



# 14

## The Bank of Canada and Monetary Policy

If you follow any of the news stories about the policies being made in Ottawa, you cannot fail to learn about what Canada's central bank, the Bank of Canada, is doing to cool down an overheated economy, to stop a recession, to deal with an illiquidity crisis, or something else of that nature. Whatever the Bank of Canada does, some part of the press or the academic world is apt to criticize it for doing the wrong thing. Whenever a vacancy occurs for the governor, on the governing council, or on the Bank's board of directors, speculation about the political leaning of the next appointee is rampant. Some analysts argue that even though the Bank of Canada is only a quasi-government agency, it is not really independent of the government's wishes. These commentators go further and argue that the Bank of Canada should become completely independent of the government. Is the Bank of Canada already independent? And if not, does it matter? To answer these questions, you need to know more about how monetary policy works.

### LEARNING OBJECTIVES

After reading this chapter, you should be able to:

- 14.1 Describe the structure of the Bank of Canada and its major functions.
- 14.2 Discuss how the Bank of Canada conducts monetary policy.
- 14.3 Identify the factors that influence people's demand for money.
- 14.4 Explain two views of how monetary policy works.
- 14.5 Assess the effectiveness of monetary policy.



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## DID YOU KNOW THAT...?

The governor of the Bank of Canada is often considered the second-most important person politically and economically in Canada after the prime minister. Why is the head of the Bank of Canada considered so important? Because the governor of the Bank of Canada, the board of directors, and the rest of the Bank's governors determine monetary policy in Canada. A strongly worded public statement by the governor of the Bank of Canada can cause instant reaction in Canada's financial markets and sometimes in those in the rest of the world.

This chapter will deal with the Bank of Canada and monetary policy—the Bank of Canada's altering interest rates or changing the supply of money (or the rate at which it grows) in order to achieve national economic goals. When you were

introduced to aggregate demand in Chapter 6, you discovered that the position of the aggregate demand curve is determined by the willingness of firms, individuals, governments, and foreigners to purchase domestically produced goods and services. Monetary policy works in a variety of ways to change this willingness, both directly and indirectly.

Think about monetary policy in an intuitive way: An increase in the money supply adds to the amount of money that firms and individuals have on hand and so increases the amount that they wish to spend. The result is an increase in aggregate demand. A decrease in the money supply reduces the amount of money that people have on hand to spend and so decreases aggregate demand. Integral to this process is the central bank.

## 14.1 Central Banks and the Bank of Canada

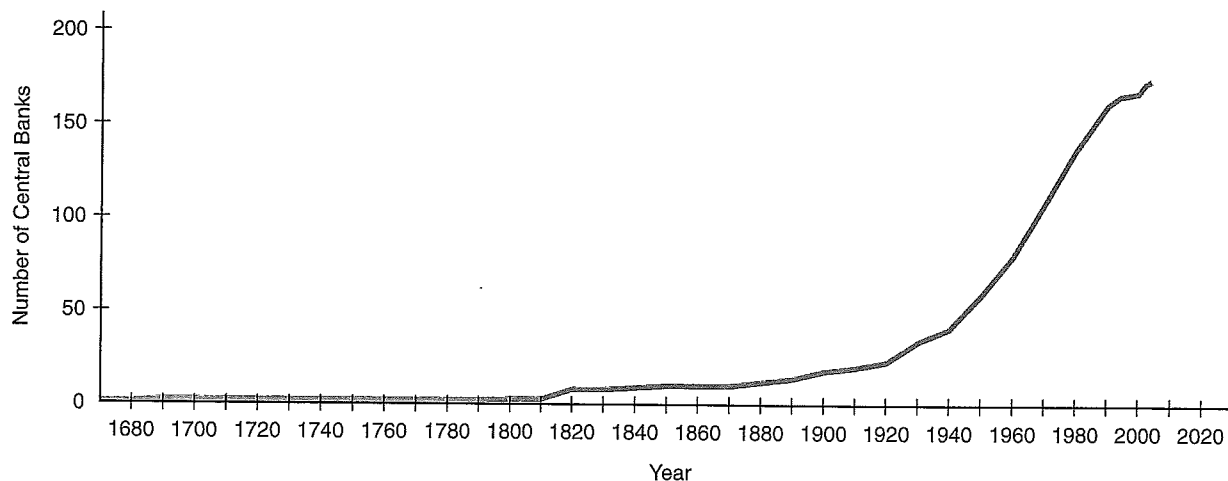
The first central bank, which began operations in 1668, was Sweden's Sveriges Riksbank (called the Riksbank until 1867). In 1694, the British parliament established the most historically famous of central banks, the Bank of England. It authorized the Bank of England to issue currency notes redeemable in silver, and initially, the Bank of England's notes circulated alongside currency notes issued by government and private finance companies. Until 1800, the Riksbank and the Bank of England were the only central banks. The number of central banks worldwide remained less than 10 as late as 1873. The number expanded considerably toward the end of the 19th century and again during the second half of the 20th century, as shown in Figure 14-1.

FIGURE 14-1

### The Number of Central Banking Institutions, 1670 to the Present

The 20th century witnessed considerable growth in the number of central banks.

Source: Data from Forrest Capie, Charles Goodhart, and Nobeert Schnadt, "The development of central banking," in Forrest Capie et al., *The Future of Central Banking: The Tercentenary Symposium of the Bank of England*. Cambridge: Cambridge University Press, 1994.



## Canada's Central Banking System

The Bank of Canada is Canada's central bank. It oversees the Canadian monetary system and, as such, is considered the country's monetary authority. The Bank of Canada was established with the *Bank of Canada Act* of 1934 and opened its doors for business in 1935. At first it was privately owned, but by 1938 the federal government had nationalized it. According to the preamble to the *Bank of Canada Act* of 1934, the Bank of Canada was expected to

regulate credit and currency in the best interest of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence 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 preamble to the *Bank of Canada Act* has never changed; however, the Bank of Canada's primary monetary policy focus is the goal of low and stable inflation—to keep Canada's inflation at 2 percent, the midpoint of 1- to 3-percent-a-year target range. Mark Carney, the governor of the Bank of Canada, gave a speech to the Ottawa Economics Association in March 2010 in which he summarized the Bank's current monetary policy as follows:

Most fundamentally, the Bank has an unwavering commitment to price stability. The single, most direct contribution that monetary policy can make to sound economic performance is to provide Canadians with confidence that their money will retain its purchasing power. That means keeping inflation low, stable, and predictable. Price stability lowers uncertainty, minimizes the costs of inflation, reduces the cost of capital, and creates an environment in which households and firms can invest and plan for the future.<sup>1</sup>

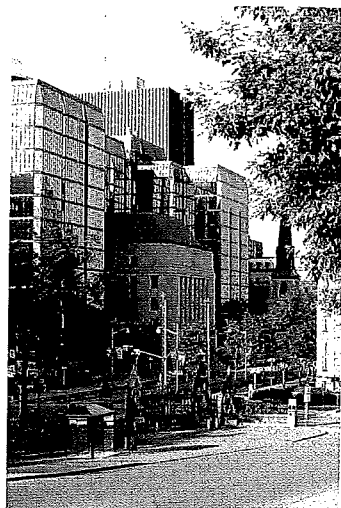
**ORGANIZATION OF THE BANK OF CANADA.** The Bank of Canada is governed by a board of directors consisting of the governor of the Bank of Canada, the senior deputy governor, 12 directors from nonbanking occupations, and the deputy minister of finance, who is a nonvoting member of the board. The governor is appointed by the board, with cabinet approval, for a seven-year term. Directors are appointed for three-year terms. Regional representation is a priority when appointing directors.

The board of directors must meet at least four times per year but frequently meets more often. The day-to-day operations of the Bank are directed by an executive committee of the board, consisting of the governor, the senior deputy governor, and two to four other directors who meet weekly. While the Bank of Canada is ultimately responsible to the federal government, it is an independent body charged with maintaining price stability and economic growth in Canada. Whether this independence is beneficial is the topic of the Issues and Applications section at the end of this chapter.

**THE BANK OF CANADA'S CUSTOMERS.** The Bank of Canada accepts deposits from the federal government, the chartered banks, credit unions and *caisses populaires*, and the trust and mortgage loan companies that make up the financial system. Almost all federal government transactions pass through the Bank of Canada, although the government also has accounts with the chartered banks.

The chartered banks, credit unions and *caisses populaires*, and trust and mortgage loan companies hold deposits at the Bank of Canada for two reasons. First, the banks hold a large part of their reserve deposits in these accounts. Until 1992, they were required to hold reserves by law; however, the *Bank Act* of 1992 eliminated this requirement. Now, they hold reserves at the Bank of Canada as part of prudent banking practice.

The second reason the chartered banks and near banks hold reserves at the Bank of Canada is to facilitate cheque clearing. When your employer pays you with a \$200



What role does the Bank of Canada play in the Canadian monetary system?

<sup>1</sup> <http://www.bankofcanada.ca/en/speeches/2010/sp240310.html>

**Canadian Payments Association (CPA)** A regulated organization that operates a national cheque-clearing and settlements system.

cheque drawn on the Royal Bank and you deposit it in your account at Scotiabank, no money actually changes hands. All across Canada, similar transactions are taking place at financial institutions. At the end of the day, the **Canadian Payments Association (CPA)** (a regulated organization that operates a national cheque-clearing and settlements system) adds up all the money that each bank owes the other—for instance, RBC Royal Bank would owe Scotiabank \$200 for your paycheque—and arrives at a net transfer of funds that should be made between banks. If TD Canada Trust owes the Bank of Montreal \$1.5 million, for example, while the Bank of Montreal owes TD Canada Trust \$1 million, the Canadian Payments Association would ask the Bank of Canada to transfer \$500 000 out of the reserve deposits of TD Canada Trust and into the deposits of the Bank of Montreal.

## Functions of the Bank of Canada

The Bank of Canada serves four basic functions. It conducts monetary policy on behalf of the federal government, it acts as a lender of last resort to the financial community, it issues bank notes, and it is fiscal agent and financial advisor to the government. Let us examine each of these functions in more detail.

**MONETARY POLICY.** The Bank of Canada is charged with keeping inflation within a target band of 1 to 3 percent to facilitate economic growth. It does this primarily by varying the reserve deposits held by the chartered banks at the Bank of Canada.

**LENDER OF LAST RESORT.** Occasionally, the chartered banks and near banks will feel that their reserve deposits are lower than they would like. In these situations, the banks can ask the Bank of Canada for short-term loans to ensure that they do not run short of cash to satisfy withdrawals. This practice lends stability to the system. Should a bank not be able to meet demand for withdrawals, it could be forced into bankruptcy.

**ISSUING BANK NOTES.** From the opening of Canada's first chartered bank in 1871, the chartered banks issued their own bank notes. This practice declined when the Bank of Canada began issuing Canadian currency and stopped completely in 1945. The Bank of Canada now is the only body that can issue legal bank notes in Canada. Read Example 14-1 for a discussion of another type of "currency"—Canadian Tire money.

### EXAMPLE 14-1 Is Canadian Tire Money Real Money?

One of the functions of the Bank of Canada is to issue bank notes. Canadian Tire, however, issues its own "currency," which can be used to purchase goods and services at any Canadian Tire store. Every time you purchase merchandise with cash, you receive a small amount back in Canadian Tire money. Are these notes "real" money?

If you said, "No, Canadian Tire money is not real money," you would be right. However, in some instances, it is used in place of real money. Consider the bartender who is given Canadian Tire notes as part of a tip. If that individual's car happens to need new tires, for example, then those notes are as good as money. If the bartender does not want anything from Canadian Tire, then they are worthless.

But what if the bartender had a friend who wanted to buy tires? The two could exchange the Canadian Tire money for Canadian currency, which is real money. However, one of the tests of Canadian legal tender is that it must be accepted in payment of debts in Canada. In this instance, Canadian Tire money would not measure up.

**For critical analysis:** What conditions would have to exist for Canadian Tire money to act as real money in practice, if not in theory?