

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date July 28, 1942.

To Chairman Eccles

Subject: Address of Governor Towers
before Bankers Association
for Foreign Trade.

From Mr. Thurston

One or two points in Towers' speech struck me as interesting, namely, his statement on the high level of Canadian personal income tax rates.

"Comparing a Canadian with an American resident in New York State," he said, "the married Canadian, without children, pays twice as much at the \$10,000 level, a little more than twice as much at the \$5,000 level, nearly three times as much at \$3,000, and six times as much at \$1,800. I should point out also that Canadian law does not allow any deduction for other taxes, and there are no tax exempt bonds in Canada. Our corporations pay a normal tax of 18 per cent on their standard profits - that is, the average profits during the years 1936 to 1939 inclusive - plus $79\frac{1}{2}$ per cent of the amount by which their profits exceed those of the standard period. There is a further provision that no corporation can pay less than 40 per cent of total profits."

As to selling Government debt outside the banks, he pointed out that the Second Victory Loan of last February yielded 845 millions in cash subscriptions from nearly 1,700,000 subscribers. "Translated into terms of U. S. income and U. S. population," he said, "these results could be compared to an American loan yielding \$13 billions cash from 20 millions subscribers."

Nevertheless, I gather from a rough estimate of the rise in Government security investments of the Canadian chartered banks that they have increased proportionately as much as have our member bank holdings of Governments between August, 1939 and February, 1942. In other words, I think the Canadians have only recently begun to make a real drive for nonbank funds, as exemplified in the Victory Loan to which Towers refers.



ADDRESS BY G. F. TOWERS, GOVERNOR,
BANK OF CANADA, BEFORE THE
BANKERS ASSOCIATION FOR FOREIGN TRADE -
MEETING JUNE 4th, 1942
- - - - -

I have been asked in my remarks this morning to give you some of the high lights of financial and economic policy in Canada since the beginning of the war. I am encouraged to believe that the subject is of interest to you, not only because of the fact that your presence here to-day is an indication of your feeling toward this country, but also because we in the democracies have a very practical interest in one another's methods of dealing with the unprecedented economic problems of all-out war. Where bold innovations succeed, they may be adapted for use elsewhere: if they don't, the experience serves as a warning to others.

First of all, let me say that from the day the war started neither domestic financial considerations nor foreign exchange considerations have been allowed to affect in any way - in any obstructive way - the scope and character of our war effort. The war plans have come first, and financial measures have been designed to fit the pattern of those plans and to facilitate their successful execution.

In September, 1939, there were many unemployed in Canada. Thus there was ample room for expansion of production, as well as large scale enlistment in our Armed Forces. In these circumstances, the first War Budget provided for relatively moderate tax increases. Even at that time, however, the Minister of Finance stated that as the war progressed, as more and more of our men and women were absorbed in the struggle, and as production and expenditures increased, taxes would be raised to higher and higher levels so that we might follow, as far as practicable, a "pay as you go" policy. I think our citizens feel that the Government is keeping its promise to tax heavily, although they do not complain of that fact. There is an understanding - instinctive in some cases - that the real costs of war - so far as a country such as

Canada is concerned - must come almost in their entirety out of current production. We cannot escape that fact, whether we finance the costs by taxation or borrowing or by inflation. Therefore, the Government aims to cover total expenditure, as far as possible, by taxation : to obtain borrowed funds, as far as possible, from current savings; and to keep bank financing of Government expenditures down to the lowest possible figures. Let me tell you very briefly what has taken place in these three departments of taxation, public borrowing and bank financing.

Tax revenues in the fiscal year which ended on March 31, 1939, were \$436 millions: and in the one which ended a couple of months ago, about \$1,360 millions. In other words, tax collections have more than trebled since the war began. It is interesting to note that income taxes of individuals and corporations, including corporation excess profits tax, accounted for \$510 millions or 55 per cent of the total increase in tax revenues. Excise tax on liquors and cigarettes, and excise duties designed to curtail imports from hard currency countries, and to curtail consumption of unessential articles at home, provided additional revenues of some \$236 millions. These levies, as you can see, accounted for most of the increase of nearly one billion dollars. Only some nineteen per cent of the total increase came from other tax sources.

In view of the fact that Canada has found it necessary to raise personal income tax rates on various occasions since the beginning of the war, it is not surprising to find that they are a good deal higher than rates in the United States, except in the case of large incomes. Comparing a Canadian with an American resident in New York State, the married Canadian, without children, pays twice as much at the \$10,000 level, a little more than twice as much

at the \$5,000 level, nearly three times as much at \$3,000, and six times as much at \$1,800. I should point out also that Canadian law does not allow any deduction for other taxes, and there are no tax exempt bonds in Canada. Our corporations pay a normal tax of 18 per cent on their standard profits - that is, the average profits during the years 1936 to 1939 inclusive - plus 79½ per cent of the amount by which their profits exceed those of the standard period. There is a further provision that no corporation can pay less than 40 per cent of total profits.

While governmental revenues have mounted, expenditures have grown even faster, from \$549 millions in 1939 to about \$2,950 millions in the fiscal year which ended on March 31st last. In the former year, total revenues represented 91 per cent of expenditures. In the latter year, 49 per cent. The balance to be financed by borrowing in various forms therefore increased from \$50 millions to about \$1,500 millions, and will increase still further during the present fiscal year. I need hardly say that all the increase in expenditure since the war began has been for war account, including our financial assistance to the United Kingdom. Peace-time expenditures have declined.

While reference to war expenditures is necessarily made in terms of the dollar amounts involved, our real interest in such figures is based on the fact that they portray the scale of the war effort. I am not going to inflict on you a mass of information in respect to the number of our Armed Forces overseas and on the sea and in this country, nor shall I give you statistics of our production of munitions and war supplies. A good deal of information on these matters is available in printed form. I will say, however, that in a great many lines of war production a really first-class job has been done in this country; and this job has not been confined to the simpler forms of instruments of war. Many

of the more complicated things are being produced in Canada on a large scale and with, I believe, a high degree of efficiency. Please do not think that I am suggesting that we have done everything perfectly and with the necessary speed, nor that we have reached our limit. Claims of that character would simply not be true. But so long as there is plenty of criticism to act as a spur - so long as complacency is not allowed to develop - I think that there is much to be gained by taking pride in positive accomplishments.

Turning now to the second field which I mentioned earlier in my remarks - the field of government borrowing - it has been the desire of the Government to secure the widest possible distribution of its public issues. The First and Second War Loans, offered during 1940, did in fact enlist the support of a large number of subscribers. The year 1940 also witnessed the inauguration of the sale of War Savings Certificates in denominations as low as \$5. As the volume of borrowings increased, the endeavour to reach a large majority of the population was intensified. At the time of the First Victory Loan in June of 1941, a Victory Loan Committee was set up, a number of full-time workers were drawn from the ranks of financial and other institutions, and provincial and local Committees were organized. The drive was accompanied by great publicity, and was highly successful. The Second Victory Loan of last February followed the same pattern - somewhat stream-lined by this time, if you will forgive the word - and produced a total of \$845 millions cash subscriptions from nearly 1,700,000 subscribers. Translated into terms of U. S. income and U. S. population, these results could be compared to an American loan yielding \$13 billions cash from 20 millions

subscribers. I think you will agree that these are imposing figures. But we all know that the war moves so fast that it soon makes past results seem inadequate.

The National War Finance Committee is now the body charged with the responsibility of selling to the public all forms of Government obligations. Having in mind that the real savings which the Government desires must come in relatively small amounts, but in tremendous totals, from the great mass of the population, the Committee faces a selling job of the most difficult kind. In the United States you are faced with this problem just as we are here. A successful solution depends on the creation of an organization of the most efficient type, drawn from all sections of the community; depends on explanatory and patriotic publicity of a high order, and requires the wide-spread support of labour and employers, indeed of everyone in the country, not only during certain periods of the year, but all the year round. The rewards of success could be extraordinarily great. During the war, these rewards would be represented by orderly abstention from consumption, and reduction of pressure on existing Controls, as well as less need for further controls. After the war, a satisfactory distribution of government debt throughout the population would be of incalculable help in solving the problems of the day. For all these reasons, we attach the very greatest importance to the activities of the National War Finance Committee, and to activities of a comparable character in the United States.

Summarizing my remarks to this point, I have referred to the Government's desire to finance the war, as far as practicable, on the "pay as you go" basis. A trebling of tax revenue is an indication of what has been done in this respect. Even so, the gap between revenue and expenditure is inevitably very large. It is the desire to bridge this gap

- 6 - *ours (member banks)
we from 13 to 20 billions
in some period*

by borrowing the savings of the public - corporations as well as individuals - a most difficult task, which will continue to require all our energies. To the extent that the gap is not fully bridged in this way, resort must be had to bank financing. Since the beginning of the war, the Government has sold issues aggregating \$450 millions direct to the banks. But this is not necessarily the true measure of bank financing. The best way to appraise this situation, I think, is to look at the figures of the chartered banks. Between August, 1939, and February, 1942, Canadian Government security investments of our chartered banks increased by \$510 millions, or approximately 45 per cent. Deposits increased by \$612 millions, or 24 per cent. These changes in the banking figures, while substantial enough, are not frightening. I hope it will be possible to make the same statement at the close of the war.

*think had
about the
same!*

I would like now to turn to the subject of our financial relationships with the United States and the United Kingdom. This brings me immediately to the subject of foreign exchange control. When the war commenced, we knew that we would be faced with an ever-growing surplus of pounds sterling, and an ever-growing shortage of U. S. dollars. The reasons are obvious. We need great quantities of war materials and supplies from the United States. We must ship far greater quantities of munitions and supplies to the United Kingdom and all the fighting fronts. A person does not need to be an economist to understand that if a country pays in cash, and sells on credit or gives its production away, its financial problems are liable to become acute.

Facing these problems, we instituted foreign exchange control on September 16, 1939. The first objective of control was to prevent the export of capital. Such exports would have consumed U. S. dollars which we desperately needed for other things. I am not going to go into details, but will only say that exchange control has worked.

It has produced stability in exchange rates, and thus helped to stabilize prices. It has been a major factor in preserving stability in the bond market. It has, on the one hand, prevented export of capital, and, on the other, given us the machinery for economizing in the current use of U. S. funds. But it has not been used to saddle any of our burdens on the other fellow. All our foreign commitments have been met. Moreover, non-residents - except, of course, those in enemy or enemy-occupied countries - have been able to exchange their Canadian dollar income into the currencies of their own countries, through the Board at official rates. The people mainly affected by this policy are, of course, residents of the United States. And I should point out that the ability to obtain U. S. dollars at official rates relates not only to income from Canadian domestic bonds and stocks or real estate. It also relates to the profits of branches or subsidiaries of U. S. companies. These profits have been transferable in full, and, in the vast majority of cases have, in fact, been transferred in full. So we are not accumulating any debts to embarrass us in the future. We are paying our way. In the process, we have had to cut down on non-essential imports, to forego pleasure travel, and to economize in the use of U. S. dollars in many other ways. These curtailments helped us to survive, but did not obviate a steady using up of our available U. S. dollar resources. Something had to be done about this problem, and that something took the form of an agreement between the President of the United States and the Prime Minister of Canada a year ago. In terms of that agreement, the United States agreed to buy a considerable quantity of war supplies from Canada - guns, ships, chemicals, metals such as aluminum and nickel - and many other things. It was our hope - and a hope which I believe will be realized - that the value of the war materials

purchased from us by the United States would come close to the cost to us of war materials and supplies which we have to obtain from the United States, and for which we naturally pay U. S. dollar cash. In essence, this is a swap of war supplies. As such, it can clearly be defended in principle as being in the best interests of both sides. It is a practical working arrangement, and so long as it does, in fact, work, we shall be able to carry on. It was not, of course, operative to any great extent in 1941, and during that year our U. S. dollar resources declined by \$142 millions. Our sales of war materials to the United States during 1942 should be considerably larger than they were in 1941, and we therefore hope that we shall come closer to a balancing of accounts than we did last year.

Our financial relationships with the United Kingdom and the rest of the sterling area constitute the other side of our picture. It has been necessary, since the beginning of the war, to make sure that no lack of Canadian dollars kept the United Kingdom from buying all the things which they needed to obtain in Canada. They were, of course, in receipt of certain Canadian dollar income from proceeds of exports to this country, from interest and dividend receipts, shipping income, and so forth. But the sum total of this income only provided a relatively small portion of their requirements for purchases from Canada. Their deficit, from the outbreak of the war until the end of February, 1942, amounted to approximately \$1,770 millions. This deficit has been financed in three ways. In the early stages of the war - that is, up to December, 1940 - we received partial payments in gold. The total involved, namely \$250 millions, was used by us to reduce our deficit with the United States. Secondly, the Canadian Government and the Canadian National Railways prepaid their bonded debt held in the United Kingdom, and this, together with some repatria-

tion of Canadian securities, accounted for approximately \$820 millions. The balance of the deficit to the end of February last was covered by a \$700 millions loan from the Canadian Government to the Government of the United Kingdom - a loan which is non-interest bearing for the duration of the war. In March, Parliament authorized a gift of one billion dollars to the United Kingdom, this amount being estimated to be sufficient to cover their deficit in Canada until early next year. While the gift is phrased in dollars, you can understand that the real meaning of the transaction is that Canada is making a contribution of guns, tanks, aircraft, other munitions of war, food stuffs and supplies to the full extent that these things are needed by other parts of the Empire. In effect, the basis on which we are now operating is this: We are dedicated to a war effort which, to the best of our knowledge and ability, is an "all out" one, providing men and equipment for our Armed Forces on land, on the sea and in the air, and providing, as well, large quantities of equipment and supplies for the United Kingdom and other members of the United Nations. Financial considerations do not enter into this picture, with this single exception; that to enable us to pay for war supplies from the United States we need to sell some war supplies to the United States.

Before closing my remarks, I would like to refer to a policy of major importance which was adopted in Canada about eight months ago, and which has received considerable attention in the United States. It was the policy of putting a ceiling on wages and prices. By last October, it was realized that, in spite of high taxation and the encouragement of voluntary savings, the growing volume of purchasing power in the hands of the people was certain to lead to rising price levels and rising wage rates unless preventive measures were adopted. We knew that once an

inflationary movement got under way it would go far. We knew that it would be bound to cause such disruption that the efficiency of our war effort would be seriously impaired, and our post-war problems aggravated to an intolerable extent.

One must know and believe these things in order to have the courage to embark on a wage and price ceiling policy. I believe that we were the first of the democratic states to do so. The price ceiling policy is administered by the Wartime Prices and Trade Board, and I recall that, when the Chairman of the Board took up his new duties, his first remark was that there were one hundred reasons why a price ceiling could not be made to work, but, in spite of these reasons, the Board was going to make it work. That is the only way in which a problem of this kind should be approached. The Board has hewed to the line, and has released practically nothing from the ceiling. It has made great efforts to apportion the burden fairly amongst the various factors of industry and trade. It has and will continue to arrange for rationalization of production and distribution, for simplification of output and other things which serve to reduce costs and so enable goods to be sold under the ceiling. The device of rationing will be used if this is the only way in which a fair distribution of scarce supplies can be ensured. Production will be subsidized if it turns out that this is the only way in which goods can be sold within the limits of the price ceiling. Because of past history in various countries, subsidies, I know, are a cause of worry, and obviously they present problems in respect to control of profits and in respect to the things to which they should be applied. Having said that on the subject of subsidies, I believe that one has said everything. To refuse to subsidize, at the cost of losing control and opening the door to a major

degree of inflation, would be nothing less than madness. It would represent a cost immeasurably greater than the subsidies themselves could ever be.

Needless to say, the price ceiling policy would not have the slightest chance of success if wage rates in general were allowed to rise, nor, indeed, if any section of the community were permitted to improve its position versus other sections of the community by means of an increase in prices.

Human nature being what it is, there are a good many people who heartily endorse the principle of wage and price ceilings, but feel that their particular case is an exception to the rule. I believe, however, that there has been general and genuine support of these policies throughout Canada, and that the Wartime Prices and Trade Board have received magnificent co-operation.

You can readily understand that the adoption of an over-all price ceiling policy in the United States was a very helpful thing from our point of view. It would have been nothing short of a disaster if the United States had decided to throw up its hands and abandon itself to inflation. Canada is a small country, and we know that our difficulties in administering policies of the character under discussion are not so great as they are in the United States. We are watching your efforts with the keenest and most sympathetic attention. Self-interest is obviously involved in our concern with what transpires south of the boundary line, but it is not a form of self-interest of which anyone need feel ashamed. What we genuinely desire is that the policies of our two countries should be such as to promote the maximum possible war effort within the shortest possible time: that they should be such that after victory is achieved both countries will find themselves in good shape to handle their post-war problems, and to co-operate with vigor and good friendship in the reconstruction of a peaceful world.