Subsection 2.—The Bank of Canada and Its Relationship to the Canadian Financial System.

The position which the Bank of Canada occupies in the financial system is one of great importance and one which should be widely and properly understood in these days of increasing public interest in national finance.

It is true that prior to the establishment of a central bank on Mar. 11, 1935, the chartered banks operated satisfactorily in normal times, for considerable periods, almost without control, and that expansion, but *not* contraction, was rendered easy by the Finance Act. Canada has indeed been fortunate in the possession of a strong banking system—ten banks with a large number of branches—as has been demonstrated during the critical years of the depression. But such machinery of control as existed prior to 1935 lagged behind that of most other countries. The student of Canadian banking, however, can recognize certain steps towards the development of a unified control. The excess circulation privilege (the right to issue bank notes during a certain part of the year above the amount of the bank's paid-up capital) was a device adopted in 1908 to enable the banks to meet an important annually recurring seasonal demand for currency. The central gold reserves, authorized in 1913, made it possible for any bank at any time to increase its note issue beyond the amount of its paid-up capital by means of what has been called the "mobilization" of cash reserves. But this system—the deposit of gold or Dominion notes in a central fund in Montreal under the supervision of three trustees—was not really equivalent to the flexibility which a central bank provides. The Finance Act of 1914 (re-enacted in 1923) provided for a method of performing in Canada one important service of a central bank, that of "rediscounting" (or turning into cash) certain paper or securities held by member banks, but the equally important function of contraction was not provided for. The Canadian Bankers' Association may also be said to have assisted in providing a measure of unity that would not otherwise have existed.

Functions of the Bank of Canada.—The preamble to the Bank of Canada Act says that the Bank is "to regulate credit and currency in the best interests of the economic life of the nation, . . . to mitigate . . . fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion" The qualification is important.

There are, of course, limitations to what a central bank can do as will be seen later; nevertheless, a central bank can undoubtedly have a most important and beneficial influence in many ways. In the enormous complexity of modern economic life, there is a number of things which can be more or less exactly measured and a number of things which cannot be measured. There may be a tendency to think that those influences which can be measured must be the controlling ones, such as the volume of deposits and cash reserves and changes in interest rates, etc. This is not necessarily the case.

The first main function, *viz.*, that of regulation of credit and currency, is really *the* distinguishing feature of a central bank, and the other functions are for the most part resultants of the first, combined with such influence as the Bank can bring to bear by means of impartial and skilled advice.

The Mechanism by which the Control is Exercised.—How does a central bank exercise this power of regulation and control? It attains this power by being the bankers' bank. (It is also the Government's bank, and this fact may assist the Bank's control from time to time.)