Unit 3

Bank of Canada & Monetary Policy

Bank of Canada

The Bank of Canada is the nation's central bank. They are not a commercial bank and do not offer banking services to the public. Rather, they have responsibilities for Canada's monetary policy, bank notes, financial system, funds management.

The principle role, as defined in the Bank of Canada Act, is "to promote the economic and financial welfare of Canada."

The Bank of Canada has five main functions:

- Issue currency for circulation in Canada
- Act as the banker for the federal government
- Act as a bank for the chartered banks
- Act as a lender of last resort
- Control the money supply (monetary policy)****

The role that we are most interested in is Monetary Policy. The goal of Canadian monetary policy is to contribute to rising living standards for all Canadians through low and stable inflation. (in the 1% to 3% band)

During a recession, the economy may see a low inflation rate and unemployment is a problem. The economy needs a “boost” and the Bank of Canada uses Monetary Policy to increase the money supply and hopefully “heat up the economy”.

During a peak, the economy may be faced with high inflation (above 3%). The economy needs to be “cooled down” and the Bank of Canada uses Monetary Policy to decrease the money supply and hopefully “cool the economy down”.

The Bank of Canada increases and decrease the money supply two different ways:

1. Open market operations

2. The bank rate

1. Open Market Operations

The Bank of Canada conducts open market operations when it buys and sells government bonds. (lending or borrowing money)

- To increase the money supply, the Bank of Canada can buy government bonds or Treasury bills from the banks. The dollars the Bank of Canada pays for the bonds increases the number of dollars in the bank's reserves leaving it with more money to loan out.
- To reduce the money supply, the Bank of Canada can do just the opposite: It can sell government bonds to the banks. The bank pays for these bonds with its reserves, directly reducing the amount of money it has to loan out.

2. The Bank Rate

- Central banks like the Bank of Canada act as bankers to the commercial banks. These banks hold demand deposits at the Bank of Canada which are part of their reserves.
- The bank rate is the interest rate on the loans that the Bank of Canada makes to commercial banks.
- The Bank of Canada can alter the money supply by changing the bank rate. A higher bank rate discourages banks from borrowing reserves from the Bank of Canada. Thus, an increase in the bank rate reduces the quantity of reserves in the banking system, which in turn reduces the money supply.
- Conversely, a lower bank rate encourages bank borrowing from the Bank of Canada , increases the quantity of reserves, and increases the money supply.
- The bank rate also affects the money supply since when the rates are lower people are more likely to borrow/spend money. (ie. buy a new house, car, go on a holiday)
- When the rates are higher people are less likely to spend/ borrow money and therefore, the economy will cool down.

Governor of Bank of Canada

-Steven Poloz