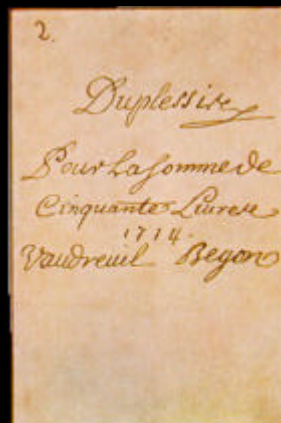


A History of the CANADIAN DOLLAR

by James Powell
BANK OF CANADA



This publication is also available in French.
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— James Powell

The Early Years (pre-1841)

The story of the Canadian dollar begins in the currency chaos of the early French and British colonial period in North America.¹ Through the seventeenth century and until well into the nineteenth, various coins from many countries circulated freely in the colonies. These included not only English and French coins, but also coins from Portugal, Spain, and the Spanish colonies in Latin America—notably Mexico, Peru, and Colombia. The hazards of sea travel and persistent trade imbalances with the home country left the colonies chronically short of coins.

In an effort to attract fresh supplies, French and British colonial authorities typically gave higher values to coins circulating in their jurisdiction than to the same coins circulating in England and France. For example, in New France, coins under the *monnoye du pays* system during the late seventeenth century were given a value one-third higher than *monnoye de france*. Similarly, British colonies in North America valued the silver Spanish dollar at rates of up to 8 shillings, despite the passage of legislation by the British government (Act for Ascertain-

ing the Rates of Foreign Coins in Her Majesty's Plantations in America) in 1707 that valued the coin at 4 shillings and 6 pence.²

The chronic coin shortage also encouraged the introduction of paper money. The most famous issue is undoubtedly the card money of New France. Introduced in 1685, card money initially consisted of playing cards cut to different sizes according to denomination and signed by colonial officials. Despite the protests of authorities in Paris, who objected to the loss of budgetary control, there were several issues of card money before it was withdrawn from circulation in 1719. Card money reappeared in 1729, however, and remained readily accepted until rising inflation, associated with the financing of the Seven Years' War during the 1750s, undermined confidence in its value.

To add to the confusion, different colonies rated coins differently. Sometimes, certain coins were deliberately overrated (i.e., overvalued) or underrated (undervalued) relative to others, given their weight in gold or silver, in order to encourage or discourage their use. In such circumstances,



Spanish 8-real piece, 1779: *This large silver coin, bearing a bust of King Charles III, was a Spanish colonial coin struck in Mexico. It was typical of the “silver dollars” that circulated in the United States and Canada.*

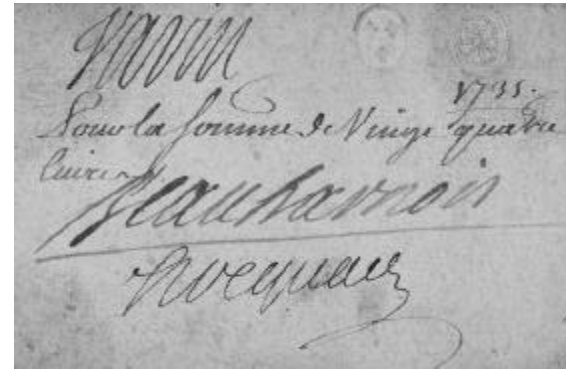
1. This section draws heavily upon McCullough (1984).

2. This act was initially issued as a royal proclamation by Queen Anne in June 1704.

overrated coins drove underrated coins from circulation—an application of Gresham’s Law, “bad money drives out good.” Underrated coins were typically hoarded or shipped to colonies that valued them more highly. To counteract this, colonial legislatures periodically revised their ratings. Ratings were also revised in response to other factors, including the decline in the value of silver relative to gold throughout the eighteenth and nineteenth centuries and the gradual wearing of old coins (which lowered their weight and reduced their intrinsic value).

The Halifax and York ratings

One rating that became particularly important in British North America was the Halifax rating. Named after the city of Halifax, where it was first used, this rating was given legal standing by an act of the first Nova Scotia House of Assembly in 1758 (McQuade 1976). This rating used pounds, shillings, and pence (£, s. and d.) as the unit of account and valued one Spanish (or colonial Spanish) silver dollar weighing 420 grains (385 grains of pure silver³) at 5 shillings, local currency. This valuation of the Spanish dollar, the most common coin in circu-



Card money, 24 livres, 1735: Printed on playing card stock, the size and shape differed with the denomination. The piece above is signed by Governor Beauharnois, Intendant Hocquart, and Varin, the agent for the Comptroller of the Marine.

lation at that time, was to be used in settling debts. In effect, the Spanish dollar became legal tender in Nova Scotia.

Although the British imperial authorities overturned the legislation in 1762, since it did not conform to the 1707 Imperial Act, the rating remained in common use and was later adopted in Quebec by

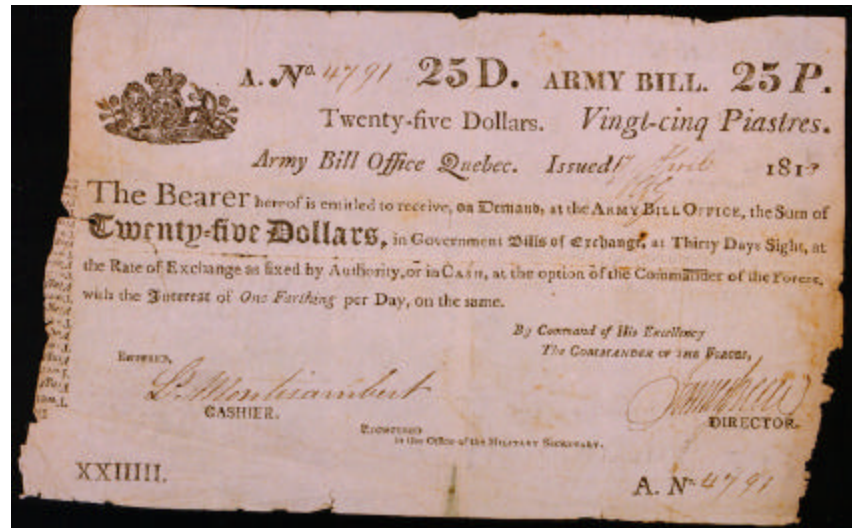
3. A grain is a measure of weight. Under the system used to weigh precious metals, there are 5,760 grains in a troy ounce.

the British authorities after the Seven Years' War, as well as in New Brunswick and Prince Edward Island. The Halifax rating, with some modifications, persisted well into the mid-1800s.

In contrast, following the U.S. War of Independence, Upper Canada used the York rating, as did merchants in Montreal, for a time.⁴ This rating had originally been established in New York and was brought to Upper Canada by Loyalist immigrants (Turk 1962). In York currency, one Spanish dollar was valued at 8 shillings. Although an 1821 act re-established the use of the Halifax rating in Upper Canada and, hence, valued one Spanish dollar at 5 shillings, the York rating remained in use in rural areas until the unification of Upper and Lower Canada in 1841.

Dollars and cents or pounds, shillings, and pence?

During the eighteenth century and the first half of the nineteenth, the pound sterling (pounds, shillings, and pence) was the unit of account in British North America. Given the scarcity of British coins, however, and the prevalence and wide acceptance of



Army Bill, \$25, 1813: Printed in Quebec City, these notes were used to pay troops and to buy provisions during the War of 1812. At the end of the war, the bills were redeemed in full, which restored trust in paper money.

Spanish silver dollars, it became increasingly difficult to maintain a currency system based on sterling. The introduction of the U.S. dollar (modelled on the Spanish dollar) in the United States in

4. In 1765, the British military authorities introduced a Quebec rating, which valued the Spanish dollar at 6 shillings. This rating was dropped in 1777 in favour of the Halifax rating.



American Silver Dollar, 1800: *These coins were the same size and fineness as Spanish dollars. The design, featuring the bust of Liberty, was introduced in 1795 and used for several years. Although this coin circulated in Canada, half dollars were much more common here.*

1792, together with growing trade links between Upper and Lower Canada and the United States, also favoured the use of dollars.

The widespread use and popularity of the dollar stymied periodic efforts by the imperial authorities in British North America to establish a common monetary system throughout the British Empire based on pounds, shillings, and pence. It is therefore not surprising that when Sir Isaac Brock issued up to £250,000 worth of Army Bills in Lower Canada in 1812, to help finance the War of 1812, the bills were denominated in Spanish dollars. Army Bills became legal tender in both Upper and Lower Canada until their redemption shortly after the war ended.

The first bank notes in Canada, issued by the

Montreal Bank following its establishment in 1817, were also denominated in dollars.⁵ These notes could be redeemed in coin, upon demand. As new banks were incorporated in Upper and Lower Canada during the 1830s and 1840s, their bank notes were typically denominated in both dollars and pounds. These notes circulated freely through both



Montreal Bank, \$1, 1821: *The Montreal Bank was chartered as the Bank of Montreal in 1822. This note belongs to a pre-charter issue, produced by the American printer Reed Stiles and Company. The design shows Britannia with a ship, the symbol of commerce, and a representation of a city, perhaps Montreal. At the centre bottom is a Charles IV Spanish dollar, an indication of value for those who couldn't read.*

5. There are examples of notes, denominated in pounds and shillings, issued by the Canadian Banking Company in 1792. It is not clear, however, whether this bank ever opened for business.

Canadas and in the United States. Dollar-denominated bank notes issued by U.S. banks also circulated widely in Upper Canada during the early 1800s. This two-way movement of notes across the Canada-U.S. border strongly favoured the continued use of dollars and cents in Canada over pounds, shillings, and pence.

In contrast, bank notes circulating in New Brunswick, Nova Scotia, Prince Edward Island, and Newfoundland, before Confederation, were typically denominated in pounds, shillings, and pence. This reflected both the stronger ties these provinces had with Great Britain and their weaker commercial links with the United States.



Bank of Montreal, 25 shillings or \$5, 1852: This note is an example of the dual currency system that existed in the Province of Canada prior to decimalization in 1858.



Shilling, 1834 (left) and William IV half-crown, 1836: These are examples of British coinage used in the mid-nineteenth century. A half-crown was worth 2 shillings and 6 pence, or 50 cents.

Currency Reforms (1841–71)

Political union of Upper and Lower Canada on 10 February 1841 led to a new standardized rating for coins in the two Canadas that took effect in April 1842.⁶ The British gold sovereign was valued at one pound, four shillings, and fourpence in local currency, while the US\$10 gold eagle was valued at two pounds, ten shillings.⁷ Both coins were considered legal tender. Spanish (including Spanish colonial) and U.S. silver dollars with a minimum weight of 412 grains were also made legal tender⁸ with a value of five shillings and one pence—a valuation very similar to the old Halifax rating.

At this time, efforts also began to move to a decimal-based currency system and to introduce a government issue of paper currency. In 1841, Lord Sydenham, Governor General of the new united Province of Canada, proposed that the provincial legislature establish a provincial bank that would

issue up to £1 million in provincial paper currency denominated in dollars, 25 per cent of which would be backed by gold, the remainder by government securities. He also recommended that notes issued by chartered banks be prohibited. In effect, Lord Sydenham's proposal amounted to the establishment of a Canadian central bank.

While Lord Sydenham sought a paper currency with guaranteed convertibility, he was also strongly motivated by a desire to acquire funds to finance provincial public works and to obtain the seigniorage profits from the note issue. Seigniorage was estimated to be at least £30,000 per annum and had the potential to rise considerably as the currency issue increased (Breckenridge 1910).⁹

The proposal was studied by a parliamentary select committee on banking and currency, headed by Francis Hincks, who strongly favoured the

6. In addition to McCullough (1984), this section draws heavily from Breckenridge (1910).
7. Recall that colonial legislatures rated coins higher than in Great Britain, where a sovereign was worth £1 in pounds sterling. The valuation for the U.S. gold eagle is for coins minted after 1834. Coins minted before that date had a higher gold content and were worth £2. 13s. 4d. each in local currency.
8. Essentially, legal tender is money that must be accepted in settlement of a debt, unless alternative payment options have been previously stipulated.
9. Seigniorage arises from the fact that the province would issue non-interest-bearing paper money, while earning interest on the securities backing the currency issue.

Governor General's plan. The provincial assembly turned it down, however, because of widespread opposition, particularly from a strong bank lobby. Banks were concerned about the impact on their profits if they lost the right to issue paper currency. Interestingly, borrowers were also worried that government control of the bank note issue would lead

to tighter credit conditions. In addition, there was concern that the government would gain too much power. Because of the assembly's rejection of the Governor General's proposal, a provincial issue of paper currency had to wait another 25 years. The establishment of a central bank was delayed by close to 100 years.

Introduction of a decimal-based currency

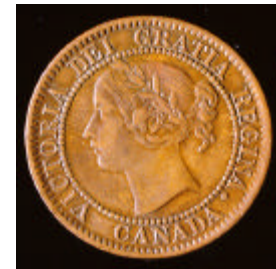


Province of Canada, 10 cents, 1858: *This piece represents the first coinage manufactured for use in Canada. It was designed and produced in England at the Royal Mint and features a crown with two sprigs of maple leaves tied at the base with ribbon.*

Despite this failure, reform efforts gained momentum through the 1850s, especially during the government of Francis Hincks, who became prime minister of the Province of Canada in 1851. In June of that year, representatives from the Province of Canada, New Brunswick, and Nova Scotia met in Toronto to work towards the establishment of a decimal currency. A few months later, the Canadian legislature passed an act

requiring that provincial accounts be kept in dollars and cents. However, the British government, still seeking to establish a currency system based on pounds, shillings, and pence throughout the Empire, delayed confirmation of the act. A compromise Currency Act was finally passed in 1853 and proclaimed on 1 August 1854. Under this act, pounds, shillings, and pence as well as dollars and cents could be used in provincial accounts.

The Currency Act also confirmed the ratings of various British and American coins that had been in place since the establishment of the Province of Canada in 1841. Pounds, shillings, and pence as well as dollars and cents were recognized as units of Canadian currency. The British gold sovereign was rated at £1. 4s. 4d. currency or Can\$4.8666, while the US\$10 gold eagle (those minted after 1834 with a gold content of 232.2 grains) was valued at Can\$10.



Province of Canada, bronze cent, 1858: *Part of the first issue of 1-, 5-, 10-, and 20-cent coins made for the Province of Canada, this coin is about one inch in diameter. It proved very unpopular compared with the larger and heavier tokens, American cents, and British halfpennies that Canadians were used to.*

Since the colonial authorities in New Brunswick had passed similar currency legislation in October 1852, the proclamation of the Currency Act in the Province of Canada meant that the two

provinces had compatible currencies, fixed at par with their U.S. counterpart, with \$1 equivalent to 23.22 grains of gold.

Decimalization received a further boost a few years later. Following a recommendation from the public accounts committee, the Province of Canada revised the Currency Act in 1857 so that, as of 1 January 1858, all provincial accounts would be kept in dollars. Silver and bronze coins, denominated in cents and bearing the word “Canada,” were also issued for the first time later that same year.¹⁰ This marked the birth of a distinctive Canadian currency.

In Nova Scotia, decimalization occurred on 1 January 1860. Nevertheless, because that province rated the sovereign at \$5 instead of \$4.8666, its currency remained incompatible with that of Canada and New Brunswick. New Brunswick officially decimalized on 1 November 1860, and Newfoundland followed in 1863. Like Nova Scotia, Newfoundland’s currency was not compatible with that of Canada or New Brunswick. The colony of Vancouver Island also decimalized in 1863, followed



Bank of Clifton, \$5, 1859: This note was issued by an early Canadian chartered bank, which was also known as the Zimmerman Bank. It became a “wildcat” bank, issuing large quantities of notes with no intention of redeeming them. The detailed engraving is typical of nineteenth-century bank notes. The coloured “FIVE” is an anti-counterfeiting device.

10. Prior to the establishment of the Ottawa Mint in 1908 (a branch of the Royal Mint under the Imperial Coinage Act of 1870), coins used in Canada were minted in the United Kingdom. The first gold coins minted in Canada were sovereigns, identical to those produced in the United Kingdom except for a small identifying “C.” It was not until May 1912 that the Ottawa Mint began to produce limited quantities of gold \$5 and \$10 coins. The Ottawa Mint became the Royal Canadian Mint in 1931.

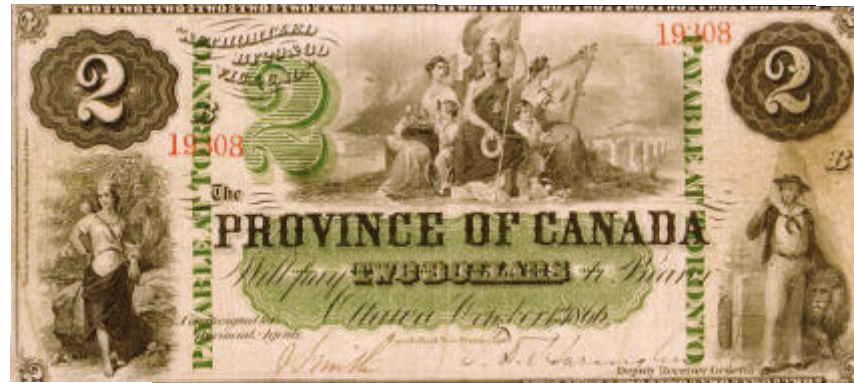
by British Columbia in 1865.¹¹ Manitoba decimalized in 1870, upon its entry into Confederation, and Prince Edward Island followed in 1871.

The first government note issue

In the late 1850s and the early 1860s, efforts were renewed in the Province of Canada to introduce a government issue of paper money. This time, the financial and political environment was more receptive than had been the case in 1841.

The collapse of a number of banks during this period brought bank notes issued by chartered banks into disrepute. In 1859, two Toronto-based banks, the Colonial Bank and the International Bank, failed. This was shortly followed by the collapse of the Bank of Clifton and the Bank of Western Canada. The failures of these last two banks were particularly scandalous, with the former pretending to redeem its notes in Chicago and the latter, owned by a tavern-keeper, attempting to circulate worthless bank notes in the U.S. Midwest. In his authoritative review of early banking in Canada, Roeliff Breckenridge wrote,

No great loss was caused to the Canadian public

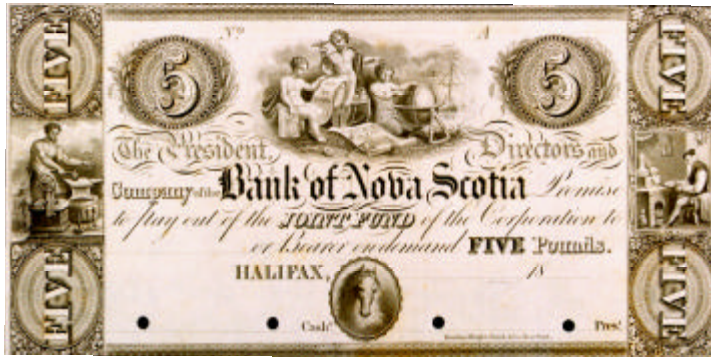


Province of Canada, \$2, 1866: *This note was produced by the British American Bank Note Company, which had offices in Montreal and Ottawa. This note was payable at Toronto.*

by their collapse, but the scandal and the ease of acquiring dangerous privileges which had led to the scandal, called forth bitter and general complaint (Breckenridge 1910, 71).

Nevertheless, a loss of confidence in chartered bank notes, the principal means of payment, posed a threat to economic prosperity. To restore confidence in the currency and to raise funds for the government in 1860, A. T. Galt, Finance Minister of

11. The colonies of Vancouver Island and British Columbia were united in November 1866 under the name British Columbia. A decimal currency act for the new combined province was passed in 1867.



Bank of Nova Scotia, £5, 1820s—1830s: An example of an early chartered bank note. This note was a “remainder” (it was never issued, as indicated by the holes punched across the bottom) and was printed in England.



Bank of New Brunswick, £1, 1831: The Bank of New Brunswick received its charter in 1820. This is a large-format note (184mm by 98mm), typical of early notes issued by chartered banks.

the Province of Canada, proposed replacing chartered bank notes with an issue of government notes.¹² Once again, the chartered banks objected strongly to the potential loss of their privileges, and the proposal was quickly withdrawn. In 1866, however, with the Canadian government seriously short of resources, the need for a new source of funding became acute. Domestic and British banks were unwilling to advance new funds or roll over existing loans. Moreover, the provincial government was

unable to sell bonds in London even at very high rates of interest. With all funding avenues apparently closed, the provincial authorities passed controversial legislation to issue up to \$8 million in legal tender, provincial notes. These notes were payable on demand for gold in either Toronto or Montreal and were partly backed by gold—20 per cent for the first \$5 million and 25 per cent for amounts in circulation in excess of \$5 million. The Provincial Notes Act received royal assent on 15

12. In contrast to Lord Sydenham’s earlier proposal, the notion of establishing a provincial bank to issue the notes was dropped.

August 1866.

Unlike Galt's earlier proposal, chartered banks were not obliged to give up their right to issue bank notes although they were encouraged to do so.¹³ Compensation was offered, including the payment of 5 per cent of their average notes in circulation and

a further 1 per cent per year for issuing and redeeming provincial notes. Nevertheless, only the Bank of Montreal, the government's fiscal agent, took up the offer. It too resumed its bank note issue following the passage of the 1871 Bank Act.

Paper currency outside the Province of Canada

Other provinces had broadly similar experiences with paper money. When the War of 1812 caused a coin shortage in Nova Scotia, the provincial authorities issued treasury notes. But unlike Sir Isaac Brock's issue of Army Bills in Lower Canada, these notes were not legal tender, although they were widely accepted. Denominated in sterling, treasury notes became very popular, leading the government to issue new notes throughout the first half of the nineteenth century. Following the incorporation of the Halifax Banking Company in 1825 and the Bank of Nova Scotia in 1832, bank notes (denominated in pounds) were also issued and circulated widely in the province and throughout the Maritimes.

In New Brunswick, the authorities also issued provincial treasury notes on several occasions, first denominated in dollars in 1805 and 1807, and then

in pounds following the War of 1812. While the government discontinued such issues in 1820, bank notes denominated in pounds filled the gap following the granting of a charter to the Bank of New Brunswick in 1820.

Prince Edward Island experimented with paper money as early as 1790, when the province issued £500 of treasury notes to make up for a shortage of coin. These notes were legal tender and were issued in amounts up to £2. Further issues followed through the first half of the nineteenth century. Government issues of paper money were supplemented by the widespread use of notes issued by chartered banks in Nova Scotia and New Brunswick and by notes from the Bank of Prince Edward Island, the island's first bank, chartered in 1855.

13. Apparently, chartered banks were required to give up their own note issues in order to acquire the right to issue provincial notes on behalf of the government.

Confederation

Confederation on 1 July 1867 brought sweeping changes to banking and currency legislation in the provinces of Canada, Nova Scotia, and New Brunswick. Under the British North America Act, the government of the new Dominion was given jurisdiction over currency and banking. The Dominion Notes Act came into effect the following year. Under this legislation, the Dominion took over the various provincial note issues. Provincial notes issued in the Province of Canada were renamed “dominion notes” and were made redeemable in Halifax and Saint John in addition to Montreal and Toronto. The Dominion Notes Act was subsequently extended to cover Prince Edward Island, Manitoba, and British Columbia in 1876 and the Northwest Territories in 1886.

Like earlier provincial notes, dominion notes were partly backed by gold. The first \$5 million

issued were 20 per cent backed and the next \$3 million, 25 per cent backed. Over time, the size of the authorized note issue was increased. There were also some changes to the percentage of notes backed by gold. By 1913, the first \$30 million had a 25 per cent gold backing.¹⁴ Issues in excess of \$30 million had to be fully backed with gold.

Interestingly, although dominion notes became redeemable in Halifax in 1868, Nova Scotia retained its own currency until April 1871, when the dominion government passed the Uniform Currency Act.¹⁵ At that time, Nova Scotian currency was converted into Canadian currency at a rate of 75 Nova Scotian cents to 73 Canadian cents.¹⁶

The Uniform Currency Act also established that denominations of Canadian currency would be “dollars, cents and mills” (a mill equalled one-tenth of a cent). Moreover, the Canadian dollar’s value

14. Legally, the 25 per cent reserve could be held in the form of gold or guaranteed debentures. In fact, the reserve was held entirely in the form of gold.
15. The dominion government circulated a special issue of \$5 notes in Nova Scotia, with the legend PAYABLE AT HALIFAX/ONLY printed vertically on them. These notes, issued in Nova Scotian currency, were worth only \$4.86 in the rest of Canada. See Haxby (1975).
16. Newfoundland’s currency was also not compatible with that of Canada. The Newfoundland dollar was worth roughly \$1.014 Canadian dollars. Newfoundland’s currency was made consistent with Canada’s in 1895. The colony joined Confederation in 1949 (McCullough 1984, 223).

was fixed in terms of the British sovereign at a rate of \$4.8666 and the U.S. gold eagle at a rate of \$10—the same rates established in the 1853 Currency Act.

The dominion government also passed the Bank Act in 1871, which repealed all provincial acts that were in conflict with federal jurisdiction over currency and banking. Consequently, chartered banks in the four provinces eventually came under common regulation.¹⁷ Chartered banks were allowed to issue notes with a minimum denomination of \$4 (raised to \$5 in 1880). Although banks, as a matter of course, held substantial reserves of dominion notes and gold, they were not required to secure their note issues either by gold or by specific collateral. Note issues could not, however, exceed a bank's paid-in capital.¹⁸ The notes that a bank had in circulation represented a first lien on that bank's assets in the event of failure.¹⁹ The government pre-



Dominion of Canada, \$1, 1870: Printed by the British American Bank Note Company, this was part of the first series of notes engraved for the new Dominion and features a portrait of Jacques Cartier. These notes were redeemable at the Receiver General's office in Ottawa or at the branch indicated on the back.

served the issuance of smaller notes for itself. It also issued notes in larger denominations to be used mainly for transactions between banks.

17. Banks chartered before Confederation continued to operate under their provincial charters until those charters expired. They subsequently received federal charters.
18. This was modified in 1908 to allow banks to increase their notes in circulation beyond the usual limits (on a temporary basis) during the harvest season. In the 1913 revision of the Bank Act, banks were allowed to issue notes in excess of their paid-in capital, provided that the excess note issue was secured by gold or by dominion notes (Beckhart 1929, 381).
19. Under the Bank Act of 1890, a Bank Circulation Redemption Fund was established by the government to give added protection to bank notes in case of insolvency. Banks maintained an amount equivalent to 5 per cent of their average annual circulation of notes in the fund and received 3 per cent interest.

The Canadian Dollar under the Gold Standard (1854–1914)

Operation of the gold standard



Canadian \$10 gold piece, 1913: Part of a series of \$5 and \$10 coins issued from 1912 to 1914, these were the only gold coins struck for use in Canada, with the exception of sovereigns.

From 1 August 1854 when the Currency Act was proclaimed, until the outbreak of World War I in 1914, the Province of Canada, and subsequently the Dominion of Canada, was continuously on a gold standard. Under this standard, the value of the Canadian dollar was fixed in terms of gold. It was also valued at par with the U.S. dollar, with a British sovereign valued at Can\$4.8666. As noted earlier, both U.S. and British gold coins were legal tender in Canada.

With the gold standard in place, monetary policy was largely “on automatic pilot.” Paper money was freely convertible into gold without restriction, and there were no controls on the export or import

of gold. This implied that there was virtually no scope for the authorities to manage the exchange rate or conduct an independent monetary policy.²⁰

Fluctuations in market exchange rates between the Canadian dollar and the U.S. dollar and the pound sterling, respectively, around their official values were generally limited by the gold “export” and “import” points. These points marked the exchange rates at which it was profitable for individuals to take advantage of price differences between the market and official exchange rates through the export and import of gold from the United States or the United Kingdom. The difference between the export and import points and the

20. Note, however, that following Confederation, the amount of dominion notes that could be issued without 100 per cent gold backing was increased over time from \$8 million in 1868 to \$30 million by 1913 (Beckhart 1929, 294). Rich (1988) argues that the marked expansion of the uncovered note issue through the 1867–85 period suggests that the government relied extensively on discretionary monetary policy during this time. After 1885, however, although the amount of dominion notes in circulation continued to rise, there was a matching increase in gold reserves. Consequently, the percentage of gold reserves to dominion notes in circulation rose from only 21 per cent in 1890 to 81 per cent at the outbreak of World War I (Rich, 71–73 and Beckhart, 296).

official rates reflected the cost of insuring and shipping gold to and from New York or London and Montreal, Canada's financial centre at that time. Given the proximity of New York, the margins against the U.S. dollar were very narrow around parity with a gold export point of Can\$1.0008 and a gold import point of Can\$0.9992. The margins around the \$4.8666 par value of the pound sterling were somewhat wider, ± 1 per cent, given the greater distance to be travelled (Rich 1988). On rare occasions, the Canadian dollar traded outside the gold points for periods of several weeks, much longer than one would have expected if arbitrageurs were efficient. This suggests that obstacles, probably imposed by governments, might have impeded their activities (Turk 1962). While not a particularly sig-

nificant phenomenon prior to 1914, government-erected impediments to the cross-border flow of gold became common during World War I and even more so through the late 1920s and early 1930s.

With monetary policy essentially on autopilot and little in the way of active fiscal policy, there was nothing to buffer economic swings and the impact of large international capital movements. Accordingly, Canada experienced significant periods of boom and bust during the gold-standard years. For example, during the 1870s, Canada suffered a prolonged economic contraction and falling prices. In contrast, between 1900 and 1914, Canada grew rapidly, and inflationary pressures mounted as huge amounts of foreign capital (as a percentage of Canadian GDP) entered the country.²¹

The Canadian dollar and the U.S. greenback (1862–79)

In 1862, the American Civil War began to affect currency in the United States. As the finances of the Union government deteriorated, U.S. banks suspended the convertibility of their notes into gold, and the government suspended the right to convert U.S. Treasury notes (government-issued paper money) into gold. Shortly afterwards, the U.S. Congress authorized the government to issue non-

convertible legal tender currency, which became popularly known as "greenbacks." While little was said officially regarding the future convertibility of greenbacks into gold, it was widely assumed that convertibility would be restored when the war was won (Willard et al. 1995). Trading in the greenback vis-à-vis gold commenced in mid-January 1862 in New York and continued with only one short

21. Net capital inflows into Canada reached a record 18 per cent of GDP in 1913 (Urquhart 1986).



United States, \$1, 1862: Known as the "greenback," and produced during the Civil War, this was part of a note issue that re-established a government (paper) currency in the United States.

interruption until the United States returned to the gold standard on 1 January 1879.

Almost from the start of trading, the greenback depreciated relative to gold and against other currencies, including the Canadian dollar, which remained on the gold standard. The weakness in the greenback undoubtedly reflected the rapid expansion of the U.S. note issue from \$150 million in early 1862 to \$450 million by March 1863. Fluctuations in its value also reflected the military and political fortunes of the Union government and, hence, the expected likelihood that the government would

eventually be able to redeem the greenbacks in gold. The greenback tended to strengthen on news of Union victories, such as the Battle of Gettysburg in 1863, and weakened on Union reversals. It reached its nadir during the summer of 1864, when the Union government, in a move against speculators, temporarily shut down gold trading for two weeks in late June, followed by a threatened Confederate raid on Washington in early July.²² Based on available information, the U.S. greenback fell from close to parity against the Canadian dollar in early 1862 to less than 38 Canadian cents (or Can\$1 = US\$2.65)

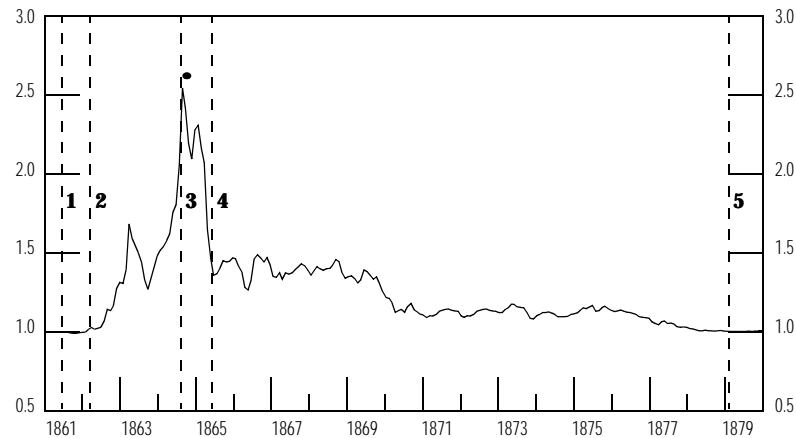
22. Confederate troops led by Jubal Early came within five miles of the White House on 11 July 1864 before breaking off the raid and returning to Virginia (Willard et al. 1995, 17).

in mid-July 1864 (Turk 1962).²³ This represents the all-time peak for the Canadian dollar in terms of its U.S. counterpart.

The greenback subsequently began to recover, almost doubling in value by the end of the Civil War in April 1865. After the war, it continued to strengthen, albeit at a slower pace, as the government retired a significant amount of greenbacks during the 1866–68 period. Deflation after the Civil War enabled the United States to return to the gold standard on 1 January 1879, with the greenback convertible into gold at the old pre-war rate of 23.22 grains of gold (Yeager 1976). Once again, the Canadian dollar traded at par with its U.S. counterpart. This exchange rate held until the outbreak of World War I.

Canadian dollar in terms of the U.S. dollar, 1861–79

Monthly averages
US\$



- 20 July 1864: Can\$1 = US\$2.65
 - 1. April 1861: Outbreak of U.S. Civil War.
 - 2. January 1862: United States suspends gold convertibility.
 - 3. June, July 1864: Closure of Gold Room, Confederate army approaches Washington.
 - 4. April 1865: U.S. Civil War ends.
 - 5. January 1879: United States returns to gold standard.
- Source: Turk (1962)

23. Exchange rate data were culled from the *Montreal Gazette* on file in the National Archives. Canadian dollar exchange rate data are incomplete for this period. Based on the movement of the U.S. dollar versus gold, it is probable that the U.S. dollar weakened further on 11 July.

Canada off the Gold Standard (1914–26)

World War I

The beginning of World War I marked the end of the classic age of the gold standard.²⁴ All major countries suspended the convertibility of domestic bank notes into gold and the free movement of gold between countries. This was often done unofficially. For example, in the United Kingdom, private exports and imports of gold remained legal in theory. However, in addition to a number of government-imposed regulations that discouraged the buying and selling of gold, bullion dealers refused to permit gold exports on patriotic grounds (Yeager 1976, 310).

In Canada, convertibility was officially suspended. As tensions mounted in the days immediately prior to the declaration of war on 4 August 1914, there were heavy withdrawals of gold from banks. In an “atmosphere of incipient financial panic” (Macmillan Report 1933, 22), there were concerns about the possibility of bank runs. In the absence of a lender of last resort, this was potentially very serious since banks were legally required to

close if they were not able to meet depositor demand for gold or dominion notes.

On 3 August 1914, an emergency meeting was held in Ottawa between the government and the Canadian Bankers Association to discuss the crisis. Later that day, an Order-in-Council was issued that provided protection for banks that were threatened by insolvency by making notes issued by the banks legal tender. This allowed the banks to meet their depositor demands with their own bank notes rather than with dominion notes or gold. The government also increased the amount of notes that banks were legally permitted to issue. The government was also empowered to make advances to banks by issuing dominion notes against securities deposited with the minister of finance. This provision enabled banks to increase the amount of their bank notes in circulation.

A second Order-in-Council, issued on 10 August 1914, suspended the redemption of dominion notes into gold. This and the previous

24. Although gold had been used as money since antiquity, a fully-fledged international gold standard lasted a surprisingly short time—roughly 40 years. It was not until the 1870s that a gold standard was finally adopted in all major economies (Yeager 1976, 295).



Dominion of Canada, \$1, 1917: This note features Princess Patricia, daughter of the Duke and Duchess of Connaught and patron of the famous Princess Patricia Canadian Light Infantry Regiment. The duke was Canada's Governor General from 1911 to 1916.



Australian sovereign, 1926: Struck in Sydney, Australia, this coin features an early-nineteenth-century design, by Pistrucci, of Saint George slaying the dragon. The obverse bears the bust of King George V. The sovereign was legal tender in Canada and contained almost a quarter ounce of gold.

Order-in-Council were subsequently converted into legislation as “An Act to Conserve the Commercial and Financial Interests of Canada” (the Finance Act), which received royal assent on 22 August 1914.

The Finance Act gave the government the power to act as a lender of last resort to the banking system—one of the powers of a modern central bank. It also provided a means for the government (Treasury Board) to set the Advance Rate, the rate at which it would make loans to the chartered banks. Advances under the Finance Act were made at the

request of banks. The government could not freely adjust bank reserves in order to expand or contract the monetary base. Hence, the government did not actively manage interest rates, nor was there any board overseeing the conduct of monetary policy (Shearer and Clark 1984, 279).

Throughout the war, the Advance Rate remained at 5 per cent, although a special 3.5 per cent rate was established in 1917 under which the government discounted British treasury bills held by the chartered banks. This facility was designed to assist the British government's war effort. It was

complemented by a special \$50 million issue of dominion notes backed by British treasury bills to help finance British purchases of war materials in Canada (Macmillan Report 1933, 22). The government also increased the fiduciary issue of dominion notes (i.e., notes not backed by gold) in 1915 under an amendment to the Dominion Notes Act.

Despite the suspension of gold convertibility in August 1914, the Canadian dollar traded in a very narrow range close to parity with its U.S. counterpart throughout the war years. In 1918, however, the Canadian dollar began to weaken, and its decline accelerated during the two-year period following the end of hostilities, until it reached a low of roughly US\$0.84 in 1920. The weakness of the currency reflected excessive monetary expansion during the war, which continued in the immediate post-war years partly because of the financial needs associated with demobilization as well as the related deterioration in Canada's balance of payments (Shearer and Clark 1984, 282; Knox 1940).



Left: American \$10 gold piece, 1914: An example of the American "eagle," featuring Liberty wearing a Native headdress. **Right: American \$20 gold piece, 1924:** An example of the American "double eagle," named for the design on the reverse. This particular coin is slightly larger than a "loonie" and was designed by Augustus Saint-Gaudens. It features Liberty striding out of the dawn into a new day, carrying a torch and an olive branch.

Setting the stage for a return to the gold standard

There was a general presumption that, after the war, the major industrial countries would return to the gold standard. The United States, which was a late entrant into the war and did not experience the

same sort of financial or inflationary pressures as the United Kingdom or Canada, returned to its old fixing in terms of gold in June 1919. The United Kingdom controversially followed suit in 1925 at its

old pre-war price in terms of gold, equivalent to US\$4.8666.²⁵

In Canada, the Finance Act of 1914, which had been adopted as a war measure, was extended in 1919 and revised in 1923. Under the revised act, provision was made for an automatic return to the gold standard after three years unless the government took steps to the contrary.

The revised act also gave the dominion government greater flexibility to adjust the rate at which banks could obtain funding.²⁶ However, the Treasury Board, which was responsible for administering the act, did not conduct an active monetary policy. The Advance Rate remained fixed at 5 per cent, the same level it had been throughout the war. Thus, there appeared to be little overt official effort to tighten monetary policy in anticipation of an eventual return to the gold standard, which would fix the dollar at its pre-war value in terms of gold and at par with its U.S. counterpart.

Canadian dollar in terms of U.S. dollar, 1914–26

Monthly averages



1. August 1914: Outbreak of World War I.

2. November 1918: End of World War I.

3. July 1926: Return to gold standard.

Source: U.S. Board of Governors of the Federal Reserve System (1943)

25. John Maynard Keynes famously opposed this move in a pamphlet entitled “The Economic Consequences of Mr. Churchill.” Given a relatively high rate of inflation in the United Kingdom during and immediately following the war, the old pre-war parity for sterling was seen as being too high. Efforts to sustain the pound at its pre-war rate led to a serious recession and deflation.

26. Under the 1914 act, the Advance Rate could not fall below 5 per cent. This minimum level was removed in the 1923 revision.

Despite the apparent lack of action, the money supply did contract significantly during the first half of the 1920s, permitting a return to the gold standard. The maintenance of the Advance Rate at 5 per cent, despite a fall in market interest rates, had deflationary consequences. Moreover, Britain's repayment of war loans from Canadian banks (which were subsequently discounted under the Finance Act at the special 3.5 per cent rate) and the retirement of the so-called "British Issue" of dominion notes issued in 1917 against British treasury bills also contributed to the monetary contraction (Shearer and Clark 1984, 291). Canada returned to the gold standard on 1 July 1926.

Back on the Gold Standard—Temporarily (1926–31)

With Canada's return to the gold standard, currency supplied by the chartered banks lost its legal tender status, although the government could restore this status under the Finance Act in the event of an emergency. Consequently, legal tender in Canada once again consisted of British gold sovereigns and other current British gold coins, U.S. gold eagles (\$10), double eagles, and half eagles, Canadian gold coins (denominations of \$5 and \$10), and dominion notes. Limited legal tender status was also accorded silver, nickel, and bronze coins minted in Canada.²⁷

Canada's return to the gold standard proved to be short-lived. It has been argued that monetary operations under the Finance Act were inconsistent with maintaining a gold standard. Dominion notes issued to banks under the authority of the act upon the pledge of securities were not backed by gold.²⁸ They were, however, legally redeemable in gold on demand. In 1933, James Creighton, a prominent University of British Columbia economics professor,

wrote,

Apparently the sponsors of the 1923 Act did not realize that when Canada went back on the gold standard, as she did 1926, the effects of the operations of the Act would be vitally different from what they were during the paper money period.

Some modern-day economists also point to excessive monetary expansion during the late 1920s as causing the eventual demise of the gold standard (Courchene 1969, 384). The percentage of gold reserves to dominion notes outstanding fell from 54 per cent on 30 June 1926 to 28 per cent three years later (Macmillan Report 1933, 38). Other economists have emphasized the unwillingness of the Canadian authorities to accept the discipline of the gold standard, especially during a period of significant international financial stress (Shearer and Clark 1984, 300). A fall in commodity prices and a resulting deterioration in Canada's trade balance

27. Silver coins were legal tender in amounts not exceeding \$10; nickel coins in amounts not exceeding \$5; and bronze coins in amounts not exceeding 25 cents (Macmillan Report 1933, 37).

28. Limits were set annually for advances to chartered banks under the Finance Act. Because they were typically set very high, such limits did not pose an effective restraint on the borrowing activities of banks.

was also a factor. The currencies of other heavily indebted, commodity-producing countries, such as Australia and Argentina, also came under significant downward pressure during the 1929–31 period (Knox 1940, 8).

The Canadian dollar experienced three bouts of weakness between 1928 and 1931. But instead of automatically allowing the export of gold when the dollar weakened beyond the gold-export point, as it would have done under a “pure” gold standard, the government increasingly relied on a number of “gold devices” to stop its export (Shearer and Clark 1984, 29–30). For example, instead of making gold available in Montreal or Toronto as required by law, it was available only in Ottawa, thereby increasing the cost and inconvenience of exporting gold. Similarly, instead of supplying U.S. gold coins, the authorities provided British sovereigns or bullion, which had to be assayed before the U.S. authorities would accept it. Alternatively, only coins of small denomination were provided. Moral suasion was also used on bullion shippers. As well, banks began to charge prohibitive fees on gold purchases or refused to purchase gold on behalf of foreign banks.

An increase in the Advance Rate would have been the expected monetary response to the outflow of gold. While the “ordinary rate” was increased from 3.75 per cent to 5 per cent on 9 June 1928, a

special 3.75 per cent rate remained in effect. To facilitate the sale of a special issue of 4 per cent treasury notes, the government had apparently made a commitment to the banks to discount these notes at this special rate (Shearer and Clark 1984, 295). When the pressure on the Canadian dollar temporarily eased in the autumn of 1928 because of seasonal factors, the ordinary Advance Rate was reduced to 4.5 per cent. It stayed at this level until late October 1931, despite the Canadian dollar falling below the gold-export point during late 1929 and early 1930 and again through the summer of 1931.

In effect, if not in form, Canada went off the gold standard in 1929. However, the export of gold was not officially banned until 31 October 1931 by an Order-in-Council. The banks and the government also used moral suasion, through appeals to patriotism, to convince Canadians not to convert dominion notes into gold (Bryce 1986). But with the politically traumatic, though economically sound, decision by the United Kingdom to abandon the gold standard on 21 September 1931, the fiction of a gold standard was finally abandoned.

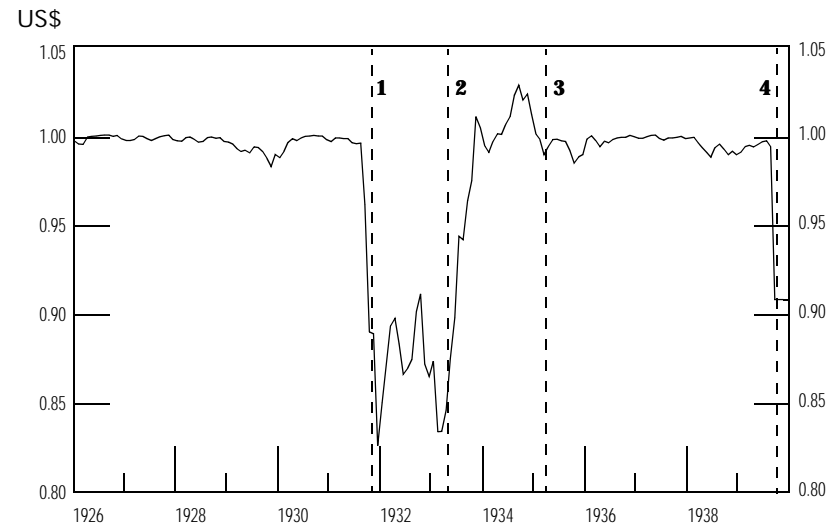
With the pound sterling falling precipitously from its old fixed rate of US\$4.8666 to as low as US\$3.40 in the days immediately following the British decision to float the currency, the Canadian dollar came under sharp downward pressure amid a

general loss of confidence in the global financial system. World money markets essentially ceased to function. High-grade borrowers, such as Canada, were therefore unable to borrow in the New York market. Investor concern focused on the wavering nature of Canada's commitment to the gold standard, its high level of debt, and its low gold reserves (Creighton 1933, 122). In this environment, the Canadian dollar fell to a low of roughly US\$0.80 in the autumn of 1931 before recovering.

The *coup de grâce* to Canada's adherence to the gold standard was finally delivered on 10 April 1933 when an Order-in-Council officially suspended the redemption of dominion notes for gold.

Canadian dollar in terms of U.S. dollar, 1926–39

Monthly averages



1. October 1931: Gold exports banned.
 2. April 1933: Redemption of dominion notes into gold suspended.
 3. March 1935: Bank of Canada begins operations.
 4. September 1939: War declared, Canadian dollar fixed, exchange controls imposed.
- Source: U.S. Board of Governors of the Federal Reserve System (1943)

The Depression Years (1930–39)

Since advances under the Finance Act were made at the initiative of banks, and there was no money market, the government had relatively limited scope for activist monetary policy. But it did not even use what little power it had. As a result, questions were widely voiced regarding Treasury Board officials' understanding of monetary issues as economic conditions deteriorated following the 1929 stock market crash.²⁹

Despite mounting evidence that a major economic contraction was underway, the government kept the Advance Rate unchanged at 4.5 per cent from September 1928 to October 1931. Concurrently, the chartered banks repaid their borrowings from the government under the Finance Act, leading to a monetary contraction. This exacerbated the economic downturn.³⁰ The banks became increasingly cautious about their own lending activities as

the economic environment deteriorated. Banks may have also repaid their borrowings under the Finance Act in response to earlier criticism for having borrowed so extensively prior to the stock market crash (Fullerton 1986, 36). While the extent of the economic downturn in Canada was undoubtedly made worse by these monetary developments, the monetary contraction helped to strengthen the Canadian dollar, which reached US\$0.90 by the spring of 1932.

The government finally made a serious effort to reflate the economy in the autumn of 1932, when it used moral suasion to force the banks to borrow under the Finance Act (Bryce 1986, 132). This led to some temporary further weakness in the Canadian dollar, which briefly fell as low as US\$0.80. However, the weakness was short-lived. Following the U.S. decision to prohibit the export of gold in

29. Creighton (1933, 86–90) argued that J. C. Saunders, Deputy Minister of Finance during the 1920s, who was the ex-officio Secretary of the Treasury Board, which administered the Finance Act on behalf of the Minister of Finance, was not competent in monetary matters. Creighton noted that, while Saunders was an able civil servant, he and other deputy ministers had “neither an academic training in economics nor practical experience in banking.” Moreover, the position of deputy minister was left vacant after Saunders' death for an extended and critical period of time—April 1930 to November 1932—leaving a serious policy vacuum.

30. Advances under the Finance Act, which had peaked at \$112.9 million in November–December 1929, fell to nil by the spring of 1931 (Macmillan Report 1933).

April 1933 and similar efforts in the United States to reflate, the Canadian dollar began to strengthen.³¹ The Canadian government's decision in 1934 to expand the amount of dominion notes in circulation by reducing their gold backing to 25 per cent did not have much impact on the Canadian dollar. In the

Establishment of a central bank

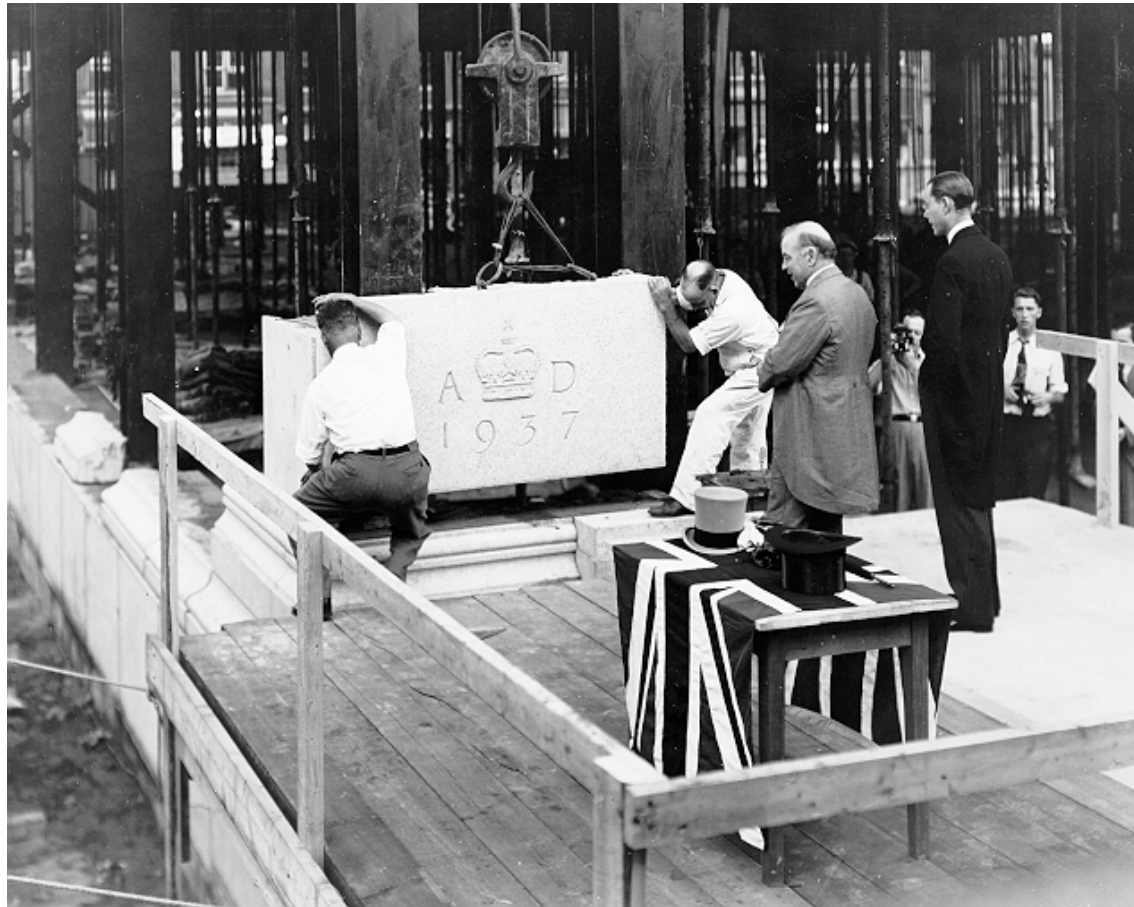
Concerns about the adequacy of the Finance Act, rising political pressure to do something about the Depression, and public distrust of a concentrated banking system led the government to set up a commission in July 1933. The commission had a mandate to study the functioning of the Finance Act and to make "a careful consideration of the advisability of establishing in Canada a Central Banking Institution . . ." (Macmillan Report 1933, 5).³² Lord Macmillan, a famous British jurist and known

economic circumstances of the time, and given similar developments in the United States, this move was viewed as appropriate and elicited little market reaction (Bryce 1986, 142). The Canadian dollar returned to rough parity with its U.S. counterpart by 1934 and, at times, even traded at a small premium.

supporter of a central bank, was chosen by Prime Minister Bennett to chair the commission.³³ The other members were Sir Charles Addis, a British banker with both commercial and central banking experience; Sir William T. White, the former wartime Canadian Finance Minister and banker; John Brownlee, Premier of Alberta; and Beaudry Leman, a Montreal banker.

Public hearings began on 8 August 1933, and the final report was presented to the government

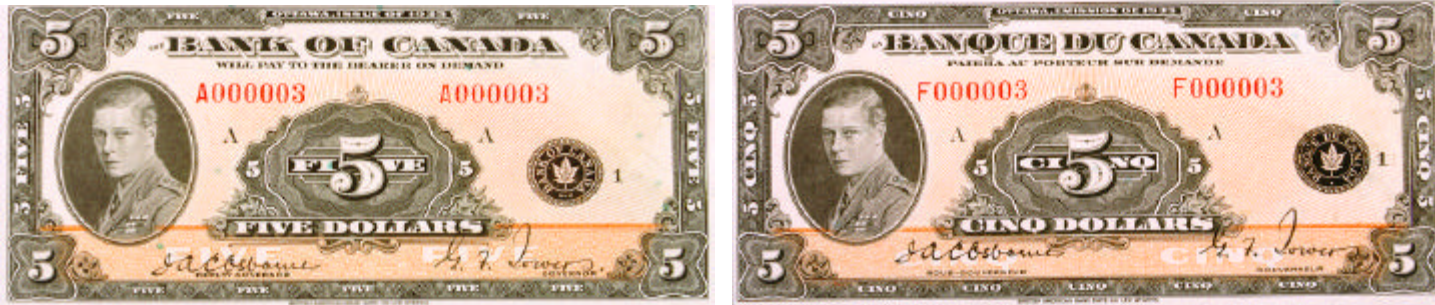
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31. The U.S. government subsequently re-fixed the U.S. dollar on 31 January 1934, such that one ounce of gold was worth US\$35, compared with the pre-1933 price of US\$20.67.
 32. Bordo and Redish (1986) argue that the establishment of the Bank of Canada had more to do with political than with economic imperatives. Watts (1993, 9), citing a 7 December 1933 speech by Prime Minister Bennett in London, Ontario, argues that the rationale for establishing a central bank had more to do with external considerations than with domestic need. In the speech, Bennett stated that for Canada to be "financially independent," it needed a central bank for "determining balances, or settling international accounts."
 33. From 1929 to 1931, Lord Macmillan had chaired a British commission called the Committee on Finance and Industry, which examined banking, finance, and credit developments in the United Kingdom.



less than seven weeks later on 28 September. While the commission voted only narrowly in favour of the establishment of a central bank, its conclusion was never really in doubt. The two British members of the committee, joined by Brownlee, voted in favour of a central bank, a position supported by both the Conservative government and the Liberal opposition.

White dissented from the majority on the grounds that it was

Laying the cornerstone for the Bank of Canada, 10 August 1937: Prime Minister Mackenzie King (left) and the Bank's first Governor, Graham Towers (right) watch as the stone is lowered into place.



Bank of Canada, \$5, 1935 series: These notes were part of the first series issued by the new central bank. It was the only series to feature separate unilingual English and French notes. A portrait of

Edward, Prince of Wales, appears on the left and the official seal of the Bank of Canada on the right.

unwise to establish a central bank in the prevailing uncertain economic environment. In his view, a newly established and untried central bank might hinder the government. Favouring a return to the gold standard, White contended that Canada's main problem was excessive debt (Macmillan Report 1933, 89). Leman shared this view and also believed that the establishment of a central bank raised constitutional issues that needed exploring (Macmillan Report 1933, 95).

The Bank of Canada Act received royal assent on 3 July 1934, and the central bank officially started operations on 11 March 1935. On that day, the Dominion Notes Act and the Finance Act were

both repealed. Dominion notes were quickly replaced by new Bank of Canada notes. A revised Bank Act, governing the operations of the chartered banks, also took effect in 1934. Revisions to this act initiated a gradual phase-out of private bank notes in favour of Bank of Canada notes.

Another important piece of legislation passed at this time was the Exchange Fund Act, which received royal assent on 5 July 1935. The primary purpose of the act was to provide a fund that could be used to "aid in the control and protection of the external value of the Canadian monetary unit" (*Statutes of Canada* 1935). The resources of the Exchange Fund came from the profits associated



Bank of Canada, \$5, 1937 series: From the Bank's second note issue, which was the first bilingual issue and the first issue to have the blue \$5 note. King George VI appeared on all notes from \$1 through \$50, and Prime Ministers Sir Wilfrid Laurier and Sir John A. Macdonald appeared on the higher denominations.

with the revaluation of the Bank of Canada's gold holdings from the old statutory price of Can\$20.67 per ounce to the prevailing world market price of US\$35 per ounce.³⁴ Although the Exchange Fund Act was passed in 1935, the section of the act dealing with the use of the fund to protect the value of

the Canadian dollar was not put into effect until 15 September 1939, following Canada's entry into World War II.

In any event, an Exchange Fund Account was not required to stabilize the Canadian dollar during the mid-1930s. With the currency trading in a relatively narrow range around parity with its U.S. counterpart, little intervention by the Bank of Canada was required. The currency's fluctuations were limited by substantial current account surpluses on the one hand and the repayment of foreign borrowings on the other (Watts 1993, 40).

By late 1938, as the international political climate deteriorated, the Canadian dollar began to slip, falling to a small discount of roughly 1 per cent against the U.S. dollar. The decline was modest, however, compared with that of the pound sterling, which fell by roughly 6 per cent in the second half of 1938, reflecting a considerable shift of funds out of the United Kingdom (Bank of Canada 1939, 13). After several months of relative stability, the Canadian dollar came under renewed, and this time significant, pressure in the last days of August 1939, as

34. Under the Bank of Canada Act, the government transferred to the Bank of Canada the gold that had backed the old dominion notes. The gold holdings of the chartered banks were also transferred to the Bank of Canada. Revaluation proceeds amounted to \$73.5 million, of which \$10.5 million was returned to the chartered banks and \$63 million credited to the Exchange Fund Account (Watts 1993, 23).

world tensions increased and funds moved to the safety of the United States. The Canadian dollar fell roughly 6 per cent vis-à-vis the U.S. dollar in the two weeks prior to Canada's declaration of war with Germany on 10 September 1939, and by another 3 per cent by the time the government imposed foreign exchange controls in mid-September (Bank of Canada 1940, 12). The pound sterling fell even more sharply, declining from US\$4.86 to US\$4.06, a depreciation of roughly 14 per cent, before the imposition of exchange controls in the United Kingdom in early September.



Dominion Bank, \$5, 1931: A good example of a large-sized (182mm by 84mm) chartered bank note, featuring portraits of the bank's president and general manager. The bank, located in Toronto, was a forerunner of the Toronto-Dominion Bank.



Dominion Bank, \$5, 1938: This small-size (150mm by 72mm) Dominion Bank note retained the same basic design as the large one.

Canada under Exchange Controls (1939–51)

The war years (1939–45)

Exchange controls were introduced in Canada through an Order-in-Council passed on 15 September 1939 and took effect the following day, under the authority of the War Measures Act.³⁵ The Foreign Exchange Control Order established a legal framework for the control of foreign exchange transactions, and the Foreign Exchange Control Board (FECB) began operations on 16 September.³⁶ The Exchange Fund Account was activated at the same time to hold Canada's gold and foreign exchange reserves. The Board was responsible to the minister of finance, and its chairman was the governor of the Bank of Canada. Day-to-day operations of the FECB were carried out mainly by Bank of Canada staff.

The Foreign Exchange Control Order authorized the FECB to fix, subject to ministerial approval,

the exchange rate of the Canadian dollar vis-à-vis the U.S. dollar and the pound sterling. Accordingly, the FECB fixed the Canadian dollar value of the U.S. dollar at Can\$1.10 (US\$0.9091) buying and Can\$1.11 (US\$0.9009) selling. The pound sterling was fixed at Can\$4.43 buying, and Can\$4.47 selling.³⁷ These rates were roughly consistent with market exchange rates immediately prior to the imposition of controls. Currency rates on futures contracts of up to 90 days were also fixed by the FECB. These exchange rates were maintained for the duration of the war.

To conserve Canada's foreign exchange and effectively support the value of the Canadian dollar, the Board introduced extensive controls. These controls allowed the Board to regulate both current and capital account transactions, although most

35. Parliament did not, in fact, have an opportunity to vote on exchange controls until after the war. The Foreign Exchange Control Act received royal assent on 31 August 1946 and became effective on 1 January 1947. The legislation contained a "sunset" clause, which obliged the government to renew the controls every two years.

36. Preparations for the imposition of exchange controls in the event of war had begun in secret as early as August 1938. See Towers (1940).

37. The spreads for both the U.S. dollar and the pound sterling were narrowed slightly in October 1945 by reducing the selling rate for the U.S. dollar to Can\$1.1050 (US\$0.9046) and Can\$4.45 for the pound.

current account transactions, other than travel, were treated fairly leniently.³⁸ Permits were required for all payments by residents to non-residents for imports of goods and services. Permits were also required for the purchase of foreign currencies and foreign securities, the export of funds by travellers, and to change one's status from resident to non-resident. Residents were also required to sell all foreign exchange receipts to an authorized dealer. Interbank trading in Canadian dollars ceased.

On 30 April 1940, the Foreign Exchange Acquisition Order stiffened the controls even further. Canadian residents, including the Bank of Canada, were now required to sell (with minor exceptions) all the foreign exchange they owned to the FECB.

The imposition of exchange controls by the Canadian authorities reflected a number of concerns (Handfield-Jones 1962). First, even though it was expected that Canadian exports to the United Kingdom would increase, there was a concern that the Canadian military buildup would lead to a significant rise in imports from the United States. Second, under U.S. law at the start of the war, loans to



To help finance Canada's war effort, the Bank oversaw the sale of Victory Bonds. Over the course of the war, Canadians bought \$12 billion worth of Victory Bonds, which paid 3 per cent interest.

"belligerent" countries were forbidden. Hence, U.S. imports had to be paid for in cash, i.e., U.S. dollars

38. The Canadian government placed controls on the importation of goods deemed to be non-essential. Such import controls were administered by other bodies.



Royal Bank of Canada, \$5, 1943: Banks were prohibited from issuing their own notes in 1944; this note is from one of the last issues by a chartered bank. The Royal Bank's General Manager, Sidney G. Dobson, is on the left, and President Morris W. Wilson is on the right.

or gold. Moreover, given British exchange controls, an increase in sterling assets arising from net Canadian exports to the sterling area could not be converted into U.S. dollars. Finally, there was a concern that Canadians might seek to place funds in a non-belligerent country and that U.S. residents, who held considerable Canadian assets, might seek to repatriate their holdings.

It is interesting to note that while all foreign

currency transactions were subject to exchange controls, in practice the controls centred on transactions involving U.S. dollars. Although permits were required for sterling transactions, there were no restrictions (FECB 1946, 19). Moreover, Canadian residents were not required to sell sterling receipts to the FECB (Wonnacott 1959, 83). This reflected the buildup of sterling balances held by the FECB, which could not be converted into U.S. dollars.³⁹

Canada's need for controls during World War II contrasts with its experience during World War I, when exchange controls were not imposed. In 1914, Canada's principal foreign creditor was the United Kingdom, with the bulk of British claims on Canada in the form of direct investment or denominated in sterling. British holdings of U.S. dollars were also substantial at the outbreak of World War I. Consequently, the British authorities were able to pay for their own U.S. imports, maintain a stable and convertible currency, and provide U.S. dollars to Canada in settlement of Canada's trade surplus with the United Kingdom.

The situation had changed by 1939. The United States had become Canada's most important source of foreign capital, and there was concern that neu-

39. Efforts to reduce these sterling balances included interest-free loans to the United Kingdom and the repurchase of Government of Canada bonds issued in sterling, including those of the Canadian National Railway.

tral U.S. residents would not wish to hold the securities of a belligerent country. British holdings of U.S. dollars were also much diminished. Therefore, Canada could not expect the United Kingdom to

provide U.S. dollars in exchange for surplus sterling balances, as it did in 1914. Indeed, the British authorities introduced their own exchange controls at the outbreak of World War II (FECB 1946, 9–10).

The revaluation of 1946

By late 1944, pressure on Canada's foreign exchange reserves had eased dramatically. The Hyde Park Agreement of April 1941,⁴⁰ the entry of the United States into the war in December 1941, as well as major U.S. infrastructure projects (such as the building of military bases and the construction of the Alaska Highway) contributed to a rebuilding of Canada's foreign exchange reserves. There were also significant capital inflows into Canada, partly from Canadian residents repatriating funds invested in U.S. securities, but also from U.S. residents buying Canadian Victory Bonds. U.S. direct investment in Canada also increased.

The rebuilding of reserves allowed a slight easing of exchange controls in 1944 to facilitate travel to the United States and to allow Canadian firms to extend their foreign business activities. By the end of 1945, Canada's holdings of gold and U.S. dollars

had increased to US\$1,508 million from only US\$187.6 million at the end of 1941.

With expectations of continued capital inflows, the Canadian dollar was revalued upwards by roughly 9 per cent against both the U.S. dollar and the pound sterling on 5 July 1946. The new rates were: buying Can\$1.000, selling Can\$1.005 (US\$0.9950) for the U.S. dollar, and Can\$4.02 buying and Can\$4.04 selling for the pound sterling. Interestingly, the rationale for the revaluation related more to dampening inflationary pressures emanating from the United States than to the buildup of reserves or to Canada's balance-of-payments situation. In a statement to the House of Commons, the minister of finance noted that the revaluation of the Canadian dollar was one of the measures taken to maintain order, stability, and independence in Canada's economic and financial



Canadian silver dollar, 1946: *This design was introduced in 1935 and was retained until 1987. Sculptor Emmanuel Hahn features the quintessential symbols of Canada: the birchbark canoe, northern lights, jack pine, coureur de bois, and the Native Canadian. No silver dollars were minted during World War II. This was the first post-war issue.*

40. The Hyde Park Agreement permitted Canada and the United States to specialize in the production of war material. Canada concentrated on the production of certain types of munitions, aluminum, and ships required by the United States (FECB 1946, 26).

affairs. He added that

these measures we feel will go a long way toward insulating Canada against unfavourable exter-

nal conditions and easing the inflationary pressures which are now so strong (Ilsley 1946, 3181).

The devaluation of 1949

The new exchange rate did not hold for long. Imports from the United States rose sharply, leading to a marked decline in Canada's holdings of gold and U.S. dollars in the second half of 1946 and through 1947. While Canadian exports to the United Kingdom and other countries remained robust, they were financed largely by Canadian loans. Hence, they did not boost usable reserves.

In November 1947, Canadian authorities reduced travel allowances for Canadians visiting the United States and tightened import controls to restrict the importation of non-essential goods. The provision of U.S. dollars for Canadian direct investment abroad was also virtually suspended. Even with the intensification of exchange controls, Canada's gold and U.S. dollar holdings declined to US\$501.7 million by the end of 1947. These devel-

opments led to considerable criticism of the Canadian government for its 1946 decision to revalue the Canadian dollar.

The situation eased somewhat in 1948. Canada's trade deficit with the United States narrowed, a sizable U.S. dollar line of credit was established with the U.S. Export-Import Bank, and Canada's trade balance with other countries improved (including an increase in actual receipts). In fact, by the end of 1948, Canada's holdings of gold and U.S. dollars had doubled to US\$997.8 million.

Nevertheless, following a major realignment of the pound sterling and most other major European currencies vis-à-vis the U.S. dollar, the Canadian dollar was devalued by approximately 9.1 per cent against its U.S. counterpart on 20 September 1949.⁴¹ The Canadian dollar thus returned to its

41. On 19 September 1949, the pound and the currencies of all other sterling-area countries, excluding Pakistan, were devalued by 30.5 per cent against the U.S. dollar. Concurrently, or shortly thereafter, the currencies of Sweden, Norway, Denmark, and the Netherlands were devalued by roughly 30 per cent. The currencies of other countries were devalued by smaller amounts—France by about 22 per cent, West Germany by 21 per cent, Portugal by 13 per cent, Belgium by 12 per cent, and Italy by 9 per cent.

pre-July 1946 value against the U.S. dollar of Can\$1.10 (US\$0.9091) buying and Can\$1.105 (US\$0.9050) selling. New official rates for the pound sterling were also established by the FECB of Can\$3.0725 buying, and Can\$3.0875 selling.

The main reason cited for the Canadian dollar's

The decision to float, 1950

Once again, international economic conditions quickly changed and obliged the Canadian authorities to alter their approach to foreign exchange policy. The earlier depreciation of the Canadian dollar against its U.S. counterpart, which boosted Canadian exports, and rising commodity prices associated with the beginning of the Korean War in June 1950 had strengthened Canada's trade balance with the United States. At the same time, the economic recovery in Europe, aided by the Marshall Plan, which provided European countries with convertible U.S. dollars, boosted Canadian exports (Muirhead 1999, 138). There were also strong inflows of direct investment into Canada. Short-term capital inflows also increased sharply, particularly through the third quarter of 1950, as speculation regarding a Canadian dollar revaluation intensified.

In this environment, Canadian authorities became increasingly concerned about the inflation-

devaluation was the possible effect of the substantial devaluations of other currencies on Canada's balance-of-payments position. There were also concerns that Canada's reserves had not recovered sufficiently from their 1947 low (FECB 1949, 7).

ary impact of the inflows if Canada tried to maintain a fixed exchange rate. There was also concern that the inflows were leading to a "substantial and involuntary increase in Canada's gross foreign debt" (FECB 1950, 14).

On 30 September 1950, Douglas Abbott, the Minister of Finance, announced that

Today the Government, by Order in Council under the authority of the Foreign Exchange Control Act, cancelled the official rates of exchange which had been in effect since September 19th of last year It has been decided not to establish any new fixed parity for the Canadian dollar at this time, nor to prescribe any new official fixed rates of exchange. Instead, rates of exchange will be determined by conditions of supply and demand for foreign currencies in Canada.

He also announced that any remaining import prohibitions and quota restrictions, imposed in November 1947, would be eliminated, effective 2 January 1951. Controls on imports of capital goods were also to be reviewed.

Interestingly, the idea of floating the Canadian dollar was widely discussed as early as the beginning of 1949. A then-secret memorandum prepared in January of that year and attributed to James Coyne, who later became Governor of the Bank of Canada, made the case for floating the currency while retaining exchange controls. In his paper, Coyne noted that it would be better to “have a natural rate which could move up or down from time to time as economic conditions might require.” He also noted that government inertia made it very difficult for the authorities to adjust a fixed exchange rate in a timely manner (Coyne 1949).

Options other than floating the exchange rate were apparently dismissed as impractical, including revaluing the Canadian dollar upwards, widening the currency’s permitted ± 1 per cent fluctuation band, or restricting capital inflows. Given the criticism levelled against the government after the 1946 revaluation of the Canadian dollar, followed by the short-lived 1949 devaluation, another revaluation was viewed as unacceptable. It was also unclear how much of a revaluation would be required to stem the

capital inflows. Widening the bands also posed problems since it was unclear how wide the bands would have to be. Likewise, restrictions on capital inflows were seen as untenable from a longer-term perspective for a country dependent on foreign capital (Hexner 1954, 248).

This view is consistent with a speech on exchange controls given by Douglas Abbott, Minister of Finance, in December 1951,

The conclusion I have come to is that we would be better advised not to rely on exchange restrictions, but rather on the general handling of our domestic economic situation to keep us in reasonable balance with the outside world and to maintain the Canadian dollar over the years at an appropriate relationship with foreign currencies.

The system envisaged by Coyne in 1949 of a floating Canadian dollar within a system of foreign exchange controls was put into practice when markets opened on 2 October 1950. With interbank trading now permitted, the Canadian dollar quickly appreciated, rising to roughly US\$0.95.

With the floating of the Canadian dollar, the rationale for the continuation of exchange controls came into question. Through 1951, controls were progressively eased. Finally, on 14 December 1951,

the Foreign Exchange Control Regulations were revoked by an Order-in-Council. New regulations were passed that exempted all persons and all transactions from the need for permits to buy and

sell foreign exchange. The Foreign Exchange Control Act itself, which had been renewed for another two-year period earlier in 1951, was repealed in October 1952.

The unofficial exchange market

Shortly after the imposition of exchange controls in 1939 and the official fixing of the Canadian dollar's value in terms of the U.S. dollar by the FECB, an unofficial market for Canadian dollars developed in New York that persisted until the Canadian dollar was floated at the end of September 1950. This was a legal market involving transactions in Canadian dollars between non-residents of Canada. Residents of Canada were prohibited from acquiring foreign exchange through the unofficial market. Similarly, no resident of Canada was ever authorized to convert foreign exchange into Canadian dollars through the unofficial market.

The source of "inconvertible" Canadian dollars consisted of Canadian dollar bank balances held by non-residents when exchange controls were introduced in 1939, sales by U.S. residents of certain types of assets (such as real estate), and the proceeds of maturing Canadian dollar securities paid to non-residents.

Canadian dollars purchased in the unofficial market could be used only in a very circumscribed

manner. For example, they could not be used to purchase Canadian goods and services. In this regard, the purpose of exchange controls was not just to conserve available foreign exchange but also to maximize the receipt of foreign exchange. U.S. residents wishing to buy Canadian securities or real estate were, however, permitted to use Canadian dollars obtained in the unofficial market, as could travellers to Canada.

The unofficial market for Canadian dollars ended with the floating of the Canadian dollar. Throughout most of its existence, the inconvertible Canadian dollar traded at a sizable discount compared with its official counterpart. The spread between the two rates mirrored the pressures on the Canadian economy, widening to more than 10 per cent during the darkest months of 1940 and narrowing as the war progressed and Canadian prospects improved. By 1945, the discount was temporarily eliminated. Indeed, for a few months during 1946, prior to the upward revaluation of the official Canadian dollar back to parity with its U.S. counterpart,

the inconvertible Canadian dollar traded at a slight premium in the free market.

Interestingly, when the official rate was finally revalued on 5 July 1946, the inconvertible Canadian dollar, while also appreciating, did not move up the whole amount. It generally traded between US\$0.95 and US\$0.96 through the remainder of that year. Clearly, the revaluation was not viewed as completely credible by free-market participants. Indeed, the free rate slowly weakened over the next few years, foreshadowing the eventual devaluation of the official rate in September 1949.⁴²

The inconvertible Canadian dollar declined with the devaluation of the official exchange rate in

1949, but to a lesser extent, temporarily eliminating the differential between the two rates. With the inconvertible Canadian dollar continuing to weaken to about US\$0.8840, through the winter of 1949–50, a differential of roughly 2.5 per cent temporarily re-emerged. Sudden improvement in Canadian economic prospects, however, and strong capital inflows from the United States, eliminated the differential between the two rates once again by March 1950. Indeed, the unofficial rate actually moved to a marginal premium to the official rate immediately prior to the decision to float the Canadian dollar.

The relevance of the unofficial rate

During the 1940s, there was an active debate over whether the unofficial rate was the “true” value of the Canadian dollar. The Bank of Canada maintained that given the “limited use” of inconvertible Canadian dollars and the small size of the market, prices were not necessarily an accurate reflection of

sentiment towards the Canadian dollar (FECB 1947, 5).⁴³

This was disputed by many economists, including then-assistant professor of economics, Milton Friedman. In a 1948 University of Chicago debate with Donald Gordon, Deputy Governor of the Bank of Canada, and Dr. W. A. Mackintosh, head of the

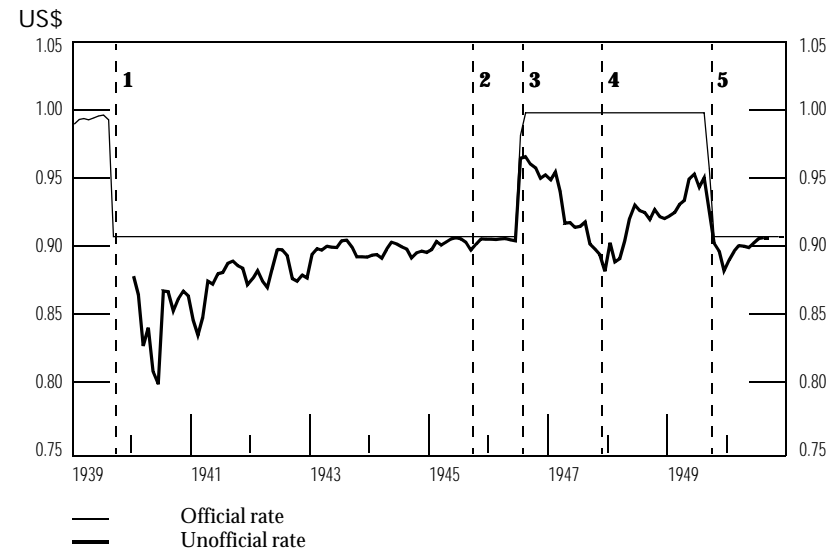
42. The unofficial rate, after trading to a low of about US\$0.9225 at the beginning of 1949, strengthened modestly to about US\$0.9450 during the months immediately prior to the devaluation.

43. The Bank of Canada estimated that, on average, the unofficial market accounted for only 3 per cent of Canada’s international transactions (Rasminsky 1946).

economics department at Queen's University and wartime economic adviser to the government, Friedman argued that there was no particular reason why a small market should necessarily lead to a distorted price. He also argued strongly that Canada should introduce a flexible exchange rate rather than relying on a system of exchange controls to balance trade. Gordon, on the other hand, contended that a 10 per cent decline in the official Canadian dollar (to roughly the level prevailing in the unofficial market) would have comparatively little impact on trade flows (Friedman et al. 1948).

Canadian dollar in terms of U.S. dollar, 1939–50

Monthly averages



1. September 1939: War declared, Canadian dollar fixed, exchange controls imposed.
2. September 1945: World War II ends.
3. July 1946: Canadian dollar revalued.
4. November 1947: Exchange controls tightened.
5. September 1949: Canadian dollar devalued.

Source: U.S. Board of Governors of the Federal Reserve System (1943 and 1976)

A Floating Canadian Dollar (1950–62)

As a member of the International Monetary Fund (IMF), Canada's decision to float the Canadian dollar was at odds with its commitment to the Fund to

maintain a fixed exchange rate within the Bretton Woods system.⁴⁴ In this regard, in 1949 the Canadian authorities had established with the IMF a "par value" of US\$0.9091 with a fluctuation band of ± 1 per cent. At least initially, floating was viewed as a temporary state of affairs. The minister of finance noted the government's intention to remain in consultation with the Fund and

ultimately to conform to the provisions of the Fund's Articles of Agreement which stipulate that member countries should not allow their exchange rates to fluctuate more than one per cent on either side of the par values from time to time established with the Fund (Abbott 1950).

It would be almost 12 years before Canada reintroduced a fixed exchange rate and regained the good graces of the IMF. Consequently, Canada came to be viewed as something of a maverick in



Bank of Canada, \$10, 1954 series: *This was the first series to feature Canadian landscapes on the backs of the notes. The notes were simpler and more modern in style. This was also the only series to portray the reigning monarch on each denomination.*

44. In July 1944, representatives from 44 countries met in Bretton Woods, New Hampshire to establish the post-war international financial architecture. Agreement was reached on creating the International Monetary Fund which, among other things, would promote monetary co-operation and discourage competitive currency devaluations. After the IMF began operations in 1946, member countries agreed to establish "par values" for their currencies in relation to the U.S. dollar and to maintain them within narrow fluctuation bands. A par value change was permitted only to correct a fundamental disequilibrium.

international financial circles. The unwillingness to re-fix the exchange rate appears to have reflected concern about repeating the mistake of 1946 when the dollar was revalued upwards only to come under significant downward pressure the next year, followed by a devaluation in 1949.

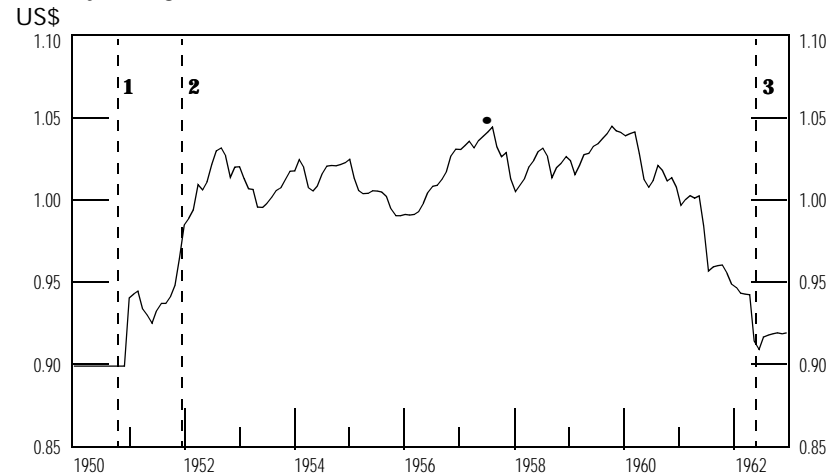
After quickly rising to the US\$0.95 level immediately after the exchange rate was freed, the Canadian dollar slowly appreciated, moving to a small premium of about 2 per cent vis-à-vis the U.S. dollar by 1952. From then until the end of 1960, it traded in a relatively narrow range between US\$1.02 and US\$1.06. The peak for the Canadian dollar during this period was US\$1.0614, touched on 20 August 1957. Foreign exchange intervention by the Bank of Canada through the Exchange Fund Account was limited to smoothing short-run fluctuations of the Canadian dollar.

While unpopular in business circles, the floating exchange rate was strongly supported by academic economists as a means of insulating the domestic economy from external shocks, either inflationary or deflationary. It was also recognized that the two-way risk associated with a flexible exchange rate could itself lessen large capital movements (Hexner 1954, 253).

Canada's successful experiment with a flexible exchange rate regime through much of the

Canadian dollar in terms of U.S. dollar, 1950–62

Monthly averages



- 20 August 1957: Modern-day Canadian dollar peak: US\$1.0614
 - 1. September 1950: Canadian dollar floated.
 - 2. December 1951: Exchange controls lifted.
 - 3. May 1962: Canadian dollar fixed.
- Sources: Bank of Canada; U.S. Federal Reserve System (1976)

1950s inspired considerable early academic work on the merits of a flexible exchange rate system. Later, it would provide a model for the rest of the world when the Bretton Woods system of fixed exchange rates finally collapsed during the early 1970s.

Return to a Fixed Exchange Rate (1962–70)

During the late 1950s, Canadian authorities became concerned about a deterioration in Canada's international competitiveness, aggravated by its strong dollar, which continued to be supported by substantial capital inflows. After the investment boom of the mid-1950s, economic activity had slowed significantly, and the unemployment rate more than doubled from 3.4 per cent in 1956 to 7.2 per cent in 1961. In this environment, the government sought to ease policy in order to support demand and reduce the economic slack in the economy.

Bank of Canada Governor James Coyne resisted any significant easing, however. He viewed Canada's large current account deficit as a symptom of excessive demand pressures, even though domestic inflationary pressure had eased throughout this period, falling from somewhat more than 2 per cent in 1958 to 1.3 per cent by the end of 1960. He was convinced that

to engage in further large over-all monetary expansion in an attempt to drive down interest rates generally, with or without the motive of thereby reducing the inflow of capital from abroad, is an unsound and dangerous approach and would prove to be an ineffective approach,

to the problems of the exchange rate, of the recession, and of achieving more consistent economic growth (Bank of Canada 1960, 22).

The policy dispute between the government and the central bank came to a head during the summer of 1961. On 30 May, the government requested the resignation of Governor Coyne but was refused. On 20 June, the minister of finance introduced an expansionary budget and announced that the government would take steps to lower the value of the Canadian dollar, including, as necessary, purchasing substantial amounts of U.S. dollars in the exchange market (Fleming 1961a). The government also introduced a bill in Parliament (An Act Respecting the Bank of Canada) to declare the position of governor vacant (House of Commons 1961). The bill passed the House of Commons on 7 July, but after testimony by Governor Coyne, the Senate Standing Committee on Banking and Commerce concluded that there had been no misconduct on his part. On 14 July, the full Senate defeated the bill. Having had "his day in court," Governor Coyne resigned. Louis Rasminsky succeeded him as Governor on 24 July 1961 (Bélanger 1970).

Not surprisingly, the Canadian dollar began to

weaken in this environment. From a level of about US\$1.01 prior to the June budget statement, the dollar quickly fell to US\$0.97. It weakened further in October 1961 to under US\$0.96, following an announcement by the minister of finance that the appropriate discount of the Canadian dollar against the U.S. dollar “might well turn out to be greater than the present 3 per cent” (Fleming 1961b).

The introduction of a “managed” flexible exchange rate regime, under which the government would intervene to keep the Canadian dollar at a significant discount to its U.S. counterpart, as opposed to just smoothing fluctuations, was in some ways a compromise with the IMF. The Fund was encouraging Canadian authorities to return to a fixed exchange rate regime within the context of the Bretton Woods system. No new par value for the Canadian dollar was recommended, however. Additional time was seen as necessary to prepare for the re-establishment of a fixed rate.

After stabilizing at about US\$0.95 between November 1961 and March 1962, the Canadian dollar began to weaken further, despite significant

intervention by the Bank of Canada to support the currency. On 2 May 1962, the government, in agreement with the IMF, established a new par value for the Canadian dollar, fixing it at US\$0.9250 with a fluctuation band of ± 1 per cent.

Fixing the exchange rate at a markedly lower level did not, however, relieve the pressure on the Canadian dollar. Doubts remained about the viability of the new rate, particularly given the prevailing political uncertainty.⁴⁵ Heavy official intervention was therefore required to hold the Canadian dollar within its allowed fluctuation band.

On 24 June 1962, the government announced a major economic and financial program aimed at restoring confidence in the Canadian dollar and indicated its determination to defend the currency’s new par value. Measures taken included a tightening of fiscal and monetary policy, the imposition of temporary import surcharges, and the marshalling of US\$1,050 million in financial support from the international community. This support consisted of a US\$300 million drawing from the IMF,⁴⁶ a US\$400 million line of credit from the U.S. Export-

45. On 18 June 1962, a minority Conservative government was elected.

46. A large proportion of the resources drawn from the IMF represented the liquidation of Canada’s “reserve position in the Fund,” which forms part of Canada’s international reserves. Actual use of Fund credit amounted to US\$138 million.

Import Bank, US\$250 million under a reciprocal swap facility between the Bank of Canada and the Federal Reserve Bank of New York, and US\$100 million from the Bank of England under a similar arrangement.⁴⁷ Other European central banks were also willing to provide additional assistance, if necessary (Bank of Canada 1962, 8).

This program restored confidence in the Canadian dollar. The resumption of private capital inflows during the second half of 1962 enabled the Canadian authorities to gradually ease the emergency measures imposed earlier. Much of the international financial assistance received, excluding that of the IMF, was repaid by the end of the year. Funds owed to the IMF were fully repaid by 1964. For the remainder of the decade, the Canadian dollar was maintained, relatively easily for the most part, within the permitted fluctuation band around its US\$0.9250 par value.

The dollar did, however, come under significant, temporary downward pressure during the summer of 1963, following the U.S. announcement on 18 July that it would impose an “Interest Equali-

zation Tax” on foreign borrowings in U.S. capital markets. Although Canada’s current account deficit had narrowed significantly over the previous two years, it remained large. Consequently, there was a general fear that unless Canadian interest rates rose by an offsetting amount (roughly 1 percentage point per year), capital inflows from the United States would cease. On 31 July, the United States agreed to exempt Canada from the tax, with the proviso that Canada would not increase its foreign international reserves through the proceeds of borrowing in the United States (Bank of Canada 1963, 6). Downward pressure on the currency ceased with this agreement, and Canadian markets stabilized.

The Canadian dollar experienced another bout of temporary downward pressure in March 1968, after the U.S. announcement of controls on capital outflows. The pressure eased with an agreement on 7 March that exempted Canada from all such controls. Similar to the exemption from the Interest Equalization Tax, Canada agreed that the U.S. balance-of-payments position would not be impaired as a result of its actions.

47. Throughout 1962, the Federal Reserve System entered into a series of reciprocal facilities with the central banks of most industrial countries aimed at providing mutual short-term financial assistance. The arrangement with the Bank of Canada was originally for US\$250 million. Over time, it increased and currently stands at US\$2 billion. This facility is renewed annually.

Because of concerns about the Bank of Canada's ability to conduct monetary policy in light of these accords, there was a follow-up agreement with the United States on 17 December 1968, which stated that no particular level of reserves would have to be targeted (Bank of Canada 1968, 13). This made it easier for the Bank to intervene in foreign exchange markets during periods of upward pressure on the currency.⁴⁸



Bank of Canada, \$20, 1969: *This note was part of the fourth series issued by the Bank. It was a multicoloured series that incorporated new features to discourage counterfeiting. The notes still featured Canadian scenes on the backs (this note shows Moraine Lake, Alberta) but there was more emphasis on commerce and industry. The Queen appears on the \$1, \$2, \$20, and \$1,000 notes. Others carried portraits of various prime ministers.*

48. The U.S. Interest Equalization Tax, as well as the capital controls, was eliminated on 29 January 1974.

Return to a Floating Rate (June 1970–present)

Rising domestic inflation led to the establishment of the Prices and Incomes Commission in 1968 and to the introduction of a restrictive stance on monetary policy. This occurred at a time when the United States was pursuing expansionary policies associated with the Vietnam War and with a major domestic program of social spending. Higher commodity prices and strong external demand for Canadian exports of raw materials and automobiles led to a sharp swing in Canada's current account balance, from a sizable deficit in 1969 as a whole to a large surplus. Combined with sizable capital inflows associated with relatively more attractive Canadian interest rates, this put upward pressure on the Canadian dollar and on Canada's international reserves. The resulting inflow of foreign exchange led to concerns that the government's anti-inflationary stance might be compromised unless action was taken to adjust the value of the Canadian dollar upwards.⁴⁹ There was also concern that rising foreign exchange reserves would lead to expectations of a currency revaluation, thereby encouraging speculative short-term inflows into Canada.

On 31 May 1970, Finance Minister Edgar Benson announced that, for the time being, the Exchange Fund Account would cease buying sufficient U.S. dollars to maintain the exchange rate for the Canadian dollar within its prescribed margins (Department of Finance 1970). Canadian authorities informed the IMF of their decision to float the Canadian dollar and of their intention to resume the fulfillment of their obligations to the Fund as soon as circumstances permitted. The Bank of Canada concurrently lowered the Bank Rate from 7.5 per cent to 7 per cent, an action aimed at making foreign borrowing less attractive to Canadian residents and at moderating the inflow of capital, which had been supporting the dollar.

The government made the decision to float the Canadian dollar reluctantly. But Benson believed that there was little choice if the government was to bring inflation under control. He hoped to restore a fixed exchange rate as soon as possible but was concerned about a premature peg at a rate that could not be defended.

As in 1950, other options were considered but

49. Consumer prices were rising at about 4 to 5 per cent through 1969 and early 1970. Wage settlements were also accelerating, touching 9.1 per cent during the first quarter of 1970.

dismissed. A defence of the existing par value was untenable since it could require massive foreign exchange intervention, which would be difficult to finance without risking a monetary expansion that would exacerbate existing inflationary pressures. A new higher par value was also rejected since it might invite further upward speculative pressure, being seen by market participants as a first step rather than a once-and-for-all change. The authorities also considered asking the United States to reconsider Canada's exemption from the U.S. Interest Equalization Tax. Application of the tax to Canadian residents would have raised the cost of foreign borrowing and, hence, would have dampened capital inflows. This too, was rejected, however, because of concerns that it would negatively affect borrowing in the United States by provincial governments (Lawson 1970a).

While recognizing the need for a significant appreciation of the Canadian dollar, the Bank of Canada saw merit in establishing a new par value at US\$0.95 with a wider fluctuation band of ± 2 per cent (Lawson 1970b). A new fix was seen as being more internationally acceptable than a temporary float, and since the lower intervention limit of about

US\$0.9325 would have been the same as the prevailing upper intervention limit, such a peg would have been accepted by academics that favoured a crawling peg. A new peg was also viewed as desirable because it would preserve an explicit government commitment to the exchange rate consistent with its obligations to the IMF. There was also some concern that a floating exchange rate might "encourage, as it had in the late 1950s, an unsatisfactory mix of financial policies" (Lawson 1970a).

For its part, the IMF urged Canada to establish a new par value. Fund management was concerned about the vagueness of Canada's commitment to return to a fixed exchange rate, fearing that the float would become permanent as it had during the 1950s. The IMF also feared that Canada's action would increase uncertainty within the international financial system and would have broader negative repercussions for the Bretton Woods system, which was already under considerable pressure. Canadian authorities declined to set a new fix, emphasizing the importance of retaining adequate control of domestic demand for the continuing fight against inflation.

The dollar in the 1970s

Immediately following the government's announcement that it would allow the Canadian dollar to float, the currency appreciated sharply, rising roughly 5 per cent to about US\$0.97. It continued to drift upwards through the autumn of 1970 and into 1971 to trade in a relatively narrow range between US\$0.98 and US\$0.99. By 1972, the Canadian dollar had traded through parity with its U.S. counterpart. It reached a high of US\$1.0443 on 25 April 1974.

The strength of the Canadian dollar through this period can largely be attributed to continued strength in the prices of raw materials. There were also large inflows of foreign capital, partly reflecting the view that Canada's balance of payments was expected to be less affected by the tripling of oil prices that occurred through 1973 than that of other major industrial countries.

During the early 1970s, the dollar's strength was also due to the general weakness of the U.S. currency against all major currencies as the Bretton Woods system of fixed exchange rates collapsed. With the U.S. balance-of-payments deficit widening to unprecedented levels, the U.S. government suspended the U.S. dollar's convertibility into gold on 15 August 1971 and imposed a 10 per cent sur-

charge on eligible imports. This action followed a series of revaluations of major currencies. On 18 December 1971, the major industrial countries agreed (the Smithsonian Agreement) to a new pattern of parities for the major currencies (excluding the Canadian dollar) with a fluctuation band of ± 2.25 per cent. The U.S. dollar was also devalued by 8.57 per cent against gold, although it remained inconvertible. This last-ditch attempt to save the Bretton Woods system failed. By 1973, all major currencies were floating against the U.S. dollar.

The strength of the Canadian dollar against its U.S. counterpart during this period concerned the authorities, who feared the impact of a higher dollar on Canada's export industries at a time of relatively high unemployment. Various measures to rectify the problem were examined but dismissed as being either unworkable or harmful. These included the introduction of a dual exchange rate system, the use of moral suasion on the banks to limit the run-down of their foreign-currency assets, and government control of the sale of new issues of Canadian securities to non-residents. None of these options were ever pursued (Government of Canada 1972). However, under the Winnipeg Agreement, reached on 12 June 1972, chartered banks agreed, with the

concurrence of the minister of finance, to an interest rate ceiling on large, short-term (less than one year) deposits. The purpose of the agreement was to reduce “the process of escalation of Canadian short-term interest rates” (Bank of Canada 1972, 15). Lower Canadian short-term interest rates and narrower rate differentials with the United States helped to relieve some of the upward pressure on the Canadian dollar. Monetary policy was also more accommodative than it should have been through this period, as the Bank of Canada sought to moderate the upward pressure on the currency.

After weakening temporarily in 1975 and falling below parity with the U.S. dollar, the Canadian dollar recovered as monetary policy was tightened to

address rising inflationary pressures. The currency moved up to the US\$1.03 level during the summer of 1976 in volatile trading, but the election of a Parti Québécois government in Quebec on 15 November 1976 prompted the markets to make a major reassessment of the Canadian dollar’s prospects. Political uncertainty, combined with softening prices for non-energy commodities, concerns about Canada’s external competitiveness related to rising cost and wage pressures, and a substantial current account deficit, sparked a protracted sell-off of the dollar, which lasted until the end of 1978. The dollar fell to under US\$0.84 by the end of this period. It steadied in 1979, however, and recovered to roughly US\$0.87 by the end of that year.

The dollar in the 1980s

Throughout the 1980s, the Canadian dollar traded in a wide range, weakening sharply during the first half of the decade, before staging a strong recovery during the second half. The weakness of the currency in the early 1980s can be attributed to several factors including, most importantly, continuing weakness in commodity prices, periodic concerns about the commitment of the Canadian authorities to an anti-inflationary policy stance, and a significant appreciation of the U.S. dollar against most other major currencies. In October 1980, the federal

government introduced the National Energy Program, which prompted a wave of takeovers of foreign-owned firms by Canadian-owned firms, particularly in the oil sector, and also placed downward pressure on the dollar. The failure of two small chartered banks in 1985 also temporarily put downward pressure on the currency.

After touching a then-record low of US\$0.6913 on 4 February 1986, the dollar rebounded following a concerted strategy of aggressive intervention in the foreign exchange market, sharply higher interest



Canadian dollar, 1988: Commonly known as the “loonie,” this coin was introduced in 1987 to replace the dollar bill. It has eleven sides to help the blind and visually impaired identify it.

rates, and the announcement of large foreign borrowings by the federal government. Initially stabilizing at about US\$0.72, the dollar began an upward trend against the U.S. dollar, which lasted through the remainder of the decade. The currency was boosted by various factors including a buoyant economy led by a rebound in commodity prices, expansionary fiscal policy at both the federal and provincial levels, and a significant tightening of monetary policy aimed at cooling an overheating economy and



Bank of Canada, \$20, 1991: The notes of this series incorporated new anti-counterfeiting features, including the Optical Security Device (upper left corner) added to denominations from \$20 up. The Queen appears on the \$2, \$20, and \$1,000 notes. All others feature portraits of prime ministers. This was the first series to have security codes built in that could be read by electronic readers for the blind and visually impaired.

reducing inflationary pressures. The Canadian dollar closed the decade at US\$0.8632.

The dollar in the 1990s

Through 1990 and most of 1991, the Canadian dollar continued to climb against its U.S. counterpart (and against major overseas currencies). This was largely due to a further tightening of monetary policy and widening interest rate differentials that favoured Canadian instruments. It crested at

US\$0.8934 on 4 November 1991. Subsequently, however, it began to depreciate, falling sharply through 1992 to close the year at US\$0.7868. The gradual, but sustained decline in the value of the Canadian dollar, which continued through 1993 and 1994, reflected various factors. With inflation

falling to—and for a time below—the target range established in 1991 and with significant unused capacity in the economy, the Bank of Canada sought easier monetary conditions through lower interest rates.⁵⁰ Downward pressure on the currency also reflected increasing concern about persistent budgetary problems at both the federal and provincial levels, softening commodity prices, and large current account deficits. The international environment was also unfavourable. The Exchange Rate Mechanism in Europe came under repeated attack through 1992 and 1993, followed by rising U.S. interest rates through 1994. The Mexican peso crisis in December 1994 and early 1995 also precipitated a generalized flight into U.S. dollar assets.

A degree of stability in the Canadian dollar was temporarily re-established through 1995 and 1996 owing to a number of factors. These included higher short-term interest rates (at least early in the period), evidence that fiscal problems were being resolved, a marked improvement in Canada's balance of payments partly because of strengthening commodity prices, and diminished focus on consti-

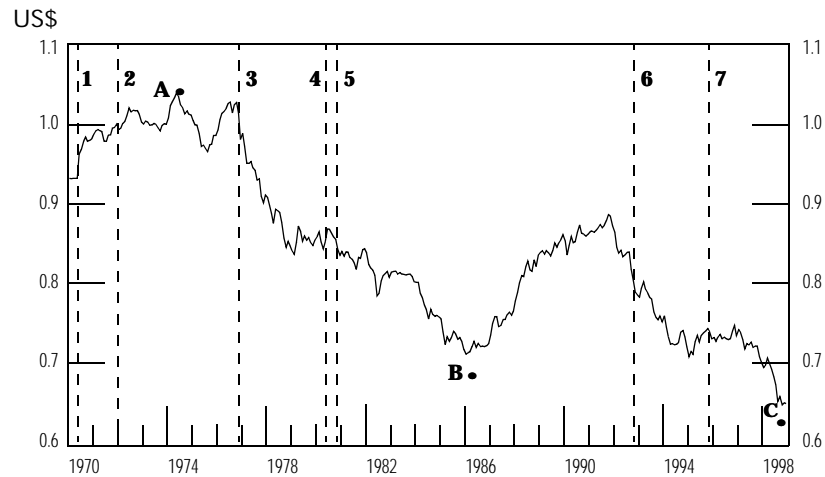
tutional issues. The Canadian dollar traded in a relatively narrow range close to US\$0.73 through much of this period.

Renewed weakness in the currency began to emerge in 1997 and became increasingly apparent in 1998 despite strong economic fundamentals—very low inflation, moderate economic growth, and solid government finances. Once again, much of the slide in the currency could be attributed to lower commodity prices, which began to soften in the summer of 1997 but subsequently weakened significantly as the financial and economic crisis in emerging markets widened and intensified. The large negative interest rate differentials that had earlier opened up between Canadian and U.S. financial instruments also weighed against the Canadian dollar, as did the U.S. dollar's role as a safe-haven currency during times of international crisis. The Canadian dollar touched an all-time low of US\$0.6311 on 27 August 1998 before recovering somewhat following aggressive action by the Bank of Canada. Interest rate reductions by the Federal Reserve Bank and the return of a modicum of stability in financial markets

50. In February 1991, the government and the Bank of Canada set out a path for inflation reduction. The objective was to gradually lower inflation (as measured by the consumer price index) to the midpoint of a 1 to 3 per cent target range by the end of 1995. This target range was subsequently extended to the end of 1998 and, later, to the end of 2001.

Canadian dollar in terms of U.S. dollar, 1970–98

Monthly averages

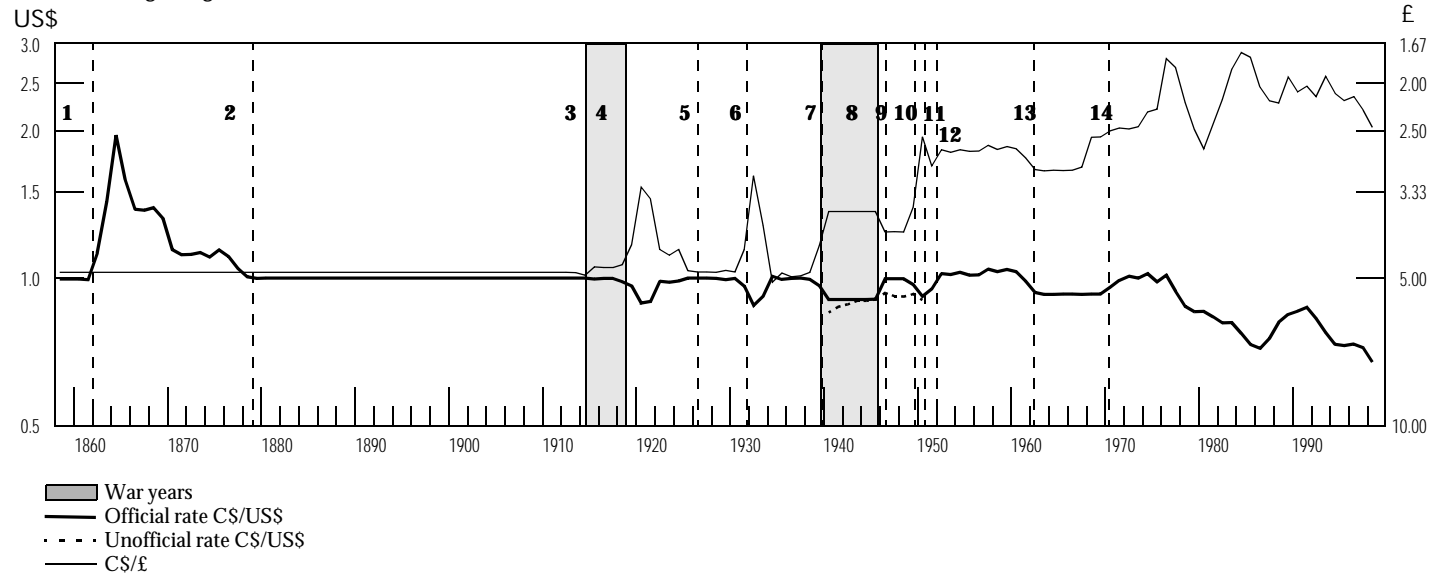


- A** • 25 April 1974: Canadian dollar high US\$1.0443
 - B** • 4 February 1986: US\$0.6913
 - C** • 27 August 1998: US\$0.6311
 - 1**. 31 May 1970: Canadian dollar floated.
 - 2**. December 1971: Smithsonian Agreement.
 - 3**. 15 November 1976: Election of Parti Québécois in Quebec.
 - 4**. 20 May 1980: Quebec Referendum
 - 5**. October 1980: National Energy Program introduced.
 - 6**. 26 October 1992: Defeat of Charlottetown Accord.
 - 7**. 30 October 1995: Quebec Referendum.
- Source: Bank of Canada

permitted the Bank of Canada to reduce Canadian interest rates without undermining confidence in the Canadian dollar. The currency closed the year at US\$0.6522.

Canadian dollar vis-à-vis U.S. dollar and pound sterling, 1858–1998

Annual average, logarithmic scale



1. January 1862: United States suspends convertibility.
2. January 1879: United States returns to gold standard.
3. August 1914: Canada suspends convertibility.
4. August 1914 to November 1918: World War I.
5. July 1926: Canada returns to gold standard.
6. September 1931: U.K. abandons gold standard. October 1931: Canada bans gold exports.
7. September 1939: Canada fixes dollar, introduces exchange controls.
8. September 1939 to September 1945: World War II.

9. July 1946: Canada repeg dollar at parity.
 10. September 1949: Canada devalues.
 11. September 1950: Canada floats.
 12. December 1951: Exchange controls end.
 13. May 1962: Canada fixes.
 14. May 1970: Canada floats.
- Sources: Bank of Canada; U.S. Federal Reserve System; Statistics Canada (1983); Turk (1962).

Concluding Remarks

This history of the Canadian dollar has been largely descriptive. Nonetheless, useful conclusions can be drawn from examining the past. Although Canada has tried most major types of exchange rate regime, it has generally favoured a flexible exchange rate system through much of the twentieth century. This has reflected three factors: Canada's role as a major commodity producer and exporter; the high degree of capital mobility, especially between Canada and the United States; and a desire to direct macroeconomic policy towards achieving domestic objectives. In this regard, concern about importing inflation from the United States led to the upward revaluation of the Canadian dollar in 1946 and to the floating of the Canadian dollar in both 1950 and 1970.

It is evident, however, that no exchange rate regime is perfect. The choice of regime involves trade-offs that may change with the passage of time and differing circumstances. Dissatisfaction with the severe policy limitations of the gold standard led

Canada and other countries to break the link between their currencies and gold during the 1930s. Dissatisfaction with the competitive devaluations and "beggar-thy-neighbour" policies of the Depression years led to the Bretton Woods system of fixed, but adjustable, exchange rates after the Second World War. Dissatisfaction with pegged exchange rates in an environment of global inflationary pressures and rising capital mobility led to the floating of all major currencies in 1973.

Most recently, the debate on appropriate exchange rate regimes has been renewed in Canada and abroad, spurred by the launch of the euro and by the collapse of fixed exchange rate regimes in many emerging-market economies. The outcome of this debate is uncertain, but the choice of regime will clearly depend on the national circumstances and preferences of countries as they enter the twenty-first century.

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