

Bank of Canada and Monetary Policy

The Bank of Canada (BOC)

- ▶ Since 1934/35, Canada's central bank, the Bank of Canada, has been acting as a monitor for the supply of money in Canada.
- ▶ This wholly government-owned institution has been given the mandate to perform four basic functions relating to money and the financial system, called Canada's "**Monetary Policy**".

Monetary Policy

- ▶ Process by which the government affects the economy by influencing the expansion of money and credit.

Benefits of Monetary Policy

- ▶ It is separated from day-to-day politics.
- ▶ Decisions regarding monetary policy can be made quickly.

Drawbacks of Monetary Policy

- ▶ It is less effective as an expansionary tool than as a contractionary tool.
- ▶ It cannot be focused on particular regions.

Functions of the Bank of Canada

1. Director of Monetary Policy

- ▶ The Bank is responsible for controlling the growth of money supply in Canada by regulating credit, currency and interest rates.



2. Banker to the Chartered Banks

- ▶ The Chartered Banks have deposit accounts with the central bank.
- ▶ The Chartered Banks use their accounts at the Bank to settle debts amongst themselves.
- ▶ The BOC also lends money to chartered banks for short periods of time for investment purposes.



3. Banker to the Federal Government

- ▶ The Federal government's revenues are on deposit in two locations:
 - ▶ Bank of Canada and the chartered banks
 - ▶ These deposits are regularly shifted between the 2 locations.
- ▶ Buys and sells Federal government bonds and makes interest payments on them to bondholders.
- ▶ Handles Foreign Exchange Reserves and uses them to intervene in the foreign exchange market to manage the Canadian dollar.



4. Issuer of Currency

- ▶ Responsible for the issue of paper currency.
- ▶ Decides on the design of the note, gauges the amount required at various times of the year.
- ▶ Tries to eliminate counterfeiting.
- ▶ Coins – Royal Canadian Mint not BOC

Organization of the Bank

- ▶ The BOC is run by a board of directors appointed by the government.
- ▶ The Governing Council is made up of the Governor, the Senior Deputy Governor and four Deputy Governors.
- ▶ The Governor and the Senior Deputy Governor are appointed by the independent directors with the approval of the federal government for a seven-year term.
 - ▶ The signatures of these two officials are on every bank note.

What does the BOC try to do?

- ▶ The most important role of the Bank of Canada is to control the amount of money circulating in the economy.
- ▶ While managing the money supply the Bank has three goals:
 - ▶ Minimizing inflation in order to preserve the purchasing power of the dollar.
 - ▶ Maintaining real output of the economy as close as possible to its potential level.
 - ▶ Regulating the external value of the Canadian dollar on foreign exchange markets.

What does the BOC accomplish?

- ▶ As the business cycle moves through its ups and downs, the Bank changes its actions to respond to the needs of the economy.
- ▶ For example, if the economy is in a deep recession or trough, the government will ease up interest rates to make money more easily available.

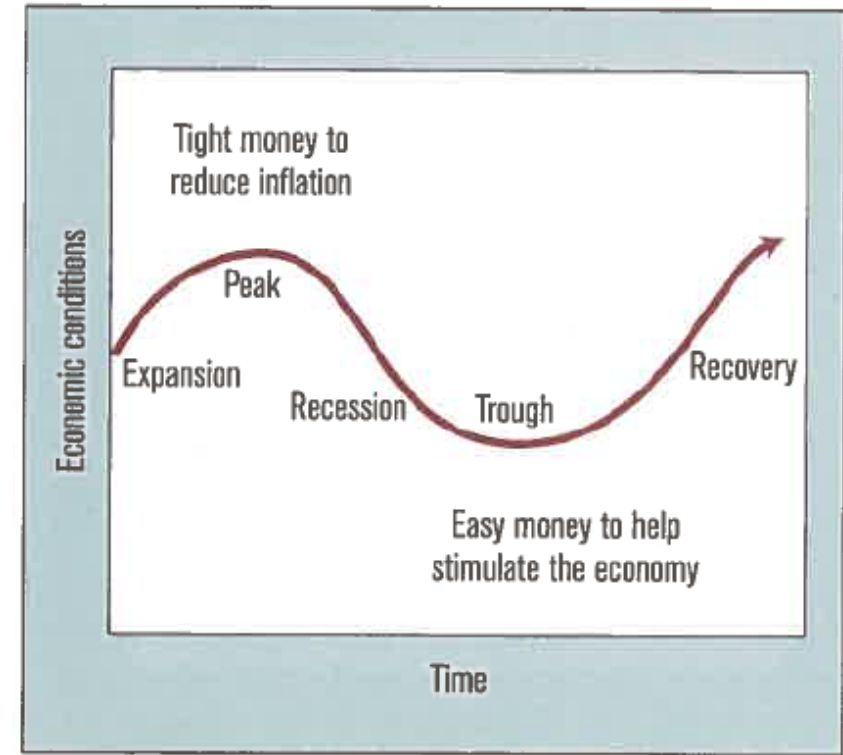
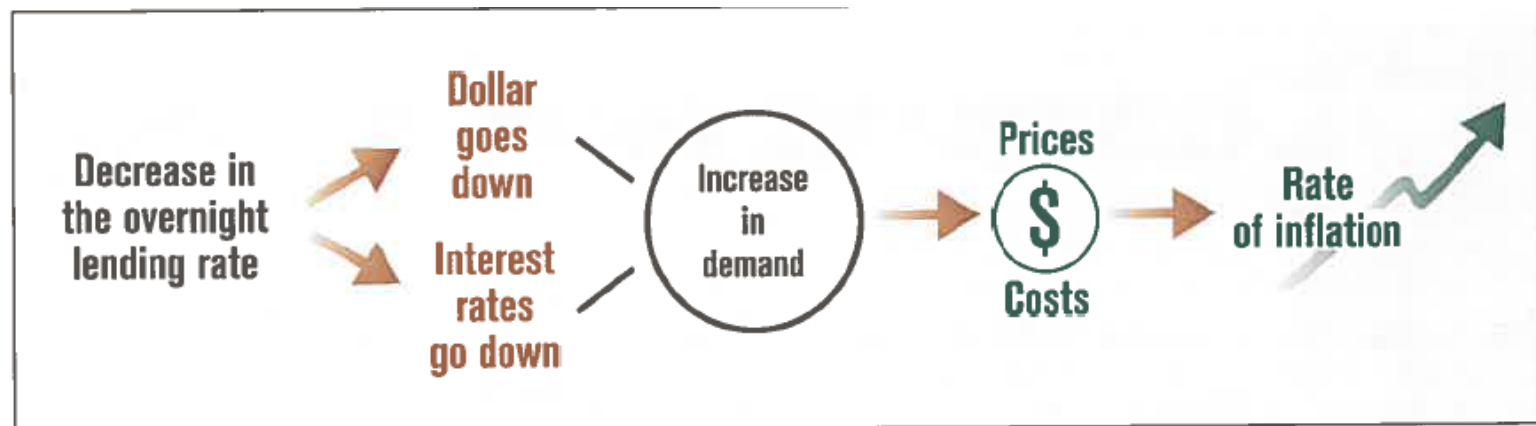
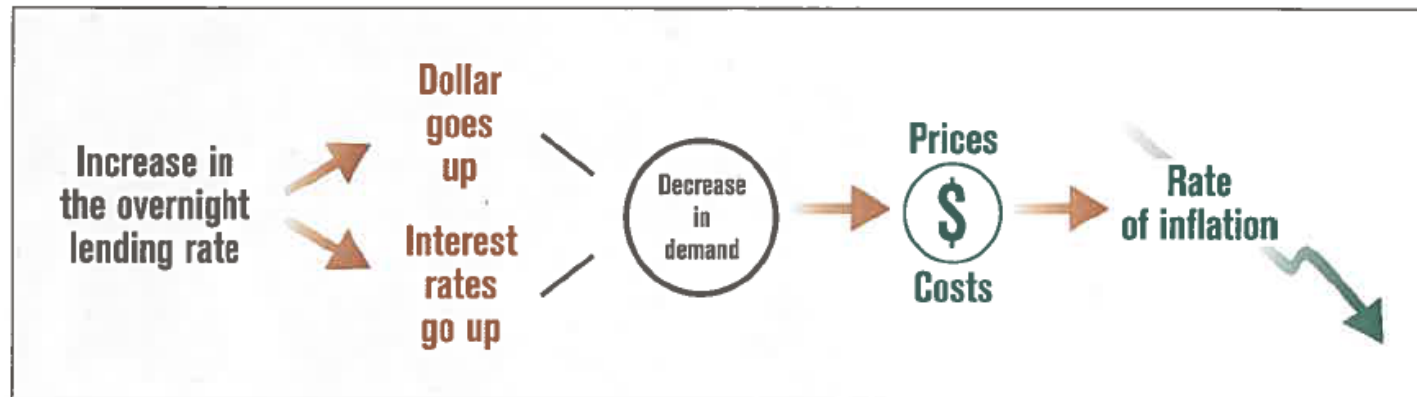


Figure 12.1 The business cycle.

- ▶ **Easy money** is a term used to describe a monetary policy where interest rates are low.
 - ▶ Credit is easy to obtain and there is an increase in the money supply.



- ▶ **Tight money** is the term used to describe a monetary policy that has high interest rates.
 - ▶ Credit is difficult to obtain resulting in less money being circulated.



The Role of Interest Rates

- ▶ Interest rates are very important because they affect the decisions of all Canadians who are deciding whether to save or borrow money.
- ▶ When interest rates are high, fewer Canadians will want to borrow money.
- ▶ Higher rates discourage businesses from investing and expanding their businesses.

The Role of Interest Rates

- ▶ Higher interest rates also attract more foreign investors to buy Canadian dollars, thus increasing the value of the Canadian dollar.
- ▶ Municipal, Provincial and Federal budgets are affected, because the higher the interest rates the more interest they must pay on their debt.
 - ▶ This causes them to spend less money on programs that Canadians need and want.

Demand for Loanable Funds

- ▶ Comes from three sources:
 - ▶ Consumers, businesses and government
- ▶ As interest rates decrease, more loanable funds are borrowed.

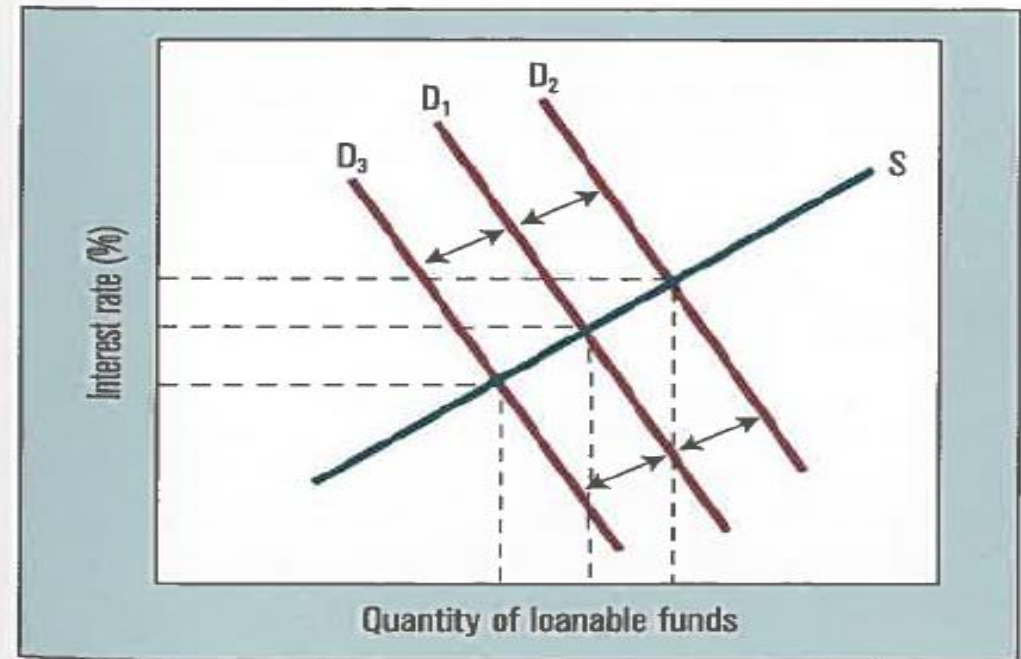


Figure 12.3 Change in demand for loanable funds. Demand falls in recessionary times (to D_3) and rises in expansionary times (to D_2).

Supply for Loanable Funds

- ▶ Comes from:
 - ▶ Individuals, businesses and chartered banks
- ▶ When interest rates rise, more loanable funds are supplied.
- ▶ When interest rates fall, less is supplied.

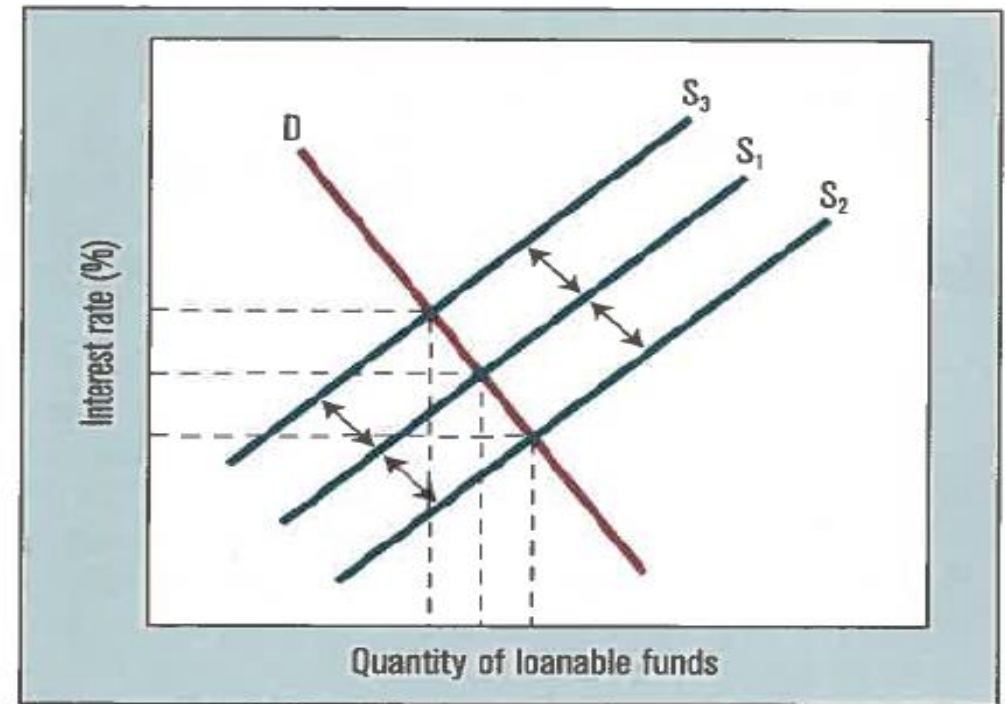


Figure 12.4 Change in supply for loanable funds. Supply falls in recessionary times (to S_3) and rises in expansionary times (to S_2).

Different Types of Interest Rates

- ▶ We will look at three different types of Interest Rates:
 - ▶ Prime Rate
 - ▶ Overnight Rate
 - ▶ Bank Rate

Prime Rate

- ▶ This is the lowest rate of interest a financial institution offers to its best customers.
- ▶ It is used as a benchmark for other lending rates that the institution offers to its customers.
- ▶ Usually a loan received by an average Canadian is rated +/- prime and tells the consumer how close they are to the best rate possible.
- ▶ If this rate changes, all other rates received by banks and customers will also change.

The Overnight Rate

- ▶ This is an important tool used by the Bank of Canada.
- ▶ Interest rate at which major financial institutions borrow and lend one-day (or "overnight") funds among themselves; the Bank sets a target level for that rate.
- ▶ This rate can have an impact on the Canadian dollar's value as well as consumer loans and mortgages.

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- ▶ When the Bank of Canada changes the overnight rate, it tells financial institutions the direction that monetary policy should go towards.
 - ▶ A fall in the target overnight rate signifies an easy money policy in the near future.
 - ▶ A rise in the target overnight rate signifies a tight money policy in the near future.

Bank Rate

- ▶ This is the rate of interest charged by the bank of Canada to the chartered banks on any loans or advances they receive.
- ▶ The bank rate is usually a quarter point higher than the overnight lending rate.

Bank of Canada's Balance Sheet

- ▶ Bank of Canada influences the economy by changing interest rates
- ▶ To influence interest rates, the Bank must change quantity of money in the economy
- ▶ Quantity depends on size and composition of Bank of Canada's balance sheet - assets and liabilities



Assets

- ▶ Government of Canada bonds
- ▶ Foreign exchange
- ▶ Advances to the chartered banks

Liabilities

- ▶ Currency outstanding
- ▶ Deposits of the chartered banks
- ▶ Deposits of the federal government

Monetary Policy at Work

- ▶ Ideally, Monetary policy works along with Fiscal policy to influence Aggregate Demand to rise if the economy is in a recession or fall if it is experiencing excessive inflation.

Easy Money Policy (Expansionary Policy)

- ▶ Considered EXPANSIONARY monetary policy
- ▶ The goal with this type of policy is to stimulate, or expand, the economy.
- ▶ Increasing the money supply and lowering interest rates, which shifts AD rightward.
 - ▶ Due to an initial increase in investment and the consumption of durable goods.
- ▶ Used to eradicate a recessionary gap.

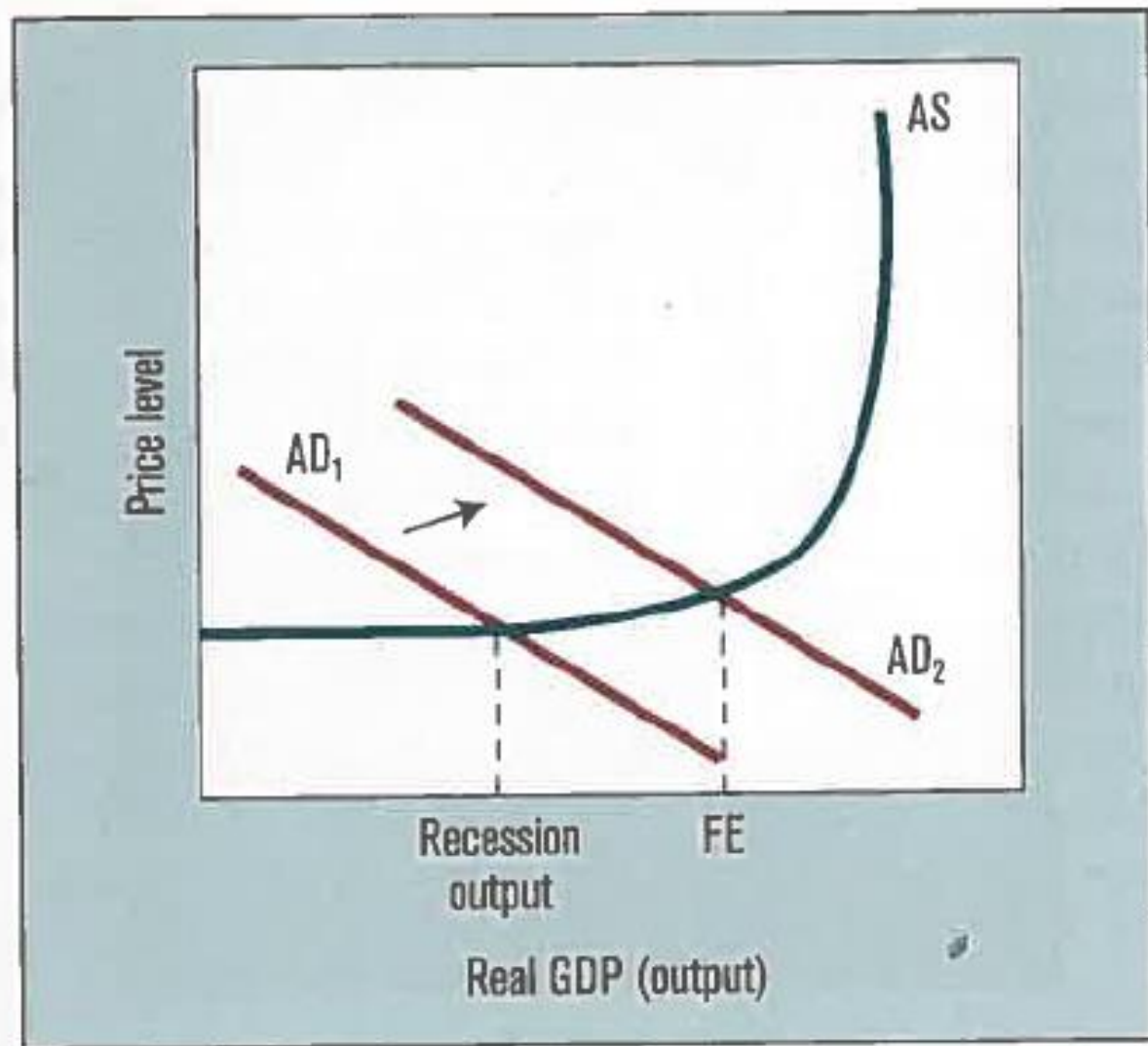


Figure 12.9 Aggregate demand and aggregate supply model illustrating a recession.

Tight Money Policy (Contractionary Policy)

- ▶ Considered CONTRACTIONARY Monetary Policy.
- ▶ Policy use if the economy is experiencing a rapid expansion that may cause high inflation.
- ▶ Decreasing the money supply and raising interest rates, which shifts AD leftward.
 - ▶ Due to an initial decrease in investment and the consumption of durable goods.
- ▶ Used to eradicate an inflationary gap.

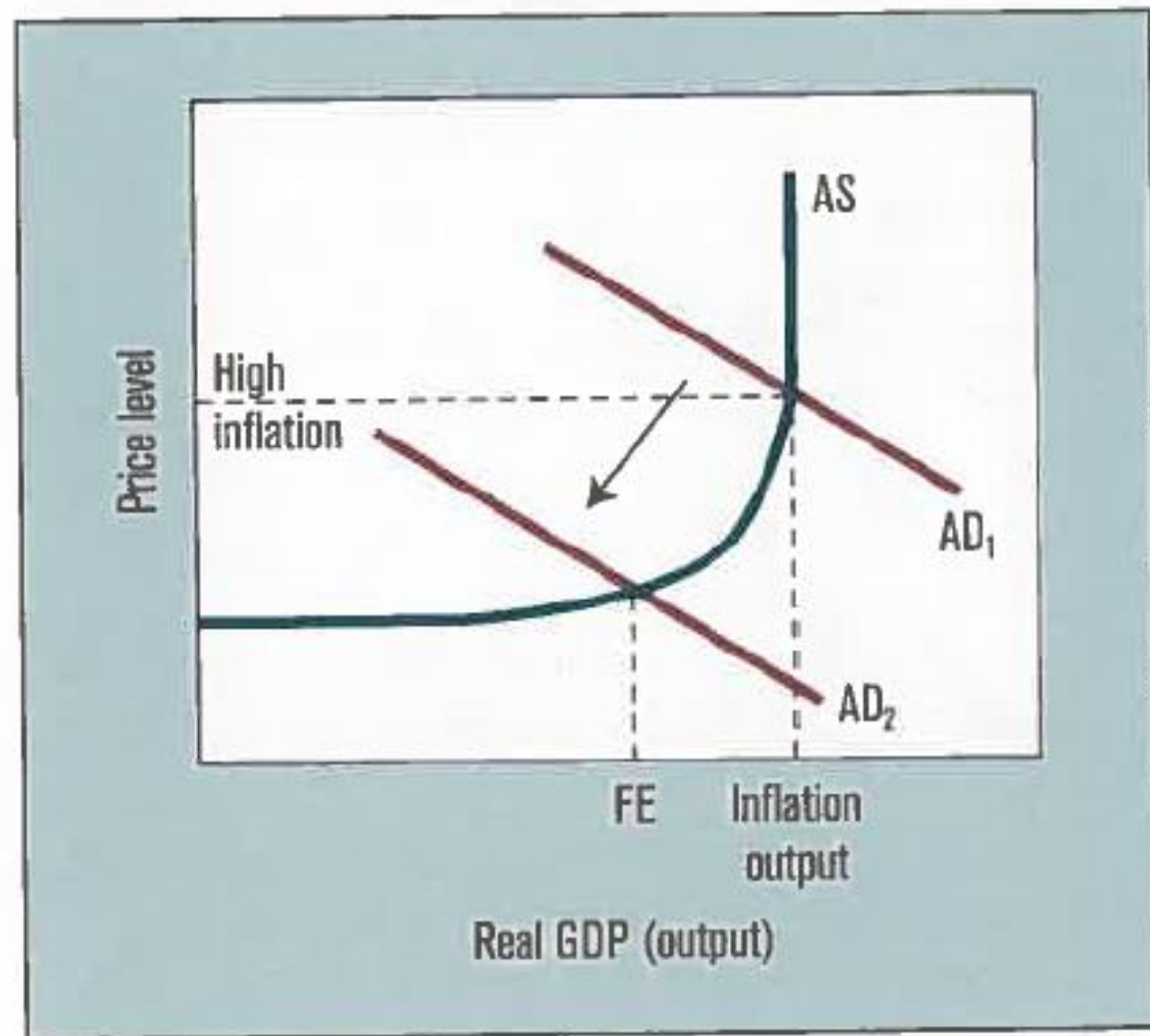


Figure 12.10 Aggregate demand and aggregate supply model illustrating a period of inflation.

Milton Friedman

- ▶ Was a leading supporter of monetarism, which stresses the influence of money in the economy.
 - ▶ Central to monetarism is the velocity of money (V), which is the number of times money is spent on final goods and services during a given year.
 - ▶ V is found by dividing nominal GDP by the money supply (M).

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- ▶ These calculations lead to the equation of exchange
 - ▶ **$M \times V = P \times Q$**
 - ▶ where P is the price level and Q is the level of real output.
 - ▶ According to the quantity theory of money, accepted by monetarists, both V and Q are relatively stable, which means that adjustments in P are due to changes in M.

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- ▶ Based on Friedman's theories, monetarists consider variations in the money supply to be the most significant factor in the economy, with changes in M translating immediately into changes in nominal GDP and the price level.
 - ▶ According to monetarists, central banks should not use discretionary policy, but adopt a set monetary rules instead.