

# **MONEY AND MONETARY POLICY IN CANADA**

## **MODULE 4: THE BANK OF CANADA**

*Money and our financial system exist to support the economy. They enable goods and services to be purchased, and they provide support for investment and growth. All these activities are linked to the primary purpose of an economy: to use our limited resources to produce goods and services to help satisfy the needs and wants of the people in our society. The prospect is that, over time, the economy will expand its capacity and output so that our environment is sustained and improved, and our natural resources are preserved. With these outcomes, the economy will be able to create jobs and incomes for Canadians, enabling us to improve our standard of living and overall quality of life.*

*The Bank of Canada plays a key role in helping our economy to achieve these goals.*

**“Money and Monetary Policy In Canada” by Gary Rabbior**  
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**Economic**

**Insight:** Money and our financial system exist to support the economy



**Economic**

**Insight:** The Bank of Canada plays a key role in helping our economy to achieve these goals

**Facts and**

**Figures:** The Bank of Canada opened its doors on March 11, 1935



## 4.1 AN INTRODUCTION TO THE BANK OF CANADA

<https://www.bankofcanada.ca>

### The Bank of Canada – Different from Other Banks

The Bank of Canada is a central bank. A central bank is not essential for the operation of a financial system, but it helps, and virtually every developed nation in the world has chosen to establish one. The Bank of Canada opened its doors on March 11, 1935, and has served as Canada's central bank since that time.



The Bank of Canada has recently completed a major renovation of the Bank's Head Office in Ottawa. Click on the following link for a video on the modernization of the Bank's Head Office - <https://www.bankofcanada.ca/multimedia/modernizing-the-bank-of-canadas-head-office/>

The Bank of Canada does not operate in the way that other banks do because it is not a commercial bank. Canadians who wish to make deposits or withdrawals, borrow money, or make certain investments conduct their business with one of our commercial financial institutions.

The Bank of Canada deals with the Canadian government, certain financial institutions, foreign central banks and international financial institutions. Through its activities with these

organizations, the Bank of Canada works to fulfill its role. But what is that role? Let's go back to its early days.



### The Creation of the Bank of Canada

For more information on the history of the Bank of Canada, click on this link -

<http://www.bankofcanada.ca/about/history/>.



*G.F. Towers was appointed as the first Governor of the Bank of Canada*

At the time the Bank of Canada was created, Graham Towers was appointed the first Governor. The Bank was a “public company” in the beginning that issued shares that were bought by Canadians. One hundred thousand shares in the Bank of Canada were issued with a par value of \$50 per share, and demand for them was strong. No one was to receive more than 50 shares. But, as it worked out, the most anyone received was 15. The average number of shares held was eight.



*Bank of Canada, Wellington Street, c. 1938*

Private ownership of the Bank of Canada did not last for long, though. The government bought the publicly held shares over the course of the first few years. By 1938, no citizen held any shares in the Bank of Canada, which was publicly owned by the Government of Canada on behalf of the people of Canada.



## 4.2 THE FUNCTIONS OF THE BANK OF CANADA

For more detailed information on the functions of the Bank of Canada, click on the following link: <http://www.bankofcanada.ca/core-functions/>

The Bank of Canada has four main areas of responsibility, which are to

1. implement monetary policy to preserve the value of money
2. foster a stable and efficient financial system to help support economic growth and rising living standards
3. be the sole authority for issuing currency (bank notes) and be responsible for the design, production, and distribution of bank notes
4. manage funds on behalf of the Government of Canada—serving as the “fiscal agent” of the government

Let's take a closer look at each of these functions.

**Function of the Bank of Canada:**  
*Implement monetary policy*

### 1. Implement Monetary Policy

The Bank of Canada and the federal government issued a joint statement on October 24, 2016. It said, “The primary objective of Canada's monetary policy is to promote the economic and financial welfare of Canadians by contributing to sustained economic growth, rising levels of employment and improved living standards.”

Note the use of the word promote. The Bank is not responsible for growth, employment, etc. in the economy. Rather it fulfills its role in such a way as to help *promote* growth, employment and the general well-being of Canadians.

**Economic Insight:** *Fiscal policy refers to the taxing and spending decisions of government*

Another policy is available for the government and elected officials to decide upon: fiscal policy. Fiscal policy refers to the taxing and spending decisions of government. Fiscal policy actions can have a direct impact on spending in the economy, for example, when the government alters its level of spending. Total spending, or demand, is represented by the following formula:

$$\text{consumption (C) + investment (I) + government spending (G) + [exports (X) – imports (M)]}$$

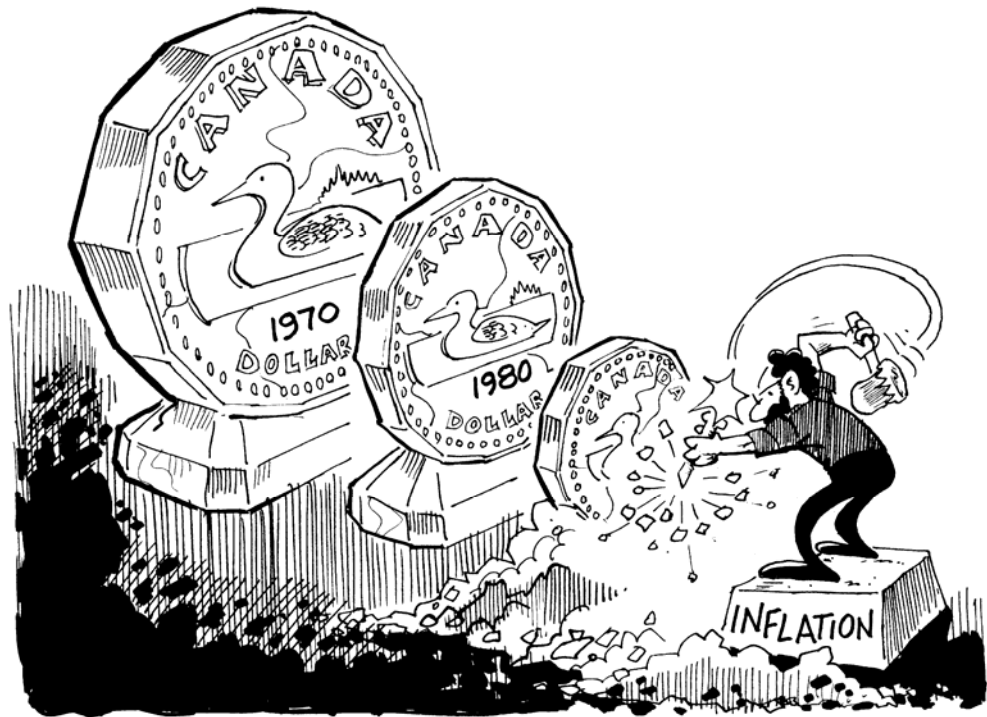
So, government spending is one of the components of total demand in the economy. In addition, by changing taxes, the government can further affect consumer spending and business investment. As a result, fiscal policy can directly affect production, growth and employment in the economy.

**Economic**  
**Insight: The**  
**Bank of Canada's**  
**Primary Objective**  
**– Controlling**  
**Inflation**

**The Bank of Canada's Primary Objective—Controlling Inflation**

Through monetary policy, the Bank helps promote economic growth, employment and production by keeping inflation low, stable and predictable and by protecting the value, or purchasing power, of our money.

Keeping the rate of inflation low, stable and predictable allows Canadians to make spending, saving and investment decisions with more confidence. Think of how your decisions might be affected by unpredictable prices. Suppose you had money to invest and you could get about a 3% return a year for, say, three years. Now, suppose that, at the same time, the rate of inflation was unpredictable—and could be 1%, 3%, 5%, 7% or even higher. That would make it more difficult for you to decide what to do.



*Inflation erodes the purchasing power of our money.*

Suppose, in this instance, the rate of inflation was 5% in each of those three years. How would that affect the purchasing power, of your money? With prices up by 5% each year, and the rate of return on your money up by 3% in each of those years, your money would be losing 2% of its purchasing power every year.



**Economic Insight:** Keeping prices and the rate of inflation low and stable within a predictable range through its monetary policy actions is seen as the most important thing that the Bank of Canada can do

**Function of the Bank of Canada:** Foster a stable and efficient financial system

### Managing Expectations for Inflation Is Very Important

With unpredictability and uncertainty about how high the rate of inflation might go, people will hesitate to save and invest. They might choose to buy now rather than run the risk of their money losing some of its purchasing power in the future.

If that occurs, two things happen. First, we lose the savings and investments that could have been made to help our economy grow—and create jobs and incomes for Canadians. Second, increasing current spending rather than saving and investing can put more pressure on prices to rise. By fearing that inflation might rise significantly in the future, or by expecting high inflation, people may spend more today and contribute to generating the inflation and higher prices they feared.

That is why it is so important for the Bank of Canada to set monetary policy so that the rate of inflation remains stable and predictable within a reasonable range. For example, if you are confident that the rate of inflation will likely stay somewhere between 1 and 3%, you can make your spending, saving and investment decisions with that in mind. You won't have to fear that the rate of inflation will rise in the future and erode the purchasing power of your money by more than you had planned for.

The Bank of Canada keeps the rate of inflation low and stable within a predictable range through its monetary policy actions. This is seen as the most important thing that the Bank can do to promote investment, growth and employment in the economy.

### 2. Foster a Stable and Efficient Financial System

A stable and efficient financial system is essential for sustained economic growth and rising living standards. The Bank of Canada aims to ensure the stability and efficiency of our financial system. As we noted in Module 3, our financial system includes financial institutions, financial markets, and clearing and settlement systems to settle all the daily transactions and flows of funds from one financial institution to another.

The Bank of Canada promotes the economic and financial welfare of Canadians through its financial system functions by:

- providing central banking services, including currency, to our economy
- serving as the lender of last resort
- overseeing financial market infrastructures—also referred to as the clearing and settlement system
- conducting and publishing analyses and research, and
- helping to develop and implement policy

By supporting our financial system, the Bank plays an important role in enhancing financial stability. This enables consumers and firms to safely and efficiently purchase goods and services, make financial investments, and transfer funds.



**Economic**

**Insight:** Banks keep reserves with the Bank of Canada for settlement purposes

**Economic**

**Insight:** If banks borrow from the Bank of Canada, they pay the overnight rate of interest

**Economic**

**Insight:** The Bank of Canada will only lend funds to a solvent bank

**Clearing and settling payments**

A great deal of money moves around our financial system and changes hands daily. All these transactions need to be settled. And that's where the Bank of Canada comes in. The Bank settles all the transactions that go on each day, moving money as needed from one institution to another. Financial institutions hold balances (deposits) with the Bank of Canada for these settlement purposes.

As we saw in Module 3, banks keep reserves of cash with the Bank of Canada to settle their accounts among themselves at the end of the day. However, if additional funds beyond those held in reserve are ever needed for settlement reasons, banks can borrow from the Bank of Canada for a brief period—for example, overnight.

If the banks do borrow from the Bank of Canada, they will pay the Bank Rate, which is the rate of interest the Bank charges on one-day loans to major financial institutions. The bank would then take steps to replenish its cash balance and repay the loan to the Bank of Canada.

**The Bank of Canada as a Lender of Last Resort**

So, banks hold and use reserves at the Bank of Canada for day-to-day banking, including settling any cash flows to other institutions. The banks no longer have legally required reserve levels. Each bank makes its own decision about what amounts of cash to hold. Even without a legal requirement, to perform its banking function responsibly, each bank maintains large quantities of liquid assets.

There is something else to note, too. Suppose a bank experienced a liquidity shortage and needed more time to get funds.

The Bank of Canada can provide loans to a bank in trouble—but only if the bank seeking funds is solvent. A bank is considered solvent if its assets (the value of its loans and investments) are worth more than its liabilities (what it owes to depositors). The Bank will not provide funds to an insolvent bank (one whose liabilities exceed its assets). Without a loan, there is a strong likelihood that the insolvent bank would fail. Moreover, the failure of an individual financial institution may have significant consequences if it raises doubts in people's minds about the state of other banks and of the entire financial system. By lending money to a solvent bank, the Bank of Canada shows it has confidence in the bank—which should help the bank's clients have confidence too. And that's important.

If the Bank of Canada does lend funds to see a troubled solvent bank through a difficult period, the Bank expects collateral in return for the loan—e.g., some of the assets held by the bank that could be sold, if needed, to repay the Bank of Canada. With the loan, the bank would be able to avoid bankruptcy and collapse, cover its needs in the short run, and take steps to stabilize itself and regain the public's confidence.

**Facts and Figures:** *The last time a Canadian bank failed was in the 1980s*

### **The Last Failure of a Financial Institution in Canada— a Unique Situation**

Recognizing that Canada's banking system is very strong, and that the Bank of Canada can act as a lender of last resort, if necessary, let's look at the last time things went wrong for a Canadian financial institution.

The Canadian Commercial Bank and the Northland Bank of Canada collapsed in the 1980s, the first banks to fail in Canada in 60 years. Yet, with both failures, depositors got 100 per cent of their deposits back—even those above the \$60,000 limit set at the time. Why?

First, this was a move to help restore confidence in the banking industry when Canadians' confidence was being rocked by the failures of these two banks. Second, the government accepted part of the responsibility for having possibly led people to leave their funds on deposit at the banks when they otherwise might have withdrawn them: before the collapse of the banks, Canadian public officials had gone on record as stating that the Canadian Commercial Bank was solvent. And, by leaving the Northland Bank open for business, officials conveyed the impression that it, too, was solvent. This unusual set of circumstances led Parliament to decide that it would be appropriate to return all deposits.

In providing this kind of service to the chartered banks and other financial institutions, the Bank of Canada is the "banker to the banks," the lender of last resort.

In addition, in unusual circumstances, if there was ever a need for greater liquidity in the economy, the Bank would be able to provide additional funds to stabilize the situation. Such a situation would be quite extraordinary—but it is within the Bank's area of responsibility, and capability, to do that.

**Function of the Bank of Canada:** *Be the sole authority for issuing currency (bank notes)*

### **3. Be the Sole Authority for Issuing Currency (Bank Notes)**

A third function of the Bank of Canada is to provide bank notes for circulation in the economy to support payments and exchange—that is, the \$5, \$10, \$20, \$50 and other denominations of bank notes that we use as money. The Bank of Canada is responsible for monitoring the need for bank notes and ensuring that sufficient currency is available to meet that need. This includes times such as Christmas and the holiday season, when spending levels increase and people use more cash. It is also the Bank's responsibility to ensure that the notes issued are readily accepted without concern that they could be counterfeit.



As Canadians know, our bank notes are now made of polymer, which is different from the paper money used in many countries, and that was used in Canada in the past. Our currency is quite colourful and ornate—and very hard to counterfeit. The Bank is responsible for our bank notes, but not our coins. The Royal Canadian Mint is responsible for coins.

*"The Life of a Bank Note: From the Lab to Your Wallet"* -

<http://www.bankofcanada.ca/multimedia/life-bank-note-lab-wallet/>

It may be of interest to know that Canada is well regarded around the world for its coins and bank notes—and actually produces money for quite a number of other countries.

*"The \$20 Polymer Bank Note"* - <http://www.bankofcanada.ca/multimedia/bank-canada-new-20-polymer-bank-note/>

### The Gold Standard Was Abandoned by Canada Many Years Ago

Now, how much currency can the Bank of Canada put into circulation? Is there a limit on how many bank notes can be printed and circulated? Some Canadians may think this amount is limited by how much gold Canada holds in reserve. The reason some may believe that is because Canada used to operate on the gold standard, when the value of money in our economy was linked to the amount of gold we had. Let's clarify this.

From the middle 1800s to the early 1900s, a good part of the world economy used the gold standard. Canada adopted the gold standard in 1853, and the supply of currency was linked to our gold reserves. We moved on and off the gold standard between the outbreak of the First

**Economic  
Insight:** We  
officially  
abandoned the  
Gold Standard in  
1931

World War and 1930, then officially abandoned it in 1931. The quantity of currency we can print and circulate no longer depends on our gold reserves.

The gold standard attempted to anchor the quantities of money supplied by the various world economies. It was clear that if countries simply printed more money to put into their economies, inflation would result and the value of their money would erode.

Adopting the gold standard meant that a government, or banks in the country, could not increase the supply of currency unless the country had enough reserves of gold to justify the increase.

Note that many countries did not actually hold all their gold reserves in their own vaults. Rather than moving gold from place to place, countries held claims on gold reserves stored in central locations (for example, London, England). The more gold a country had claim to, the more currency the country could provide.

In 1914, at the outbreak of the First World War, Canada feared that the cost of the war would result in a run on its gold reserves and that a banking crisis would result. There was a concern about having enough currency for our financial system if our gold reserves were not sufficient to back the currency needed.

So, the *Finance Act* was passed that year, changing the structure of the Canadian banking system. And, as mentioned above, Canada finally abandoned the gold standard in 1931.

Since the supply of money in the Canadian economy is not related to the quantity of gold we have, what does control the amount of currency? The Bank of Canada determines this supply as it considers the needs of our economy. Actually, there is nothing limiting the supply of bank notes that can be printed and put into circulation. We could turn on the presses and print money 24 hours a day. But that wouldn't be a good idea. As we saw in Module 1, money needs to be relatively scarce so that the supply of it can be controlled. What limits the amount of currency in our economy is the judgment and decisions of the Bank of Canada as it implements monetary policy to maintain stable and predictable prices.

**Facts and Figures:** In 1914, the *Finance Act* was passed changing the Canadian banking system

**Function of the Bank of Canada:** Manage funds and serve as the fiscal agent for the Government of Canada

#### 4. Manage Funds and Serve as the Fiscal Agent for the Government of Canada

A fourth function of the Bank of Canada is to serve as the banker for the Government of Canada. The federal government receives large quantities of funds from various sources, particularly taxes. These funds are managed by the Bank of Canada, which operates the accounts through which government payments and receipts flow. Some of the government deposits are held at the Bank of Canada, but some are placed with the chartered banks.

The Bank ensures that there is enough money in government accounts to meet daily needs. It also invests any surplus in term deposits to earn a return on those surplus funds.

The Bank advises the government on its activities in foreign exchange markets and manages its foreign currency reserves in the Exchange Fund Account. That is, the Bank of Canada buys and sells Canadian dollars and other currencies, as well as assets such as gold, on behalf of the government. The Bank helps ensure orderly conditions in the Canadian-dollar foreign exchange market.

**Economic  
Insight: The  
Bank of Canada  
manages the  
federal  
government's  
debt**

The Bank of Canada is also involved in issuing bonds and treasury bills on behalf of the government. This is a way in which the government borrows funds. You have probably heard the terms federal debt and federal deficit. In a given year, if the government spends more than it brings in through tax revenue, it runs a deficit. To address the deficit, the government needs to borrow money. The federal debt (also known as the public debt) is made up of the accumulated deficits and surpluses that the government has experienced over all previous years.

The Bank of Canada arranges payments on the outstanding public debt and pays back the debt when it matures. The Bank takes full responsibility for the public debt records. In short, most of the of the federal government's financial transactions (making payments, holding deposits, issuing bonds etc.) are handled by the Bank of Canada.

## 4.3 THE STRUCTURE AND OPERATION OF THE BANK OF CANADA

**Economic Insight:** The government receives any profit that is earned by the Bank of Canada

The Bank of Canada's headquarters are in Ottawa, but there are regional offices of the Bank throughout Canada. As the owner of the Bank of Canada, on behalf of the people of Canada, the government receives any profit the Bank earns. Those profits go into the government's general revenues from such sources as the taxes it levies and the earnings of Crown corporations, including the Bank of Canada.

The head of the Bank of Canada is the Governor. The name of the Governor is often quite familiar to Canadians because it appears on every bank note.



Stephen S. Poloz, Governor, Bank of Canada



The Governor and the Senior Deputy Governor are appointed by the Bank of Canada's Board of Directors for a term of seven years each—with the approval of the federal government. The Board of Directors oversees the management and administration of the Bank for strategic planning, financial and accounting matters, risk management, human resources, and other internal policies. The Board is composed of 12 independent directors appointed by the Cabinet (the executive branch of the government) to three-year renewable terms. The Directors are not full-time employees of the Bank, and they meet periodically. The Governor and Senior Deputy Governor also serve as Directors. The Deputy Minister of Finance is a member of the Board as well and participates in all its activities but has no official vote in the Bank of Canada's decision making.

**Facts and Figures:** *The Governor of the Bank is legally responsible for the decisions affecting monetary policy in Canada*

The Governor of the Bank is legally responsible for the decisions affecting monetary policy in Canada. In making such decisions, the Governor will commonly confer with and seek consensus from the Governing Council of the Bank. The Governing Council consists of the Governor, the Senior Deputy Governor and four Deputy Governors.

Let's examine this relationship between the Bank of Canada and the federal government in a little more detail.



*Mark J. Carney, former Governor, Bank of Canada 2008-2013*



## **4.4 THE RELATIONSHIP BETWEEN THE BANK OF CANADA AND THE GOVERNMENT**

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**Economic Insight:** *Communication links between the Bank and the government are very strong*

Both the Bank of Canada and the Government of Canada are concerned with the economic well-being of the country and with achieving certain economic goals. The Bank's policies are set somewhat independently of the government. But since the Deputy Minister of Finance sits on the Board of Directors, the communication links between the Bank and the government are very strong. The Governor is also legally required to meet regularly with the Minister of Finance.

### **The Governor and the Minister of Finance**

It is important that strong communication links exist between the Bank and the federal government because the Minister of Finance is responsible for the other key economic policy—fiscal policy. As we noted, fiscal policy consists of the government's taxing and spending decisions. Monetary policy and fiscal policy are the two major forms of policy that aim to influence Canada's economy as a whole. If the Minister of Finance is trying to accomplish one goal in the economy with fiscal policy while the Bank of Canada is trying to do something else—possibly the opposite—with monetary policy, this can pose problems.

**Economic Insight:** *The financial crisis of 2008 led to some lesson to be learned*

The financial crisis that began in 2008 provided an experience from which policy-makers could learn—with the hope of avoiding such a crisis in the future. One of the lessons was to recognize the importance of having a policy framework that could try to ensure the stability of the entire financial system. This is referred to as a macroprudential policy framework. Such a policy framework aims to reduce risk to the financial system by coordinating all the policies that affect the economy—including regulations and the supervision of the various institutions making up the financial system. Such a policy framework is not meant to undermine the independence of those responsible for various aspects of policy, regulations and supervision. Its goal is to achieve greater coordination and collaboration to reduce risk to the system.

The Governor and the Minister of Finance co-operate to achieve this objective. The Governor of the Bank of Canada cannot change the government's fiscal policies, but can offer advice to the Minister.

### **The Coyne Affair**

On one historic occasion in Canada, during the 1960s, the policies of the Governor of the Bank of Canada differed from those desired by the government.

## 4.4 THE RELATIONSHIP BETWEEN THE BANK OF CANADA AND THE GOVERNMENT

### **Economic**

**Insight:** Issuing a “directive” to the Governor is a power of the government – but unlikely to be used

In 1959–60, Canada was suffering from high unemployment and slow economic growth. The government thought that the Bank of Canada should loosen monetary policy and credit conditions (in other words, lower interest rates and make it less expensive to borrow money) to encourage spending.

The Governor of the Bank, James Coyne, disagreed. When Coyne refused to change the Bank’s policy, the government asked him to resign. At first, he refused, but then did so in June 1961 and was replaced by Louis Rasminsky. However, before Rasminsky would take the job of governor, he insisted that the government’s relationship with the Bank of Canada, and specifically with the Governor of the Bank, be clarified.

Rasminsky said, “If there should develop a serious and persistent conflict between the views of the government and the views of the central bank ..., the government should be able formally to instruct the Bank what monetary policy it wishes carried out and the Bank should have the duty to comply.”

As a result of the Coyne Affair, the *Bank of Canada Act* was changed so that the government could issue a directive to the Governor regarding the policy that should be followed. If the Governor ever received such a directive, he or she would have to follow it or resign.

So, although the Governor and the Bank may have considerable independence, the government holds the final responsibility for monetary policy through its ability to issue a directive to the Governor. In other words, the Minister of Finance is ultimately responsible for both fiscal and monetary policy on behalf of the government. But, since 1961, Canada’s governors and ministers of finance have been able to agree on the appropriate policies of the Bank, and a directive has never been issued. It is unlikely that will ever occur now with the inflation-control agreements reached by the Bank with the government.



*James Coyne, former Governor,  
Bank of Canada 1955-1961*



*Louis Rasminsky, former Governor,  
Bank of Canada 1961-1973*

### Quick Summary

As a quick summary then, the four functions of the Bank of Canada are to:

1. implement monetary policy to preserve the value of money
2. foster a stable and efficient financial system to help support economic growth and rising living standards
3. be the sole authority for issuing currency (bank notes) and be responsible for the design, production, and distribution of bank notes in the financial system, and
4. manage funds on behalf of the Government of Canada—serving as the “fiscal agent” of the government.

As we noted at the beginning of this module, the Bank’s primary objective is to *“promote the economic and financial welfare of Canadians by contributing to sustained economic growth, rising levels of employment and improved living standards.”*

To understand monetary policy, and how the Bank goes about implementing it, requires a good knowledge of the economy. We need to understand when and how production levels in the economy can be affected by monetary policy decisions. Let’s take a closer look at the economy.