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PRECURSORS OF THE MONETARY APPROACH TO
EXTERNAL EQUILIBRIUM AND THE ORIGINS OF
CANADIAN CENTRAL BANKING 1932-34

by

Derek Chisholm

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and the Origins of Canadian Central Banking 1932-34

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This paper presents new evidence to show that the origins of Canadian central banking from 1932 to 1934 were based upon theoretical notions which are precursors to the monetary approach to external equilibrium. Contributions by Stokes (1939), Brecher (1957, Part III), McIvor (1958, Ch. VII), and Watts (1972) have not discussed the theoretical background for the Bank's creation. Recently available documentary evidence sheds new light upon the theoretical background and provides new insights into such other issues in Canadian monetary history as: the planned allocation of responsibility for monetary policy, the significance of the adoption of a floating exchange rate during 1950, and the government's reluctance to seriously undertake expansionary monetary or exchange rate policies before mid-1934.

The paper is arranged in four sections. The initial section briefly outlines the central features of the monetary approach and its precursors, then reviews the essential characteristics of the Canadian monetary system as it developed prior to 1934. The second section presents new evidence to chronicle the genesis of Canadian central banking from early 1932 until the World Economic and Monetary Conference of mid-1933. The third section chronicles the fulfillment of Canadian central banking from mid-1933 until shortly after the first carefully planned use of monetary expansion to stimulate domestic economic activity in June 1934. A concluding section briefly comments on the implications of the new evidence.
I. PRECURSORS

The monetary approach to external equilibrium resuscitates certain aspects of the international application of the quantity theory of money. The approach can be distinguished from its precursors by its emphasis upon a stable domestic demand for money to explain external adjustments to domestic monetary disequilibrium and its assumption of full employment. The nature of the external adjustment critically depends upon the exchange rate regime.

For a fixed exchange rate domestic monetary disequilibrium is associated with balance of payments adjustments. Hence: "the various accounts of the balance of payments [are] the 'windows' to the outside world, through which the excesses of domestic flow demands over domestic flow supplies, [of money] and of excess domestic flow supplies over domestic flow demands are cleared," Frenkel and Johnson (1976, 1). Domestic residents adjust actual to desired cash balances by rapidly shifting between foreign and domestic supplies of commodities and financial instruments. Within a fixed exchange rate regime the rapid shifts between foreign and domestic supplies are such that the domestic price level cannot differ significantly from the world price level. An excess demand for money is the counterpart of a balance of payments surplus, while an excess supply of money is the counterpart of a balance of payments deficit. Monetary disequilibrium thus leads to a balance of payments disequilibrium which alters the composition of domestic cash reserves between international and domestic components to restore domestic monetary equilibrium.

For a flexible exchange rate domestic monetary disequilibrium is associated with exchange rate adjustments. Hence: "the equilibrium exchange rate is attained when the existing stocks of the two [national] moneys are willingly
held," Frenkel (1978, 2). Domestic residents can adjust actual to desired cash balances by rapidly shifting between foreign and domestic sources of supply. However, the flexibility of the exchange rate implies that the domestic price level can differ from the world price level. Consequently, an excess demand for money is the counterpart of a fall in the domestic price level and an exchange rate appreciation, while an excess supply of money is the counterpart of a rise in the domestic price level and an exchange rate depreciation. Monetary disequilibrium thus leads to domestic price level and exchange rate adjustments.

Early precursors of the monetary approach placed less emphasis upon a stable demand for money and did not restrict price level adjustments to the flexible exchange rate case. R. G. Hawtrey and Gustav Cassel provide representative samples of the pre-General Theory of Employment paradigm in international monetary theory. Hawtrey developed a monetary theory of the business cycle while Cassel expounded the purchasing power theory of the exchange rate. For the gold standard, fixed exchange rate case if: "the currency is depreciated [to the gold export point] by a credit expansion, the world prices of foreign-trade products at the fixed par of exchange become too low in relation to peoples' purchasing power. Too many of these artificially cheapened goods are bought," Hawtrey (1926, 52). For the flexible exchange rate case: "should an inflation of A's currency take place, and consequently its purchasing power be reduced, the value of A's currency in the country B will necessarily fall in like proportion," Cassel (1922, 140). Thus Hawtrey admitted the possibility of declines in the domestic prices of traded goods, while Cassel implicitly assumed an unchanged domestic demand for money in the external adjustment process.
The vicissitudes of the post-1925 gold standard and the onset of the great contraction after 1929 modified the dominant paradigm of international monetary theory. The haunting spectre of massive unemployment increasingly infected discussions of theory and policy. Unlike the subsequent Keynesian attribution of unemployment to aggregate demand failures, or the assumption of full employment characteristic of the monetary approach, the dominant paradigm then attributed unemployment to rapid declines in the price level. Hawtrey's 1926 paper did not mention unemployment but he subsequently explained that: "the fall [of the price level] while in progress, inflicts loss on traders and so intensifies the discouragement to production. It is the decline in production thus caused that makes itself felt in unemployment," Hawtrey (1931, 82-83). Likewise, Cassel pointed out that a restrictive monetary policy: "may have an effect on the general level of prices that will result in a depression in production...followed by a decrease of employment," Cassel (1932, 74). Hence, an expansionary monetary policy to raise the price level could alleviate unemployment. The balance of payments constraint implied by fixed exchange rates could be avoided by internationally coordinated expansionary measures such as the 1931 British Macmillan Commission recommended. With Britain's suspension of the gold standard in September 1931 the balance of payments constraint was replaced by the constraint of competitive devaluations.

Subtle differences distinguish the policy instruments and objectives of the monetary approach from its early precursors. For the gold standard fixed exchange rate case: "a monetary disturbance of the balance of payments is caused by a maladjustment of credit. So long as other disturbing causes do not interfere, all that is required is that credit conditions should be as
nearly as possible the same in different gold-[standard] countries," Hawtrey (1926, 53). Thomas J. Courchene in a recent critique asserts that: "if the government opts to sterilize the impact on the money supply of the balance of payments deficit...the original disequilibrium will still exist...Canadian monetary policy must supply the nominal quantity of money to ensure that domestic prices and interest rates remain consistent with world levels" Courchene (1976, 29). For the flexible exchange rate case: "if the country itself is not provided with the means capable of supporting a rise in prices - then an inflation in foreign countries will merely express itself in a fall in the value of the exchanges of those countries," Cassel (1922, 145). For a more recent view: "the role, then, for the central bank under flexible rates is, by its policy towards nominal money expansion, to allocate the world inflation rate between domestic inflation and exchange rate changes," Courchene (1976, 32). The objective for a fixed exchange rate is balance of payments equilibrium while for a flexible exchange rate it becomes the domestic price level. The instruments of policy in the early precursors are vaguely referred to as "credit conditions" or "the means capable of supporting a rise in prices" while for the modern approach it is the nominal quantity of money.

In a speech delivered in Montreal on 7 September 1934 the Canadian Deputy Minister of Finance, William Clifford Clark, outlined the future role of the Bank of Canada that was to commence operations in slightly less than six months. The Bank's instrument for control would be the issue of paper money and thereby the total volume of currency and credit. The Bank's policy objective under a fixed exchange rate would be: "to protect and defend the external value of our Canadian monetary unit," Clark (1934c, 338-9). Under
a flexible exchange rate it would be: "the function of the central bank to carry out whatever the [government] policy may be in this respect, whether the objective of that policy be to maintain approximate internal stability of the price level and allow the exchanges to fluctuate, or conversely to stabilize our exchanges in terms of one or more existing currencies and allow the repercussions to impinge on the domestic price structure," Clark (1934c, 339). Although this expression of instruments and objectives for the new central bank seemingly accords with those of the monetary approach there was an implicit association between 'the domestic price structure' and domestic employment in Clark's remarks. To fully appreciate the context of the remarks it is necessary to sketch the development of the Canadian monetary system up to 1934.

Section 91 of the British North America Act vests authority for legislation on banking, incorporation of new banks, and the issue of paper money with the federal government. Prior to 1914 the monetary system rigidly operated in accordance with the requirements of a fractional gold standard through the provisions of the Currency Act, the Dominion Notes Act and the Bank Act. These Acts collectively regulated the issue of legal tender or high powered money to conform with international gold flows.

The Currency Act regulated the gold component of legal tender money in Canada. It specified that dollars, cents, and mills were the Canadian units of account with the British gold sovereign legal tender for $4.86 2/3 Canadian, and the American gold eagle legal tender for $10.00 Canadian. After the opening of a branch of the Royal Mint in Ottawa during 1908 the 1910 Currency Act authorized the minting of Canadian gold coins based upon one ounce of pure gold being equivalent to $20.67. The Currency Act thus
defined the positions of the monetary gold supply and demand schedules (respectively \( S_G^G \) and \( D_G^G \)) in the north-east quadrant of Figure 1. The fixed gold price \( \bar{P}_g \) specified by the Currency Act implied that less would be supplied and more would be demanded for domestic monetary purposes as the Canadian commodity price level \( P_c \) rose. The price level \( OP_{cl} \) thus conforms to an equilibrium quantity of monetary gold OMG.

The Dominion Notes Act regulated the supply of the paper money component of legal tender money known as dominion notes. Dominion notes were issued by the federal government under two separate gold reserve requirements. Fractional gold reserves ranging from 15 to 25% were required for a fixed issue rising from $8 million in 1867 to $30 million in early 1914. Complete gold reserves were required for unlimited further issues. The Dominion Notes Act thus generated a supply schedule of the shape \( S_{DN}^D_{DN} \) in the southwest quadrant of Figure 1, with Od being the partially backed issue and further issues varying inversely with the commodity price level \( P_c \). The Dominion Notes Act also specified that dominion notes were convertible on demand into an equivalent value of gold thereby fixing the relationship between the price of gold \( \bar{P}_g \) and the price of dominion notes \( P_{DN} \). This in turn implied that \( P_c/\bar{P}_g \) was equivalent to \( P_{DN}/P_{DN} \) as shown in the northwest quadrant of Figure 1.

The Bank Act generated the demand for dominion notes. The act specified that: each bank must maintain 40% of its Canadian reserves in dominion notes, banks were forbidden to issue their own notes in denominations of less than $5.00, and bank notes and deposits were convertible on demand into gold or dominion notes. The resulting demand for dominion notes is depicted in the southwest quadrant of Figure 1 by \( D_{DN}^D_{DN} \). The price level \( OP_{cl} \) also conforms to an equilibrium quantity of dominion notes ODN.
The pre-1914 arrangement operated automatically in response to changes in the balance of payments position. A balance of payments deficit would lead to a rise in the Canadian price of the American dollar to the gold export point of $.0075. The banks then shipped monetary gold to fulfil external debts, and after 1908 gold producers responded by exporting their output to the United States instead of the Ottawa mint. Such shipments shifted the monetary gold supply schedule to \( S'\) in Figure 1. The banks also converted their dominion notes into gold at the Department of Finance to obtain gold for export. This shifted the Dominion Notes Act supply schedule to \( S_{DN} S'_{DN} \) with a reduction of outstanding dominion notes and government gold reserves of \( DN DN' \).

The shipments of \( MG MG' \) monetary gold and \( DN DN' \) government gold implied a reduction of the banks' legal tender reserves and their consequent ability to meet daily clearings. Reductions in legal tender thus curtailed Canadian economic activity and facilitated a reduction in the general price level from \( OP_{c1} \) to \( OP_{c2} \) sufficient to restore balance of payments equilibrium.

The automatic characteristics of the pre-World War I system were significantly modified subsequent to August 1914. Soon after the financial crisis on the outbreak of war the 1914 Finance Act was passed. The act suspended the convertibility of dominion notes so the northwest quadrant of Figure 1 was no longer bisected by a fixed 45° angle. Two revisions to the Dominion Notes Act increased the issue without gold reserves by $41 million. This modified the southwest quadrant of Figure 1 as shown by the shift in the Dominion Notes Act schedule in Figure 2 from \( S_{DN} S_{DN} \) to \( S'_{DN} S'_{DN} \) and the increase in the partially backed issued from Od to Od'. Suspending the convertibility of dominion notes ostensibly anchored the Dominion Notes Act schedule at.
The Finance Act provided an alternative avenue for variations in the dominion note issue by permitting the banks to rediscount approved collateral at the Department of Finance. The legislation fixed the rediscount rate at five percent so there was no explicit instrument for government control over the volume of advances. The Finance Act supply schedule $S'_{FA} S'_{FA}$ is displayed in Figure 2 at a uniform distance from the Dominion Notes Act supply schedule. During 1923 a supplement to the Finance Act made the rediscount facilities available to the chartered banks on a permanent basis, permitted discretionary changes in the rediscount rate by the Treasury Board, and specified that dominion notes would become convertible into gold by 1 July 1926. The 1923 supplement to the Finance Act implied that the post-1926 gold standard would require discretionary control to ensure that the total volume of Dominion Notes varied in accordance with the balance of payments position.

The apparent failure of discretionary control during 1928-9 led to demands for a central bank as a superior arrangement for monetary control. In late 1928 the balance of payments deteriorated and the banks converted their dominion notes into gold for export, shifting the Dominion Notes Act supply schedule in Figure 3 from $S'_{DN} S'_{DN}$ to $S'_{DN} S'_{DN}$. This was associated with a reduction in outstanding dominion notes and government gold reserves by an amount equivalent to $DN_{2} DN_{3}$. The concomitant reduction in Finance Act advances did not materialize as the rediscount rate was not systematically used to curtail rediscounting. The volume of advances actually increased, shifting the Finance Act supply schedule in Figure 3 from $S_{FA} S_{FA}$ to $S'_{FA} S'_{FA}$. The reduction in dominion notes occasioned by gold conversions was more than offset by the increase in Finance Act advances $DN_{1} DN_{4}$. The reduction in monetary gold $OMQ_{1} - OMQ_{2}$ was counterbalanced by the net increase in dominion
notes from $ODN_1$ to $ODN_3$. The balance of payments deficit did not induce a corrective reduction in legal tender. Rather than curtail rediscounting, the government resorted to a surreptitious gold export embargo throughout 1929. This was followed by a formal gold export embargo in October 1931 after Britain's departure from gold. The Canadian dollar then simultaneously depreciated with respect to the American dollar and appreciated with respect to sterling. This intermediate position was maintained until late 1933 when Roosevelt's devaluation of the American dollar returned the Canadian dollar to approximately its gold parity with respect to the American dollar and sterling. A series of papers by C. A. Curtis (1930), (1931), (1932) claimed that because Department of Finance officials displayed little or no expertise on monetary matters and because the initiative for advances rested with the banks, monetary control and a definite exchange rate policy were virtually unrealizable.

The government appointed a royal commission during July 1933 to investigate the prevailing monetary system and the advisability of a central bank. After public hearings throughout Canada during August and September the Commission issued a report in November that a central bank was indeed advisable to: "substitute for the present undeveloped and anomalous system a more rational and unified control over the credit structure; [and to] provide a suitable instrument for the execution of a rational policy in regard to the external value of the currency," Report (1933, 69). Both the Finance Act and the Dominion Notes Act were repealed on the opening of the Bank of Canada and dominion notes were replaced by Bank of Canada notes with a uniform 25% gold reserve. The convertibility of dominion notes into gold was provisionally suspended upon the opening of the central bank.
Monetary gold held by the chartered banks was appropriated by the Bank of Canada, eliminating the northeast quadrant of Figure 1. The gold was used to establish an Exchange Fund Account and the banks' note issue privilege was gradually transferred to the Bank of Canada. To consolidate monetary control the Bank of Canada was provided with extensive powers to conduct open market operations. The profound reconstruction of the monetary system ostensibly facilitated the monetary control necessary to attain the alternative price and exchange rate objectives outlined by W. C. Clark in his September 1934 speech. Clark refused to publicly state whether internal stability of the price level or stability of the exchanges was the paramount objective of policy. His ingenious reconciliation of the alternatives was intimately related to the genesis and fulfillment of Canadian central banking.

II. GENESIS

The factors governing Canadian monetary policy from 1932 to 1934 are obscure in the existing literature. The Royal Commission on Banking and Currency Report (1933, 58-9) which recommended the creation of a central bank conjectured that the discount rate on Finance Act advances had been adjusted solely to induce the banks to purchase short-term government debt. With one exception the parliamentary statements prior to mid-1934 by the Prime Minister, R. B. Bennett, and his Minister of Finance, E. N. Rhodes consistently rejected the use of expansionary monetary policy or devaluation of the Canadian dollar to promote domestic recovery. The exception occurred in November 1932 after the Imperial Economic Conference held in Ottawa during July-August, when the government apparently attempted an expansionary monetary policy through the Finance Act. The government sold a $35 million treasury bill issue to the chartered banks and through moral suasion had them pledge the entire issue for Finance Act advances. This attempt was not followed by
further expansionary measures until June 1934 when the Dominion Notes Act was amended by raising the issue without gold reserves from $50 million to $120 million to facilitate the transition from the pre-1934 monetary system to the Bank of Canada system and to expand economic activity. Historical accounts by Knox (1939), McIvor (1958, Ch.VII), and Courchene (1969), note the virtual absence of an active monetary policy prior to 1934 but do not explain the factors responsible for the absence.

My research on surviving unpublished evidence facilitates an accurate explanation of the factors governing policy. The evidence reveals that during and after 1932 the reluctance to undertake an active policy was the result of notions closely akin to those of the monetary approach to external equilibrium. Such notions were combined with an evaluation and rejection of an early Keynesian suggestion to deliberately manage the exchange rate for countercyclical purposes. The policy orientation also provided the basis for the creation of the Bank of Canada. This orientation of policy originates with Canadian preparations for the Imperial Economic Conference of July-August 1932.

Early in the 1932 parliamentary session a resolution was passed that monetary issues be placed on the agenda for discussion at the forthcoming Imperial Economic Conference. The Under Secretary of State O. D. Skelton, recommended Professor W. C. Clark of Queen's University to Prime Minister Bennett and Bennett commissioned Clark to prepare the pivotal Memorandum on Monetary Reconstruction. This document contained the initial outline of a comprehensive design for a major reconstruction of both the international and the Canadian monetary systems.

Clark's detailed document was arranged in two parts. Part I, comprising 115 pages, dealt principally with international monetary issues. The remaining 60 pages comprising Part II dealt with Canadian monetary
issues. Both parts were unified by the view that the source of employment and output fluctuations was instability of the general price level. In turn, the price level could be stabilized chiefly through monetary policy. The stabilization objective necessitated a further choice for open economies between stabilization of the exchange rate (and international trade) or stabilization of the domestic price level (and domestic economic activity). This policy choice which bears a close resemblance to the implications of the modern monetary approach was resolved by Clark through an ambitious proposal for international monetary reconstruction and internationally coordinated expansionary measures whereby all countries would: "aim at external stability by accepting an international standard such as gold, and then to endeavour to secure international cooperation to stabilize the value of gold" [Clark] (1932e, Part I, 11).

The international monetary issues discussed in Part I included a detailed examination of three alternatives: the international gold standard, silver remonetization, and the sterling exchange standard. Each alternative was carefully weighed as a technique for achieving the ultimate objectives of simultaneously stabilizing domestic price levels and exchange rates. The case for the international gold standard focussed upon the strengths displayed prior to 1914 such as: maintenance of balance of payments equilibrium, inflation prevention, and its 'grip on the public imagination'. The case against the international gold standard focussed upon the weaknesses displayed since 1925 such as: balance of payments adjustment costs, weakness of the traditional bank rate weapon, the 'alleged' gold shortage, the international maldistribution of gold reserves, and failure to control the business cycle. Hence, restoration of an international gold standard would necessitate international management to achieve the ultimate objectives. Various schemes for silver remonetization were untried and unlikely to obtain the international
agreement requisite for coordinated stabilization measures. The sterling exchange standard was managed by Britain and implied flexible exchange rates with countries outside the sterling area which was inconsistent with the stable exchange rate objective. Overall, an internationally managed gold standard was judged the most appropriate technique for achieving the ultimate objectives.

Part II exhaustively considered the Canadian monetary system and its suitability for attaining the external and internal objectives. The objectives were such that Canadian monetary policy "should aim primarily to secure stable exchange rates with other countries, because of the important role which both foreign trade and foreign borrowing play in our national economy" [Clark] (1932a, Part II, 13-14). When considering the Canadian techniques to attain this objective Clark explicitly rejected an early Keynesian proposal by A. F. W. Plumptre (1932). In a paper read to the Canadian Political Science Association annual meeting during May 1932 Plumptre urged a continuing countercyclical management of the exchange rate through capital account controls rather than attempting to control the Canadian price level. Clark stressed the difficulties with the proposal and claimed that the contraction since 1929 was an "abnormal situation" which had "led to an undue emphasis on Canada's economic instability" [Clark] (1932a, Part II, 12). Nonetheless government control over foreign borrowing might be a suitable short-run policy to avoid wide exchange rate fluctuations. Various techniques to achieve the internal objective of stabilizing the value of gold or raising prices could be achieved with minor modifications to the monetary system but Clark was skeptical about the ability to maintain the monetary control necessary for the external stable exchange rate objective. Hence, "there can be no question that the existence of a central bank would greatly
facilitate the task of achieving the objectives we have set up as the goal of monetary policy" [Clark] (1932a, Part II, 30). Pending the consultations on international monetary reform and common expansionary measures Clark advised that the Canadian dollar be allowed to freely float.

Upon completion of Clark's memorandum Bennett enriched the academic input by sending copies to 13 economists asking each one to: "express your opinion and indicate any criticisms which occur to you," Bennett (1932a).

Summaries of seven responses on Clark's recommendations for international monetary reconstruction are tabulated in Table I.

Qualifications concerned matters of degree rather than substance. Regarding objectives most of the qualifications concerned the ability to promote recovery through monetary policy. Regarding techniques the qualifications were matters of detail except for those offered by B. F. Kierstead and A. F. W. Plumptre. Kierstead advocated a devaluation of the Canadian dollar to parity with sterling while Plumptre also advocated incorporating the Canadian dollar in the sterling area on condition that the British authorities would pursue a more expansionary policy. Summaries of five responses on Clark's recommendations for Canadian monetary reconstruction are tabulated in Table II. Only Edouard Montpetit opposed the recommendations
# TABLE I

**ECONOMISTS' OPINIONS ON W.C. CLARK'S RECOMMENDATIONS FOR INTERNATIONAL MONETARY RECONSTRUCTION**

<table>
<thead>
<tr>
<th>Economist</th>
<th>Objectives</th>
<th>Techniques</th>
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<td></td>
<td>exchange stability and price stability</td>
<td>restoration of gold standard</td>
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<td>qual. disagree agree disagree</td>
<td>qual. disagree agree disagree</td>
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<tr>
<td>Angus</td>
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<td>X</td>
</tr>
<tr>
<td>Balcolm</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Kierstead</td>
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<td>Knox</td>
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<tr>
<td>Mackintosh</td>
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<td>X</td>
</tr>
<tr>
<td>Montpetit</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Plumptre</td>
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<td>X</td>
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</tbody>
</table>

Source: Public Archives of Canada, Ottawa (hereafter P.A.C.), R. B. Bennett papers, reel: M1175, 112593, 112599, 112600, 112602.

# TABLE II

**ECONOMISTS' OPINIONS ON W.C. CLARK'S RECOMMENDATIONS FOR CANADIAN MONETARY RECONSTRUCTION**

<table>
<thead>
<tr>
<th>Economist</th>
<th>Central Bank As &quot;Ultimate Solution&quot;</th>
<th>Monetary Control Through Finance Act</th>
<th>Controls Over Foreign Borrowing</th>
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<tr>
<td>Plumptre</td>
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Source: P.A.C., R. B. Bennett papers, reel: M1175, 112606.
to create a central bank and impose capital account controls, presumably on
the view that the existing system was both adequate and was functioning
effectively. Kierstead followed up his international recommendations by
urging immediate monetary expansion through the Finance Act.

The international objectives of Clark's memorandum defined the official
Canadian outlook on monetary issues at the Ottawa Conference. Part I of
his memorandum was subdivided into four documents printed for the Canadian
delegation. Clark extended the close connection between international
reconstruction and future Canadian policy in two further papers. One
summarized the reconstruction goals, concluding that: "these objectives
can only be fully attained by broad international cooperation and, therefore,
[the Commonwealth countries] should resolve to strive for such cooperation
through an international monetary conference, continuing [the] development
of the facilities and services of the Bank for International Settlements"
[Clark] (1932b). The other paper counselled that in view of the deflationary
prospects likely to continue for countries still adhering to the gold
standard, and the uncertain situation in the sterling area the Canadian
dollar should continue to float. Nonetheless: "a decision to tie-up
with London or New York may wisely be made before another six months have
passed. If gold prices continue their downward and uncertain trend, we
may decide that the possibility of less deflationary pressure and more
price stability to be achieved by sterling outweighs the disadvantages of
greater fluctuations in our exchange with the United States and that con-
sequently a tie up with sterling is the least of two evils" [Clark] (1932c).
The internationalist complexion of the Canadian position on monetary policy
contrasts with the empire orientation on commercial policy.
Canada was represented on the Imperial Conference Sub-Committee on Monetary and Financial Questions by Clark as Financial Adviser and by Watson Sellar, Comptroller of the Treasury and senior executive officer of the Department of Finance. The Sub-Committee's lengthy statement on price-raising objectives expressed the major concern of most countries at the Conference but the statement on Empire currency stabilization: "that the ultimate aim of monetary policy should be the restoration of a satisfactory international standard...[in conjunction with domestic price raising objectives] precedent to the re-establishment of any international monetary standard," Report (1932, 38-9), coincides closely with Clark's hopes for internationally coordinated expansionary measures in conjunction with international monetary reconstruction. Regarding the program for domestic monetary reconstruction the Canadians privately discussed the case for a Canadian central bank with representatives from the Bank of England during and after the Conference.

Canada's November 1932 attempt at an expansionary monetary policy has been widely interpreted as a natural development from the monetary recommendations made at the Conference. Although it was undoubtedly an expansionary measure, the surviving evidence reveals that it was not carefully orchestrated to promote domestic recovery. It was arranged by Watson Sellar who had been previously appointed Assistant Deputy Minister of Finance in the midst of a serious personnel upheaval early in 1930. In the monetary sphere he covertly disciplined the banks concerning Finance Act advances by sharply curtailing their annual applications for lines of credit under the Finance Act during April 1930 and then arranged for resuming the convertibility of dominion notes into gold the following September. Immediately after his 1930 election victory Bennett assumed the Finance portfolio and commenced a major overhaul of the Department of Finance. In February 1932
he transferred Sellar to a newly created position of Comptroller of the Treasury with the responsibility of monitoring the government financial position on a daily basis. Bennett also searched for a Deputy Minister with particular expertise on money and banking affairs that led him to Clark. The November 1932 attempt at an expansionary policy was thus the last important monetary decision made by Sellar.

The use of the Finance Act for implementing an expansionary monetary policy had been carefully considered in the reconstruction memorandum [Clark] (1932a, Part II, 39-41). Clark noted the difficulties involved because the initiative for advances rested with the banks. Nonetheless, the banks: "might consent to use the facilities of the Act temporarily to further a well-considered Governmental program, pending the passage of legislation changing the basis of [the] Dominion Note issue at the next session of Parliament," [Clark] (1932a, Part II, 41). The surviving evidence reveals that the November 1932 attempt at an expansionary policy was not particularly "well-considered". On May 30th Sellar intimated to Finance Minister E. N. Rhodes the mingled motives of deficit finance and monetary expansion which motivated the issue. Concerning $43 million of government debt maturing on November 1st. Sellar suggested: "We should force the banks to take [a renewal of] this and if they want to, have them discount it under the Finance Act. In other words inflate our currency" Sellar (1932a).

Perhaps reassured by the commitments to monetary ease expressed at the Imperial Conference, Sellar subsequently suggested to Rhodes that the government might sell a $35 million treasury bill issue in November or December to the banks which could be freely discounted under the Finance Act. Rhodes in turn asked G. W. Spinney, Assistant General Manager of the Bank of
Montreal for his opinion on a four percent issue discountable under the Finance Act at 2.5 percent. Spinney was not enthusiastic because the tentative 1.5 percent: "margin between the running yield on the 4% notes and the rate at which they could be used for borrowing under the Finance Act is approximately the same margin which is available in the ordinary cause on the [government bonds maturing in 1933 and 1934]" Spinney (1932). When Rhodes next discussed the proposal with the bankers deficit financing considerations predominated because: "it would be desirable to arrange our financing in such a way that it would be done as cheaply as possible and with as little embarrassment as was inevitable in connection with a large transaction" Sellar (1932b). The $35 million four percent issue was eventually made on November 1st. and the discount rate for Finance Act advances was only lowered to three percent, thereby narrowing the margin to one percent. As the banks pledged the issue for Finance Act advances it attracted attention as an 'inflationary' measure.

The parliamentary explanation of the November issue can be associated with Clark's accession to the Deputy Minister of Finance position on October 15, 1932. Clark was in the process of moving to Ottawa when the issue was made and on November 4th he telephoned Sellar and indicated that he was "somewhat disturbed" over the publicity associated with the issue. He asked for an explanation and Sellar's response emphasized expansionary considerations such: "that the future of this country demands that [long term] interest charges be kept down," Sellar (1932c), so the federal government was resorting to treasury bills that could be rediscouned under the Finance Act as an alternative to debt issued in the capital market.
The subsequent parliamentary explanation by Bennett (1932b) with its emphasis on similar expansionary measures in Britain and the United States bears little resemblance to Sellar's memorandum and probably reflects Clark's cosmetic improvements to emphasize internationally coordinated expansionary policies rather than debt management. Clark's acceptance of the Deputy Minister of Finance position marks the initial definite steps towards creation of a central bank. It has been suggested by George S. Watts (1972, 26) that Clark's acceptance was made conditional upon a commitment to establish a central bank. This seems likely to have been the case since the new Deputy Minister's earliest surviving memorandum for Rhodes outlines the steps involved to establish a Royal Commission that would undertake an: "authoritative examination of the pros and cons of the argument for a central bank, and the working out of the details of organization for such a central institution" Clark (1932d). The memorandum leaves little doubt that Clark fully expected the commission to recommend a central bank. He recommended Sir Josiah Stamp of the Bank of England as chairman because: "If Sir Josiah told our Canadian bankers, as he probably would, that a central bank was desirable in this country his arguments would likely be accepted." As commissioners, Clark recommended Walter W. Stewart, formerly of the Federal Reserve Board, and Sir Thomas White, Vice-President of the Bank of Commerce and Minister of Finance from 1911 to 1919 with "two or three bankers as well as an industrialist or two." At this juncture Clark's views on international monetary reconstruction closely paralleled White's.

The subordination of domestic monetary policy to international monetary reform is implicit in a discussion involving Clark and Sir Thomas White in late 1932 and early 1933. During December the Minister of Finance
compained to White about: "a condition of mind which has become an obsession to such an extent that the idea of inflation has swept the country like a prairie fire" Rhodes (1932). White replied with a previously written memorandum warning about the dangers certain to follow after departure from financial orthodoxy. He intensely disputed the "inflationist position" that a devaluation could improve national welfare and concluded that: "The remedy lies in international cooperation for the purpose of stabilizing currencies, adjusting production so far as possible, revising war debts and reparation payments... No one nation can, in present world conditions, effect any material improvement in its own condition. Its fortunes are bound up in general recovery," White (1932). White suggested to Rhodes that Clark should review White's submission to check up for inaccuracies or false conclusions. Clark was pleased to review it and noted his "general agreement on all the fundamentals of [White's] argument." While he was prepared to moderate some of White's more pessimistic speculations, he was: "in complete agreement with Sir Thomas in regard to the remedy, and I think that we should use all the influence we have as a nation towards the furthering of the international programme whose main lines are so clearly apparent" Clark (1933a). When Clark composed the review the 1933 World Economic and Monetary Conference was a very uncertain future event. Hence, the clearly apparent programme was little more than Clark's desire to reconcile internal and external objectives by international agreement upon fixed exchange rates and internationally coordinated expansionary policies. Although White and Clark could agree upon the program for international monetary reconstruction they were to disagree on the need for domestic monetary reconstruction.
The 1933 decennial Bank Act revision was delayed for a year pending the outcome of the World Economic and Monetary Conference. Clark hoped to have a Royal Commission on the central bank in operation prior to the Conference. On 3 February he suggested as commissioners: Sir Josiah Stamp or Sir Otto Niemeyer of the Bank of England as Chairman, Walter W. Stewart, Sir Thomas White, Professor Gilbert Jackson of the University of Toronto, Beaudry Leman, immediate past President of the Canadian Bankers' Association, and Alfred Speakman, a prairie member of parliament; who could provide: "a unanimous report and facilitat[e] its acceptance by the country as a whole" Clark (1933b). Clark hustled to have the Royal Commission announced when a resolution was introduced in parliament to have the Commons Committee on Banking and Commerce study devaluation. He provided precise instructions for the appointment of a Royal Commission on the central bank in lieu of having devaluation studied by the Banking and Commerce Committee. A Royal Commission could "do for Canada what the MacMillan Committee on Finance and Industry did for the United Kingdom" because it could: "spend the next two or three months in a preliminary examination of the subject, particularly in the study of the Canadian financial system and the assembling of data; can possibly make an interim report which would be of value to the Canadian delegates at the coming World Conference; and could then await the outcome of the latter Conference before submitting its final report which should be made in the light of developments at that Conference" Clark (1933c). The Royal Commission on Banking and Currency was finally announced over a month later by Rhodes in the course of his budget speech while the World Conference was in progress.
The outlines for future Canadian exchange rate policy had already been defined in Canadian preparations for the Conference. Although the Conference was not specifically intended for discussing international monetary reconstruction, Clark provided an outline of international monetary matters in a lengthy memorandum on 24 April. It was arranged in four sections discussing the annotations to the Agenda on monetary and credit policy, prices, and resumption of international capital movements, World Conference (1933a, 3-7). In the initial sections he reviewed the Conference agenda and reiterated his previous views that the only viable long-run solution was eventual restoration of an international gold standard coupled with internationally coordinated recovery measures. Unlike the pre-1914 version of the gold standard that had rigidly fixed parities at essentially arbitrary values, the future selection of parities would be a deliberate policy decision. Canada's decision would have to await the British and American decisions because: "when we go back to gold we should adopt a parity somewhere between [our previous parity with] the United States dollar and the British Pound, but this decision cannot be made until the United Kingdom-United States parity is determined" Clark (1933d, 6). Concerning the positions of Britain and the United States at the Conference, Clark conjectured that Britain would be unlikely to make a firm commitment at the Conference regarding a return to gold, and Roosevelt's domestic programme might endanger the prospects for internationally coordinated expansionary measures. With such dim prospects for international coordination, Canada should encourage recovery measures. In particular, she should give consent "without question" to: reductions in gold reserve ratios of up to 25 percent, to wider use of the gold exchange standard, and central bank coordination of expansionary measures.
The concluding section criticized conference agenda annotation III on resumption of international capital movements, World Conference (1933a, 6-7). Clark was skeptical in the light of prevailing French and American attitudes whether international lending could be resumed through the normal credit channels supplemented by a monetary normalization fund or an international credit institute. Instead he favoured the international gold notes scheme developed by Hubert Henderson of the British Treasury and expounded by Keynes (1933). The scheme proposed an international organization with authority to issue notes (that would serve as international reserves) to member countries on deposit of their bonds. Keynes suggested the acceptance of this plan by other countries at the World Conference as a condition for Britain's return to the gold standard. However, the ultimate failure of the Conference temporarily destroyed the prospects for international monetary reconstruction.

The Canadian position at the World Conference is somewhat imprecise. Bennett's parliamentary explanation that the Canadian government had met other British representatives at the Conference: "with a view to the further development of empire cooperation; and adopted certain resolutions with respect to monetary and financial policies" Bennett (1934a), was rather sketchy. W. A. Brown (1940, 1291), later conjectured that Britain had obtained Canadian adherence to the Empire Currency Declaration in exchange for permission to make a £15 million registered stock issue in London during August 1933. This conjecture is refuted by the surviving evidence. By the end of June Bennett and General Smuts of South Africa were discussing a possible meeting
for Conference countries adversely affected by the devaluation of the gold content of the American dollar. Soon after the Roosevelt telegram that undermined the prospects for international agreement was received Smuts prepared a memorandum on British Empire monetary policy. He discussed it with Bennett who in turn urged the other British delegates that: "it seemed to him that the only solution would be, as General Smuts had suggested, to seize the present opportunity of making some striking declaration of policy...if nothing was done, all those present, in a few months would be faced in their respective countries with the reactions of the failure of the Conference World Conference (1933b). The resulting Declaration, World Conference (1933d), reiterated the objectives of the 1932 Imperial Economic Conference Sub-Committee on Monetary and Financial Questions. The Declaration was partly the result of Canada's initiative and officially signified her spiritual association with the policies of the sterling area.

Although the Canadians' optimistic international reconstruction objectives set out for the Conference were not attained it did provide an opportunity to secure the key commissioners for the Royal Commission on Banking and Currency. Sir Thomas White and Beaudry Leman had already been secured early in June. Lord Macmillan, the previous Chairman of the British Committee on Finance and Industry, agreed to serve as Chairman on 30 June and suggested Sir Ernest Harvey, Deputy Governor of the Bank of England, or Sir Bertram Hornsby, Governor of the Bank of London and South America, or Sir Charles Addis, a previous Director of the Bank of England, as the most suitable candidates for the remaining position. Sir Charles Addis accepted on 22 July and the order-in-council creating the Royal Commission was passed on 31 July. Although the failure of the World Conference indefinitely postponed international monetary reconstruction, Clark's complementary program for domestic reconstruction materialized during the following year.
III. FULFILLMENT

The period from November 1933 until June 1934 is marked by the fulfillment of Clark's domestic monetary reconstruction program. Roosevelt's decision not to further the World Conference objectives muted the prospects for international monetary reconstruction, but his devaluation of the American dollar altered the international environment sufficiently for the initial conscientious use of Canadian monetary policy to stimulate domestic economic activity. Nonetheless, Clark's proposals for international monetary reconstruction still dominated his thinking about the future operations of the Bank of Canada. Indeed, his recourse to what has recently become a central implication for monetary policy under fixed exchange rates in the monetary approach to external equilibrium resolved sensitive issue of ultimate responsibility for monetary policy.

As expected, the Canadian Macmillan Commission recommended the creation of a central bank in their report of November 13. Although the Commission did not make specific recommendations about exchange rates, it did make three basic recommendations concerning monetary arrangements that could facilitate operation of a gold bullion standard: the central bank should have a monopoly of currency issues, the chartered banks should be required to maintain deposits of five percent of their reserves with the bank, and all domestic gold reserves should be centralized in the central bank, Report (1933, 98-100).

The international emphasis in the Commission's report was mildly inconsistent with contemporary policy formulation. On the very day that the Commission announced its recommendations Clark provided Bennett with a detailed review of an article in the financial press by Stewart Bates
criticizing the government's failure to undertake expansionary policies since 1931, Bates (1933). After defending policy conduct throughout the previous two years Clark cautiously expressed support for an expansionary policy to manage the exchange rate and raise domestic prices as follows:

"The general type of policy suggested by Mr. Bates is one that was recommended for serious consideration by the present writer at the time of the Ottawa conference. I felt that at that time it would have been possible to embark on a certain measure of inflation without causing a lack of confidence or causing an outflow of capital. A few months later it became impossible because of the condition of the investment markets. Today with recent developments in the United States, the danger of an outflow of capital to that country has probably been removed and it may again be desirable to consider whether some expansionist policy designed to keep the Canadian dollar depreciating at least as rapidly as the United States dollar might not be in order." Clark (1933e). Hence, the long-awaited internal expansionary measures could now be undertaken because the declining American dollar had temporarily relaxed the external constraints.

The 'expansionist policy' was implemented through the transition from the 1914-34 system to the central bank system. Clark worked out three proposals for expanding the dominion note issue through an upward revision to the issue without gold reserves by $37.5 million, $49 million, or $52.5 million. The alternative yielding the maximum issue was chosen and Clark had no hesitations about currency issued to finance public works expenditures as he explained: "that the expansion of cash reserves which this will make possible will do a great deal to ease the credit situation in this country and coupled, as it is, with the public works program will do a great deal to accelerate business recovery..." Clark (1934a). Bennett had already prefaced his
parliamentary introduction of the bill by blending international and domestic considerations. He commenced by directly quoting from paragraph seven in the World Conference Report of the Sub-Commission on Permanent Measures for the Re-Establishment of an International Monetary Standard, World Conference (1933c, 3), that recommended reductions in statutory gold reserve ratios to 25 percent. He then continued that the monetary expansion was: "part of a policy primarily concerned with the restoration of sound business conditions in the dominion" Bennett (1934b). Hence, the expansionist policy was undertaken with close attention to both the internal and the external situation.

The expansionist counterpart to domestic monetary reconstruction did not detract Clark from the primary objective of eventual international monetary reconstruction. His inference about the future relationship between the Bank of Canada and the federal government follows from an implicit notion analogous to a key policy implication of the modern monetary approach to external equilibrium. As noted above the monetary approach implies little or no scope for an independent monetary policy within a fixed exchange rate regime. Similar views were used to resolve the sensitive issue of ultimate responsibility for Canadian monetary policy. In the final days of parliamentary debate on the Bank of Canada bill Mackenzie King, leader of the Liberal opposition, pressed Bennett about the possibility that there could be: "a real danger of the financial control which may thus be exercised by the bank being exercised against what may be the fiscal policy of the government of the day" King (1934). King also noted that such a conflict could never arise under the provisions of the Finance Act. Bennett was temporarily confounded by the possibility which King had raised and replied that he would "certainly consider it and try to provide a remedy against it." He took up the possibility with Clark who dealt with it in an important memorandum.
Before outlining "the purpose for which the Bank is to be created" by reciting the preamble of the Bank of Canada bill, Clark emphasized that he found: "a considerable difficulty in visualizing the nature of the conditions under which the conflict between the Central Bank and the Government, suggested by Mr. King, might arise. He evidently exaggerates the degree to which the Bank of Canada will play a part in determining commercial [currency] policy. It should be clearly realized at the outset that the Bank is to provide the mechanism by which trade is to be facilitated, rather than an instrument for the control of the direction of this trade." He had noted the 'vital weakness' of the 1914-34 monetary system, namely that "It is in view of the limitations of the Finance Act that a central bank is being set up." International monetary reconstruction in the shape of an international gold standard would obviate conflicts between the Bank of Canada and the federal government because: "The government will define the currency unit and it will be the duty of the Central Bank to so direct its policy that this currency unit, if defined in terms of gold shall be maintained. Clearly, with the gold standard in operation, the duty of the Bank of Canada will be that of maintaining the [external value of the] currency unit of Canada at a parity with other gold currencies. Under such conditions, it is impossible to see the means whereby the Bank of Canada, in itself, possesses any means of directing trade in one direction rather than another..." [Clark] (1934b, emphasis added). Clark then asserted that conflicts would not arise under a flexible exchange rate because the federal government would determine: "whether or not our currency should be stabilized in terms of the pound sterling or the United States dollar or any other basis." Bennett's subsequent parliamentary reply to King confirms that the Bank of Canada was to be primarily (if not exclusively) responsible for exchange rate management. Bennett acidly claimed that: "the Bank of Canada cannot control the mechanism used by the government for the purposes of its policy under any circumstances whatever." Bennett (1934c).
The concluding period witnesses the fulfillment of the domestic objectives outlined only two years previously. Domestic monetary reconstruction was fulfilled with the creation of the Bank of Canada. The endeavour to stabilize the value of gold was fulfilled through the June 1934 amendment to the Dominion Notes Act. The contemporaneous search for international monetary reconstruction with Canada's return to a fixed exchange regime proved to be a more elusive objective. In October 1950 Clark again resolved the conflict between external and internal objectives by opting for a flexible exchange rate. This decision established the conditions for potential conflicts over ultimate responsibility for monetary policy that materialized in the late fifties and reawakened debate on Canadian monetary affairs.

IV. CONCLUSION

The preceding two sections have closely chronicled the application of the theoretical background sketched in the initial section to the development of Canadian central banking. They provide new historical insights into such issues as the intended relationship between the central bank and the government on responsibility for policy and the government's reluctance to seriously undertake expansionary measures before mid-1934.

Clark's recourse to the minimal role for independent policy in the context of a fixed exchange rate reveals the intended policy roles for the government and the central bank. The government was to be responsible for policy formulation while the central bank was to be responsible for policy conduct. This separation presumed a particular theoretical underpinning for monetary policy that was overturned by the Keynesian revolution. The post-1935 increase in the role assumed by the government for stabilizing domestic
employment through fiscal policy and the depreciation of monetary policy as a stabilization instrument contributed to the subsequent neglect of the danger of policy confrontations. Canada's early departure from the reconstituted gold standard in October 1950 signifies the frustration of the international objectives so clearly mapped out in early 1932. As such, the reluctance to undertake expansionary measures prior to mid 1934 becomes historically more culpable when viewed in retrospect. As noted in the second section both the precursors and the monetary approach crucially depend upon a stable domestic demand for money or velocity of circulation. Yet between 1929 and 1933 the velocity of circulation declined by over 40% and net national income declined by 49% in Canada. The theoretical background for policy formulation is empirically culpable in retrospect. The research agenda now calls for a counterfactual analysis of more expansionary policies.
FOOTNOTES

* This paper originates from the penultimate chapter of my doctoral dissertation on Canadian monetary policy from 1914 to 1934. I am grateful to: R. B. Bryce, Ian Drummond, Susan Howson, and George S. Watts for numerous constructive criticisms on the chapter and also to the Social Science Federation for financial assistance. The paper owes much to helpful comments from, and discussions with: Tom Courchene, George Freeman, Knick Harley, and Anjie Redish. Liability for the finished product rests exclusively with the author.

1 George Rich (forthcoming) shows that the banks offset and reinforced the impact of gold flows on Canadian economic activity by pro-cyclical variations in their reserve ratios.

2 Nonetheless, the discount rate was specially reduced under the War Measures Act for advances on up to $200 million of British Treasury Bill collateral held by the banks from 20 October 1917 until 31 March 1922.

3 Two of the three Canadian commissioners: Sir Thomas White and Beaudry Leman dissented from the recommendation to create a central bank.

4 Other memoranda prepared for monetary issues discussed at the conference include: The Evils of Monetary Instability, Memorandum on Silver Remonetization, Memorandum on the Currency aspects of Canada's Trade With the Far East, and Memorandum on Canada's Balances of International Payments with Commonwealth Countries and the United States. The silver remonetization memorandum was written by Professor Humfrey Michell of McMaster but the other authors are not designated.
5Thus: "monetary instability has become in the past year at least the paramount cause of continuing economic deterioration," [Clark] (1932a, Part I, 3). The paper on the evils of monetary instability is even more explicit: "A drastic decline in the general level of price also exercises a disastrous effect upon production—depressing business enterprise, reducing output, increasing unemployment and impoverishing labour," p. 3-4.


7George S. Watts of the Bank of Canada has informed me that although the expansionary effect of the issue was unsubstantial it provided a needed reallocation of dominion notes among the banks to ensure their ability to meet daily clearings.

8Howson and Winch (1977, 114-21) provide an excellent account of the scheme's development.

9The figures are taken from Friedman and Schwartz (1963, 352n). For a detailed comment on the decline in velocity see Barber (1966).

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FIGURE 1.
CANADIAN LEGAL TENDER ISSUES AND BALANCE OF PAYMENTS ADJUSTMENTS 1867-1914

FIGURE 2.
LEGISLATIVE ALTERATIONS GOVERNING THE DOMINION NOTE ISSUE 1914-1923

FIGURE 3.
THE FAILURE OF DISCRETIONARY CONTROL 1928-1929