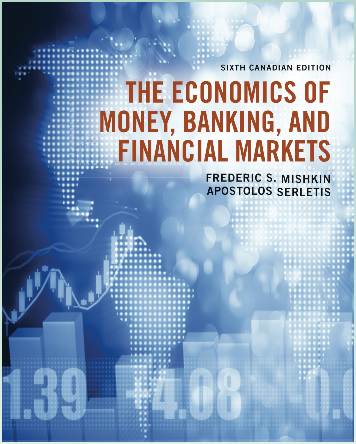
Mishkin/Serletis

The Economics of Money, Banking, and Financial Markets

Sixth Canadian Edition



Chapter 14

Central Banks and the Bank of Canada

Learning Objectives

1. Recognize the historical context of the development of the Bank of Canada
2. Describe the key features and functions of the Bank of Canada and assess its degree of independence
3. Summarize the arguments for and against the independence of the Bank of Canada
4. Identify the ways in which the theory of bureaucratic behaviour can help explain central bank actions
5. Discuss the structure and independence of other major central banks around the world

Origins of the Bank of Canada

- The Bank was created by the Bank of Canada Act in 1934 and started operations in 1935
- Initially the Bank was a private institution but was nationalized in 1938, so is now a national institution with headquarters in Ottawa
- Unlike a private bank that operates in pursuit of profit, the Bank of Canada is responsible for the country's monetary policy and for the regulation of Canada's deposit-based financial institutions

Structure of the Bank of Canada

- Responsibility for the operation of the Bank rests with a **Board of Directors**, which consists of fifteen members:
  - *The Governor (who is also the chief executive officer and chairman of the Board of Directors)*
  - *The Senior Deputy Governor*
  - *The Deputy Minister of Finance*
  - *Twelve outside Directors*

Structure of the Bank of Canada (cont'd)

- The Board appoints the governor and senior deputy governor with the government's approval, for a renewable term of 7 years
- The outside directors are appointed by the minister of finance, with cabinet approval, for a 3-year term
- The **Governing Council** is chaired by the governor and is composed of the senior deputy governor and four deputy governors

Functions of the Bank of Canada

- The functions of the Bank of Canada are:
  - *Currency*
  - *Funds Management*
  - *Financial System*
  - *Monetary Policy*

Currency

- Before the creation of the Bank, the federal government and the early banks issued notes
- By 1945 the Bank had a monopoly over note issue in the country
- The Bank also conducts ongoing research
  - *To improve cost-effectiveness*
  - *Increase the durability of bank notes*
  - *Reduce counterfeiting*

Currency:

- The original Bank Act required the Bank to redeem notes in gold
- Removed from the Bank Act revision of 1967.
- No longer constrained by the amount of gold. the Bank now has unlimited power to issue legal tender.

Funds Management

- As the federal government's fiscal agent, the Bank:
  - *Provides debt-management services for the federal government such as:*
    - *advising on borrowings*
    - *managing new debt offerings*
    - *servicing outstanding debt*
  - *Manages the government's foreign exchange reserves held by the* ***Exchange Fund Account***
  - *Engages in international financial transactions to influence exchange rates*

Financial System

- As Canada's central bank, the Bank of Canada:
  - *Serves as the lender of last resort if a bank faces a liquidity crisis (thereby preventing bank runs and panics)*
    - *Has power to create* ***base money***
  - *Has explicit responsibility for the regulatory oversight of the national payments system, operated by the CPA* Canadian Payment Association
  - *Acts as the holder of deposit accounts for:*
    - *the federal government*
    - *the directly clearing members of the CPA*
    - *international organizations such as the IMF*
    - *other central banks*

$$\frac{\cancel{n-2}}{n} \cdot \frac{n-3}{n-1} \cdot \frac{n-4}{\cancel{n-2}} \cdots \frac{}{n-} \qquad \frac{1}{n-(k-2)} \cdot \frac{1}{n-(k-1)}$$

Monetary base - the sum of BoC notes, coin, and deposits at the BoC belonging to depository institutions.

Depository institution deposits represent BOC liabilities, Changes in these deposits affect the amount of reserves in the banking system and money supply.

National Payment System - electronic system that clears and settles payments

Monetary Policy

- The Bank employs such tools as:
  - ***Open market operations***
  - *Shifting of government balances between it and the direct clearing members of the CPA to implement changes in the money supply*
- The Bank's ultimate objective is to keep inflation low
  - *Low inflation is closely related to the goal of steady economic growth*
  - *Low inflation protects the purchasing power of pensioners and those on fixed incomes*

Open market operations - purchase or sale of goverment securities.

+ Buy-back operations - shifting balances between BoC and financial institutions.

Renewing Candda's Inflation - Control Agreement :

In 2016, BoC and gov renewed Canada's Agreement on the Inflation - Control Target. First signed by gov in 1991, renewed every 5 Y.

How Independent is the Bank of Canada?

- Instrument but not goal independence

- Two main principles reflecting Louis Rasminsky's view of Bank of Canada independence
  - *" .. 1) in the ordinary course of events, the Bank has the responsibility for monetary policy, and 2) if the government disapproves of the monetary policy being carried out by the Bank, it has the right and responsibility to direct the bank as to the policy which the Bank is to carry out." (Louis Rasminsky, July 24, 1961)*

How free is the Bank from the gov?

Instrument independence - the ability to choose monetary policy instruments.

Goal independence : - the ability to set goal of monetary policy.

BoC has instrument independence. Goals have to be jointly agreed upon with the gov.

Note: the current agreement btw Bank and gov was renewed in December, 2016.

This arrangement came out after the Coyne Affair. There was a difference of opinion btw Governor of Bank. James Coyne and the minister of finance Donald Fleming. Coyne eventually resigned.

Factors Making Bank of Canada Dependent

- Joint responsibility system
- Minister of Finance can issue a directive to the Bank indicating the specific policy changes that the Bank must follow
  - *Published, set out new policy, period that it applies*
- While the ultimate authority rests with the government, Bank of Canada is quite independent and no government directives have ever been issued

Third Govenor, Louis Rasminsky, was the architect of the Directive.

Directive Power (1967) - a written order from the minister of Finance to the Governor indicating specific policy changes the Bank must undertake, and the period of time during which it will apply.

- A Directive must be published.
- None has been issued. Why? Consequence?

The Changing Face of the Bank of Canada

- Bank desires to explain and build confidence in the Bank's actions
- Bank has moved towards greater transparency and accountability in its operations
- The Bank's Governing Council publishes the ***Monetary Policy Report***
- Increased the number of press conferences/releases and speeches, and reorganized its regional offices, with the objective of improving communication
- Has a comprehensive website: www.bankofcanada.ca

The Changing Face of the BoC

1. Clarifying objectives.
   - price stability.
   - clearly defined targets.

2. Improve Communication.

- 1960s and 1970s, the Bank kept its monetary policy, instruments, and goals secret from the public.

- More recently, the Bank has adopted the overnight interest rate as its main policy instrument, to achieve their primary goal of price stability

- Also adopted an explicit inflation target, 1%-3%, aiming for 2%.

Should the Bank of Canada Be Independent?

- The Bank of Canada is probably the most independent government agency in Canada
- The question arises whether the independence given to the Bank of Canada should be curtailed
- Politicians who strongly oppose a Bank policy often want to bring it under their supervision in order to impose a policy more to their liking

The Case for Independence

- Political pressure would impart an inflationary bias to monetary policy
- Should avoid **political business cycles**, where before elections expansionary policies are pursued
- Avoids using the Bank to facilitate government financing of large budget deficits: accommodation
- Monetary policy is too important to leave to politicians — the principal-agent problem is worse for politicians

The case for independence.

- Politicians are concerned with winning the next election. and are unlikely concerned with the long run. The Bank would have more long-run objectives.

- The gov can use the Bank to finance deficits by having the Bank buy bonds from the gov, increasing money supply., leading to inflation. An independent. Bank could. resist such requests.

- The Bank has more expertises.

The Case Against Independence

- Undemocratic
- Unaccountable
- Difficult to coordinate fiscal and monetary policy
- Some may feel the Bank has not used its independence successfully

- Internationally, while countries with independent central banks have lower inflation, they don’t have very different unemployment rates or output fluctuations

The Case against independence.

- The Governor of the Bank and the Directors are not elected.
- If bad decisions are made, there is no procedure for replacing them during their term.
- Monetary and fiscal policy may be working at cross-purposes if not controlled by the same group (government)

Explaining Central Bank Behaviour

- Theory of bureaucratic behaviour
  - *Is an example of principal-agent problem*
  - *Bureaucracy often acts in own interest*

- Implications for Central Banks:
  - *Act to preserve independence*
  - *Try to avoid controversy*
  - *Seek additional power over banks*

Theory of bureaucratic behavior - suggests bureaucracies have a "maximizing" behavior just like people want to maximize their welfare and firms want to max profits.

Implications.

Bureaucracies want to maximize their power and prestige and will work to achieve the goal.

Principal - Agent Problem - arises when one party (Agent) agrees to work in favor of another party (Principal). Such an agreement may incur costs for the Agent leading to problems of moral hazzard and conflict of interest.

How might it applys to BoC.

Is the Bank always conducting the best monetary policy in the best interest of public? Or, does the bank have other motives?

Explaining Central Bank Behavior (cont’d)

- Theory of bureaucratic behavior: objective is to maximize its own welfare which is related to power and prestige
  - *Fight vigorously to preserve autonomy*
  - *Avoid conflict with more powerful groups*

- Does not rule out altruism

Federal Reserve System

- U.S. central bank, the Federal Reserve System
  - ***"the Fed"***

- Includes:
  - ***Board of Governors of the Federal Reserve System***
  - ***Federal Reserve Banks***
  - ***Federal Open Market Committee (FOMC)***
  - *Federal Advisory Council*
  - *2500 member commercial banks*

Structure and Responsibility for Policy Tools in the Federal Reserve System

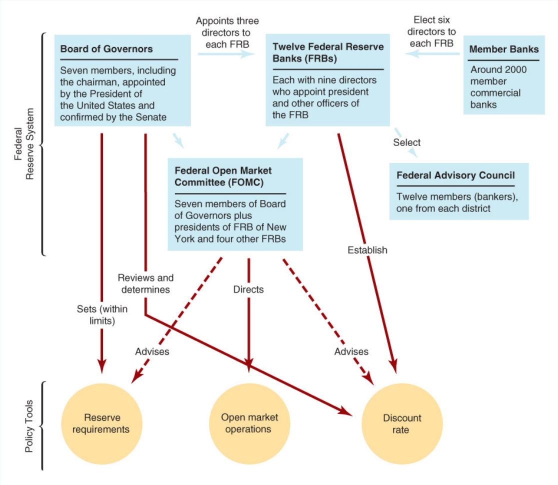


FIGURE 14-1 Structure and Responsibility for Policy Tools in the Federal Reserve System

The relationships of the Federal Reserve banks, the Board of Governors of the Federal Reserve System, and the FOMC to the three policy tools of the Fed (open market operations, the discount rate, and reserve requirements). Dashed lines indicate that the FOMC "advises" on the setting of reserve requirements and the discount rate.

Board of Governors of the Federal Reserve System

- Seven members headquartered in Washington, D.C.
- Governors are appointed by the president and confirmed by the Senate
- Serve 14-year non-renewable term
- Required to come from different districts
- Chairman is chosen from the governors and serves four-year term

Federal Reserve Banks

- Each of the twelve Federal Reserve districts has one main Federal Reserve bank
- The three largest Federal Reserve banks in terms of assets are those of New York, Chicago, and San Francisco
  - *They hold more than 50% of the assets of the Federal Reserve System*
  - *The New York bank, with around one-quarter of the assets, is the most important of the Federal Reserve banks*

The Federal Reserve System

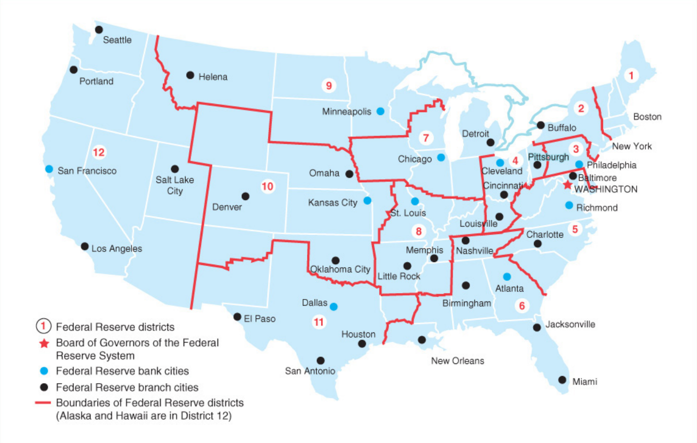


FIGURE 14-2 Federal Reserve System

The locations of the Federal Reserve districts, the Federal Reserve banks, and their branches.

Source: Federal Reserve *Bulletin*.

Federal Open Market Committee (FOMC)

- Meets eight times a year
- Consists of seven members of the Board of Governors, the president of the Federal Reserve Bank of New York and the presidents of four other Federal Reserve banks
- Chairman of the Board is also chair of FOMC
- Makes decisions regarding:
  - *The conduct of monetary policy*
  - *The setting of the policy interest rate (the **federal funds rate**)*

How Independent is the Fed?

- The Federal Reserve appears to be remarkably free of the political pressures that influence other agencies
- The power of the U.S. President in appointing members to the Board is limited
  - *The term of the Chairman of the Board is not necessarily concurrent with that of the president*
- Not entirely free of politicial pressures
  - *To understand the Fed's behaviour, we must recognize that public support for the actions of the Federal Reserve plays a very important role in its decisions*

The European Central Bank

- European Central Bank (ECB)
  - *The central bank of the euro area countries*
  - *Conducts monetary policy for countries that are members of the European Monetary Union*
  - *Monetary operations of the* ***Eurosystem*** *are conducted by all the National Central Banks in each country*
  - *The ECB is the most independent central bank in the world*
- Maastricht Treaty
  - *Established Eurosystem*
  - *Makes the ECB instrument-independent*
  - *Specifies that the goal of the ECB is price stability*

ECB Governing Council

- Monthly meetings at ECB in Frankfurt, Germany
- Twelve National Central Bank heads and six Executive Board members
- Operates by consensus
- ECB announces the target rate and takes questions from the media
- To stay at a manageable size as new countries join, the Governing Council will be on a system of rotation

How Independent Is the ECB?

- Most independent in the world
- Members of the Executive Board have long terms
- Determines own budget
- Less goal independent
- Charter cannot by changed by legislation; only by revision of the Maastricht Treaty

Structure and Independence of Other Foreign Central Banks (cont'd)

- Bank of England
  - *Has some instrument independence*
  - *Government can overrule the Bank and set interest rates*
- Bank of Japan (Nippon Ginko)
  - *Has some degree of instrument and goal independence*
  - *The objective of monetary policy is to attain price stability*
  - *Government can request delays in monetary policy decisions*

- Growing international trend towards greater Central Bank independence