L. Rev. 393; Arthur Nussbaum, *A History of the Dollar* (New York: Columbia University Press, 1957); Wilson, *supra* note 90; William J. Shultz & M.R. Caine, *Financial Development of the United States* (New York: Prentice Hall, 1937); Hepburn, *supra* note 65; James Willard Hurst, *A Legal History of Money in the United States, 1774-1970* (Lincoln: University of Nebraska Press, 1973).

institutions by promoting independent local banks and granting charters freely. Instead, Canadian authorities were more inclined to follow the British model, and facilitated the emergence of branch banking.[96]

In a branch bank system, a network of branch offices is linked together by a national organization.[97] This is in contrast to a unit banking system, where each "banking office" must remain a separate institution.[98] A branch banking system is believed to be more stable, since its risks are automatically diversified as the branches make loans in different geographical regions and to a wide variety of industries.[99] Moreover, since branch banks have access to more resources than unit banks, they can more readily make large-scale loans, which a unit bank could only participate in as a part of a syndicate of lenders.[100]

At the time of Confederation, branch banking proved to be a very successful means of facilitating economic growth throughout the country. Being a resource-based economy, Canada needed a banking system that was adaptable and could easily respond to activities such as agriculture, lumbering and fishing, all of which were highly seasonal in their financing requirements.[101] The branch bank network made it easier to transfer assets across the country in order to meet these seasonal demands, which varied in their timing from one part of the country to another.[102] Less capital and fewer skilled officers were needed to set up branch banks than would have been needed to establish independent banks in each location, and this helped to extend banking facilities into more areas.[103] Moreover, Canadian authorities were well aware of the need to spread capital from large cities to rural areas. Experiences with land banks in the United States fuelled the belief that a branch model

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96. George S. Watts, "The Origins and Background of Central Banking in Canada" (1972) Bank of Can. Rev. 15 at 16.
97. J.W. O'Brien, *Canadian Money and Banking*, 1st ed. (Toronto: McGraw-Hill, 1964) at 46-48.
98. *Ibid.*
99. *Ibid.*
100. *Ibid.*
101. Watts, *supra* note 96 at 16.
102. *Ibid.*
103. *Ibid.* at 17.

based on a few strong banks would avoid some of the pitfalls of the American system.[104]

While note issuing privileges continued to be exercised by banks following Confederation, important changes pertaining to Canada's money supply began to take place. The federal government retained the prerogative to manufacture all of Canada's coinage in a manner consistent with the implementation of the standard formula. Before Confederation, the provinces of Canada, Nova Scotia, New Brunswick and Prince Edward Island had all experimented with government-issued paper money at one time or another.[105] The federal government's assumption of power over banking and currency was explicitly recognized by the *Constitution Act, 1867* (formerly the *British North America Act*, or *B.N.A. Act*),[106] and it was consistent with the economic centralization envisioned by that Act.[107]

The *B.N.A. Act* gave the federal government exclusive jurisdiction over "Currency and Coinage" in section 91(14),[108] and also over "Banking, the Incorporation of Banks and the Issuance of Paper Currency" in section 91(15).[109] These provisions might appear to treat the regulation of currency generally as a matter distinct from the regulation of paper currency in particular. Yet it must be borne in mind that the issuing of paper currency was one of the primary functions of a bank at that time, and judicial interpretation of section 91(15) widely endorsed the view that it was intended to encompass those activities traditionally associated with banking.[110]

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104. Holladay, *supra* note 85 at 19.

105. James Powell, *A History of the Canadian Dollar* (Ottawa: Bank of Canada, 1999) at 9-11.

106. *British North America Act*, 1867 (U.K.), R.S.C. 1985, [*B.N.A. Act*], ss. 91(14)-(20); renamed the *Constitution Act, 1867* by the *Constitution Act, 1982*, R.S.C. 1985, s. 53 (2).

107. William H. McConnell, *Commentary on the British North America Act* (Toronto: Macmillan, 1977) at 205.

108. *B.N.A. Act*, *supra* note 106, s. 91(14).

109. *Ibid.*, s. 91(15).

110. In the leading case on the meaning of this section—*Tennant v. Union Bank of Canada*, [1894] A.C. 31 at 46—Lord Watson said:

> The legislative authority conferred by these words is not confined to the mere constitution of corporate bodies with the privilege of carrying on the business of bankers. It extends to the issue of paper currency, which necessarily means the

The federal government began to exercise many of its powers over currency and coinage through the *Dominion Notes Act*[111] of 1868, which allowed it to issue its own notes backed by gold (called Dominion notes). Despite periodic revisions, that Act remained substantively the same and was put into its final form in 1914.[112] Dominion notes were issued in two distinct configurations and were primarily used for two purposes.[113] Part of the issue was in notes of smaller denominations, which were used as a hand-to-hand currency to fill the gap between the largest coin (the fifty-cent piece), and the smallest banknote (five dollars).[114] Banks had previously been allowed to issue notes as small as one dollar, but concerns from the Colonial Office[115] that the currency be founded on a "sound and metallic basis" required their withdrawal in 1870.[116] At that time, the chartered banks voluntarily surrendered their

> creation of a species of personal property carrying with it rights and privileges which the law of the province does not, and cannot, attach to it. It also comprehends "banking," an expression which is wide enough to embrace every transaction coming within the legitimate business of a banker.

The House of Lords could have meant that the power to regulate the issuance of paper currency was an ancillary power governed by s. 91(15). Yet this view would not accord with the fact that currency is listed in another subheading. If the federal government had the authority to regulate currency generally, why would it also need the power to regulate paper currency? Lord Watson's statement on what constitutes banking would seem to flow more logically if the issuance of paper currency were interpreted as a function of banking. This view finds some support in *Reference Re Alberta Legislation*, [1938] S.C.R. 100 at 115, where Duff C.J. held that s. 91 gave the federal government the power to regulate credit, and differentiated between the power to regulate credit as a "medium for effecting the exchange of goods and services, and the machinery for issuing and circulating it."

111. 31 Vict., c. 46.

112. John D. Falconbridge, *Banking and Bills of Exchange*, 4th ed. (Toronto: Canada Law Book, 1929) [Falconbridge 4th ed.] at 435. The 1914 Act can be found at R.S.C. 1927, c. 41.

113. Clifford A. Curtis, "The Canadian Monetary Situation" (1932) 40 J. Pol. Econ. 314 [Curtis, "The Canadian Monetary Situation"] at 316.

114. *Ibid.*

115. The Colonial Office was a British government department that was empowered to revise or disallow colonial legislation, particularly that pertaining to banking and currency. McIvor, *supra* note 51 at 31.

116. Falconbridge 4th ed., *supra* note 112 at 434.

right to issue notes under four dollars, in exchange for the abolition of the tax of one percent per year on their note circulation and the repeal of the statutory requirement that they hold one-tenth of their capital in Dominion securities.[117]

The *Dominion Notes Act* made Dominion notes redeemable in specie upon presentation to offices established in branches of the Receiver-General in Montreal, Toronto, Halifax and St. John.[118] The Minister of Finance was empowered to make arrangements with the chartered banks for this purpose.[119] Specie had originally been limited to coins in accordance with the standard formula, but it was extended in 1914 to include bars that bore the stamp of specifically designated mints certifying their weight and fineness.[120] Notes of the provinces were declared to be obligations of the Dominion, and were redeemable in gold when presented at the place where they were made payable.[121] The Act also made Dominion notes legal tender,[122] and mandated certain reserve requirements in order to build public confidence in those notes.[123] It authorized the issuing of a specified amount of notes that were to be backed 25 percent by gold and 75 percent by government securities (in the form of guaranteed debentures).[124] Any amounts issued beyond these limits had to be backed 100 percent in gold. In 1870, the limit was held at $9 million and was gradually increased to $50 million in 1914.[125]

The second function of Dominion notes was as cash reserves for commercial banks.[126] As Curtis observed, although Canadian banks had never been required to carry any specified legal cash reserve, the *Bank*

117. *Ibid.*

118. *Ibid.* Additional offices were established in Charlottetown, Victoria and Winnipeg. (*Ibid.* at 435).

119. *Ibid.* at 434.

120. Holladay, *supra* note 85 at 12.

121. *Ibid.*

122. *Dominion Notes Act*, *supra* note 1121, s. 3.

123. *Ibid.*, s. 5.

124. *Ibid.*

125. J.W. O'Brien & G. Lermer, *Canadian Money and Banking*, 2d ed. (Toronto: McGraw-Hill, 1969) at 30.

126. Curtis, "The Canadian Monetary Situation", *supra* note 113 at 316.

Act had always required that Dominion notes form at least 40 percent of whatever cash reserves the banks actually carried in their vaults.[127] Moreover, Dominion notes were frequently issued in large denominations in order to facilitate interbank clearing.[128] The Department of Finance would be responsible for the exchange of gold for notes, and notes for gold.[129]

B. Private Banknotes

The demand for notes greater than five dollars was met by the private banknote. It is important to note its particular legal characteristics. A banknote was typically a promissory note payable to the bearer upon demand, initially at a location printed on the note itself.[130] Material alterations invalidated the note, even though this did not affect the underlying contract or promise to pay.[131] However, as John Falconbridge observed, the operation of section 145 of the *Bills of Exchange Act*[132] waived such invalidity if the alteration was not apparent and the note was acquired by a holder in due course.[133] Property in the note would pass on delivery, and an individual who took it in good faith and for value acquired title to it, even if it had been stolen from a former owner.[134] Holders of banknotes were *prima facie* entitled to prompt payment from the bank that had issued them.[135] However, private banknotes were not generally considered to be legal tender in the same way as Dominion notes, although, as discussed below, legislation temporarily gave them this status at times.

Political wrangling over the role of private notes resulted in a compromise. In March of 1870, the new Minister of Finance, Sir Francis

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127. *Ibid.* See also *Bank Act*, R.S.C. 1927, c. 12, s. 60.
128. Curtis, *ibid.*
129. *Ibid.*
130. Falconbridge 4th ed., *supra* note 112 at 139.
131. *Ibid.*
132. R.S.C. 1927, c. 16.
133. Falconbridge 4th ed., *supra* note 112 at 139.
134. *Ibid.*
135. *Ibid.* Certain exceptions did exist, however. See *ibid.* at 139-140, citing *Solomons v. Bank of England* (1791), 12 East 135n., 3 R.C. 634.

Hincks, proposed that the federal government be granted the sole right to issue them.[136] As had happened earlier in the former Province of Canada, the proposal was withdrawn due to the opposition of banking interests and adverse popular opinion.[137] Undeterred, however, the Minister proceeded with a number of reforms. Determined to procure a share of the profits that the banks derived from note issuance, he proposed that the government alone should issue all notes below four dollars, and he argued in favour of the reserve requirements outlined above.[138] Many of his views found expression in the *Act respecting Banks and Banking*[139] of 1870 and in the *Dominion Notes Act* referred to above.

Sir Francis Hincks believed that any issuing of notes by the banks should be done in a way that thoroughly protected the noteholders. Experience with private notes in pre-Confederation Canada and the United States demonstrated a tendency by some banks to make imprudent loans and over-issue their notes. When this happened, they lacked the resources to redeem outstanding notes, which circulated at a heavy discount and often became worthless following a run on the bank, with tremendous loss to noteholders.[140]

Thus, the *Act* provided that before issuing its own notes or commencing operations, a bank had to have $500,000 of capital stock *bona fide* subscribed and $100,000 *bona fide* paid up, with a further sum of $100,000 to be paid up within two years after the commencement of business.[141] The *Bank Act* of 1871 provided that the amount of notes intended for circulation, issued by a bank and outstanding at any time, was not to exceed the amount of the bank's unimpaired paid-up capital.[142] No one other than a chartered bank was allowed to issue any bill, note or other instrument that was intended to circulate as money or be used as a substitute for money.[143]

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136. Falconbridge 4th ed., *ibid.*, at 133.

137. *Ibid.* On previous governmental flirtations with central banking, see Powell, *supra* note 105 at 6-11.

138. Falconbridge 4th ed., *supra* note 112 at 133.

139. 33 Vict., c. 11 [*Bank Act 1871*].

140. See generally Powell, *supra* note 105; Hepburn, *supra* note 65.

141. Falconbridge 4th ed., *supra* note 112 at 134-135.

142. *Ibid.* at 135.

143. *Ibid.*

One of the more interesting facets of the 1871 version of the *Bank Act* was its provision for double liability. The Act stated that if a financial institution declared insolvency, each shareholder would be liable for the deficiency "to an amount equal to the par value of the shares held by him, in addition to any amount not paid up on the shares."[144] Thus, shareholders could be required to pay up to twice the face value of their shares in the event of a failure.[145] This provision was also extended to render shareholders liable, below that ceiling, for any amount required to satisfy the debts of the bank.[146] This was added primarily to protect the interests of noteholders.[147]

The decennial revision of the *Bank Act* in 1880 brought additional measures designed to safeguard the interests of noteholders. Opposition to Sir Francis Hincks' proposals subsided, and they were in the end supported by the bankers themselves.[148] The reforms of 1880 gave holders of an insolvent bank's notes a first charge (a prior lien) on the assets of the bank.[149] This move was justified on the ground that noteholders were involuntary creditors who, unlike depositors, had little choice as to which bank liabilities they held.[150] As Falconbridge noted, the privilege of note circulation brought easy and substantial profit to the banks, so they looked favourably upon any measures that would assure the banking public with respect to those notes.[151]

Yet this reform had its defects. Although the prior lien would make payment almost certain, holders of a failed bank's banknotes would face considerable delay, and would have to pay a discount, if they wished to

144. *Bank Act 1871, supra* note 139, s. 125, cited in Falconbridge 4th ed., *ibid.*, at 342-344.

145. O'Brien & Lermer, *supra* note 125 at 31.

146. Falconbridge 4th ed., *supra* note 112 at 343.

147. O'Brien 2nd ed., *supra* note 125 at 31.

148. Falconbridge 4th ed., *supra* note 112 at 135.

149. *Bank Act,* R.S.C. 1927, c. 12, s. 131.

150. O'Brien & Lermer, *supra* note 125 at 32. Indeed, Sir Francis Hincks, Minister of Finance, said ten years earlier that "if provision is made for the security of note holders, the House will have done all it could in that direction, and it had no more to do with depositors who, if they choose to deposit in a Bank, must do so at their own risk." *House of Commons Debates,* (1870) at 219-221, cited in Patrick N. McDonald, "The *B.N.A. Act* and the Near Banks: A Case Study in Federalism" (1972) 10 Alta. L. Rev. 155 at 177.

151. Falconbridge 4th ed., *supra* note 112 at 135.

realize their notes at par immediately after a suspension.[152] Those who were ignorant or unmindful of the operations of the *Statute of Limitations*, and who did not present their outstanding notes for redemption, would be unjustly injured.[153] In most cases, the notes of a failed bank were not fully redeemed during the limitation period. The 1880 Act also failed to deal with a negative consequence of having a privately issued currency, namely the fact that notes did not tend to circulate at par in localities remote from the office where they were payable, or in localities whose trade centre was different from that of the issuing bank. Moreover, the Act's security requirements, in the form of the amount of capital that was to be paid into a bank before it began to operate, were considered inadequate for the protection of noteholders.

Revisions to the *Bank Act* in 1890[154] set about curing some of these defects. The prior lien in favour of holders of notes outstanding at the time of suspension was extended to cover interest owing.[155] Banks were prohibited from pledging, assigning or hypothecating their notes, and no loan made on the security of a bank's notes was to be recoverable from the bank or from its assets.[156] Moreover, banks were required to ensure the circulation at par in every part of Canada of all notes issued or reissued by them and intended for circulation, and to this end, to establish agencies for the redemption and payment of their notes in the chief city of each province and at other places designated by the Treasury Board.[157] Capital requirements for the establishment of new banks were also raised.[158]

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152. *Ibid.* at 136.
153. *Ibid.*
154. 53 Vict., c. 31 [*Bank Act 1890*].
155. Falconbridge 4th ed., *supra* note 112 at 136. See also *Bank Act 1890, ibid.*, s. 53.
156. Falconbridge 4th ed., *ibid.* at 137. See also *Bank Act 1890, ibid.*, s. 52.
157. Falconbridge 4th ed., *ibid.* See also *Bank Act 1890, ibid.*, ss. 55-56.
158. *Bank Act 1890, ibid.*, ss. 10 and 13. The 1890 revisions also established a bank circulation and redemption fund, to provide for payment of notes on which the issuing bank had defaulted. See Falconbridge 4th ed., *ibid.* at 147, and *The Bank Act*, R.S.C. 1927, c. 12, [*Bank Act 1927*] ss. 64-66. Each bank contributed five percent of the amount of its notes in circulation. If a bank suspended payment of its notes, and its liquidator did not pay them within two months, the Minister of Finance could arrange for their payment,

C. The Crisis of 1907

Rapid growth in the economy brought the system of private note issuance to its limits by the early 1900's.[159] One will recall that a bank's note issuance was restricted to the amount of its unimpaired paid-up capital. Pressure was brought to bear on the money supply mechanism during the crop-moving season, when demand for credit would reach its peak.[160] Deposit banking could not replace the need for more paper money to keep pace with demand that was fuelled by the expanding economy.[161] The year 1907 proved to be a bad one for both the wheat and banking industries, as a low-quality wheat crop had to be moved to market quickly to avoid deterioration.[162] At the time, however, demand for notes was greater than their supply, and the banks could not provide them fast enough to facilitate movement of the crop.[163] The crisis was symptomatic of the larger issue of the inelasticity of the money supply and the lack of rediscounting facilities[164] available to the banks to meet cash emergencies such as this one.

The limited rediscounting mechanisms that were available to the banks were entirely in the form of funds that could be obtained from

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with interest, out of the fund. If the amount paid out from the fund was more than the insolvent bank had paid into it, the Minister could require the solvent banks to cover the balance, not exceeding in any year one percent of the average amount of the notes of each bank in circulation. If the insolvent bank repaid the excess to the fund, the contributing banks would receive refunds.

159. O'Brien & Lermer, *supra* note 125 at 33.

160. *Ibid.*

161. *Ibid.*

162. *Ibid.*

163. *Ibid.*

164. *Ibid.* at 116:

> The older term 'rediscounting' arises from the manner in which the lender of last resort function was originally performed in England. Discount houses bought or 'discounted' commercial acceptances in the normal course of business. When the banks needed more funds, they called loans made to the discount houses, who, in order to raise money, sold these acceptances outright to the central bank. Since this was the second time that the same paper had been discounted, the term applied was 'rediscounting.' Under the current method the chartered banks borrow directly from the Bank of Canada rather than sell assets to it, and pledge part of their securities portfolio as collateral for the loan.

abroad. Cash reserves in the system consisted primarily of gold and Dominion notes redeemable in gold.[165] Added cash reserves could only come from outside Canada by liquidating foreign call loans or borrowing or selling securities, which frequently occurred in the New York marketplace. The problem was compounded by the fact that at the time, there were no active domestic bill or securities markets and no liquid call loan markets.[166] These structural deficiencies hampered the realization of assets needed to expand the money supply within the legal limits.

The gold standard placed additional burdens on the money supply mechanism. From 1854 to 1914, the Canadian dollar (as a unit of account) was continuously on the gold standard,[167] so its value was fixed in terms of gold.[168] There was virtually no scope for authorities to conduct any sort of monetary policy.[169] Fluctuations around fixed values were constrained by gold "import" and "export" points, which marked the exchange rates at which it was profitable for individuals to take advantage of the price differential between official and market exchange rates through importing and exporting gold.[170] An efflux of gold from the economy would result in a restriction of credit domestically, with the converse being true in the event of an influx.[171] The gold standard was seen as beneficial, as it resulted in the maintenance of stable exchange rates and kept the movement of domestic and international price levels in harmony.[172]

Banks in the financial system needed to maintain the gold standard, as government took a hands off approach. Gold was needed by the banks, not only to meet the domestic demand for cash but also to meet external requirements.[173] When Canada sold securities in London or New York,

165. Curtis, "The Canadian Monetary Situation", *supra* note 113 at 316.
166. Courtland Elliott, "Bank Cash" (1938) 4 Can. J. Economics & Political Science 432 at 434.
167. Powell, *supra* note 105 at 14.
168. *Ibid.*
169. *Ibid.*
170. *Ibid.*
171. Macmillan Commission Report, *supra* note 54 at 58.
172. *Ibid.*
173. This section draws heavily from the Macmillan Commission Report, *ibid.* at 58.

the proceeds of the loan were deposited in a branch of a Canadian bank. Parts of the proceeds were used to purchase imports, and a large part was used to finance domestic expenditures.[174] Accordingly, when borrowers sold their London balance to a Canadian bank in exchange for a deposit in Canada (which they could use to purchase Canadian securities), the bank would increase its assets abroad and its deposit liabilities in Canada. This was the means by which banks could increase their reserves of foreign balances. The domestic deposit did not need a 100 percent reserve equal to the foreign balance, so the bank could use the excess balance as it saw fit. Quite often, the proceeds were lent or invested abroad, or brought to Canada in the form of gold. In either case, the bank was left with an additional reserve asset that could facilitate the further extension of credit. However, balances obtained through a sudden increase in Canada's trade surplus, either through added volume or an advance in prices, would also result in an expansion of credit.

The system had, however, reached its limits in 1907, and it could not provide for the expansion of credit needed to get the wheat crop to market in time. To deal with the crisis, the federal government advanced Dominion notes to the banks in sufficient quantities to meet the need.[175] The banks pledged securities against the advances, and the interest rate rose in stages from four percent per year for the first 60 days to six percent after four months so as to ensure prompt payment.[176]

This experience led to amendments to the *Bank Act* in 1908,[177] which permitted a bank to issue extra notes in excess of its unimpaired paid-up capital and reserve or rest fund, up to a maximum of 15 percent of that total during the "usual" crop moving period from October to January of each year.[178] If a bank wished to exercise this right, it had to give notice to the Minister and to the President of the Canadian Bankers'

174. *Ibid.* at 58.
175. O'Brien & Lermer, *supra* note 125 at 33.
176. *Ibid.*
177. *An Act to Amend the Bank Act*, 7-8 Edward VII, c. 7.
178. *Ibid.*, s. 1(3). This excess was taxed, to ensure its prompt withdrawal. *Ibid.*, s. 1(5); O'Brien & Lermer, *supra* note 125 at 33.

Association (CBA).[179] The CBA had been set up as a result of amendments made in 1900. It was given responsibility for supervising the note issuance of its members,[180] and it was also given the power to appoint a curator to supervise the affairs of any bank that had suspended redemption of its notes.[181]

The solutions put forth in these amendments were short lived, as they did not provide enough elasticity to allow the banks to respond to the expansion of the Canadian economy.[182] In 1913, Parliament adopted a different method of allowing the banks to issue excess notes. This initiative permitted the banks to issue more notes at any time of year if the excess issue was backed 100 percent by gold or Dominion notes held in a Central Gold Reserve.[183]

These reforms did not have the effect of increasing money supply elasticity in the long run. As O'Brien and Lermer observed, their long run impact was to tie note issuance more closely to the amount of gold and Dominion notes held by the banks as demand for currency increased.[184] This put additional strains on the money supply mechanism that was in the hands of the banks by virtue of the gold standard. The supply of Dominion notes themselves was restricted by the government's gold holdings, with the end result that the money supply could no longer respond to the needs of trade.[185] O'Brien and Lermer went on to conclude that had the First World War not broken out, Canada would inevitably have faced another currency crisis.[186]

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179. *Supra* note 177, s. 1(4).

180. *The Bank Act Amendment Act 1900,* 63–64 Vict., c. 26, s. 30(b).

181. *Ibid.*, s. 24. A 1912 amendment extended the crop moving period for the purposes of the Act from September 1 to February 28. *The Bank Charters Continuation Act 1912*, 2 George V., c. 5, s. 4.

182. O'Brien & Lermer, *supra* note 125 at 33.

183. *Ibid.* See also *The Bank Act 1927*, *supra* note 158, s. 61(4). This reserve was in the care of trustees, three of whom could be appointed by the Association with the approval of the Minister, and a fourth by the Minister alone.

184. O'Brien & Lermer, *supra* note 125 at 33.

185. *Ibid.* at 34.

186. *Ibid.*

D. *The* Finance Act 1914

The First World War had profound consequences for the Canadian economy as a whole[187] because it created pressing needs that required a fundamental change in the money-supply process. The beginning of the war marked the end of the classical gold standard, as all major countries suspended the convertibility of domestic banknotes into gold and the free movement of gold between countries.[188] With the outbreak of the war and the suspension of the gold standard, individuals were not always able to obtain information on international financial developments.[189] Early in August of 1914, banks were faced with runs throughout the country and with customers withdrawing gold in the face of a general panic.[190] A means of reassuring the banking public had to be devised to halt the runs. After a series of meetings between the government and the CBA,[191] an order in council was issued, followed by the passage of the *Finance Act 1914*,[192] which was meant to address the crisis. Although the war had closed foreign markets to Canadian securities, the Act provided a means by which credit could be extended indefinitely without the requirement of the convertibility of banknotes into gold.[193]

The government had to devise a way to allow banks to meet their obligations vis-à-vis noteholders. The *Finance Act* could be proclaimed in force by the Governor in Council during times of crisis.[194] The Act made private banknotes legal tender, so that banks could meet depositor demands with their own notes rather than Dominion notes or gold.[195] It suspended redemption of Dominion notes in gold, coinciding with the

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187. For the war's effects on the banks, see Clifford A. Curtis, "The Canadian Banks and War Finance" (1931) 3 *Contributions to Canadian Economics* 7.

188. Powell, *supra* note 105 at 18.

189. Holladay, *supra* note 85 at 188.

190. Macmillan Commission Report, *supra* note 54 at 22.

191. Powell, *supra* note 105 at 18.

192. 5 Geo. V., c. 3.

193. Holladay, *supra* note 85 at 193.

194. *Finance Act 1914, supra* note 192, s. 4. A crisis was defined as "war, invasion, riot or insurrection, real or apprehended, and . . . any real or apprehended financial crisis."

195. *Ibid.*, s. 4 (b).

suspension of the gold standard.[196] To ensure that Dominion notes could continue to be issued even in the absence of the gold standard, the Act suspended the requirement in the *Dominion Notes Act* that additional issues of notes in excess of $50 million be secured by an equivalent amount of gold, and substituted eligible securities pledged by the chartered banks in kinds and amounts approved by the Treasury Board.[197] The *Finance Act 1914* also extended the excess issue of private banknotes during the crop-moving season to the entire year,[198] although this provision was repealed in 1920.[199]

For the first time since Confederation, the *Finance Act 1914* gave the banks rediscounting facilities. It provided for the more elastic supply of money needed to create the inflationary conditions that were used to finance the war effort.[200] Under section 4(a) of the Act, chartered banks could "pledge" securities (approved by the Treasury Board) with the Minister of Finance in return for an equivalent amount of Dominion notes. The indefinite expansion of the Dominion note issue[201] would also allow for chartered bank reserves to be increased.[202] In practice, the banks bought government bonds to finance the war, then pledged them under the *Finance Act 1914* to build up cash reserves that they could draw upon to buy more government bonds.[203] The government would then repay the banks from the proceeds of bonds sold to the public.[204] Proceeds from those sales would be spent quickly by the government, so liquid assets in the hands of the public mounted rapidly.[205] The money supply grew from a total of $480 million in 1914 to $874 million in

196. *Ibid.*, s. 4 (d).
197. *Ibid.*, s. 4 (a).
198. *Ibid.*, s. 4 (c).
199. O'Brien & Lermer, *supra* note 125 at 95.
200. *Ibid.*
201. Thomas J. Courchene, "An Analysis of the Canadian Money Supply: 1925-1934" (1969) 77 J. Pol. Econ. 363 at 365.
202. O'Brien & Lermer, *supra* note 125 at 95.
203. *Ibid.*
204. Holladay, *supra* note 85 at 192.
205. O'Brien & Lermer, *supra* note 125 at 95

1918, and banknotes grew from 21.88 percent of the total in 1914 to 24.71 percent in 1918.[206]

Not surprisingly, the consumer price index rose by 55 percent during the war, and the wholesale price index by 105 percent—twice the World War II increases.[207] Unlike a traditional rediscount mechanism, controlled by a central bank, the *Finance Act 1914* could not unilaterally adjust bank reserves in order to expand or contract the monetary base.[208] Any advances made under that Act were solely at the request of banks.[209]

E. The Finance Act *After the War*

Following the War, Canada began to reorganize its finances and pave the way for the eventual reinstatement of the gold standard that it expected other countries would also carry out.[210] Although the *Finance Act* was initially conceived as a temporary war measure, it played a more prominent role in the Canadian financial system in the years after the war. It was extended in 1919 for two years,[211] then was revised and made permanent in 1923.[212] The 1923 Act retained the rediscounting mechanisms of its predecessor, and empowered the Treasury Board to fix the rate of interest and make regulations with regard to advances, the deposit of securities and all other matters necessary to give effect to the Act.[213]

In the 1920s, the Treasury Board consisted of the Ministers of Finance (chairman), Railways and Canals, Customs and the Interior, the Postmaster General, and the Deputy Minister of Finance.[214] Although the Board had authority to set the advance rate of interest charged to the banks for their borrowing, it did not use this power to control the

206. O'Brien, *supra* note 97 at 184.
207. O'Brien & Lermer, *supra* note 125 at 96.
208. Powell, *supra* note 105 at 19.
209. *Ibid.*
210. *Ibid.* at 20.
211. Macmillan Commission Report, *supra* note 54 at 22, para. 49.
212. *Finance Act 1923*, 13-14 Geo. V., c. 28.
213. Macmillan Commission Report, *supra* note 54 at 23, para. 52.
214. Watts, *supra* note 96 at 19.

expansion and contraction of credit.[215] In the early 1920's that rate consistently remained at five percent despite declining market interest rates, and this had deflationary consequences. The stage was then set for Canada's return to the gold standard in 1926.[216] The Treasury Board/Department of Finance arrangement was an attempt to bring a sense of accountability to the operation of the *Finance Act 1923*, but the Treasury Board's expertise was a far cry from what was needed to carry out the functions traditionally associated with monetary policy management by a central bank.

Canada returned to the gold standard, but this time with the *Finance Act* firmly in place. That made it difficult to preserve the automatic adjustment mechanism that had existed before 1914 to control credit.[217] In 1928-1929, Canada experienced a boom that had grave repercussions for its financial machinery. To quote from O'Brien and Lermer:

> The operation of the *Finance Act* neutralized the adjustment mechanisms of the gold standard. The price-specie flow mechanism required that when a country lost gold the commercial banks would lose reserves and contract credit. This in turn would lower prices, stimulate exports, and prevent further loss of gold. In Canada this did not happen. The banks obtained gold for export by redeeming Dominion notes with the Department of Finance, and then replaced their holdings of notes by borrowing under the *Finance Act*. Their reserves did not fall and no credit contraction took place. The outflow of gold continued and the gold reserves were depleted. At the beginning of 1929 the government imposed an un-official embargo on the export of gold, enforced through the co-operation of the banks. In fact, Canada left the gold standard at this time, although the embargo was not made official until 1931.[218]

Indeed, most of the proceeds of the *Finance Act* borrowings by the banks were invested in the form of call loans in New York during the stock market boom of 1928-1929.[219] However, this is not the only

215. Powell, *supra* note 105 at 19.
216. At this time, Dominion Notes were once again made redeemable in gold. Curtis, "The Canadian Monetary Situation", *supra* note 113 at 322.
217. O'Brien & Lermer, *supra* note 125 at 97.
218. *Ibid.* at 98. For a more technical discussion of these events, see generally Curtis, "The Canadian Monetary Situation", *supra* note 113; Elliott, *supra* note 166; Courchene, *supra* note 201.
219. Watts, *supra* note 96 at 21.

explanation given for the massive efflux of gold and securities to the U.S. market. As James Holladay has pointed out, a bumper wheat crop in 1928 required excess bank credit, which could only be supplied by the banks through the use of the *Finance Act*.[220] The Prime Minister stated at the time that the government had exported some $40 million of gold in late 1928 in order to meet its obligations abroad.[221] In spite of these explanations, it is clear that the existing financial machinery was inadequate to provide a stabilizing force for the expansion and contraction of credit.

Some relief came after the stock market crash of 1929 and the onset of the Depression, which brought about lower price levels and modest contractions in bank credit.[222] As the Depression progressed, the monetary system was again placed under strain, this time in the opposite direction. Despite the major economic contraction that was underway, the Treasury Board maintained the advance rate at 4.5 percent from 1928 to 1931.[223] During this period, the banks repaid their advances under the *Finance Act*, which in turn led to a monetary contraction that exacerbated the economic downturn.[224] However, the monetary contraction did strengthen the Canadian dollar, which climbed from US$0.80 in 1931 to US$0.90 in 1932.[225]

Faced with a deteriorating monetary position, the Treasury Board finally decided to take a more proactive approach in October 1931. The advance rate was reduced from 4.5 to 3 percent at a time when open market rates were rising, then raised to 3.5 percent in May 1932—considerably above the New York open market money rate but considerably below the yields obtainable from short-term high-grade Canadian securities.[226] Although the rates on Canadian bonds had their

220. Holladay, *supra* note 85 at 201.

221. *Ibid.*

222. Elliott, *supra* note 166 at 444.

223. Powell, *supra* note 105 at 26.

224. *Ibid.*

225. *Ibid.* For a discussion of how various interests were affected by the monetary policies of the day, and how they sought to influence those policies, see Donald V. Smiley, ed., *The Rowell-Sirois Report (Abridgement of Book 1)* (Toronto: McClelland and Stewart, 1963) at 168-169.

226. Elliott, *supra* note 166 at 448.

most rapid rise on record in a single month in July 1932, bank condition statements revealed no tendencies on the part of the banks to increase their bond purchases.[227]

Regardless of the favourable rates, many individual banks had been reluctant to borrow reserves under the *Finance Act 1923* even when their own credit expansion possibilities were limited.[228] Courtland Elliott attributed this fact to the orthodox belief in the banking industry at the time, that bank cash should only be acquired through the disposal of other assets, and that any borrowing should be for a real emergency or for a seasonal period and should be secured by self-liquidating commercial paper.[229]

In November 1932, the federal government tried yet another means of facilitating an easy money policy, to stimulate aggregate demand and lower the value of the dollar with a view to stimulating exports. An agreement was reached whereby all Canadian banks would acquire $35 million in Treasury Bills at a rate of four percent per annum, and would pledge them under the *Finance Act 1923* as collateral in exchange for cash advances at a three percent rate.[230] Once again these efforts were ultimately futile.

Despite the *Finance Act* advances, the volume of bank credit and the velocity of bank deposits continued to decline.[231] The Canadian dollar fell to a low of US$0.80, but the U.S. decision to prohibit the export of gold in April 1933, coupled with a similar effort by that country to reflate its economy, led the Canadian dollar to drift upward again.[232] A final attempt was made to expand credit under the existing machinery in 1934, when the government sought to expand the amount of Dominion notes in circulation by reducing their gold backing to 25 percent.[233] The measure had little effect on credit expansion; banks tended to retain the increase in the Dominion note issue as additions to cash reserves, using

227. *Ibid.*
228. *Ibid.*
229. *Ibid.* at 449.
230. *Ibid.*
231. *Ibid.*
232. Powell, *supra* note 105 at 27.
233. *Ibid.*

only marginal amounts for circulation or repayment of *Finance Act 1923* obligations.[234] The effect on the Canadian dollar was equally minute. It returned to parity with its U.S. counterpart in 1934, and at times even traded at a small premium.[235]

III. The Complete Nationalization of the Money Supply Mechanism

A. Initial Calls for Reform

The failure of the Canadian financial system to respond adequately to the challenges of the Depression brought renewed scrutiny of its operations. Popular discontent toward banking interests put increased pressure on the government to take action.[236] Initially, this pressure focused on the fact that Canada lacked a money market, which would have allowed it to manage its foreign exchange. Popular discourse abounded with suggestions that Canada ought to "make" direct exchange rates with the rest of the world, to prevent New York from "making" such rates for Canada and therefore depreciating the Canadian dollar.[237] Ultimately, public demand to deal with this ailment took the form of pressure for the establishment of a central bank.[238]

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234. Elliott, *supra* note 166 at 451.
235. Powell, *supra* note 105 at 27.
236. *Ibid.*
237. Curtis, "The Canadian Monetary Situation", *supra* note 113 at 334.
238. Indeed, the July 1, 1933 edition of *Maclean's Magazine* read:

> The point which our bankers seem to miss is that what the Canadian people want in a central bank is not to supply the other banks with rediscount facilities which they already have or to save us from future panics [as, it is previously noted, U.S. experience showed that they did not], but they do want an institution that will effectively control the whole of the money and credit of the nation, now under the control of the other banks and which will somehow be able to make that money and credit available in sufficient volume wherever legitimately needed, and on terms much more fair and equitable than at present.

Michael Bordo and Angela Redish concluded that much of the impetus for a central bank came from practical political considerations.[239] Banks had become an attractive political target, due to the concentrated nature of the industry. In 1930, Canada was left with ten banks, three of which owned 75 percent of the industry's assets.[240] The CBA was seen as a forum for collusion, and itself admitted that collusion had played a part in such matters as western bank closures.[241] Political forces were gathering momentum through the Social Credit and Progressive parties, which had championed the cause of farmers hurt by the banks' failure to extend credit and expand their note issuance.[242]

It was only a matter of time before the matter came to the attention of Prime Minister R.B. Bennett. Canada was in the midst of a depression, and people began to look to government for solutions in the face of market failures to stimulate aggregate demand. The Prime Minister declared the following in December 1933:

> I learned to my surprise that there was no direct means of settling international balances between Canada and London, that the only medium was New York, and the value of the Canadian Dollar would have to be determined in Wall Street. I made up my mind then and there that this country was going to have a central bank because there must be some financial institution that can with authority do business for the whole of the Dominion with the other nations of the World. If Canada was to be financially independent there had to be a means of determining balances, of settling international accounts; and a central bank would furnish this.[243]

The passage is cited by Bordo and Redish as evidence that the Prime Minister had decided *a priori* that a central bank should be created, even before any recommendations to that effect were made by the Royal Commission on Banking and Currency in Canada, discussed below.[244] Bordo and Redish concluded that the decision was made independent of

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239. Michael D. Bordo & Angela Redish, "Why Did the Bank of Canada Emerge in 1935?" (1987) 47 J. Econ. History 405 at 415.

240. *Ibid.*

241. *Ibid.*

242. *Ibid.* at 416.

243. *Ibid.* at 416-17.

244. *Ibid.* at 417.

any economic considerations, or as an outgrowth of the existing financial architecture.

However, the historical record suggests that political considerations provide an incomplete explanation for the genesis of central banking in Canada. As we have seen, the inability of the private sector to adequately address credit concerns of consumers had compelled the federal government to intervene several times since Confederation. Inadequacies in the system not only brought the issue to the public's attention, but also to the attention of scholars. George Watts pointed out that much of the initial impetus for the establishment of a central bank came from the Queen's University Department of Economics.[245] While calls for such a bank had been made from Confederation to the 1920s, Watts credited that university department, and Professor Clifford A. Curtis in particular, with making the idea more relevant in the face of the inadequacies of the *Finance Act 1923* outlined above.[246] Unlike the Prime Minister, Curtis, writing in 1932, did not advocate the establishment of a Canadian money market.[247] What he did suggest was that the Canadian financial system needed a radical restructuring, and that Canada needed a "Macmillan Report" of its own.[248]

The original Macmillan Report was named after Lord Macmillan,[249] an eminent jurist who had chaired the U.K. Commission on Finance and Industry,[250] of which John Maynard Keynes was a member.[251] That Commission had held hearings from 1929 to 1931 in response to charges that the interests of industry and trade in the U.K. had been sacrificed to

245. Watts, *supra* note 96 at 21.

246. *Ibid.*

247. "Wiser counsels prevailed," Curtis said, "and the suggestion was deemed 'impractical' for the time being." Curtis, "The Canadian Monetary Situation", *supra* note 113 at 334.

248. *Ibid.*

249. Baron Hugh Pattison Macmillan, 1873-1952.

250. Watts, *supra* note 96 at 23.

251. In his memoirs, Lord Macmillan expressed much admiration for Keynes, and confessed his own discomfort in comprehending the intricate details of finance. Lord Macmillan attributed much of the technical material in his report to a drafting sub-committee, of which he described Keynes as having been the "leading spirit." Lord Hugh P. Macmillan, *A Man of Law's Tale: The Reminiscences of the Rt. Hon. Lord Macmillan* (London: Macmillan, 1952) at 196-197.

those of the financial community.[252] The Commission is known for having proposed a significant role for central banking,[253] and although its recommendations were largely seen as being on the cautious side,[254] it set several precedents. Chief among them was the fact that for the first time, the operations of what was then a private entity—the Bank of England—were subjected to public scrutiny.[255] The Commission's report revealed the Bank of England's previously secret inner workings,[256] and that Bank thereafter disclosed more information to the public.[257] Moreover, Keynes had taken a leading role in recommending a more proactive role for the Bank, to counter the effects of unemployment through expansionary monetary policy designed to increase bank reserves and facilitate credit.[258]

One can only imagine Curtis's delight when Prime Minister Bennett, after a visit to England in 1933, asked Lord Macmillan himself to head a Royal Commission on Banking and Currency in Canada.[259] In his memoirs, Lord Macmillan recalled that Bennett "would take no refusal from me and insisted on my going out to Canada."[260]

B. The Canadian Macmillan Commission

The Canadian Macmillan Commission[261] had as its mandate to study the functioning of the *Finance Act* and to consider the advisability of

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252. R.S. Sayers, *The Bank of England 1891-1944*, vol. 1 (Cambridge: Cambridge Univ. Press, 1976) at 360.
253. Powell, *supra* note 105 at note 33.
254. John Giuseppi, *The Bank of England: A History from its Foundation in 1694* (London: Evans Brothers, 1966) at 158.
255. Sayers, *supra* note 252 at 360.
256. *Ibid.* at 373-374.
257. *Ibid.* at 383-385.
258. *Ibid.* at 372.
259. Watts, *supra* note 96 at 23.
260. Macmillan, *supra* note 251 at 197.
261. In addition to Lord Macmillan, the commissioners were Sir Charles Addis, a former director of the Bank of England; Sir Thomas White, the Canadian wartime Minister of Finance and Vice-President of the Bank of Commerce; Beaudry Leman, General Manager of the Banque Nationale; and John Brownlee, Premier of Alberta. Sir Charles Addis was appointed at the request of Lord Macmillan. Watts, *supra* note 96 at 23.

establishing a central bank.[262] The Commission began its hearings in August 1933 and issued its final report a mere seven weeks later, on September 28.[263] In their submissions to the Commission, the banks maintained that a central bank was unnecessary, and that all that was needed was an administrative board to supervise the operation of the *Finance Act*.[264] The bankers balked at the suggestion that a central bank might be desirable to facilitate the establishment of a Canadian money market. They felt that such a market would be "artificial" and could never have the vitality of the London Bill Market, which they described as a "natural growth."[265]

With respect to the banks' note-issuing privileges, the bankers warned of dire consequences should they be lost. M.W. Wilson, General Manager of the Royal Bank of Canada, claimed that the closure of bank branches in small communities would result,[266] since banks could no longer concentrate their reserves at central points and use their own unissued notes as the cash reserves of their smaller branches.[267] The situation, Mr. Wilson said, would be aggravated by the fact that banks would also lose a significant source of revenue from issuing notes (estimated to yield 1.5 percent of their average circulation after taxes).[268] He submitted that it would not be necessary to give the proposed central bank the sole right to issue notes, and that private banknotes ought to remain in place even if such a bank were established.[269]

The Commission was not persuaded by the bankers' predictions. It voted to recommend a central bank by a margin of three to two, with the two bankers dissenting.[270] The Commission explicitly rejected the suggestion that Canada's economy was too underdeveloped to support

262. Macmillan Commission Report, *supra* note 54 at 5.
263. Powell, *supra* note 105 at 28.
264. O'Brien & Lermer, *supra* note 125 at 99.
265. Royal Commission on Banking and Currency in Canada, *Final Hearings at Ottawa* (14 September 1933), (Ottawa: King's Printer, 1933) at 7 [Submissions to Macmillan Commission].
266. *Ibid.* at 22.
267. *Ibid.*
268. *Ibid.* at 23.
269. *Ibid.*
270. O'Brien & Lermer, *supra* note 125 at 99.

central banking in the way that the U.K. and the U.S. had.[271] To quote Lord Macmillan:

> The financial system and economic life of Canada are already sufficiently well developed to make the instruments of the discount rate, the purchase and sale of securities, and operations in the foreign exchange market, of sufficient importance in the hands of a well managed central bank to give it a decisive influence on the credit situation in Canada.[272]

These were seen as effective tools that would enable a central bank to fulfil its mandate, which the Commission saw as having three components: to regulate credit and currency, both domestically and in the foreign exchange market;[273] to co-operate with other central banks and the Bank for International Settlements, in order to mitigate fluctuations in the general level of economic activity;[274] and to dispense skilled and impartial financial advice to the government of the day, with a primary goal of community service rather than profit maximization.[275]

The banks' claim that issuing notes was not a necessary function of a central bank was also explicitly rejected. The sole right to issue legal tender notes, the Commission said, "is essential for the full and satisfactory working of a central bank."[276] It was seen as complementary to the essential powers of maintaining bank reserves, holding various government accounts and carrying out all major governmental financial transactions.[277] To the bankers' claim that a transfer of note issuing privileges would greatly disrupt the economy, the Commission argued that this should not happen if the transfer was spread over a suitable period.[278]

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271. Macmillan Commission Report, *supra* note 54 at 68.
272. *Ibid.*
273. *Ibid.* at 63.
274. *Ibid.*
275. *Ibid.*
276. *Ibid.* at 65.
277. *Ibid.*
278. *Ibid.*

C. Establishment of the Bank of Canada

Interestingly enough, both the Bennett Conservative government and the Liberal opposition led by Mackenzie King had originally opposed the establishment of a central bank.[279] Yet mounting political opinion to the contrary, coupled with the rise of the Social Credit and Co-operative Commonwealth Federation parties in the west, made a central bank a more attractive political option.[280] The Macmillan Commission Report was tabled on September 27, 1933, and the government indicated that it was willing to accept the Commission's recommendations on November 20, 1933, one week after they were made public.[281]

In June of 1934, *An Act to Incorporate the Bank of Canada*[282] received Royal Assent. The preamble stated that the Bank's purpose was to

> regulate credit and currency in the best interest of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion.

The Bank of Canada was slated to commence operations on March 11, 1935.[283] In keeping with the Macmillan Commission's recommendations, provisions were made for the gradual phasing out of private note issues. By proclamation dated March 7, 1935, three repealing statutes took effect when the Bank began to operate.[284] They repealed the *Dominion Notes Act*,[285] the *Act respecting certain issues of*

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279. O'Brien & Lermer, *supra* note 125 at 99.
280. *Ibid.* at 100.
281. Watts, *supra* note 96 at 26.
282. 24-25 George V, c. 43 [*Bank of Canada Act*].
283. Holladay, *supra* note 85 at 204.
284. John D. Falconbridge, *Banking and Bills of Exchange*, 5th ed. (Toronto: Canada Law Book, 1935) [Falconbridge 5th ed.] at 442.
285. *Dominion Notes Act*, R.S.C. 1927, c. 41 as amended by 1932-33, c. 12 and 1934, c. 34, cited in *ibid.*

Dominion Notes,[286] and the *Finance Act 1923*.[287] The Bank of Canada was given the responsibility to redeem all outstanding Dominion Notes,[288] to be replaced with the Bank's own notes which were made legal tender.[289]

Other changes to the *Bank Act* repealed the banks' authority to issue excess notes during the crop-moving period.[290] Issues were once again limited to the amount of a bank's unimpaired paid-up capital. Beginning in 1936, the limit was reduced by five percent each year for five years,[291] and then by ten percent for each of the following five years, so that by 1945 it was down to 25 percent of paid-up capital.[292] In 1944, banks were prohibited from any further issue or reissue of chartered banknotes.[293] On January 1, 1950, the banks paid the Bank of Canada a cash sum equal to the notes still outstanding,[294] and the Bank of Canada assumed responsibility for them. Also in 1950, double liability on bank stock, initially enacted as a consumer protection measure, expired.[295] The era of private banknotes had ended.

IV. Did Nationalization Make a Difference?

In their 1987 article, Bordo and Redish argued that the Bank of Canada had little impact on macroeconomic variables.[296] They used an econometric analysis to test whether any changes had occurred in the

286. S.C. 1915, c.4., repealed by S.C. 1934, c. 30, cited in Falconbridge 5th ed., *supra* note 284.

287. Repealed by S.C. 1934, c. 35, cited in Falconbridge 5th ed., *ibid.*

288. *Bank of Canada Act*, *supra* note 282, s. 24.

289. *Ibid.*, s. 24(1). The legal nature of the Bank of Canada banknote was defined many years later in *Bank of Canada v. Bank of Montreal*, [1978] 1 S.C.R. 1148. An evenly split Supreme Court of Canada upheld the Ontario Court of Appeal's decision that the Bank of Canada's pre-1967 banknotes were promissory notes.

290. *Bank Act*, R.S.C. 1934, c.12, s. 61(2).

291. O'Brien & Lermer, *supra* note 125 at 101.

292. *Ibid.*

293. *Ibid.*

294. *Ibid.*

295. *Ibid.*

296. Bordo & Redish, *supra* note 239 at 413.

money stock, price levels and exchange rates in the period after the advent of the Bank of Canada in March 1935. They found that there was no structural break at that point,[297] and they concluded that political forces played a larger role in the establishment of the Bank than economic ones.[298]

A number of facts appear to be inconsistent with Bordo and Redish's conclusions. To be sure, and as the historical record bears out, political considerations did play a large role in the establishment of the Bank of Canada and in the consequent demise of private banknotes. However, the Bank did not have complete control over the money supply until 1950, when its notes became the sole circulating medium. Provision also had to be made for the accumulation of central reserves by the Bank before it could effectively engage in monetary policy. As a result, it is no surprise that the Bank had only a marginal effect on macroeconomic variables as of the day it commenced operations. However, this does not necessarily mean that it had no effect at all on subsequent events.

Bordo and Redish also failed to consider the fact that central banking was a relatively new phenomenon in Canada, and that it would take the Bank of Canada some time to master many of the tasks typically performed by a central bank. The Bank's first Governor was Graham Towers,[299] formerly Assistant General Manager of the Royal Bank of Canada (one of the banks that had supported the Bank of Canada's creation) and someone who was well respected in the banking community.[300] The Deputy Governor was J.H.C. Osborne, Secretary of the Bank of England, who was on loan to the Bank until 1938.[301] The excellent credentials of these people notwithstanding, the Bank's staff needed time to acquire enough credibility in the eyes of other bankers to be able to influence their operations through moral suasion. This point had been made in bankers' submissions to the Macmillan Commission,[302] and it was not lost on the commissioners themselves.[303]

297. *Ibid.* at 410-415.
298. *Ibid.* at 414-417.
299. O'Brien & Lermer, *supra* note 125 at 101.
300. Watts, *supra* note 96 at 20.
301. O'Brien & Lermer, *supra* note 125 at 101.
302. Submissions to Macmillan Commission, *supra* note 265 at 8.

As Bordo and Redish indicated, the annual reports of the Governor of the Bank of Canada from 1935 to 1939 cited concerns that there had been a transfer to the Bank of elements of the former financial system rather than an endeavour to achieve a proactive macroeconomic agenda.[304] Yet one must remember that the establishment of the Bank of Canada was intended to eliminate structural deficiencies in the former system, not in the short run but in the long run. The Bank was certainly not seen as a panacea that would halt any variations in Canada's economic fortunes,[305] but it was hoped that it would bring a sense of stability and would mitigate economic fluctuations. This role is clearly expressed in the *Bank of Canada Act* preamble set out above.

After its operations began, the Bank of Canada was credited with an increase in the demand for currency.[306] It also brought about improvements in chartered bank investment positions, by providing sufficient reserves to assure the absorption of government issues at a pace synchronized with the government's financial requirements.[307] Through its day-to-day dealings in securities and foreign exchange, the Bank provided an auxiliary market that minimized price fluctuations that might have been accentuated by temporary changes in the Bank's financial position.[308] Canada would thenceforth be on a managed money basis,[309] no longer constrained by a lack of cash reserves.[310] The banking system became free to acquire assets, and no longer faced the legal requirements to dispose of them that it had faced under the previous regime.[311]

The demise of private note issuance had important ramifications for the development of the monetary system. The banks were relieved of

303. Macmillan Commission Report, *supra* note 54 at 67.

304. Bordo & Redish, *supra* note 239 at 414.

305. Macmillan Commission Report, *supra* note 54 at 69.

306. Elliott, *supra* note 166 at 454.

307. *Ibid.*

308. *Ibid.*

309. O'Brien and Lermer defined a managed money system as one that was based upon central bank liabilities in the form of central bank notes or deposits which the central bank was free to vary at will. O'Brien & Lermer, *supra* note 125 at 94.

310. Elliott, *supra* note 166 at 456.

311. *Ibid.* at 457.

their responsibility to maintain Canada's foreign exchange position, and no longer had to worry about the acceptability of their note issues. Those responsibilities were consolidated in the Bank of Canada, which could exploit increasing returns to scale and had the full force of the country's gold reserves behind it. People no longer had to worry that the money in their pockets might become worthless overnight, as the Bank of Canada banknote had the guarantee of government behind it.

Even more important, by assuming the power to issue notes, the Bank of Canada markedly improved the availability of credit. As was mentioned earlier, the money supply could now be expanded or contracted in a number of ways which the private system could not hope to emulate. Through the use of open market operations, the money supply could be adjusted to suit economic needs. When the Bank wished to decrease the size of the money supply, and hence encourage the chartered banks to contract credit, it could sell some of its bond holdings to them. The banks would pay with bank drafts which the Bank of Canada would cash by decreasing the banks' accounts with it, thereby reducing the monetary base and the reserves backing the banks' ability to lend.[312] The converse was true when the Bank of Canada wished to increase the money supply. In that event, it would buy securities from the chartered banks or the public, pay for them with bank drafts and deposit the proceeds with the banks, which they would then be free to lend.[313] Reserves could also be adjusted by direct deposits or withdrawals to or from Bank of Canada accounts at the chartered banks.

Conclusion

Despite its promising beginnings, the issuing of private bank notes in Canada came to be seen as an inauspicious experience. Why did it fail to surmount the hurdles it faced? One answer lies in the fact that laws prevented the banks from supplying adequate amounts of money or

312. Rudiger Dornbusch, Stanley Fisher & Gordon Sparks, *Macroeconomics*, 4th ed. (Toronto: McGraw-Hill Ryerson, 1993) at 400.
313. *Ibid.*

credit when the situation warranted it, as had happened in 1907. Those laws were implemented in response to experiences in the United States and pre-Confederation Canada that had shaken the public's confidence in the ability of banks to redeem their obligations. Controls on note issuance were seen as a vital means of preventing bank failures, by ensuring that such issuance did not deplete a bank's resources and leave it unable to function as a going concern. Although those regulations were necessary if the system was to remain stable, they had the effect of aggravating economic booms and downturns, and they ultimately proved to be unreliable in extending credit in times of adversity.

The onset of the First World War only made matters worse for the financial system. The circumstances leading to the *Finance Act* showed that the existing system of private note issuance was inadequate to meet the economic needs of the country. Yet the solution envisioned by that *Act* only served as an incentive to the banks to disconnect themselves from the gold standard, and did not have the effect of expanding credit in the face of the Depression. The lack of expertise in the Treasury Board's management of the *Finance Act* only served to erode the public's confidence in the financial system as a whole. In Courtland Elliott's words:

> It seems to me only natural that in a period of unprecedented depression with its alteration of values, reduction of income, and social distress a demand would arise for monetary panaceas. It may be an illusion but it is a species of logic for an articulate public opinion, aware that a War of destruction and an era of speculation can be financed in a period of fifteen years, to demand that poverty in the midst of plenty be abolished by monetary means.[314]

The market approach had failed in this instance, and politicians, citizens and even some bankers once again turned to the state in search of a remedy. Political considerations undoubtedly played a large role in the ultimate choice of a course of action. Although private note issuance had served Canada well in its first half century, the economic benefits derived from it had failed to keep pace with the growing needs of the economy. When reforms within the existing system could no longer

314. Elliott, *supra* note 166 at 457.

provide a solution, a systemic change was inevitable. In the result, the Bank of Canada, whatever its shortcomings, has stayed true to its mission and has helped mitigate economic swings, at least with respect to meeting the demand for currency in the face of financial challenges.

With the end of private note issuance, Canada (and indeed the rest of the world) had come full circle. The development of the standard formula demonstrated that government had to take a proactive role in curing the failure of the market to supply adequate amounts of small change. Despite partial governmental interventions, a complete solution was not found until government obtained a monopoly over coin issuance. The same would ultimately prove to be the case with respect to private banknotes.

More importantly, the story of private banknotes in Canada demonstrates how money and credit have evolved, and illustrates the qualitative change in the nature of paper currency. From goldsmiths' notes and on to the first banks of issue, the precursors to banknotes emerged in Europe as a means of furnishing a workable currency and extending credit. We then witness the importation of banknotes into Canada as a replacement for bons. They served as the backbone for the loan activities of chartered banks, and they finally became an obligation issued by the Bank of Canada itself. This latter development reflected a change in attitude from a quantitative perspective as well. Not only did government retain the prerogative to determine the *quality* of money, which it had enjoyed since the implementation of the standard formula, but it thenceforth also played a role in determining the *quantity* of money.

In assessing the desirability of institutional reforms, one must remain aware of the tradeoffs that arise from competing systems. Hayek envisioned a system that would curb what he perceived to be governmental excesses, but the system he envisioned closely resembled that which preceded the present one. In charting a course for the future, we must look back on the roads previously travelled, so that we may learn from past mistakes. The form of money has changed, and will undoubtedly continue to change; for example, the decades since the demise of the private banknote have seen the emergence of travellers' cheques, credit cards and electronic money. Policymakers and academics must find ways to redesign and modify institutions to meet present and future needs. In doing so, they should be attentive to history's lessons.