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Marketnomics 103: The Role of the Bank of Canada

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In many respects, the Bank of Canada's role in the Canadian economy is identical to the role of the Federal Reserve Bank in the U.S. economy (see "Marketnomics 102: Economic statistics and the Fed", *Canadian Treasurer,* April/May 2003). We could end this article right here, say nothing more and probably few people would care.

Why do people, and particularly the financial markets, care less about the actions of the Bank of Canada than the actions of the Fed? Well, mostly because in the grander scheme of things Canada is a far less influential player than the U.S. In the first article in this series (*Canadian Treasurer,* February/March 2003), I glossed over much of the Canadian economic information for that very reason. People simply pay more attention to the U.S. than Canada because the U.S. is far bigger and plays a far more important role in the world economy.

The U.S. is Canada's largest trading partner and our economy has been much more influenced by the U.S. economy's performance and by U.S. monetary and fiscal policy as a result. However, this is beginning to change. In the last couple years we have seen a divergence between the performance of the two economies. Without getting into a detailed discussion of the causes, suffice it to say it is a positive development.

As for the Bank of Canada, it performs essentially the same role as the Fed in its economy. Both act as the central banker and banker of last resort to the country's chartered banks. Both set and administer monetary policy through the manipulation of the money supply, interest rates and reserve requirements. Both have the goal of promoting an environment that is conducive to low inflation and stable, long-term economic growth.

Unlike the Fed, however, the Bank of Canada concerns itself with the value of the Canadian dollar. The Fed evaluates the level of the U.S. dollar against other world currencies but, because the U.S. dollar is arguably the most important currency in the world economy, because the U.S. dollar is sought after in difficult times as a safety net and for a variety of other reasons, the U.S. dollar is much more resilient and less prone to dramatic swings than the Canadian dollar.

Here in Canada, in these modern times, we have to worry about provinces threatening to secede from the Commonwealth (the Commonwealth of Canada, not Britain) and the subsequent effects on the currency. The U.S. hasn't had to worry about those sorts of things since the 1860s. As much as they have to worry about the value of the dollar, it can also be helpful in promoting economic growth. Canada is an export-driven economy. When the Canadian dollar is weaker, Canadian exported goods are less expensive and more attractive to U.S. buyers. The downside of this is that, if demand for imported goods remains stable or rises, the risk of imported inflation increases. This requires the Bank to perform a delicate juggling act: It has to identify a currency value and a level of interest rates that promote economic growth without making the currency too strong or leaving it vulnerable to sharp decreases in value; at the same time, it has to keep inflation in check. As with most other central banks, up until the mid to late 1980s, when the dangers of high inflation and high interest rates became better understood, the Bank of Canada didn't do a very good job at maintaining this balance. But since a series of central bank heads in most of the major developed nations of the world began to really combat inflation and beat it down, this balancing act has been maintained much more effectively.

So what does the Bank of Canada actually do? Prior to the Bank being set up, chartered banks in Canada were permitted to conduct their business in any way they chose. They didn't have to work by any established set of rules. During the Great Depression, chartered banks received significant criticism for their actions, and there were doubts about the efficiency and stability of the Canadian banking system. In 1935 the Bank of Canada was formed. In its first few years, it was a privately owned entity but was nationalized in 1938. According to the act that created the Bank, its purpose was "to regulate credit and currency in the best interests of the economic life of the nation," a pretty broad statement of purpose to be sure. More specifically, the bank was mandated to maintain financial stability and regulate the money supply, influence interest rates and the value of the currency and stimulate the economy by exercising its monetary powers. Additionally the Bank was responsible for settling international accounts, and it was to be the lender of last resort to the country's chartered banks. In other words, the role of the Bank of Canada is virtually identical to that of the Fed.

The role of the Bank of Canada has changed little today from a fundamental perspective. Its role has become more complicated as a result of electronic payments systems and the increasing value of non-paper currency transactions. It still has responsibility for the money supply and for managing economic growth through monetary policy. The tools its uses to effect monetary policy are the same as the Fed's. It uses the money supply, which it can influence with reserve requirements. It uses open-market securities transactions. It uses interest rates to stimulate or slow the economy, as well. Like the Fed, the Bank of Canada indicates changes to its interest-rate policy to the market via the overnight rate.

As indicated earlier, the Bank of Canada has the additional challenge of influencing the value of the Canadian dollar. While this is a concern of the Fed, it is a bigger concern for the Bank of Canada. Historically the Canadian dollar has been much less volatile than other major currencies. In recent years, the volatility of the dollar – a measure of the extent to which the value of the currency may change in a given period – has increased quite substantially, putting additional pressure on the Bank to to manage and smooth the changes (generally downward in the last 10 years) if not to stabilize it around a certain level then.

Influenced by the men in charge, both the Fed under Alan Greenspan and the Bank of Canada initially under John Crowe became strong inflation fighters in the late 1980s. This effort to keep inflation under control continues today. But there is one significant difference between the way the Fed and the Bank approach inflation control. The Fed has no set targets for inflation. The Bank of Canada does. This is a fairly recent development for the Bank, but it marks a significantly different approach between the two countries. Right now, the Bank's inflation target band is 1% to 3%, with a target of 2%. This has the potential to cause broad differences in the implementation of monetary policy in Canada and the United States. Because the Fed has no such hard targets, it is, in theory, more flexible in its approach to fighting inflation. If inflation moves up and it is seen as a temporary aberration, the Fed can decide to take no action and let the market correct itself. In Canada, in theory, the Bank doesn't have this luxury. If it sees inflation moving up and it appears that the level of inflation as measured by the CPI will move outside the upper band, or if it does move outside the band, the Bank of Canada has little choice but to take action. Some will argue that this is a good thing; some will argue it's not. It could lead the Bank to implement monetary policy that is overly restrictive when it need not be or to be overly stimulative when it shouldn't be. Since the bands have been put in place, this has yet to become a significant issue.

The economy is now growing modestly but inflation has been bumping up against the upper band and the Bank has been hiking interest rates to keep the inflation rate within the bands. Given that the economic growth is modest at best and not firmly entrenched, there is a risk that the need to keep inflation within the bands may choke off the modest economic recovery we are experiencing. Time will tell.