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B A C K G R O U N D   R E A D I N G

for

**Royal Bank of Canada: Yesterday, Today and Tomorrow –
The 2006 Annual General Meeting**

The Creation of the Bank of Canada

MGT 2917

Canadian Business History

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This reading was prepared by Katherine Macklem to supplement the class discussion on The Royal Bank case.

The Creation of the Bank of Canada

Although the banks were regulated by Parliament in Canada's early days, they operated with a great degree of autonomy. The Bank Act of 1871 set minimum capital requirements (at $500,000) and allowed chartered banks to issue notes valued at $4 and up. (The government issued notes valued at less than $4.) The system worked reasonably well until after the turn of the century. But by 1908, kinks started to appear when a shortage of hand-to-hand currency arose during the peak wheat-crop moving season of September to February.

Still, it wasn't until 1913 that the creation of a central bank was proposed. One of the most vocal critics of the chartered banks was an independent conservative Member of Parliament named William F. Maclean. Owner of the newspaper, *The World,* and representing York South, Ont., Maclean advocated the formation of "a big government bank, having no interest to serve except the public interest."[1] Maclean believed the state should not only control currency, but that it should also have the power to compel chartered banks to finance private and commercial expansion, if necessary.

Public concern focused on the concentration of bank ownership. From 1901 to 1914, a period marked by bank failures, liquidations and mergers, the number of chartered banks in Canada fell from 34 to 22. These concerns were put aside, naturally, during the years of the First World War (1914 to 1918). But almost immediately following the war, in 1919, Finance Minister Thomas White, who believed a central bank was a good idea, asked Canada's bankers for recommendations on how to establish one.

The Canadian Bankers Association had already concluded that a central bank would not be in the best interests of its members. It feared, correctly, they would lose the right to issue notes. Furthermore, the association predicted that the new institution would compete against the existing banks. Vincent Meredith, then president of the Bank of Montreal, argued that a central bank would: exert undue political influence and patronage on the existing private-sector banks; encroach on the banks' business and profits; and eliminate free competition among the banks. He suggested that the Canadian banks' branch system already functioned as though each one had its own central bank.

White backed down – a move that illustrates the power and the degree of influence wielded by private-sector banks. To take them on would have required a political battle that White was unwilling to undertake. "White had neither the stamina nor the support to fight one of the most powerful and highly organized professional associations in Canada," Grayson writes in her thesis.

Pressure from outside the private banks continued to grow through the 1920s in favour of a central bank. Western Progressives, who felt alienated from the central levers of power and who resented higher interest rates charged in the West, joined Maclean in arguing for a central bank. Supporters of a central bank saw it as a way to exert "social control" on the banking system. Those who challenged the existing system were convinced that there was a relationship between the availability of credit, the level of prices in the marketplace and the soundness of the economy. Reformers thought a central bank would deliver easier credit and lower interest rates. By 1925, the Progressive Party included a central bank as part of its party platform.

Still, as today, other issues dominated the political scene. From the ruling politicians' perspective, a central bank had little political value, or currency. From time to time, in what has become a time-honoured

[1]Linda Grayson doctoral thesis, "The Formation of the Bank of Canada 1913 – 1938," 1974

Canadian tradition, one committee or another would investigate the need for a central bank, usually wrapping up with a non-conclusion. For instance, in 1928, the House banking committee concluded that a central bank wasn't necessary at that time but that the matter required more study.

Then in October 1929, the stock market collapsed, causing economic mayhem across North America and around the world. Canada was particularly hard hit. Canada's GDP/Capita declined a precipitous 35% from the peak of 1928 to the trough of 1933 compared to a 30% decline in the United States. In the United Kingdom the comparable figure was only 6.5%.[2]

In the 1930 federal election, the economy dominated political debate and once again, the idea of creating a central bank re-emerged. This time, though, it gained credence. Academics wrote reports and newspapers published editorials on the topic of whether Canada needed a central bank. Following the election, won by the Conservatives, the issue was hotly debated in the House of Commons. Conservative Prime Minister R.B. Bennett initially argued strenuously against the measure. In response to a motion introduced in 1931 by a United Farmers Association member to establish a central bank, Bennett argued the existing banking system was sufficient. The establishment of a central bank "would not do a single thing beyond what we are doing now through the operations of the Finance Act without maintaining a bank at all," Bennett said in the House of Commons.[3] Still, he recognized the time might come for a central bank in Canada. "I am sufficiently alive to human progress," he said, "to realize that time may come, and if when it comes, we are here, as we probably shall be half a century hence, that action will be taken." The Liberals didn't support the U.F.A. motion, and it died on the order table.

But as the Depression continued, Canadians looked to the federal government to provide relief. Farmers, among the hardest hit during the Depression years, were paying 7 per cent mortgages that had been signed in the 20s, while their products were selling for less than half of their 1926 values. Suddenly, a central bank had political value. Mackenzie King, leader of the Opposition Liberals, knew that supporting a central bank could indicate to the public that the Liberals had positive economic policies to deal with the Depression. King, who had rejected the idea of a central bank when he was prime minister in the 1920s, now adopted the policy as a plank in his party's election campaign platform. The year was 1932.

R.B. Bennett may also have been coming around. In 1932, he appointed W.C. Clark as deputy finance minister. Clark, an academic who had also worked with a Chicago investment firm, had been a well-known advocate of a central bank for at least a decade. Meanwhile, the CBA continued its lobbying against a central bank. Shareholders of the Bank of Toronto were told in 1932 by the general manager that the formation of a central bank "would mean a heavy increase in expense with little or no offsetting benefits to the banking facilities of the country – and goodness knows this is no time to indulge in extravagances."

Only the Royal Bank showed some interest in the creation of a central bank. In a speech in 1930 to the Canadian Institute of International Affairs, the Royal Bank's S.R. Noble said "the lack of interest and, in fact, active antagonism of the commercial bankers to a central bank is due … to the fact that they do not understand the problem."

Noble might not have understood it either, because as much as a central bank might be able to address the incredible economic strain Canada was facing, the politicians who would be instrumental in putting it in place needed a political fix. A central bank would only happen when they saw that the risk of moving it forward would have political pay-off.

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2 Figures are calculated using 1990 Geary-Khamis Dollars as found in Monitoring the World Economy by Angus Maddison, OECD,1995

3 p. 91, Grayson

Bennett, who only a few years earlier sided with most of the bankers in opposition to a central bank, grew irritated with them as the economy continued to sour. In 1933, he wrote to CBA president J.A. McLeod of his "disapproval" of the banks, who he accused of "forcing to the wall customers who are unable to meet their liabilities at this time." This was strong stuff coming from the PM, who had earlier lamented having to resign from his seat on the board of the Royal Bank.

That year, 1933, represented a turning point. With the Depression now entering its fourth year, Bennett established the Royal Commission on Banking, which spent five weeks hearing submissions from across the country. Farmers were pro-central bank, as was labour. Businessmen were mixed in their reaction, many expressing indifference. Western politicians were pro; Quebec was against; Ontario didn't really say. And the bankers fought to keep their banking system free of outside intervention.

Remarkably, within two weeks of hearing the last submission, the Royal Commission published its report, recommending the creation of the Bank of Canada. While the Canadian banks "give admirable evidence of security, efficiency and convenience," and through the early Depression years, had "continued to render to the people of the Dominion the same high quality and the same wide variety of services as in the past," the commissioners were "impressed by the absence in Canada of any single banking authority which, while linked by its activities with national finance and commerce, is nevertheless detached by its constitution and the temper of its administration from the ordinary pursuits of commercial banking."[4]

The bankers' response to the Commission report was pragmatic. If a central bank was to be established, they wanted to influence certain aspects of it. They opposed public ownership of the institution, as it would likely lead to political interference in economic affairs. They wanted to hold onto their note-issuing powers, "in order that their revenues be not unduly impaired," argued Charles Roy, of the Provincial Bank.

Bill 19 was introduced in Parliament in February 1934 with the aim of creating a privately owned institution. The new entity would regulate the volume of credit, cooperate with other nations, and issue tender.

Bankers, who had earlier enjoyed a cozy relationship with the government, requested a preview of the bill before it went to the House, but to no avail. By now, there was little to be gained by siding with the bankers and Bennett responded harshly. "If the people must engage in conflict with those who worship profits as their god and who regard the welfare of the nation as being of secondary importance," the prime minister said, "then I know in which camp I will be enlisted."[5]

Bennett further distanced himself from the CBA. He warned the bankers that if they continued to pressure the government and to criticize the formation of the new central bank, he promised to remind "the people in my next broadcast that this government and its majority in Parliament are not under the control of the bankers of this country, nor do they propose to be dictated to by them nor swerved from their course of action by threats or otherwise. Let there be no misunderstanding," he concluded, "if the issue is to be joined on that ground, the battle will have but one result."[6]

While the banks in general opposed the new central bank, the Royal Bank stood out. Its general manager, M.W. Wilson, told the House committee investigating the bill that his bank was not opposed to the idea.

4 p. 196, Grayson
5 Ibid., p. 238
6 Ibid., p. 238

On July 3, 1934, Bill 19 received Royal Assent. In the fall of 1934, Graham F. Towers, assistant general manager of the Royal Bank, was named the first Governor of the Bank of Canada.

It wasn't long before the Bank of Canada was the object, once again, of political intrigue. In 1934, the Liberals had voted against Bill 19 on the grounds the new central bank would not be publicly owned. In October of the following year, an election was held and part of the Liberal platform was that the central bank should be publicly owned. The Liberals handily won the election.

During the campaign, King had made so many broad, vague statements about the Bank of Canada that an aide was hired to sort through just what he had said publicly since 1934. In his Throne Speech in February 1936, King alluded to changes to the Bank of Canada, indicating that ownership and control should reside with the government. Much debate followed, over whether 100% government ownership was necessary to give control of the bank in government hands. Predictably, the CBA argued that the governor must be free of political interference. In June 1936, government amendments giving Ottawa ownership of 51% of the bank shares were passed. However, only two years later, King, who was worried that his longtime nemesis, R.B. Bennett, was about to propose full government ownership of the bank, announced the new measure for full ownership first. These last amendments were adopted in 1938, giving the bank the shape it has today.