THE MANDATE AND GOVERNANCE

OF THE BANK OF CANADA

FIRST REPORT OF THE SUB-COMMITTEE ON THE BANK OF CANADA
EIGHTH REPORT OF THE STANDING COMMITTEE ON FINANCE

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February, 1992

HOUSE OF COMMONS

Issue No. 34

Monday, February 24, 1992

Chairman: Murray Dorin

CHAMBRE DES COMMUNES

Fascicule nº 34

Le lundi 24 février 1992

Président: Murray Dorin

Minutes of Proceedings and Evidence of the Standing Committee on

Finance

Procès-verbaux et témoignages du Comité permanent des

Finances

RESPECTING:

Pursuant to Standing Order 108(2), consideration of the First report of the Sub-Committee on the Bank of Canada

INCLUDING:

The Eighth Report to the House

CONCERNANT:

Conformément à l'article 108(2) du Règlement, questions relatives au Premier rapport du Sous-comité de la Banque du Canada

Y COMPRIS:

Le Huitième Rapport à la Chambre

Third Session of the Thirty-fourth Parliament, 1991-92

Troisième session de la trente-quatrième législature, 1991-1992

24594-1

STANDING COMMITTEE ON FINANCE

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Vice–Chairman: Clément Couture

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Herb Gray
Steven Langdon
Diane Marleau
René Soetens
Greg Thompson
Brian White—(8)

(Quorum 5)

Susan Baldwin

Clerk of the Committee

COMITÉ PERMANENT DES FINANCES

Président: Murray Dorin

Vice–président: Clément Couture

Membres

Herb Gray
Steven Langdon
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(Quorum 5)

La greffière du Comité

Susan Baldwin

Published under authority of the Speaker of the House of Commons by the Queen's Printer for Canada.

Available from Canada Communication Group — Publishing, Supply and Services Canada, Ottawa, Canada K1A 0S9

Publié en conformité de l'autorité du Président de la Chambre des communes par l'Imprimeur de la Reine pour le Canada.

En vente: Groupe Communication Canada — Édition, Approvisionnements et Services Canada, Ottawa, Canada K1A 0S9

The Standing Committee on Finance

has the honour to present its

EIGHTH REPORT

In accordance with its mandate under Standing Order 108(2), your Committee has examined the mandate and governance of the Bank of Canada and, in particular, Proposal 17 of the Government's proposals for a renewed constitution entitled "Shaping Canada's Future Together" and agreed to report the following:

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Acknowledgement

The Finance Committee became involved in this study of the Bank of Canada as a result of discussions among several members concerning the low level of public understanding of monetary affairs, and the lack of any recent study of these matters, particularly insofar as the mandate and role of the Bank of Canada is concerned. Further stimulus was provided by the very important monograph written by Professor David Laidler and published by the C.D. Howe Institute in May 1991.

The Government's constitutional proposals which were released in September 1991 and which contained proposals concerning the mandate and governance of the Bank of Canada made the preparation of this study imperative.

I am very grateful to the members of the Finance Committee, in particular its Chairman, Murray Dorin M.P., for the opportunity afforded to me to serve as Chairman of the sub-committee on the Bank of Canada. The honour of leading such a study is one which I believe is too infrequently accorded to members of the opposition parties.

I believe that all members of the Committee approached this study with open minds, with the result that none of us reached the conclusion we anticipated at the outset. For my part, I embarked on the enquiry believing that a more collegial approach to the formulation of monetary policy should be sought, thus addressing what I perceived was a lack of legitimacy arising from the perception that policy was arrived at in an Ivory Tower in the Nation's Capital.

In the end, however, I became convinced that in our own typically Canadian way, we have evolved a system in which the Bank of Canada is neither totally independent nor is it totally under the control of the Department of Finance. The Bank is, if you like, independent if necessary, but not necessarily independent. This, in essence, is the genius of the consultation-directive approach which is not paralleled elsewhere in the world. In the end, the Bank of Canada plays an important role in the formulation of monetary policy, but the Minister of Finance remains answerable to the House of Commons for that policy.

In its work, the sub-committee was very ably assisted by the Clerk of the full Committee, Ms. Susan Baldwin, who kept our sub-committee moving along while endeavouring to balance the other work of the full Committee as well as other sub-committees.

The text of the Report was prepared by the regular research staff of the Committee, led by Basil Zafiriou, who was assisted by Marion Wrobel and Anthony Chapman. It was the hope of the sub-committee members that the Report would be a valuable resource in the future for any who wish to travel this road again. It is my view that if this Report is capable of such lasting value, it is primarily because of the excellent work of the research staff in preparing the text.

All members of the sub-committee worked very diligently together, in as open-minded and entirely non-partisan manner. In addition to sub-committee members Murray Dorin M.P. and Don Blenkarn M.P. of the Progressive Conservative Party, and Stephen Langdon M.P. of the New Democratic Party, I appreciated the participation, and helpful advice of the Honourable Herb Gray M.P., P.C., a fellow Liberal.

All of which is
respectfully submitted,

John Manley, M.P.
Ottawa South
Chairman, Sub-committee on
the Bank of Canada

Acknowledgement

The Finance Committee committed to establishing a Sub–committee to examine the Bank of Canada in June, 1991 as a result of a concern that one of the most significant federal government institutions was increasingly being called into question. The inclusion of the issue in the constitutional documents added greater urgency to the task.

All Sub–committee members conducted themselves in a manner towards hearing and examining the evidence with the objective of coming to the best possible conclusions. I want to make particular mention of the Chairman, John Manley, Liberal Member for Ottawa South—a precedent, I believe, in having a member of the opposition serve as Chair. Mr. Manley carried out his duties in a competent and non–partisan fashion.

I hope that the success of this effort and the unanimous report might encourage other similar initiatives by parliamentary committees and Members of Parliament to help bring a non–partisan consensus building approach to issues that Canadians currently demand.

Murray Dorin, M.P.
Chairman
Standing Committee on Finance

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Ottawa South
Chairman, Sub-committee on
the Bank of Canada

PREAMBLE AND SUMMARY

As a public institution with unparalleled influence on the day-to-day performance of our economy, the Bank of Canada frequently finds itself the subject of public controversy. Usually, the controversy is over the particular policies the Bank pursues. Recently, much of the public debate concerning the Bank has centred not on the policies of the Bank but the process that brings them about.

In May 1991, the C.D.Howe Institute published a study by David Laidler, Professor of Economics at the University of Western Ontario, focusing on the two key elements of that process: the mandate under which the Bank of Canada operates and the way that the Bank is governed. The Bank's current mandate, dating from the establishment of the Bank in 1935, requires the Bank to protect the exchange rate and stabilize fluctuations in prices and economic activity. Contending that this mandate is now dated, Laidler proposed making price stability the Bank's only aim.

With respect to the Bank's governance, Laidler argued that powers over monetary policy are concentrated in the hands of the Governor and that, as a consequence, the policy-making process is perceived to be too easily subject to dramatic change and inadequately sensitive to regional concerns. As a way of addressing both of these problems, he recommended that policy-making powers devolve to the board of directors of the Bank, that Bank directors be full-time appointees, and that the provinces be given some role in their selection.

In September 1991, the Government released its proposals for renewed federalism, in a document entitled *Shaping Canada's Future Together: Proposals*. Among the 28 sets of proposals contained in that document, one — proposal #17 — dealt with reforms to the Bank of Canada. The reforms proposed by the Government dealt with the same two aspects that Laidler had addressed; and the solutions proposed were similar in direction, if not in detail, to Laidler's suggestions. As had Laidler, the Government proposed that the Bank's mandate be revised to make the achievement and maintenance of price stability the Bank's only goal. To enhance regional representation on the Bank's board, the Government proposed a) to consult with the provinces before making appointments to the board and b) to create regional consultative panels to advise the directors of the Bank on regional economic conditions.

These proposals were amplified in a subsequent government document, entitled *Canadian Federalism and Economic Union: Partnership for Prosperity*. Noting that the speed towards price stability would affect economic activity, the document recommended that the *Bank of Canada Act* establish a mechanism though which the government and the Bank of Canada would arrive at an agreed price-stability path and make it public. It also recommended that the Governor be required to report regularly to Parliament on economic conditions and monetary policy.

The Commons Finance Committee has held hearings on the Bank of Canada's annual report on several occasions during the course of the current Parliament. These hearings disclosed concerns going beyond recent Bank policies to the role and governance of the Bank of Canada. The Laidler C.D. Howe paper crystallized a number of these concerns and offered some very concrete and well thought out proposals for addressing them. Early last fall, therefore, the Committee resolved to undertake a broad-ranging inquiry into the Bank of Canada. Areas that the Committee wanted to examine included the current mandate of the Bank, the composition and responsibilities of the Board of Directors, the role of the Bank in the Canadian payments system and the Bank's foreign exchange operations.

The Committee's plans were in part overtaken by events with the release of the Government's constitutional proposals last September. The joint Parliamentary Committee on a Renewed Canada that is examining the Government's proposals is required to report to Parliament by the end of February 1992. To contribute to that Committee's deliberations and accommodate its schedule, the Finance Committee decided to separate the planned Bank of Canada inquiry into two phases, confining the first phase to the areas covered by the Government's proposals, namely the mandate and governance of the Bank of Canada. The Sub-Committee on the Bank of Canada was established to conduct this phase of the inquiry.

The Committee began its hearings on November 19, with the Governor of the Bank of Canada as its first witness. We received testimony from an additional 25 witnesses, including experts on the central banks of Japan, U.S. and the U.K., business and academic economists, a former federal Minister of Finance and a former provincial Treasurer.

On the whole, the prevailing view of the witnesses who appeared before us was that the Government's proposals on the mandate of the Bank of Canada went too far while the proposals on governance did not go far enough.

Price stability as an aim of monetary policy was endorsed by a large majority of the witnesses. Their consensus view was that inflation yields no lasting benefits to the economy in terms of higher rates of employment or real growth. Inflation results from a rate of monetary expansion in excess of the real needs of the economy. Such a rate of monetary growth can stimulate economic activity only if not fully anticipated. Once market participants come to expect the rising prices, the stimulus to the real economy is dissipated and the excess rate of monetary growth is reflected in a higher rate of inflation only. The temptation to exploit the short run potency of monetary policy in order to lower unemloyment or accelerate growth lends monetary policy an inflationary bias that, if not checked, results in higher inflation with no improvements in output or employment: in short, an inferior economic performance in the long run. A price stability objective can provide an anchor for monetary policy that may help arrest that bias.

Few witnesses however were prepared to support narrowing the focus of monetary policy to price stability alone. Opposition to that proposal was based on several grounds. First and most general, controlling inflation is not the only legitimate goal of monetary policy: there have been others in the past (maintaining a fixed exchange rate, for instance) and we should not foreclose others in the future. More immediately, monetary policy has the capacity to influence economic activity in the short run and cannot therefore shun responsibility for responding to events that may throw the economy far off its potential growth path and output. Also, how price stability is attained and maintained has implications for the real economy that monetary authorities should not be permitted to ignore. Finally, the timing for radical revisions to the Bank's mandate is wrong: it amounts to adding yet another divisive issue on an already very crowded constitutional agenda. In sum, a broad mandate is superior to a narrow one, and the present preferrable to the one proposed.

Concerning the governance of the Bank of Canada we found substantial consensus in favour of change, but much less agreement on specific proposals for change. Most witnesses supported the notion of diffusing power within the Bank of Canada so that monetary policy would be determined by a group of full time, competent, and regionally-based individuals who have been subject to the scrutiny of the federal and provincial governments, and have been ratified by an elected Senate. Such a body would be responsible for setting and implementing monetary policy. While the Governor of the Bank of Canada would sit on such a body as the "first among equals", and have the pre-eminent stature on the board, the power over monetary policy would rest with several individuals rather than just one. Such an institutional arrangement would add greatly, in the eyes of these witnesses, to the legitimacy of

the Bank of Canada. We also received testimony, however, on the advantages of the present arrangement in terms of the speed with which the Bank can adapt policy to changing conditions and the ability to focus responsibility for monetary actions taken.

A better system of policy making should, at the very least, not lead to any worsening of monetary policy and could even lead to better policy. With very few exceptions, most economists believe that a monetary institution independent of direct political control generally delivers better monetary policy. In Canada we have struck a balance between day-to-day independence of the Bank with ultimate responsibility for monetary policy resting with the federal government. The more legitimate is the Bank of Canada's policy making process, the less likely is the government to interfere in its operations and the more real is this independence.

Even though the support for a revised system of governance was widespread, the Committee did receive words of caution which we have attempted to take into account in composing our recommendations. Those witnesses who expressed caution were primarily concerned with the possibility that regional directors become spokesmen and agents for provincial governments. Given the past record of pronouncements from these governments, such an event could easily lend an inflationary bias to the Bank's policies. The Committee was warned to guard against such an eventuality and it was in this vein that a number of witnesses linked a revised mandate with a change in the constitutional makeup of the Bank of Canada. Other witnesses stressed the importance of the board of directors' oversight role vis-à-vis the management of the Bank and the need therefore for a board comprised mainly of independent and hence outside directors.

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LIST OF RECOMMENDATIONS

Recommendation 1

The present mandate of the Bank of Canada, as set out in the preamble to the *Bank of Canada Act*, remain unchanged.

Recommendation 2

***The Bank of Canada Act* be amended to require that the Bank of Canada report to Parliament each year on current and anticipated economic conditions and on the intended course of monetary policy over the short and medium term, in light of those conditions. One of these reports would be tabled in Parliament in conjunction with or following the tabling of the Governor's annual report to the Minister of Finance, in March of each year. A follow–up report would be tabled in the fall. These reports would be automatically referred to a designated committee of Parliament, which could invite the Governor to appear before it and defend the Bank's reports.**

Recommendation 3

Monetary policy should continue to be formulated and conducted by the Bank of Canada, with the ultimate responsibility resting with the federal government. That government should continue to maintain the power to issue a directive to the Bank regarding the conduct of monetary policy.

Recommendation 4

The current practice of maintaining a regional balance on the Bank of Canada's Board of Directors should be enshrined in law and some, but not all, directors should be chosen for their expertise in monetary policy.

Recommendation 5

In order to foster better public understanding of the workings of monetary policy, some Board and Executive Committee meetings should be held in locations in Canada outside of the National Capital Region.

INTRODUCTION

We live in a monetary economy. Money "is the medium that links buyers and sellers, savers and investors, lenders and borrowers in all parts of the country."[1] Our economy therefore cannot perform well unless money does. In Canada, the agency primarily responsible for ensuring that money functions properly, i.e. for monetary policy, is the Bank of Canada. The Bank's influence, for good or ill, over our economy is consequently profound. When money is stable and the economy in good health, the Bank of Canada receives little attention from the public. When money is erratic or the economy under stress, the Bank is favoured with assiduous public attention.

The Bank of Canada has been much in the public spotlight over the past two decades. Judged by the standards of the early postwar years, the performance of the economy since the early 1970s has been distinctly poor. Unemployment levels have been much higher, rates of productivity growth much slower and financial markets much more volatile. Money experienced a greater depreciation in value over this period than at any time in our history. Difficulties of this nature have not been unique to Canada of course. Nor can they be attributed solely to monetary factors. But when our economy, in both its real and monetary sectors, experiences so much stress, it is natural that the authority responsible for monetary policy should attract attention.

In Canada, the difficulties besetting the conduct of monetary policy are compounded by the wide regional diversities that characterize our country. Given the high degree of integration of financial markets in Canada—a welcome feature, incidentally, for it promotes an efficient allocation of capital and hence a more productive economy—there can be only one monetary policy for the whole country. That is, monetary policy must be national. An implication of this fact is that monetary policy cannot be precisely tailored to the specific needs of each region. It is a suit of one size that must fit all. The frequent complaint is that the suit is made to the measurements of Central Canada, leaving the rest of the country ill-fittingly attired. Calls for reform to make the Bank of Canada more sensitive to regional needs are a natural complement to these complaints.

The reforms to the Bank of Canada proposed by the Government in September 1991—proposal #17 among the Government's proposals for a renewed federation contained in the document entitled: "*Shaping Canada's Future Together: Proposals*"—were motivated by a desire to respond to such regional concerns as well as to more general perceptions of failings in the design and execution of monetary policy. As explained in *Canadian Federalism and Economic Union: Partnership for Prosperity*, a background paper discussing the rationale for the economic reforms proposed in *Shaping Canada's Future Together: Proposals*, the guiding principles behind the proposed reforms to the Bank of Canada were to clarify the Bank's mandate, increase the transparency of monetary policy, and improve the ways of communicating monetary policy objectives and performance. To these ends, the Government proposed a) revisions to the mandate of the Bank of Canada to make price stability the Bank's sole objective and b) measures to increase regional representation on the Bank's board of directors. These proposals are discussed respectively in chapters two and three of this report. The chapter immediately following this introductory section provides a brief review of the origins, early development and functions of the Bank of Canada.

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1 Bank of Canada, *Memorandum on Bank of Canada Functions and Responsibilities Submitted to the House of Commons Standing Committee on Finance*, November 19, 1991, pp.7-8.

CHAPTER I
Origins and History of the Bank of Canada

A. THE CANADIAN MONETARY SYSTEM BEFORE 1935

1. The Bank of Canada began operations in March 1935 making Canada a comparative late-starter in establishing a central bank. The Bank of England, for instance, was established in 1694, the Banque de France was founded by Napoleon in 1800 and the United States Federal Reserve System was introduced in 1913. Even countries less economically and financially developed than Canada, such as Australia (Commonwealth Bank of Australia, founded 1911—later the Reserve Bank of Australia) and South Africa (South African Reserve Bank, founded 1920) had some form of central bank earlier.

2. Before examining the origins of central banking in Canada, it is useful to know something about the monetary system that it replaced, particularly since some have argued that, under the earlier system of "free banking", management of the money supply was superior to the subsequent record of the Bank of Canada.[2] Free banking in this context refers to a banking system that, although not completely laissez-faire in nature, was lightly regulated, where the banks were able to issue competing currencies in the form of bank notes and (until 1914) there was no government-sponsored lender of last resort.

3. Up until 1914 Canada operated on the gold standard with currency (Dominion of Canada notes) issued by the government payable in gold on demand. The Dominion Notes Act provided for a fixed issue of notes without gold backing, another specific amount to be partially backed by gold while issues of dominion notes over these amounts had to be fully backed by gold. Once the amount of Dominion notes in circulation exceeded the first (uncovered) tranche, further notes could be issued only if there was an increase in gold reserves or the government changed the legislation. Dominion notes of small denominations (25 cents, $1, $2, $5) were used by the public for completing everyday transactions, while large notes were held within the banking system as reserves and for transactions between banks.

4. Another component of the Canadian monetary system was the supply of bank notes issued by the individual chartered banks. These could be issued in denominations of $5 and multiples thereof, to the value of the bank's paid up capital. The government imposed a 1% tax on the value of these bank notes in circulation. In the early 1930s, Bank notes comprised about two-thirds of the value of circulating currency and coinage in the hands of the general public. During the crop moving season (September 1 to February 28) when demand for cash was heaviest, the banks were allowed to issue additional bank notes up to 15% of their unimpaired capital and rest or reserve fund, with the government charging interest at the rate of 5% per annum on amounts issued under this provision. While issues of bank notes up to these amounts did not require the pledge of assets or the maintenance of minimum cash reserves, the 1913 revision of the Bank Act permitted increases in bank notes in excess of these amounts if an equal value of gold or Dominion notes was deposited with a board of trustees in Montreal.

[2] Kurt Schuler, "Free banking in Canada," in Kevin Dowd ed., *The experience of free banking*, (London: Routledge, forthcoming.)

5. Nor was the total amount of credit offered by the banks limited by statutory reserve requirements. Instead, the consensus view by bankers that cash reserves should represent at least 10% of their liabilities constituted a self-imposed reserve requirement. The fact that cash reserves included gold and subsidiary coin and that at least 40% of cash reserves were legally required to be in the form of Dominion notes (which were partially gold backed) linked the country's gold reserves to the amount of credit outstanding. Under the gold standard in effect prior to WWI the country's gold reserves would expand when Canada's international balance of payments was in surplus and contract when it was in deficit. The corresponding expansion (contraction) of credit in the economy corrected the international payments imbalance.

6. At the outbreak of WWI in 1914 a financial panic began to develop with "runs" on the banks taking place across the country and heavy withdrawals of gold occurring. The Canadian banks kept part of their secondary reserves in the form of callable loans in the New York market but these proved to be unavailable during the crisis. Without a national lender of last resort, the banks found their sources of liquidity exhausted.

7. In August 1914 the government passed the Finance Act which, among other provisions, suspended the redemption in gold of Dominion notes and authorized the issue of Dominion notes to the banks against deposits by the banks of securities approved by the Minister of Finance. Although other powers granted the banks under the Act were subsequently suspended, the provision enabling the banks to obtain Dominion notes in return for the deposit of securities continued to be used and was subsequently enshrined in the Finance Act of 1923.

8. In a sense the Finance Act represented a first step towards central bank operations. When the chartered banks' cash reserves were low, they could borrow Dominion notes against the deposit of qualified securities. Dominion notes issued under the terms of the Finance Act were not required to be backed by gold reserves, effectively severing the link between the country's gold reserves and the amount of credit extended by the banks. The passive lending operations under the Finance Act, however, were a far cry from constituting an active monetary policy. As the first Governor of the Bank of Canada, Graham Towers, stated in 1939 before a Parliamentary Committee, "The second great flaw [in relying on the Finance Act] was this: If it seemed desireable to encourage expansion there was no way for the government to take the initiative."[3] It is true that in November 1932 the government actively tried to expand credit by persuading the chartered banks to borrow $35 million under the Finance Act. The fact that expansionary monetary policy had to be carried out, in effect, by moral suasion of the banks pointed to the need for a central bank, according to the Governor.

B. THE ORIGINS OF THE BANK OF CANADA

9. Although not given serious consideration by the Canadian government until the 1930s, the idea of setting up a kind of central bank in Canada can be traced as far back as 1841 when the Governor General of the Province of Canada, Lord Sydenham, suggested the establishment of a provincial bank of issue. In 1913 a Member of Parliament, W.F. MacLean, called for the consolidation of the two or three largest Canadian banks into "a great national or state bank. . . along the lines of the Imperial Bank of Germany" to be called the Bank of Canada. Proposals for a central bank were also made in 1914 by Mr. D.R. Wilkie, a former President of the Imperial Bank of Canada and in 1918 by Mr. E.L. Pease, a former President of the Royal Bank of Canada. However, these calls to set up a central bank were not received favourably by most other Canadian bankers and by governments of the day.

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[3] Canada, House of Commons, Standing Committee on Banking and Commerce, *Memoranda and Tables Respecting the Bank of Canada*, Session 1939, p. 24.

10. As part of the decennial review of the Bank Act in 1923, the Select Standing Committee on Banking and Commerce was charged with investigating the "basis, function and the control of financial credit, and the relation of credit to the industrial problems." In response to a proposal by one of the members, the Committee also considered the establishment of a Federal Reserve Bank in Canada. Before the Committee, the President of the Canadian Bankers' Association argued that the reasons that gave rise to the U.S. Federal Reserve System did not exist in Canada. First, in contrast to the earlier U.S. banking system, under the Finance Act Canadian banks were able to obtain currency to meet seasonal or other temporary requirements. Second, legislation limited branching by U.S. banks inhibiting the transfer of resources throughout the country to where they were needed most. Such was not the case in this country where Canadian banks operated an extensive branch bank system.

11. Despite some other evidence supporting the formation of a central bank, the Government revised the Bank Act without any major changes to the organization of the financial system. The Minister of Finance argued at the time that there was no need for a central bank since the Finance Act performed all the functions of a central bank. The idea that the functions of a central bank were already being carried out by the Treasury Board, empowered by the Finance Act, was restated by the Liberal government in 1924 when the Progressive Members of the House of Commons attempted unsuccessfully to enlarge a Banking and Commerce Committee order of reference to "embrace the study and consideration of some type of properly administered Central or Reserve Bank."

12. Nevertheless, calls for a central bank persisted and the Banking and Commerce Committee again considered the question in 1928. Although the Committee was not convinced of the need for a central bank, it did recommend that a study be undertaken to determine whether there was ample facility for much larger expansion of credit to accomodate the future rapid expansion of the Canadian economy. The study, which was never carried out, was also to examine whether the Treasury Board was able to control unusual variations in the rate of interest.

13. Demands for a Canadian central bank continued from Members of the Progressive Party and from the fast-growing Cooperative Commonwealth Federation (C.C.F.) Party. Several Queen's University professors, notably Clifford Curtis, W.A. Mackintosh, Frank Knox and W. Clifford Clark, who was later to be named Deputy Minister of Finance, were also among the advocates of establishing a Canadian central bank. However, it was not until 1933 when the decennial revision of the Bank Act came due that the Conservative government appeared to reverse its long-standing opposition to a central bank. The Bank Act revision was postponed for one year so that a Royal Commission could study the Canadian banking system and the entire monetary system and consider the advisability of establishing a central bank.

14. The Royal Commission on Banking and Currency in Canada began work in August 1933 chaired by Lord Macmillan, an eminent British jurist who had previously served as Chairman of the Commission on Finance and Industry in Britain. At Lord Macmillan's request, Sir Charles Addis, Chairman of the Hong Kong and Shanghai Banking Corporation and former director of the Bank of England with experience on several British financial inquiries, received an appointment as commissioner. The other three commissioners were Canadians: Sir Thomas White, Vice President of the Canadian Bank of Commerce and Canada's Minister of Finance during WWI; the Premier of Alberta, Mr. J.E. Brownlee; and Mr. Beaudry Leman, General Manager of the Banque Canadienne Nationale.

15. Travelling by rail, the Macmillan Commission held hearings in 13 Canadian cities receiving testimony from 221 witnesses and gathering 196 written submissions. Evidence was received from governments, political organizations, farmers, merchants, manufacturers, Boards of Trade and Chambers of Commerce, economists, banks and monetary cranks.[4] The report was provided to the government on September 27, 1933, fifty days after the first meeting. "Few if any commissions have moved at a faster pace; asked to appraise one of the most important proposals in Canadian financial history, its duties were carried out with lightning speed."[5]

16. The Macmillan Commission Report, a thin volume of 119 pages including dissenting opinions, appendix and index, recommended by a 3 to 2 majority that Canada establish a central bank. Premier Brownlee of Alberta sided with the the two British members of the Commission, Lord Macmillan and Sir Charles Addis, in favour of creating a central bank while Sir Thomas White and Mr. Beaudry Leman represented the dissenting opinions. Thus, a majority of the Canadian members of the Royal Commission actually argued against establishing a central bank at that time.

17. Given the membership of the Macmillan Commission, the report's recommendation for a central bank may have been a foregone conclusion. Indeed, there is reason to believe that the Conservative government had already decided prior to receiving the Royal Commission report to create a Canadian central bank. The depression had increased public distrust of the banks and led to a loss of faith in the market system. On the left of the political spectrum the CCF Party was calling for nationalization of the banks and the establishment of a national central bank. From the political right the Social Credit Party was insisting on government intervention to inject more currency into the economy. Western farmers, facing falling prices for their commodities while encountering difficulty obtaining credit even at high real rates of interest, were also sympathetic to reform of the financial system.

18. Prime Minister Bennett announced on November 20, 1933, that the government intended to introduce legislation to establish a central bank. The legislative framework for the Bank of Canada followed fairly closely suggestions for the main features of the Bank of Canada contained in the Macmillan Commission Report. As recommended, the legislation provided for the Bank of Canada to be privately owned. However, this provision proved highly controversial during debate in the House of Commons and, although it was retained in the final legislation, when the Liberals gained power the government took control of 51% of the shares in 1936 and 100% of the shares in 1938.

19. The Bill establishing the Bank of Canada passed third reading in the House of Commons by a vote of 97 to 56. Before it received Royal Assent the government had introduced consequential legislation. One of the most important changes was the repeal of the Finance Act, which provided the chartered banks and savings banks with cash reserves in the form of Dominion notes against deposit by the banks of qualified securities.

20. The first Governor of the Bank of Canada was Mr. Graham Towers, assistant General Manager of the Royal Bank. In order to bring some central banking experience into the operation, the government appointed as Deputy Governor Mr. J.H.C. Osborne, Secretary of the Bank of England. On March 11, 1935, the Bank of Canada opened its doors at temporary quarters pending the completion in 1938 of the Bank of Canada building on Wellington Street.

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[4] Milton L. Stokes, *The Bank of Canada — The Development and Present Position of Central Banking in Canada*, (Toronto: Macmillan Company, 1939), p. 74

[5] Douglas H. Fullerton, *Graham Towers and His Times*, (Toronto: McClelland and Stewart, 1986), p. 42

C. THE FUNCTIONS OF THE BANK OF CANADA

21. The mandate provided the Bank of Canada in the legislation was based on the tasks of a central bank summarized in the Macmillan Report, although the preamble in the Bill placed relatively more emphasis on the Bank's domestic responsibilities and less on its international duties and functions. According to the Macmillan Report, the tasks of a central bank can be summarized as the following:

> "In the first place, from a national point of view, the central bank, within the limits imposed by law and by its capacities, should endeavour to regulate credit and currency in the best interests of the economic life of the nation and should so far as possible control and defend the external value of the national monetary unit. In the second place, from the international point of view, the central bank by wise and timely co-operation with similar institutions in other countries should seek, so far as may lie within the scope of monetary action, to mitigate by its influence fluctuations in the general level of economic activity. These functions do not, of course, exhaust the tasks of a central bank. Within a state the central bank should, in addition, be a ready source of skilled and impartial advice at the disposal of the administration of the day. In return for the privileges which the state confers upon it, the bank should use its store of experience in the service of the community without the desire or the need to make profit a primary consideration."[6]

22. The preamble of the Bank of Canada Act read as follows: "Whereas it is desireable to establish a central bank in Canada to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion:. . ."

1. Monetary Policy

23. A major reason for establishing a central bank in Canada was the need to gain active control over the money supply. Under the previous system, there was no way for a public authority to take the initiative in expanding credit. One way the Bank of Canada implements monetary policy is by means of open market operations, that is buying and selling securities in the financial market.[7] This operation affects the chartered banks' cash reserves at the Bank of Canada thereby influencing the amount of credit they are willing to extend.

24. In its first annual report (1935) the Bank of Canada emphasized the importance of developing a strong Canadian treasury bill market to facilitate the conduct of open market operations. However, it was not until 1954 that a secondary market for treasury bills began to develop outside the banking system.

2. Lender of Last Resort

25. One of the primary functions of the Bank of Canada, or any central bank, is to act as lender of last resort to the banking system. This role, previously exercised by the Treasury Board under the Finance Act, provides liquidity support by making loans to the banks at a specific interest rate (the

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[6] Canada, *Report of the Royal Commission on Banking and Currency in Canada*, (Ottawa: King's Printer, 1933), p. 63

[7] Today the primary method of implementing monetary policy is through the control of cash balances maintained by financial institutions at the Bank of Canada for the purpose of settling claims arising from the clearing of cheques and electronic fund transfers.

Bank Rate) when additional reserves are required. The Bank of Canada distinguishes "ordinary" loans to make up temporary shortfalls due to unexpected payments flows, from "extraordinary" loans made to institutions with liquidity problems stemming from a loss of depositor confidence.

3. Issue of Bank Notes

26. When the Bank of Canada assumed responsibility for issuing the country's currency, the Dominion Notes Act was repealed and the facility of the chartered banks to issue bank notes was phased out over a period of time. The Bank of Canada must see that an ample supply of currency is available across the country and must take measures to ensure the authenticity of bank notes by guarding against counterfeiting.

4. Financial Adviser and Fiscal Agent to the Federal Government

27. In accord with the Macmillan Report, the legislation empowered the Bank of Canada to act as financial adviser and fiscal agent for the provinces as well as the federal government. In fact, the Bank never did act in this capacity for the provinces and in 1967 the provision as it affected the provinces was repealed. As the federal government's financial adviser and fiscal agent, the Bank of Canada provides advice respecting issues of government securities, arranges for the sale of new government securities, arranges the servicing of the outstanding public debt and provides for its redemption at maturity. As the government's banker, the Bank of Canada operates the accounts through which almost all government receipts and expenditures pass. The Bank of Canada can also make loans to the government by purchasing its securities. The Exchange Fund Act passed in July 1935 provides for a fund to "aid in the control and protection of the external value of the Canadian monetary unit." On behalf of the government, the Bank of Canada intervenes in the foreign exchange market and manages the foreign currency reserves in the Exchange Fund Account.

5. Other Functions

28. Other functions and responsibilities of the Bank of Canada include: providing advice on the regulation and supervision of financial institutions; providing oversight with respect to the payments system; providing advice to the government on international financial issues and representing Canada at meetings of international organizations such as the IMF and OECD.

D. RESPONSIBILITY FOR MONETARY POLICY

29. The decision by Prime Minister Bennett at the outset to opt for private ownership of the Bank of Canada was motivated by the desire to lessen the danger of political interference in Bank policy. Although the Bennett government clearly intended the Bank to maintain a degree of independence, the question of who bore ultimate responsibility for monetary policy — the government or the Bank — remained unclear. In this respect, "the Act defined neither the division of responsibility between the Government and the Bank nor the precise powers of the Governor".[8]

30. The independence of the Bank of Canada was enhanced in the Act by providing that the Governor is "appointed for a term of seven years during good behaviour." The stipulation that the Governor should hold office during "good behaviour" rather than at the pleasure of the government

[8] George S. Watts, "The Legislative Birth of the Bank of Canada," in *Bank of Canada Review*, (August 1972), p. 20.

may explain some of the subsequent confusion about whether the Bank or the government were ultimately responsible for monetary policy. As Governor James Coyne would later point out, "Apart from the judges of our superior courts, there are relatively few high offices of state which are held during good behaviour, and that phrase has, of course, a legal meaning. The meaning as I understand our British constitutional practice, is that the holder of such an office cannot be removed or dismissed by the Executive, but only by Parliament". [9]

31. Evidently, Edgar Rhodes, the Minister of Finance in the Bennett government, believed that the Bank of Canada would not be subject to the will of the government. "The services of the bank should obviously be at the disposal of the government, particularly in times of severe crisis and emergency. Clearly, however, the bank should not be subject to dictation by the government, for at times the exigencies of public finance might not be wholly in harmony with banking policies that might be considered wise and essential in the public interest."[10] In the event of a disagreement between the government and the central bank, "unquestionably the authority of the Governor and Board of Directors of the Bank would prevail." Distinguishing between the government and Parliament, the Minister did acknowledge, however, that the Governor and the Bank's directors were ultimately subject to the will of Parliament.

32. In response to a similar question, Prime Minister Bennett appeared to contradict his Finance Minister, "my judgement for what it may be worth, and I offer it after having looked over the bill again, is that the Bank of Canada cannot control the mechanism used by the government for the purpose of its policy under any circumstances whatever. . . The ideas of the Bank in regard to carrying on open market operations might conceivably be different from what an individual in the Government might think, but I do not see how it could be said for a moment that they would interfere with the general policies of administration."[11]

33. An opposition amendment to the Bank of Canada Bill actually increased the Governor's powers by conferring on him a veto over decisions by the Board of Directors who represented private shareholders. However, when the government became the majority shareholder in 1936, the Act was amended to provide the Cabinet with authority to confirm or override the Governor's veto. The provision giving the Governor a veto over the Board was repealed in 1967 when the Act was amended to give the Minister the power to issue a directive to the Governor.

34. In 1936 the Finance Minister in the Mackenzie King government stated that, although the Bank of Canada should not bow to temporary public whims, in the long run it must show responsiveness to public opinion and be responsible to government. This view was also expressed by the first Governor of the Bank, Graham Towers, who stated publicly that, in the event of a disagreement between the Government and the Bank on an important question of monetary policy, the Governor should resign.

35. The assumption of government responsibility for monetary policy was held until 1956 when, with unemployment rising, Walter Harris, the Liberal Minister of Finance stated that he would not accept responsibility for the Bank. The next Minister of Finance, Donald Fleming in the Diefenbaker government, reiterated his predecessor's position that the government of the day was not responsible for monetary policy.

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[9] Canada, Senate of Canada, *Proceedings of the Standing Committee on Banking and Commerce*, July 10, 1961, p. 9.

[10] Canada, House of Commons, *Debates*, (February 22, 1934), p. 827.

[11] House of Commons Debates, cited in George S. Watts, "The Legislative Birth of the Bank of Canada," in *Bank of Canada Review*, (August 1972), p. 20.

36. In 1960 the Governor of the Bank of Canada, James Coyne, came under criticism for a tight monetary policy instituted despite rising unemployment and a low rate of inflation. That year Governor Coyne began giving public speeches on economic and fiscal policy that appeared at times critical of the government and seemed to contradict government statements.

37. In the House of Commons, Opposition Leader Lester Pearson castigated the government for creating uncertainty as to "whether the Governor of the Bank of Canada is or is not speaking for the government." The Finance Minister appeared to absolve the government of responsibility for the Bank of Canada, stating that the government had no authority in the field of monetary policy. Criticisms of monetary policy Mr. Fleming claimed "were directed at the Bank of Canada and not at the government." As for the Governor's controversial speeches, the Finance Minister said, "I trust that I am not to be made responsible for what may be said by the Governor of the Bank of Canada when he exercises his right as a citizen to make speeches." Finally, on March 18, 1961, Finance Minister Fleming warned Governor Coyne that his speeches were embarassing the government. After that the Governor's speaking engagements ceased.

38. There was widepread public opposition to the Governor's tight money policies and much disagreement with his public statements. In 1961, 29 economics professors signed a letter to the Minister of Finance criticizing the policies of the Bank of Canada, questioning the competence of the management of the Bank and calling on the government to alter the Bank's management.

39. On May 30, 1961, the government requested the Governor's resignation. The Governor's public refusal to resign forced the government to introduce legislation which would deem the office of the Governor of the Bank of Canada to be vacated. As noted earlier, the Governor took the position that the Governor and the Bank of Canada are ultimately responsible to Parliament, not to the government. On July 13, after emotional appearances before Parliament, Governor Coyne resigned.

40. The government gave a number of reasons for forcing the resignation of Governor Coyne. One issue raised was the $13,000 per year increase (to $25,000) in the Governor's pension. However, this had been legally voted upon by the Bank's board of directors and, although the Minister stated that he was not told about it, a representative of the Minister had been present at that meeting.

41. Another point was the Governor's controversial speechmaking. Although the Governor probably stepped beyond his responsibilities and had certainly embarassed the government, he had not been warned until March 1961 at which time his speeches ceased.

42. It was also alleged that Governor Coyne had "firmly and angrily" rejected the Minister's request in the winter of 1957-58 to reduce the chartered banks' liquidity reserve ratio. The Governor argued that this request had been opposed by the Minister's own Deputy Minister and all but one of the chartered banks. Further, after discussions and letters on the matter, the Minister had seemingly been converted and had defended the liquidity reserve ratio in the House of Commons.[12]

43. From the Minister of Finance's statement in the House of Commons, it appears that the primary reason for Governor Coyne's dismissal was the government's conviction "that Mr. Coyne's continuation in office. . .would stand in the way of the implementation of a comprehensive, sound and responsible economic program designed to raise the level of employment and production in Canada."[13]

44. On July 24, 1961 the government appointed Louis Rasminsky as Governor of the Bank of Canada. Eight days later, the new Governor issued a statement presenting his views on the administration of the office.

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[12] John T. Saywell ed., *Canadian Annual Review for 1961*, (Toronto: University of Toronto Press, 1962), p. 203.

[13] House of Commons Debates, cited in Saywell (1962), *Canadian Annual Review for 1961*, p. 204.

> "I believe that it is essential that the responsibilities in relation to monetary policy should be clarified in the public mind and in the legislation. I do not suggest a precise formula but have in mind two main principles to be established: (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 the responsibility to direct the Bank as to the policy which the Bank is to carry out."[14]

45. In January 1963, Governor Rasminsky appeared before the Royal Commission on Banking and Finance under the Chairmanship of the Honourable Dana Porter, Chief Justice of Ontario. Mr. Rasminsky reaffirmed his earlier position, stated shortly after he became Governor, that control of monetary policy is a joint responsibility divided between the Bank and the government. In the event that the government disagrees with the monetary policy of the Bank, it has the right to direct the Bank as to the policy which the Bank is to carry out.

46. The Porter Commission Report made a number of observations, and some recommendations for change, regarding the status and organization of the Bank of Canada. The Porter Commission observed that there are good reasons for maintaining a measure of independence for the Bank of Canada from political pressures. Most importantly (citing former Governor of the Bank, Graham Towers), it insulates the central bank from "the historical tendency of governments of all forms to develop the habit of inflating the currency."[15]

47. The Porter Commission Report also stated that the Bank's independence can best be assured by a system of dual responsibility where the Bank of Canada formulates and carrys out day to day monetary policy while the government accepts full responsibility for the policy being followed, but not the actual execution of that policy. Most notably, it was recommended that the Bank of Canada Act be amended to provide the Minister of Finance with the authority, after cabinet consultation, to issue a directive to the Bank if the government disapproves of its policy. This recommendation was incorporated in the Bank of Canada Act by the 1967 amendments to the legislation.

48. The Coyne affair crystallized the issue of who ultimately bears responsibility for monetary policy. From 1936 to 1956 it had been firmly established that the government must accept responsibility for the Bank of Canada's policies. In the event that the Governor of the Bank felt that he could not carry out government policy, it was understood that he would have to resign. Statements in the House of Commons by Finance Minister Fleming and his predecessor, Walter Harris, contradicted this view, seeming to place the Bank of Canada outside the control of the government.[16] After the Coyne affair it became clear that the government cannot disclaim responsibility for the policies of the Bank of Canada. If the government disagrees with monetary policy it has the right to direct the Bank as to the policies it should follow. However, prior to 1967 there was no way, short of introducing legislation, to force the Bank to carry out the government's policies.

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[14] Canada, *Bank of Canada, Bank of Canada Annual Report 1961*, p. 3.

[15] Canada, *Report of the Royal Commission on Banking and Finance*, (Ottawa: Queen's Printer 1964), p. 541.

[16] Scott Gordon, *The Economists versus the Bank of Canada*, (Toronto: Ryerson Press, 1961), p.1-3.

[illegible] that it is essential that [illegible] monetary policy [illegible] the [illegible] the legislation [illegible] Bank [illegible] the responsibility for [illegible] the government [illegible] the monetary policy being carried out by the Bank in 1961-62 [illegible] the Governor [illegible] the policy which the Bank [illegible]

45. In January 1962 Governor Rasminsky appeared before the Royal Commission on Banking and Finance under the Chairmanship of the Honourable Dana Porter, Chief Justice of Ontario. Mr. Rasminsky affirmed [illegible] monetary policy [illegible] responsibility [illegible] between the Bank and the government. In the event that the government disagreed with the monetary policy of the Bank, it has the right to direct [illegible] as to the policy which the Bank is to carry out.

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[13] Canada, Bank of Canada, [illegible]

[14] Canada, Report of the Royal Commission on Banking and Finance (Ottawa: Queen's Printer, 1964), [illegible]

[15] Scott Gordon, The Economists versus the Bank of Canada (Toronto: Ryerson Press, 1961), [illegible]

CHAPTER II

The Bank of Canada's Mandate

A. PROPOSED REVISIONS TO THE MANDATE

49. As outlined in the previous chapter, the Bank of Canada performs a number of roles including that of banker to the Government of Canada, lender of last resort for chartered banks and leading umpire in the Canadian payments system. The Bank's most prominent function, however, is the formulation and conduct of monetary policy. With respect to this function, the preamble to the Bank of Canada Act enjoins the Bank:

> "to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada."

50. In the document *Canadian Federalism and Economic Union: Partnership for Prosperity*, released last September as part of the Government's proposals for a renewed federation, the Government has proposed that this rather broad and vague mandate be revised to make price stability the Bank's only goal. To quote from that document, a revised mandate should state that "in formulating and implementing monetary policy, the Bank of Canada is to guide the pace of monetary expansion and influence monetary and credit conditions with the objective of achieving and preserving stability in the general level of prices in Canada. The references to mitigating fluctuations in production, trade and employment and other objectives should be eliminated." (p. 39)

51. Price stability has been the overriding goal of monetary policy in Canada for several years now. Among many Canadians, this goal is closely identified with Bank of Canada Governor John Crow, who, more than any previous Governor of the Bank, has singled out price stability as the uppermost objective of monetary policy and pursued it with tenacity and vigour. But the goal itself is by no means new. It has been an explicit part of the Bank's mandate since the Bank was founded in 1935. During the Bank's early years, memories of the Great Depression and concerns about backsliding into deflation and recession shaped domestic monetary policy. With the emergence of inflationary pressures in the post-war period the Bank shifted focus, and the need for monetary policy to resist increases in the general level of prices has been a key concern of successive Bank Governors since the early 1950s. The following statement on the aims of monetary policy, from a January 1959 speech by James Coyne, can easily be introduced without change in any speech on the same topic by John Crow:

> There are three recognized major economic goals of modern states — economic growth, a high level of employment, and a stable value of the currency. A sound currency and price stability are not only of major importance in themselves but are essential to the maintenance over a long period of fruitful economic growth and a consistently high level of employment.

52. James Coyne is of course the Governor of the celebrated "Coyne affair". Many readers may argue therefore that he was uncommonly preoccupied about the ills of inflation. But the record will show that his successor, Louis Rasminsky, was no less firm in the view that a sound currency was central to a sound economy. In his opening statement before the Royal Commission on Banking and Finance, on January 9, 1963, he rejected the then-fashionable view that there is conflict between price stability and the other objectives of monetary policy: "For my part," he said, "I am convinced that, in its pursuit of good economic performance, public economic policy will be more successful over time if it pays regard to the advantages of stability in the value of money as a means of achieving such performance." We also have it on the testimony of Mitchell Sharp, federal Finance Minister between 1965-1968, that "Louis Rasminsky warned me and the public about the dangers of inflation," and was recommending tighter fiscal policies despite that fact that the government was operating in a surplus.(8:48) Incidentally, inflation during the 1960s averaged 2.7 % a year.

53. Naturally, as inflation mounted over the next two decades, the need to contain it grew more pressing and the focus on fighting inflation grew more intense. Here is Governor Gerald Bouey, John Crow's predecessor, speaking before the House of Commons Standing Committee on Finance, Trade and Economic Affairs, on October 30, 1980:

> "The idea that some inflation is on balance helpful to the performance of an economy, that inflation is benign—an idea that was never more than superficially plausible but was nevertheless quite popular—is now thoroughly discredited. What has discredited it so effectively is not economic theory but economic experience. The experience of the world economy and the widely varying experience of its national members have shown beyond reasonable question that inflation is malignant." (emphasis added)

54. Clearly, support for price stability within the Bank of Canada predates Governor Crow. At the same time, historically the sights of monetary policy have been set at a broader set of goals than price stability, pure and simple. As part of the panoply of public policy instruments, monetary policy was assumed to share the aims of public economic policy generally, usually defined to include sustained economic growth and high employment levels (i.e. a low rate of unemployment), in addition to price stability. It was to be used jointly with other economic policies, in varying combinations depending on economic conditions, to steer the economy along a desirable path. It was not viewed as having a role independent of that of other policies nor objectives that were different (though it did bear main burden for achieving price stability). In this light, the proposal that monetary policy henceforth be confined to the single aim of price stability appears as a sharp departure from the way that monetary policy has been viewed in the past. Many of our witnesses certainly so argued.

55. The Government for its part has framed its proposed revisions to the Bank's mandate as a clarification, rather than abandonment, of the traditional role of monetary policy embodied in that mandate. In the Government's view, the present mandate is too general and prone to misunderstandings about what monetary policy is actually capable of doing. As stated in the background paper on *The Canadian Federalism and Economic Union*, objectives related to real economic variables, such as employment, output, and economic growth, "represent objectives either that history has taught us a central bank cannot achieve or that can only be achieved through price stability." (p.39) In short, the case for revising the Bank's mandate along the lines proposed by the Government rests on the proposition that maintenance of price stability is the best contribution that monetary policy can make to the attainment of the broader objectives of economic policy. In our hearings, the Committee found broad acceptance of this proposition but little backing for the proposed revision to the mandate. The prevailing view, even among witnesses generally supportive of price stability and recent monetary policy, was that monetary policy must have a broader scope.

B. WHAT CAN MONETARY POLICY DO?

56. Monetary policy refers to the process of managing the supply of money and credit in order to achieve certain economic aims. While the process in its implementation may be involved and arcane, at bottom it amounts simply to the regulation of the rate of expansion of the stock of money in the economy. To inquire therefore about the effects of monetary policy is to ask what happens when the stock of money in the economy changes.

57. In answering that question, one must distinguish between the short run and the long run. Most analysts believe that, in the long run, changes in the money supply affect only prices. Real magnitudes—the volume of output, the level of employment, relative prices—are determined by the non-monetary features of the economy: the economy's resource endowment, the nature of technology, the skills and attitudes of the population, the institutional framework, the legal and constitutional order. Money, as the medium of exchange and standard of value, allows the economy to function much more smoothly and efficiently of course than would a non-monetary economy, which would have to contend with the inconvenience and uncertainty of barter. But it is the existence and not the amount of money that is crucial. If it were otherwise, nations could easily increase their wealth by adding zeros to their currency notes. The proposition that money has no real effects in the long run is one of the oldest and best established in the history of economic thought. Few economists take issue with it today.

58. Money does matter however in the short run—a run, it is important to note, which may last for several years. Very briefly, money matters in the short run because prices and wages are sticky: they do not adjust instantaneously and with infinite speed to changes in demand. The process of changing prices entails costs, including costs of decision-making, printing new price lists and advertising. Often, prices are set many months in advance, as in the case of catalogue sales. Wages are even more sticky. By convention or contract, they are set for fixed periods, often extending into two, three or more years. In these circumstances, changes in demand make themselves felt first on real magnitudes and only later on prices. Over time, the impact on quantities diminishes and the impact of the demand change is absorbed by prices. The full adjustment can take a long time, depending on how quickly information about the demand change is disseminated throughout the economy and how flexible prices are.

59. It follows from the foregoing that monetary policy can have real effects. A stimulative monetary action, for instance, will tend to quicken the pace of economic activity and drive unemployment down for a time, until prices rise sufficiently to dissipate the real effect of the stimulus. A contractionary action will have the opposite effect, slowing down output and lowering employment until prices fall sufficiently to restore the original equilibrium.

60. Can monetary policy maintain the economy indefinitely at higher levels of output and employment through continuous injections of stimulus? Many economists thought so in the late 1950s and 1960s. The notion was even vested with a name, the Phillips curve trade-off, named after the New Zealand economist A. W. Phillips who first formally proposed it. As subsequently popularized, the Phillips curve summarizes the relationship between unemployment and inflation. Greater stimulus, and hence higher inflation, yields lower unemployment; less stimulus results in lower inflation, but is associated with more unemployment. There is in other words a trade-off between inflation and unemployment, less of one being purchased at the cost of more of the other. The trade-off was assumed to be permanent, providing policy-makers with a set menu of unemployment-inflation pairs from which to choose according to their preferences or in order to maximize social welfare.

61. Most economists no longer believe that there is a permanent trade-off between inflation and unemployment. As with the impact of a one-time stimulative action, the expansionary effects of inflation (which can be thought of as a continuous series of stimulative actions) result from the sluggish

response of prices to demand changes. They are reversed as soon as market participants incorporate inflation into their expectations and adjust to the rising prices. The only way for the monetary stimulus to retain its real effects would be to have the economy inflating faster than expectations. Such a process is of course unsustainable, for it would quickly degenerate into hyperinflation and monetary collapse.

62. It follows that monetary policy cannot jolt the economy into higher levels of output, growth or employment on a permanent basis. A policy geared to such aims would almost certainly be counter-productive, for it would end up generating inflation only, without any improvements in output, employment or other real magnitudes. In the long run, according to most economists, monetary policy can determine price levels only: its long-run targets therefore can only be price-level targets.

63. Price-level targets must of course be viewed as averages over time. Monetary policy cannot peg prices to a specific level and keep them there without change. Nor should it try to do so. The economy is subject to random disturbances that can cause significant deviations in prices from their long-term trend. Attempts to offset these disturbances so as to maintain the price level trend constant from month to month or from quarter to quarter would lead to undesirable fluctuations in the real economy.

64. As long as the price-level targets are viewed as objectives to be attained on average over a suitably long period of time, they do not prevent the use of monetary policy to deal with economic shocks or disturbances, such as a sharp increase in energy prices or a stock market crash. Indeed, the existence of credible price-level targets enhances the effectiveness of monetary policy in such circumstances. In the absence of price targets, any one-time increase in monetary growth to deal with an unanticipated event may be interpreted as a change in the direction of monetary policy and cause market expectations of inflation to increase. If monetary growth were then to revert to its previous trend, economic activity would decline and employment would suffer. Phrased differently, in a regime of volatile expectations, every shock to the economy forces monetary authorities to choose between a) accommodating the shock and launching the economy on to a higher inflation spiral or b) standing firm and seeing the economy suffer. Credible price-level targets give monetary authorities more room to manoeuvre.

65. Price-level targets are also not inconsistent in principle with the use of monetary policy for more activist stabilization purposes. Such targets impose restrictions on the average rate of monetary growth over time. The actual rate of monetary expansion within any one time period can be varied to mitigate fluctuations in the general level of production, employment and trade, as the current Bank of Canada mandate enjoins the Bank to do. When the economy is slowing down or slides into recession, stimulative monetary actions can expedite a recovery. When the economy is booming and its productive capacity is stretched, monetary restraint can moderate the expansion. In theory, judicious application of such countercyclical measures can stabilize economic activity and enhance the economy's overall performance.

66. The efficacy of such fine-tuning in practice, however, is very much in doubt. This is not a commentary on the intelligence of policy-makers but on the formidability of the task relative to the instruments available. The only policy instrument the Bank of Canada directly controls is the size of its own balance sheet. By raising or lowering its liabilities, the Bank affects the liquid reserves available to the banking system and hence the willingness of financial institutions to extend credit. The change in the supply of credit, in conjunction with the demand for it, influences interest rates and the expansion of money. These in turn affect people's decisions to invest and spend, which determine output and prices. Thus, there are many steps between the initial monetary action and its ultimate effect. The relationship between each step can vary depending on economic conditions and people's perceptions about the nature of the policy involved. Monetary actions therefore affect the economy with long and

variable lags. Since we cannot predict with any accuracy either the length of these lags or the state of the economy months or years hence, the likelihood of monetary actions being badly timed—and therefore destabilizing — is considerable. Certainly our experience on this score is not at all reassuring: the policies followed by monetary authorities during most of the postwar period have on balance yielded procyclical money stock changes, that is, they have tended to exacerbate economic fluctuations. [17]

67. Discretionary policies have also proven to be inflationary. In retrospect, the explanation for this effect is easy enough to fathom. The potency of monetary policy in the short run provides a constant temptation for policymakers with discretion to inflate monetary growth in order to stimulate economic growth and lower unemployment, even though in the end, once the public catches on to these policies, inflation may be their only consequence. As Doug Purvis, of the Department of Economics at Queen's, testified before us: "monetary history in Canada and in most other western industrialized countries suggests that the imperfect science of determining monetary policy has repeatedly given way to political pressures to pursue short-term gain in return for long-term pain; that is, to adopt expansionary policy to attain employment and growth objectives that turn out to be very temporary in nature but that nevertheless give rise to permanent inflation." (7:55) Commitment to a price-level goal can provide an anchor to help offset the tendency of discretionary policies to generate inflation.

68. To conclude this section, monetary policy has real effects in the short run but may affect only prices in the long run. Establishing a long run price-level objective does not preclude the use of monetary policy for stabilization purposes—although other considerations caution against activist use of monetary policy for such purposes. Indeed, a credible commitment to a price-level objective can incease the effectiveness of monetary policy in pursuit of stabilization aims. It also helps offset the inherent inflationary bias of discretionary policies. To appreciate the advantages of this last effect one must appreciate the costs imposed by inflation, a subject to which we now turn.

C. THE COSTS OF INFLATION

"The process [of inflation]," Keynes wrote, "engages all the hidden forces of economic law on the side of destruction, and does so in a manner that not one man in a million is able to diagnose."[18] The process is destructive for two basic reasons: it undermines the capacity of the price system to perform its crucial function of allocating resources efficiently and it promotes social strife.

69. In a market economy, prices play a vital coordinating role, providing producers and consumers with signals respecting opportunities for profit and offers of good value. Inflation hinders this coordinating role by reducing the information content of prices. When the general price level is stable, a change in the price of an individual commodity denotes a change in the value of that commodity relative to other commodities. An increase in the price of commodity X would induce producers to increase the output of that commodity and encourage consumers to seek cheaper substitutes for it. In times of inflation, it is not immediately clear to what extent a price rise represents a relative price change, which calls for a behavioural response, and to what extent it reflects merely an increase in the general price level, which would require no change in behaviour.

70. The distinction between the two is difficult because inflation does not affect all prices simultaneously. Depending on how the inflationary pressure is introduced into the economy and on the pricing practices of different sectors, some prices rise first followed by others, in a staggered

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[17] See, Peter Howitt, *Constitutional Reform and the Bank of Canada*, Paper presented to a conference on Economic Dimensions of Constitutional Reform, Queen's University, 4-6 June 1991, p. 4.

[18] John Maynard Keynes, *Essays in Persuasion* (London: Macmillan and Co. Ltd., 1933), p. 78.

pattern difficult to decipher or interpret. In these circumstances, buyers and sellers find themselves unable to distinguish between relative price changes and price changes that are merely part of the inflationary process. Worthwhile adjustments in production and purchases are not made and wrong turns are taken, leading to missed opportunities and wasted resources.

71. Even more serious than the contemporaneous confusion between relative and absolute prices is the uncertainty that inflation creates over the future level of prices. Money, in addition to being a medium of exchange, also serves of course as a standard of value for determining deferred payments and evaluating future transactions. Clearly, the more variable the standard, the less valuable it is. In a world of fiat money with no binding commitment by the monetary authorities to price stability, the standard becomes meaningless. Monetary authorities are free to change the stock of money, and hence the price level, as they see fit from one period to the next. There is no rational way to forecast future price levels in such a system. The increased uncertainty attached to future outcomes increases the risk premium on long-term financing and discourages investments, with adverse effects on capital formation and economic growth.

72. The interaction of the tax system with higher prices compounds the disruptive effects of inflation. While attempts have been made since 1973 to adapt the tax system to price changes, indexation has proven too costly to accomplish fully. Thus today, interest costs are fully deductible from business income even though only part of the interest payments represent the cost of borrowing, the rest being comprised of the reduction of the real value of the principal through inflation (and therefore representing in effect repayment of principal); only 75% of realised capital gains are included in taxable income, but there is no adjustment for the fact that in inflationary periods a large part of those gains—the full amount, possibly—is the result of price changes only; under the first-in, first-out accounting method, the cost of inventories is understated, increasing the recorded profits of firms and hence their tax liabilities; similarly, with historical cost accounting, allowable deductions for depreciation understate the true depreciation expense. The overall effect of these distortions on the tax liabilities of the business sector is hard to determine, since in some cases the effect is positive and in other cases negative. But the aggregate effect is less important for economic outcomes than the effect within sectors. As Peter Howitt has argued,

> "nonindexation of the tax system matters because it allows inflation to to distort the relative rates of taxation across different classes of investments and different industries. In particular, inflation raises the relative cost of investing in inventories and lowers the cost of investing in nondepreciable capital. It also tends to favour investment in industries, such as utilities, that rely heavily on debt financing . . .
>
> "The distortion of the structure of taxation in turn distorts the allocation of investment. Through this effect, a [higher inflation rate] reduces the efficiency of the economy and the overall productivity of capital. Also, the deductibility of all nominal interest, including the inflation compensation, which does not represent a real cost, encourages firms to engage in debt financing, which, in turn, tends to make the degree of leverage of the corporate sector an increasing function of the [inflation rate]."[19]

73. Additional costs arise from the efforts people make to protect themselves against the effects of inflation. In an environment where hedging against unpredictable price level changes may be more important to a firm's ultimate success or failure than improvements in the firm's product or method of delivery, resources will be diverted from the latter to the former. The ability to hedge against inflation becomes more important to the survival of business than efficiency and competition in the production

[19] Peter Howitt, "Zero Inflation as a Long-Term Target for Monetary Policy," in Richard Lipsey, ed., *Zero Inflation: The Goal of Price Stability* (Toronto: C.D. Howe Institute, 1990), p. 95.

of goods and services. "The rules of the economy's natural selection of individuals for fame and fortune change: finance people are favoured over marketing people, lawyers over product designers, accountants over production managers. People, especially ambitious people, will reallocate their efforts and ingenuity accordingly."[20] The frenzied pace of financial innovation and rampant speculation in real estate (widely viewed as a hedge against inflation) over the past two decades are not unrelated to the unprecedented inflationary experience of that period.

74. Beyond its economic costs, inflation may also generate serious social strife. This result arises from the arbitrary distributive effects that inflation has on income and wealth. Unanticipated price increases confer windfall gains on debtors at the expense of creditors, on landlords at the expense of renters, on the young at the expense of the old. The sense of unfairness thereby engendered is not diminished by the fact that often the same individual may gain as well as lose, and that losses and gains in the aggregate cancel out. One is likely to view his own gains as deserved while inveighing against the losses as being out of his control. And even those who recognize both outcomes as equally unwarranted are unlikely to feel reassured by the system that brings such results about. In these circumstances, demands on governments to intervene on behalf of particular interests or groups are likely to rise. Political intervention, however, can only mitigate the degree to which some groups win and others lose; it cannot undo completely the distributive effects. Public indignation with private markets, therefore, cannot find complete release through political markets. If disenchantment afflicts one sphere it will also infect the other, with the type of disruptive results for social peace of which Keynes cautioned.

D. THE COSTS OF DISINFLATION

75. The main source of opposition to the goal of price stability is not the goal itself but the anticipated costs of getting there. Even supporters of the goal concede that the transition from positive to zero inflation will be costly, but conclude that the permanent benefits of price stability exceed the transitional costs of getting there. Opponents of price stability reach the opposite conclusion.

76. The costs of disinflation arise from two main sources, the entrenchment of inflationary expectations in the minds of market participants and the sluggish response of costs and prices to changes in demand conditions. Entrenched expectations and sticky prices lend inflation a strong inertia, making it difficult to slow down or bring to a halt without collateral damages to the economy. To illustrate, consider an economy that has been inflating at a rate of about 5% for a number of years. Market participants will have come to expect that prices will continue rising at this pace into the future and will set their wage and price contracts accordingly. Assume now that monetary expansion tightens and it no longer accommodates this expected inflation rate. Costs and prices do not respond immediately, but instead continue to rise at their predetermined rates for as long as the periods of the fixed contracts. Since aggregate demand no longer rises sufficiently to clear markets at these prices, sales—and hence output and employment—decline.

77. In theory, disinflation may be possible without cost. The requirements for this happy result are flexible prices and a credible disinflation policy. If the policy is believed, then expectations will adjust to conform with it; and if prices are flexible, they will be adjusted to conform with the new expectations and hence with the new demand conditions. The reduction in the rate of monetary expansion, then, will be reflected in a correspondingly lower increase in prices, with real magnitudes remaining unchanged.

[20] Axel Leijonhufvud, "Constitutional Constraints on the Monetary Powers of Government," in Richard B. McKenzie, ed. *Constitutional Economics: Containing the Economic Powers of Government* (Lexington, Massachusetts: D.C. Heath and Company, 1984) p. 98.

78. Experience on this score, unfortunately, is not that reassuring. Policy credibility cannot be had in practice through a simple pronnouncement by the central bank of a change in policy direction. To be convinced, markets normally need to be shown that the bank is sufficiently determined to stay the announced course. Expectations therefore only adjust after the policy begins to show results, thereby making an economic slowdown inevitable. In addition, prices are sticky. This is particularly true of wages, given the existence of multi-year wage contracts. Thus wages, and hence production costs, are very slow to adjust to changes in the inflation trend. Consequently, when monetary expansion decelerates making it impossible for cost increases to be passed on to consumers, profits suffer and output and employment decline. Experience suggests that these unhappy outcomes are almost unavoidable side-effects of disinflation. In both Canada and the U.S. over the past four decades, periods of significant disinflation have always been associated with recession.

79. Supporters of price stability view the costs of disinflation as temporary. The benefits of lower inflation on the other hand are assumed to last indefinitely. Calculations made on this basis show that the present value of the benefits of lower inflation outweigh by a large factor even the largest estimates of the costs of disinflation. [21]

80. Opponents of an exclusive focus on price stability are much less sanguine about these cost/benefit calculations. They view the costs of disinflation not as transitional but permanent, or at least lasting a very long time. Put very simply, their argument is that there is no unique "natural" unemployment rate to which the economy gravitates following a shock or disturbance. Unemployment once created tends to persist, which means that the "natural" unemployment rate is largely determined by the actual rate. An implication of this view is that the unemployment resulting from the drive to price stability will be, at least in large measure, permanent. [22]

81. The possibility of persistence effects, or *hysteresis* in the current economic jargon, suggests that disinflation policies be proceeded with gradually—to minimize increases in economic slack and unemployment rates—and be complemented with structural policies that promote the efficiency of markets—and thereby increase the speed with which the economy adjusts to any disturbance. It does not imply, as some do argue, that authorities give up on disinflation policies. To do so would amount to establishing a floor below inflation, whatever its rate happens to be at any point in time. Any price shock that raised that rate would automatically raise that floor as well. It does not take much concentration to realise the adverse effects of such a policy on the economy's performance. Inflationary expectations would always exceed the actual rate of inflation, forcing upon monetary authorities the dilemma of choosing between a) accommodation of the expectations, which would lead to an inflationary spiral, and b) resistance, which would leave the economy operating permanently below capacity.

E. WHAT IS AN APPROPRIATE MANDATE FOR THE BANK OF CANADA?

82. Price stability has been a key objective of economic policy in Canada throughout the past half-century or so, which is to say throughout the period when governments in Canada have assumed an obligation for regulating the macroeconomic behaviour of the economy. From what we have said in

[21] Howitt, for example, estimates the costs of reducing inflation by one percentage point at 4.7% of GDP and the gains at 125% of GDP, or 27 times greater. See Howitt, (1990), pp. 105-106. For a more recent study yielding an even higher benefit/cost ratio, see Barry Cozier and Gordon Wilkinson, *Some Evidence on Hysteresis and the Costs of Disinflation in Canada*, Technical Report No. 55 (Ottawa: Bank of Canada, August 1991)

[22] For a recent exposition of this view and its policy implications for disinflation, see Pierre Fortin, "The Phillips curve, macroeconomic policy, and the welfare of Canadians", *Canadian Journal of Economics*, XXIV: 4 (November 1991) pp. 774-803.

this report thus far, it should be clear as well that it is an objective we endorse. Moreover, given the Bank of Canada's overall responsibility for domestic monetary policy—which is to say for the rate of expansion of the money supply and, hence, the rate of inflation—it also follows that responsibility for the attainment and maintenance of price stability ought to reside primarily with the Bank of Canada.

83. A favourable view of price stability as a policy aim, however, does not imply that price stability ought to be the only concern of monetary policy or to be singled out as the only aim of the Bank of Canada. Support for such a revision to the Bank's existing mandate was weak and limited even among witnesses who were very supportive of price stability in general and of the Bank's current approach for getting there in particular.

84. As already alluded to, the key reason advanced by the Government for the proposed revision is that the achievement and maintenence of price stability is the best contribution that monetary policy can make to the promotion of the broader aims of economic policy. The Bank of Canada has strongly endorsed this view. The following statement from the memorandum submitted by the Bank to the Committee concisely sets out the argument:

> ". . . money has an absolutely essential function [in the economy]. It is the mediun that links buyers and sellers, savers and investors, lenders and borrowers in all markets in all parts of the country. If our economy is to work well, the money that we use needs to retain the confidence of Canadians that is can perform that function.
>
> "The Bank of Canada has sought to explain that only when money holds its value will it retain confidence. It follows that the underlying basis of monetary policy should be to achieve a rate of monetary expansion that preserves the value of money. In other words, monetary policy should be directed at ensuring that the value of money is not eroded by persistent price rises. Theory and experience have taught us that increases in employment and output cannot be sustained by running an inflationary policy. In fact, since an inflationary policy damages the ability of money to play its crucial role in a monetary economy such as ours, it will worsen economic performance." (p. 8)

85. One can support every point made in this statement and still oppose narrowing the Bank's mandate to the single goal of price stability. Indeed, that was the case with most of the witnesses appearing before us. Some witnesses opposed the proposed revision to the mandate because they oppose the aim of price stability itself, deeming it too costly to attain or inconsistent with other desirable objectives (a fixed exchange rate for example). This was not the majority view, however. Most witnesses agreed with the proposition that in the long-run the rate of monetary expansion determines principally the rate of inflation, with no sustainable effects on output growth, employment or other real variables. And they accepted as a corollary instruction that monetary policy should aim for a rate of monetary expansion that delivers price stability over time. Nevertheless, with few exceptions, they opposed making this aim the exclusive focus of monetary policy or, more precisely, they opposed legislating this aim as the exclusive focus of monetary policy. We summarise their arguments below:

— The proposed revision is unnecessary. This is confirmed first of all by the fact that the Bank of Canada is already pursuing a very firm anti-inflation policy under its existing mandate. Evidently, we do not need to revise the Bank's mandate in order to pursue price stability. Furthermore, international experience suggests that narrowing the Bank's mandate is not necessary for that policy to succeed. That experience indicates that a central bank's independence from government is a more significant factor in the maintenance of low inflation than is the bank's policy mandate.

— The proposed change may have adverse consequences for fiscal policy. If monetary policy were assigned the sole objective of stabilizing the general price level, fiscal authorities at all levels of government would soon interpret this as a licence to shun any responsibility for inflation control. This would lead in turn to distinctly worse macroeconomic outcomes.

— Controlling inflation is not the only legitimate goal of monetary policy. It may be so today, given the current economic conditions and state of economic knowledge, but in the past there have been others. In the 1950s, for example, maintaining low interest rates for the purpose of debt management was an important goal; in the 1960s, maintaining a fixed exchange rate with respect to the U.S. dollar was the overriding objective. Similar or other objectives may loom desirable in the future. We should not, through legislation, set monetary policy on a rigid path that is contingent on specific preferences, economic conditions and knowledge, all of which are subject to change.

— The timing is wrong. There is no consensus in the country for the proposed revision at this point. Enacting it, therefore, would tend to undermine, rather than enhance, the legitimacy of the central bank. Also, given the wide range of divisive issues on the current constitutional agenda, pressing forward with this proposal will compound the already very high level of political friction in the country and divert efforts from the fundamental constitutional issues that have to be addressed.

— Monetary policy has powerful effects on the real economy in the short-run, and the Bank ought not to be absolved of responsibility for these effects.

86. A second argument we heard for narrowing the Bank's mandate to the single goal of price stability is that this would improve the Bank's accountability. The essence of this argument is that accountability entails a clear specification of attainable objectives against which the Bank's performance can be measured. The current mandate does not meet this test, so the argument goes, being both too vague and too broad in relation to what monetary policy can reasonably be expected to achieve. David Laidler has framed this argument most forcefully: "the vagueness of the Bank's mandate as currently set out, its concentration on multiple (and perhaps sometimes inconsistent) goals, to say nothing of the obsolescence of the economic understanding which underlies it, all make it difficult to ensure that the Bank is held accountable for its actions. If Parliament is unclear about what it expects from the Bank, it is bound to find it difficult to decide whether, in any particular instance, the Bank has failed to fulfill its designated task."[23]

87. The import of this argument is that the Bank's present mandate, standing alone, is not sufficiently precise to enable a fair evaluation of the Bank's performance. It does not make out a case for a mandate narrowly focused on price stability. As we propose below, the Bank's mandate can be supplemented with a process of reporting that will clarify the objectives of the Bank over any time frame relevant to an assessment of the Bank's performance.

88. The problem with a mandate narrowly focused on price stability is that it would tend to enhance the Bank's accountability by reducing unduly the Bank's area of responsibility. Price stability, after all, is largely a means to promoting the overall economic well-being of the nation. At the extreme, a single-minded pursuit of price stability without regard to this ultimate objective could be exceedingly costly and counter-productive. The Bank and the Government acknowledge that monetary policy, though powerless by itself to lower unemployment or increase real output in the long run, does have significant real effects in the short-run. In its conduct of monetary policy, the Bank ought to take these effects into account—i.e. it ought to be accountable for them.

[23] David E.W. Laidler, *How Shall We Govern the Governor? A Critique of the Governance of the Bank of Canada* (Toronto: C.D. Howe Institute, 1991), p. 10.

89. It has been suggested that establishing price stability as the clear, long-term objective of monetary policy would help the Bank resist narrowly-motivated pressures for stimulative actions, which result in higher inflation down the road. As David Slater points out in a submission to the Committee: "History is full of examples of 'clipping the coinage', paying government bills with newly printed money, and borrowing by governments from central banks and the banking systems. In a crunch, a central bank cannot refuse to lend to the national government that is its master no matter what the act says. When governments find themselves with large debt burdens, as Canada does today, the temptation to lighten those burdens by inflation are almost irresistable." (7A:14) In addition to delivering lower inflation then, a mandate strongly focused on price stability may also have the serendipitous effect of bringing about better fiscal policies, by forcing governments to face up to the costs of their spending decisions rather than hide those costs through resort to the invisible inflation tax.

90. On the other hand, we also heard concerns that an accountability regime narrowly focused on price stability, to the exclusion of other aims, would tend to tilt the Bank's incentives too far towards a ruthlessly rigid anti-inflation policy. This concern was expressed most strongly by T.K. Rymes in his submission to the Committee: "If the Bank is charged only with price stability, then it can properly turn a deaf ear to those who counsel some concern about the real effects of its rigid adherence to price stability and price stability only. If price stability and price stability only were written into the Bank of Canada Act, then [complaints] from the electorate and its elected representatives about the real variables which govern our economic lives will be shrugged off with the argument that monetary policy is not responsible for such matters."[24] While we do not necessarily consider such conduct from the Bank as likely, it is a logical inference that may be drawn from an excessively narrow mandate.

91. In its memorandum to the Committee, the Bank points out that among policy makers in the major countries there is broad agreement on price stability as the appropriate objective of monetary policy. It is surely not without significance, however, that despite this consensus no central bank of any major country operates under a mandate confined to price stability. The proposed European System of Central Banks (ESCB) probably comes closest, and the Bank of Canada memorandum does cite it as an example of the new thinking internationally on the proper role of central banks. The draft statute of the ESCB states that:

> "The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the realization of the objectives of the Community."

92. Two points about this mandate deserve being emphasized. One, price stability is proposed as the primary, but not the only, objective of the ESCB. And two, the ESCB would be expected to support the general economic policies of the Community and contribute to the Community's over-all objectives. In other words, the ESCB is viewed as part of the broader structure of public policy instruments of the European Community and its policies would have to be coordinated with those of these other instruments. This arrangement appears to us closer to the framework within which monetary policy has traditionally operated in Canada than the uni-dimensional framework implied by the proposed revisions to the existing mandate.

93. A mandate narrowly focused on price stability would in our view be selling money and monetary policy short. It does not reflect the power of money to influence the economy and does not recognize the complex nature of monetary policy. The reason money has been studied so much and

[24] T.K. Rymes, "Entrenching Monetary Rules in the Constitution: Economic and Political Criticisms", presentation to the Sub-committee on the Bank of Canada of the House of Commons Standing Committee on Finance, December 9, 1991, pp. 21-2.

monetary policy creates so much controversy is because money matters and monetary policy has consequences—not just for inflation but for the real economy as well. A commitment to sound money is a prerequisite for the sound performance of an economy based on money. But the responsibility of monetary policy does not end there. Monetary policy has the capacity to influence economic activity in the short run and cannot thererefore be exempt of responsibility for helping cushion economic disturbances and shocks. Also, to repeat a point already made, how price stability is attained and maintained has implications for real economic activity that cannot be ignored. The quicker the path to price stability and the more rigid the policy of pegging it there in the face of price shocks, the more adverse will be the effects on output and employment. Trade-offs in this context are inevitable, and the need for judgement cannot be escaped. The analogy to a delicate balancing act drawn by Michael Parkin before the Committee is very apt: "monetary policy has to walk a tightrope. It's a tightrope on one side of which is unemployment, on the other side of which is accelerating inflation. The central bank, though not a circus actor, is a tight rope walker. It's a blind tightrope walker, furthermore. It's blind in the sense that it can't see where it's going. It's also walking a tightrope that is moving around quite a bit. The winds that blow it keep changing and it's subject to a great deal of uncertainty. But that is the nature of the business." (2:8)

94. We are not saying anything here of course that the Government and the Bank of Canada do not already know. The discussion paper *Canadian Federalism and Economic Union* explicitly recognizes that the "speed by which [price stability] is achieved will be important in shaping economic activity" and cautions that "monetary policy should be conducted with due cognizance of the path to price stability that best contributes to other Canadian economic objecives." (p.39) The Bank of Canada, in its memorandum to the Committee and in the testimony of John Crow appearing before us, has taken a similar position. The irony is that the proposed revisions to the Bank's mandate, made in part in order to clarify the the Bank's responsibilities, would be misleading in this regard, leaving the mistaken impression that monetary policy would no longer require judgement and the Bank could be turned into a computer appropriately programmed.[25]

95. As the agency responsible for the management of the national currency, the Bank of Canada must inevitably be concerned about its value. Maintaining the value of the currency—i.e. price stability—must be a central goal of the Bank. The current mandate of the Bank explicitly recognizes this goal. It identifies other goals for the Bank as well. This makes it difficult to extract the policy aims of the Bank at any one time from a reading of the mandate alone. But it also has the virtue of flexibility, allowing the Bank to shift its policy focus as conditions, knowledge and priorities change. And it provides a constant reminder to the Bank that, in the pursuit of price stability, it must not ignore other objectives of public policy over which its actions can have an influence.

96. Clarity of policy aims and accountability for achieving them do not require a narrowly focused mandate. They can be accomplished through a process requiring regular reports to Parliament by the Bank on the specific targets of monetary policy and plans for achieving them, along the lines suggested in *Canadian Federalism and Economic Union: Partnership for Prosperity*.

[25] For example, see testimony of Douglas Peters before the Committee, 2 December 1991, *Proceedings and Evidence* Issue No.3, p. 26.

The Committee therefore recommends that:

Recommendation 1

The present mandate of the Bank of Canada, as set out in the preamble to the *Bank of Canada Act*, remain unchanged.

Recommendation 2

***The Bank of Canada Act* be amended to require that the Bank of Canada report to Parliament each year on current and anticipated economic conditions and on the intended course of monetary policy over the short and medium term, in light of those conditions. One of these reports would be tabled in Parliament in conjunction with or following the tabling of the Governor's annual report to the Minister of Finance, in March of each year. A follow-up report would be tabled in the fall. These reports would be automatically referred to a designated committee of Parliament, which could invite the Governor to appear before it and defend the Bank's reports.**

The Committee therefore recommends that:

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CHAPTER III

Governance of the Bank of Canada

97. In his pamphlet for the C.D. Howe Institute, Prof. David Laidler outlines some possible guidelines for a revised system of governance for the Bank of Canada.[26] That document has become the focus of attention for an update of the institutional and legislative structure under which the Bank operates. While the mandate of this Committee is to examine the recent Constitutional proposals of the federal government as they relate to the Bank of Canada, the C.D. Howe pamphlet has overtaken the government proposals as the point of departure for much of what the Committee heard.

98. This pamphlet makes the case for a revision of the Bank of Canada's mandate, instructing the Bank to maintain medium-term price stability. And in addition, it recommends that changes be made regarding the governance of the Bank. In particular it outlines several areas in which that governance is currently deficient, namely in the areas of independence/accountability and legitimacy.

THE ISSUES

1. Accountability

99. Accountability concerns the extent to which individuals or organizations are answerable for their actions. Organizations build into their constitutions such a chain of responsibility and central banks are no different. But to whom should the Governor of the Bank of Canada give account, and what should be the manner in which he is held accountable?

100. It is generally felt that the major public institutions of the nation should be part of the democratic process or accountable to that process. At issue is how that accountability takes place, what happens when it is apparent that performance is not satisfactory, and how might this process affect bureaucratic behaviour. In the case of monetary policy there is a trade-off, perceived if not actual, between the desire for accountability and the argument that central bank independence is needed for the proper conduct of that policy.

101. The most important aftermath of the "Coyne Affair" is today's explicit recognition that monetary policy is ultimately the responsibility of the federal government. The day-to-day operation of monetary policy rests with the executive of the Bank of Canada. Its conduct takes place within an environment of co-operation and consultation with the Minister of Finance.

102. Should there ever be a profound disagreement between the Bank and the federal government, the Minister of Finance, with the consent of the Cabinet, can issue a directive to the Governor which details the policy to be followed. It is this power which makes monetary policy ultimately subservient to the wishes of the federal government.

[26] David E.W. Laidler, May (1991) *op. cit.*

103. In the event that such a directive is ever issued, it is likely that the Governor would resign; after all, if he could live with the government's directive, there would be no need to issue it in the first place. And several witnesses have pointed out that such a resignation could trigger serious, adverse consequences in Canadian financial and foreign exchange markets. As such, the directive power has been compared by some to a weapon of such destructive power that it is in fact impotent because no one would contemplate using it.

104. The consequences of a directive, however, depend upon its nature. As long as participants in the economy are aware of the broad thrust of existing monetary policy and are fully apprised of the bearing of any directive, they can judge its appropriateness. If a directive represents a turn for the worse, it would likely have negative consequences. If it represents a turn for the better, it would likely not.

105. In this respect, the power of directive represents a potent weapon, one which can and should be used in the appropriate circumstances. It confers upon the federal government the power to ultimately determine the course of monetary policy. At the same time, these institutional arrangements allow the Bank of Canada to conduct monetary policy as it sees fit on a day to day basis and to use its expertise to develop medium and long-term policy. Should there be a disagreement between the two arms, the policy debate leading up to a directive, and the publicity that would accompany it will enable the market to pass appropriate judgement.

106. The directive represents only one aspect of the chain of accountability, albeit a most dramatic one. But there are other, more informal, avenues by which the Governor of the Bank must answer for his actions. These include his regular contact with the Bank's Board of Directors and the consultation with the Minister of Finance. And his term of office is renewable, requiring nomination by the Board and approval by the federal government.

2. Legitimacy

107. Legitimacy can be thought of as a somewhat different concept, independent of accountability. It deals with the manner in which monetary policy and its implementation are decided upon, and whether Canadians see that process as representative of their wishes and aspirations, or at least in their best interest.

108. The matter of legitimacy, as it applies to the Bank of Canada, refers to the feeling that this institution has little support among Canadians for its actions. In part, this represents a complaint about the stance of monetary policy, but in part it also represents a complaint about the way that policy is determined. Even supporters of current monetary policy question this process.

109. The questioning of the Bank's legitimacy stems from the feeling that policy is determined by a very small group of individuals who are unresponsive to the wishes and needs of Canadians, and that no sufficiently powerful body stands competent to oversee these decisions. There is of course policy debate within the Bank, but it takes place within a hierarchical structure where participants are subordinates of the Governor. Such debate is quite different than that which would take place in a forum of equals. Compounding this is the accusation that the actions of the Bank inadequately take into account the diversity of economic conditions in the various regions of Canada.

3. Independence and Inflation

110. According to Robin Bade and Michael Parkin, current research suggests that monetary policies will differ "... depending on whether the policy making agent is a discretionary democratically-elected relatively short-lived government or rule-governed, autonomous and relatively

long-lived central bank for which reputation is an important consideration."[27] More specifically, this research is suggesting that countries with independent central banks enjoy lower rates of inflation, other things being equal, than do countries where monetary policy is more directly controlled by fiscal authorities. It also suggests that independence with commitment to a price stability mandate may be preferable to independence with discretion.

111. Although it is a commonly held principle that modern political institutions should be directly and clearly accountable to the democratic process, it is also recognized that democratic institutions can fail to act as they should. Methods of restraining government are not uncommon. There is also a great deal of evidence to suggest that the direct control over monetary policy by governing institutions does not result in monetary policy conducted in the best interests of the populace.

112. It is now widely believed that changes in the pace of monetary expansion lead ultimately to changes in the pace of inflation. This occurs only after some time, a period which is generally long and unpredictable. Immediate effects of monetary expansion, however, often manifest themselves in real-side effects.

113. There exists a tendency, then, for the political abuse of monetary policy as a consequence of the short-term beneficial effects of monetary expansion, coupled with a political cycle whose duration is short when contrasted with the lengthy process required for monetary policy to fully impart its effects on the price level. Furthermore, money creation can also be used as an alternative to taxation or borrowing from the public, and as such represents a means of financing fiscal initiatives.

114. This, in short, is the rationale for the independence of monetary authorities. To quote Professor Howitt:

> "It appears that the more control a government is able to exert over the choice and conduct of the officials of the central bank, the more is the long-run objective of low inflation subjected to the dictates of either government fiscal needs or the political expediency of exploiting a short-run tradeoff between inflation and unemployment."[28]

115. Several studies have attempted to put to the test this notion that central banks which are not independent of governments tend to have an inflationary bias to their policies. As a general rule, they have concluded that a statistical relation exists between these variables and that it cannot lead one to reject the hypothesis outlined above. [29]

116. While independence appears to have the advantage of greater stability of prices, it also appears to have the advantage of less variability. From the latter part of the 1970s to the middle 1980s, central governments in the United States, United Kingdom and Germany have moved from the left side of the political spectrum to the right side. The change in monetary policy, reflected in the change in the rate of inflation, was directly related to the degree of bank independence. Where the monetary

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[27] R. Bade and M. Parkin, *Central Bank Laws and Monetary Policy*, Department of Economics, University of Western Ontario, London, Ont. October 1988, p. 3.

[28] Peter Howitt, *Constitutional Reform and the Bank of Canada*, Paper presented to a conference on Economic Dimensions of Constitutional Reform, Queen's University, June 4-6, 1991, p. 7.

[29] For an analysis of this issue, and a report on earlier studies, see: A. Alesina, "Macroeconomics and Politics", in S. Fischer ed. NBER *Macroeconomics Annual, 1988*, The MIT Press, Cambridge Mass., 1988.

authorities were the most independent, in Germany, monetary policy appears to have been least susceptible to changes in political whims. Where these authorities possess the least amount of independence, the United Kingdom, the shift in monetary policy was the most dramatic.[30]

117. A more recent study has examined the role of political institutions and the relationship between monetary and fiscal policy.[31] The study concluded that central bank independence tended to lead to low inflation, even when the fiscal authorities ran high budget deficits. Where central banks tend to be less independent, fiscal deficits are more likely to be accommodated through monetary actions.

118. These studies did not find any evidence that countries with low inflation suffered any long-term penalty with respect to other economic variables such as output or employment.

ALTERNATIVE CENTRAL BANK MODELS [32]

A. The Existing Bank of Canada Model

119. The Bank of Canada now operates under a very broad mandate which instructs it to protect the external value of the dollar and to control fluctuations in prices, output and employment. On a day to day basis, it is independent of the government of Canada, even though it is the federal government which is ultimately responsible for monetary policy and even though there is close consultation between the Bank and the Minister of Finance. For all practical purposes, then, there is a separation of functions between the body spending money and the body printing it.

120. The federal government appoints 12 directors to the Bank who, in addition to the Governor and Senior Deputy Governor, constitute the Board of Directors. These "citizen" directors are appointed for three year renewable terms and concern themselves for the most part with the non-monetary aspects of bank governance. The Bank of Canada Act specifies that these directors be from diverse backgrounds and it is currently government practice that they come from the various regions of Canada, although there is no legislative requirement that this be the case. Subject to government approval, these directors choose the Governor and his senior deputy, and set their salaries.

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[30] Ibid. p. 43.

[31] V. Grilli et al. "Political and monetary institutions and public financial policies in the industrial countries", *Economic Policy, A European Forum*, Vol. 13 (October 1991), p. 342-392.

[32] These central bank models have been compiled from several sources:

J. B. Goodman, *Central Bank—Government Relations in Major OECD Countries*, A Study Prepared for the Joint Economic Committee Congress of the United States, August 1, 1991;
R. Bade and M. Parkin (1988);
W. D. Coleman, *Monetary Policy, Accountability and Legitimacy: A Review of the Issues in Canada*, Department of Political Science, McMaster University, Hamilton, Ont., 1990;
Bank of Canada, *Memorandum on Bank of Canada Functions and Responsibilities and Appendix on Central Bank Arrangements in Other Countries*, Submitted to the House of Commons Standing Committee on Finance, Sub-Committee on the Bank of Canada, Ottawa, 1991;
Board of Governors of the Federal Reserve System, *The Federal Reserve System—Purposes & Functions*, Washington, D. C. 1985;
Canada, *Canadian Federalism and Economic Union: Partnership for Prosperity*, Ottawa 1991;
D. Laidler (1991);
Commission of the European Communities, *Economic and Monetary Union*, Communication of the Commission of 21 August 1990, Office for Official Publications of the European Communities, Luxembourg, 1990; and Euromoney Research Guides, *The 1991 Guide to Currencies*, Euromoney Publications PLC, London, 1991.

121. Monetary policy is neither formulated nor implemented by the Board of Directors. It is really the senior management of the Bank (the Governor, Deputy Governors, and advisors who meet daily) which performs these functions. Outside directors do no more than give evidence as to the economic conditions prevailing in their respective regions. They do perform a useful role in ensuring that the corporate entity is managed competently.

122. While the Bank and the government co-operate in the conduct of economic policy through regular consultations between the Minister of Finance and the Governor, or their delegates, it is clear that monetary policy originates with the Bank. It is only in the event of a significant disagreement between the Bank and the Minister that the Minister may, with the approval of Cabinet, issue a directive to the Bank which must be obeyed. Such a directive has never been issued to date.

123. In the past, it had become clear that the Department of Finance and the Bank of Canada were using quite different forecasts of inflation, indicating that the research groups were not co-operating fully. In the 1991 federal budget, however, the fiscal and monetary authorities jointly offered inflation targets for a five year period.

124. The Governor of the Bank of Canada must submit an annual report to the Minister of Finance and appears before Parliamentary committees when called. The Bank's budget is not controlled by Treasury Board and in this respect differs from mainline government departments. There has been some recent controversy as to rate of increase of wages and salaries within the Bank as these increases exceeded the ones offered to employees of the federal government.

125. The Bank is accountable in the sense that the Governor meets regularly with the Minister of Finance, he appears before Parliamentary committees, his appointment is subject to government approval, and he is subject to a Ministerial directive.

B. The Proposed Federal Government Model

126. The key feature of the federal constitutional proposals is the change in the mandate of the Bank of Canada, making it responsible solely for the attainment of price stability over the medium term. The discussion associated with this proposal argues that a clarification of the mandate would help to facilitate greater harmonization of the fiscal policies of the federal and provincial governments and the monetary policy of the Bank of Canada. In terms of institutional governance, the proposals are less dramatic.

127. These proposals provide for directors to be nominated by the federal government after consultation with provincial governments. These directors would chair regional consultative panels which would enable the Bank of Canada to better keep abreast of regional conditions. They would also make the appointment of the Governor subject to ratification by the Senate and mandate that the Governor appear before Parliamentary committees and meet with federal and provincial ministers of finance on a regular basis.

C. The Laidler Model

128. The model put forward by Professor Laidler in his C. D. Howe pamphlet also has as a key component the provision of a zero-inflation mandate.

129. His governance proposals are quite extensive. The Minister of Finance should be presented with short lists of candidates for director which have been provided by the provincial governments, although the federal government would be under no obligation to choose from those lists. These

directors would be appointed for relatively long periods of time, at least seven years, and these positions would be full time and well paid. This board would have real power in determining the conduct and implementation of monetary policy. Consequently, nominees would be expected to have some competence with respect to monetary policy and have access to some independent research capability.

130. Although he is not explicit on the size of the board, Prof. Laidler appears to support a small board in which the majority would be outside appointees, who would be regionally, but not necessarily provincially, based. These appointments would be staggered so that the composition of the board cannot be drastically altered except in extraordinary circumstances.

131. The current degree of independence of the Bank of Canada should be maintained. The federal government should continue to have the power to issue a directive to the Bank.

D. The Federal Reserve Model

132. The Federal Reserve System in the United States constitutes its central banking authority. This system is fairly complex by the Canadian standard. The Federal Reserve Board of Governors comprises seven members appointed by the President to 14 year non-renewable terms, staggered in such a way that a position comes up every second year. The Chairman and Vice-Chairman are appointed by the President from this Board for a four year renewable term. All of these appointments are subject to Senate ratification. Monetary policy is decided upon by this Board. The Federal Reserve, through its Chairman, must report to Congress twice annually on monetary policy at which time he presents monetary targets as well as his assessment of the economy. There is also frequent contact with Congressional and Administration officials. There is no means by which Congress or the Administration may instruct the Federal Reserve as to the appropriate conduct of monetary policy. Because of this, the Federal Reserve System is generally regarded as independent of political influence.

133. The United States is divided into 12 Federal Reserve districts, each with its own reserve bank. The stock of these banks is owned by member institutions in the district. These banks perform certain regulatory and payments functions. The presidents of these reserve banks are not expected to be advocates for their regions but to take a national view of monetary policy.

134. Monetary policy in the United States is conducted by the Federal Open Market Committee (FOMC) which is comprised of the seven members of the Board of Governors and the Presidents of five reserve banks, one of which is always the FRB New York. It is these features which give the federal reserve system its regional flavour.

135. The Board of Governors and the Federal Reserve Banks have full financial authority to establish their own budgets. They are not dependent upon the federal government for financing.

136. The striking feature of the Federal Reserve System is the extent of independent research and public commentary on monetary policy that it produces. Every Reserve Bank has a research department which produces an economic journal published at least quarterly. These banks also sponsor symposia, conferences and seminars, the results of which are also distributed widely. It is this capacity which has enabled certain banks to be in the forefront of the debate on monetary and economic policy and has enabled Presidents of the reserve banks to speak out independently on such topics. The President of the Federal Reserve Bank of Cleveland, for example, is now one of the leading proponents of a zero inflation mandate for American monetary policy.

E. The German Model

137. The German model is similar to the American Federal Reserve System in the sense that a high degree of regional representation exists in recognition of the federal system of government.

138. The Central Bank Council consists of the presidents of the eleven state central banks, plus members of the Bundesbank's directorate, up to ten. These appointments are for a period of eight years and are renewable, with revocation possible only in the case of incompetence or neglect of duty. It is this body which sets monetary policy. Members of the federal government may participate, without vote, in Central Bank Council deliberations. In response to a request by a government member, the Council may delay a decision for no more than two weeks.

139. The members of the directorate and the president and vice-president are nominated by the federal government. The presidents of the state central banks are now appointed by the upper chamber, based on proposals from the state governments. They are not, however, expected to be regional advocates.

140. The Bundesbank in Germany determines monetary policy. The Bundesbank enjoys considerable independence from the federal government and there is not a strong chain of accountability between the Bank and any level of government or Parliament. Although the Bank is required by law to support government economic policies, this support is qualified by the fact that it not hinder or threaten monetary stability. The Bundesbank is independent of instructions from the federal government, even, it appears, in the event of serious disagreement between the Bank and the government. As well, it is independent in its own budgetary affairs. The Bundesbank may extend short-term credit to various government agencies although it is not obliged to do so. Its holdings of government bonds is for monetary policy reasons, not for financing the fiscal requirements of the government.

F. The French Model

141. The French system of monetary control confers little power to its central bank, the Bank of France. Its role in the formulation of monetary policy is advisory only, although it does execute that monetary policy. In the final analysis, monetary policy comes from the Ministry of Finance, although there is a relatively complicated structure of agencies (the Bank, the National Credit Council, and the Banking Control Commission) involved in the process.

142. The implementation of monetary policy is done through a General Council of twelve members. One member is appointed internally from the Bank while the remainder are appointed by the Minister of Economics and Finance. The term of office is six years. The Governor and two deputies are appointed by the President on an indefinite basis although the practice has been to limit terms to five years. Budgetary authority resides with this General Council.

143. The Minister of Economics and Finance has the power to review and even postpone all decisions of the General Council. He appoints an auditor, "censeur", to preside at all council meetings and this auditor may oppose any council decision, at which point the matter must be reconsidered at a future date. This power, in addition to the fact that monetary policy is set at the Treasury, with consultation of the Bank, indicates that little independent authority rests with the Bank.

G. The British Model

144. The Bank of England is the central banking authority in the United Kingdom. It, like the Bank of France, has little independent authority in setting monetary policy.

145. Similar to the situation in Canada, the Bank of England is subject to directives issued by the Chancellor of the Exchequer. Because of the close consultation that takes place between the Bank and the government, no need has ever arisen for such to be issued.

146. Both the Bank and the Treasury engage in research on economic and monetary matters, with officials from both meeting regularly to discuss their economic reports. In the end though it is the Governor of the Bank who expresses his views while the Chancellor of the Exchequer makes the ultimate policy decisions.

147. The Bank of England is governed by a Court of Directors, including the Governor, the Deputy Governor and sixteen other directors, of which no more than four may be internal to the Bank. Although this body meets regularly it is not active in making policy decisions.

148. All appointments are made by the Crown, with the term for directors being four years and the Governor and deputy at five years. The Bank has independent authority over its own budget.

H. The European Community Model

149. The nations of the European community are moving inexorably toward economic and monetary union. With this, the Members of the Community see a need for a new institution which will play the role of the central bank for that community.

150. The new Eurofed constitution would have three basic principles: 1. it would have price stability as its objective; 2. it would be independent of government at both the national and community levels; and 3. it would be accountable to the democratic process.

151. The price stability commitment is to be included within the legislation creating the new monetary body. This gives it much more strength than would be the case with a simple verbal commitment. But the Commission does not see even this as sufficient. It calls in addition for the full independence of the central monetary body as well as national independence for each of the constituent central banks.

152. With independence comes the need for some kind of democratic accountability. The details have not yet been worked out, but essentially this would be achieved by having the new body report to the central parliament and by imposing rules by which board members are chosen to the new body. A council of governors of constituent central banks would set monetary policy. Day to day operations would be the responsibility of a smaller board of directors representing the central body. These members would be chosen on the basis of their professional competence, for terms of eight years. While the council of governors would make recommendations in this regard, the final choice would be made by the European Council. The choice of the president and vice-president would be subject to consultation with the European parliament. These terms should be non-revocable, although it is not clear whether they could be renewed.

153. An important feature of the new central body is that monetary and fiscal policies of the community are to be harmonized and that the central body will not guarantee the debt of member states. Nor will privileged access to capital markets be granted to these nation states.

154. With full monetary integration, the European community will have one currency and central bank institutional organization resembling that of the American federal reserve system, with the national central banks playing the role of the reserve banks in the U.S.

WHAT THE COMMITTEE HEARD

155. The federal proposals for Bank of Canada governance did not receive much prominence during the Committee's investigation. Most witnesses, when discussing governance issues, went well beyond the government's suggestions, using as a point of departure the model presented in the C.D. Howe pamphlet authored by Professor Laidler.

156. The issues of concern can be placed in the followed categories: the need for greater legitimacy and diffusion of power within the Bank; independence of monetary policy and its effects on economic variables, most notably inflation; and the accountability of Bank actions to democratic institutions.

157. Legitimacy was identified by a number of witnesses as a key problem with the Bank of Canada. Professor Fortin saw the root of the problem as the concentration of power within the Bank and suggested as a solution that directors be full time and well paid with research facilities and long overlapping terms. With such directors being responsible for monetary policy, it would have the appearance of being more in touch with the wishes and needs of Canadians. Professor Laidler also saw monetary policy as being more stable if conducted by a well-informed committee rather than a single individual.

158. Also, according to Professor Pierre Fortin, there is a perception that the Bank of Canada "...is being run by a non-representative, unresponsive, monolithic and self-perpetuating clique of bureaucrats." (5:5) Despite the fact that the Board of Directors has a strong flavour of regional representation, this has little impact in enhancing legitimacy because the Board has no power in setting monetary policy. More important, though, is what Professor Fortin saw as "...the excessive concentration of power in the hands of one individual, the governor..." (5:6) The diffusion of power among individuals or institutions seems to him to be a prudent practice employed in most other large organizations.

159. As part of the government's proposals for an enhanced role for directors, it recommended that they chair regional consultative panels. Most witnesses had little to say on this topic, although Dr. Neufeld thought these proposals should be dropped. He viewed the real problem as one of inadequate fiscal policy harmonization across the nation and argued that regional panels might be useful in such a context. They are not needed to provide access to regional information and might be counter productive if they give the impression that monetary policy could be conducted along regional lines.

160. To some extent, accountability and independence are contradictory. Strict accountability can mean strict control if it leads central bank officials to behave not in ways they think appropriate but in ways their political masters think appropriate. At present, the Bank of Canada Act appears to have achieved a good compromise between the independence of the central bank while at the same time making it ultimately accountable to a democratically elected government.

161. Most witnesses supported the concept of a relatively independent central bank, believing that such independence will generally provide better monetary policy than would be the case if the bank were beholden to fiscal authorities. Professor Howitt went so far as to suggest that there should not even be active co-ordination with fiscal policy since this might threaten independence. He saw the biggest danger with central banks occurring when they continually monetize deficits.

162. There is a very real trade-off then between two desired elements in the structure of the Bank. Economists like independence but at the same time most people feel that the Bank cannot be fully independent of our democratic institutions—it must be accountable. Professor Howitt argued that

enhancing the legitimacy of the Bank improves its independence. If power is diffused among several people, if they have been nominated by provincial governments and ratified by an elected Senate, their monetary policy decisions would be difficult to overturn through the use of section 14 of the Bank of Canada Act. Perceived legitimacy of the institution of the Bank of Canada is a substitute for after the fact accountability of the institution for its actions.

163. Professor Parkin described the Bank of Canada Act as good compromise, one which "...cleverly combines independence of the central bank with ultimate political control and ultimate political authority in the hands of the Minister of Finance." (2:11) Professor Howitt also approved of the balance now existing with the potential use of the section 14 provision and preferred that it continue to be at the disposal of the government, even if the Board of Directors were to take on a real role in formulating monetary policy. There was some disagreement on this point as Professor Chant felt that the directive cannot work effectively when the responsibility for monetary policy is shared among several individuals. Professor Fortin suggested that a directive would be issued to the Bank of Canada. Those who support the directive would state so publicly and remain. Those who oppose it would resign. Most other witnesses saw no need to alter this provision while Professor Courchene thought it should be dropped if the governance provisions of the Bank of Canada were enhanced.

164. Whereas most witnesses argued in favour of central bank independence, some felt that even day to day responsibility for monetary policy should be in the hands of the federal government, fully integrating central bank functions inside the government bureaucracy. In this regard Professor Rymes suggested a Department of Monetary Affairs which would undertake the functions now handled by the Bank of Canada. This would make it clear to people that monetary policy is in fact the responsibility of the government and makes it accountable in the same way that other government departments are accountable. Such an approach is consistent with his view that monetary policy can and should accommodate several goals and should be harmonized with fiscal policy. He also suggested that the directive power of the government has actually enhanced the power of the Governor of the Bank of Canada rather than having curtailed it.

165. The Governor, Mr. John Crow, testified before the committee on two occasions. He argued strongly for a price stability mandate and linked it to accountability. The point he raised was that observers are better able to judge the Bank if it has a single mandate and this mandate refers to a variable which is under the ultimate control of the Bank's actions. He also pointed out that there now exists a number of relationships between himself and the Board of Directors and the Minister of Finance and this latter relationship might have to be re-appraised in a changed system of governance.

THE COMMITTEE'S MODEL

166. Despite the many calls for a change to the institutional structure of the Bank of Canada and the many alternatives from which we might choose, the Committee is of the opinion that none of the models have demonstrated their obvious superiority over the current structure of the Bank of Canada. Hence we are reluctant to recommend any wholesale changes to the way the Bank is organized and the way in which it conducts its affairs.

167. The Committee is of the opinion that the existing relationship between the Bank of Canada and the Government of Canada strikes a good balance between independence and accountability. The Governor of the Bank of Canada works in an environment of close consultation with the Minister of Finance, extensive independence in the day-to-day operations of the Bank, all subject to a possible directive issued by the Minister. The Committee believes that this balance has served Canada well. We further believe that any major change to the institutional structure of the Bank would put such a balance in jeopardy without any certain prospects of offsetting benefits.

168. The Committee has been convinced by the evidence that it would be undesirable to lessen the degree of independence of the Bank. A central bank too heavily influenced by politicians could well create a bias in favour of greater inflation and this would be clearly undesirable, especially in light of the great efforts and high cost borne by the economy to reduce the rate of inflation in the past few years. On the other hand, greater independence of the Bank would make the Minister of Finance far less accountable for the path of monetary policy. This would tend to erode the system of dual responsibility for monetary policy that has existed in Canada over the past three decades and thereby undermine the legitimacy of monetary management in Canada. In a democratic society, a public policy instrument as powerful as monetary policy cannot be entirely removed from the political process. The Parliament of Canada should continue to be a legitimate and effective forum in which monetary policy is debated, which implies that the elected government must remain ultimately accountable for the monetary policy followed.

169. The Committee feels that the concerns of witnesses regarding the concentration of decision making power with the Governor and the lack of regional input in such decision making have merit, although we are not convinced that the extent of the problem is very great. It is likely that minor changes to the Bank's institutional structure could rectify these real or apparent flaws. The Committee therefore makes the following recommendations:

Recommendation 3

Monetary policy should continue to be formulated and conducted by the Bank of Canada, with the ultimate responsibility resting with the federal government. That government should continue to maintain the power to issue a directive to the Bank regarding the conduct of monetary policy.

Recommendation 4

The current practice of maintaining a regional balance on the Bank of Canada's Board of Directors should be enshrined in law and some, but not all, directors should be chosen for their expertise in monetary policy.

Recommendation 5

In order to foster better public understanding of the workings of monetary policy, some Board and Executive Committee meetings should be held in locations in Canada outside of the National Capital Region.

168. The Committee has been convinced by the evidence that it would be unadvisable to lessen the degree of independence of the Bank. A central bank too heavily influenced by politics would well create a bias in favour of greater inflation and this would be clearly undesirable, especially in light of the great efforts and high cost borne by the economy to reduce the rate of inflation in the past few years. On the other hand, greater independence of the Bank would make the Minister of Finance far less accountable for the path of monetary policy. This would tend to erode the system of dual responsibility for monetary policy that has existed in Canada over the past three decades and thereby undermine the legitimacy of monetary management in Canada. In a democratic society, a public policy instrument as powerful as monetary policy cannot be entirely removed from the political process. The Parliament of Canada should continue to be a legitimate and effective forum in which monetary policy is debated, which implies that the elected government must be ultimately accountable for the monetary policy followed.

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Recommendation 3

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Recommendation 4

The current practice of maintaining a regional balance on the Bank of Canada's Board of Directors should be enshrined in legislation; but new directors should be chosen for their expertise in monetary policy.

Recommendation 5

In order to foster better public understanding of the workings of monetary policy, some Board and Executive Committee meetings should be held in locations in Canada outside of the National Capital Region.

APPENDIX A

List of Witnesses

Associations and Witnesses	Issue No.
Bank of Canada	
John Crow, Governor	1, 8
Brian Heidecker, Director	7
Frederick Hyndman, Director	7
John T. Douglas, Director	7
Gorden Thiessen, Senior Deputy Governor	8
Charles Freedman, Deputy Governor	8
Canadian Bankers' Association	
Helen Sinclair, President	7
Thomas Rymes	5
Carleton University	
Alec Chrystal	8
City University Business School	
Confédération des caisses populaires et d'économie Desjardins du Québec	
Yves Morency, Vice-president	7
Gilles Soucy, Chief Economist & Director	7
Japan Centre for International Finance	8
Rei Masunaga, Deputy President	
Macaulay, Chusid & Freedman	8
Larry Grossman, Counsel	
John McCallum	6
McGill University	
William Coleman	6
McMaster University	
Mortgage Bankers Association of America	8
Lyle E. Gramley, Chief Economist	
David Slater	7

Associations and Witnesses	Issue No.
Doug Purvis	7
Thomas Courchene Queen's University	2
Royal Bank E.P. Neufeld, Executive Vice-President	3
John Chant Simon Fraser University	7
Strategico Mitchell Sharp, Policy Associate	8
Toronto Dominion Bank Douglas Peters, Senior Vice-President	3
Trust Companies Association of Canada John Evans, President & CEO	4
Gordon Boreham University of Ottawa	4
Pierre Fortin University of Quebec	5
Peter Howitt	5
David Laidler University of Western Ontario	2

A copy of the relevant Minutes of Proceedings and Evidence of the Standing Committee on Finance (*Issue No. 34, which includes this report*) is tabled.

Respectfully submitted,

MURRAY DORIN, M.P.,

Chairman.

A copy of the relevant Minutes of Proceedings and Evidence of the Standing Committee on Finance (Issue No. 34, which includes this report) is tabled.

Doug Purvis Thomas Courchene Queen's University	7 2
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Toronto Dominion Bank Douglas Peters, Senior Vice-President	3
Trust Companies Association of Canada John Evans, President & CEO	4
Gordon Boreham University of Ottawa	4
Pierre Fortin University of Quebec	5
Peter Howitt David Laidler University of Western Ontario	9 2

Minutes of Proceedings

MONDAY, FEBRUARY 24, 1992
(44)

[*Text*]

The Standing Committee on Finance met *in camera* at 2:00 o'clock p.m. this day, in Room 269, West Block, the Acting Chairman, René Soetens, presiding.

Members of the Committee present: Steven Langdon and René Soetens.

Acting Members present: David Bjornson for Greg Thompson, Don Blenkarn for Clément Couture, Pat Sobeski for Brian White and John Manley for Diane Marleau.

In attendance: From the Research Branch of the Library of Parliament: Basil Zafiriou and Marion Wrobel, Senior Analysts.

Pursuant to Standing Order 108(2), the Committee proceeded to the consideration of the First Report of the Sub-Committee on the Bank of Canada.

After debate, on motion of Don Blenkarn, it was agreed,—"That the First Report of the Sub-Committee on the Bank of Canada be adopted as the Committee's Eighth Report to the House and that the Chairman present it to the House".

It was agreed,—"That the Report be printed in tumble format".

It was agreed,—"That the Committee print an additional 1500 copies of Issue No. 34 of the Committee's *Minutes of Proceedings and Evidence*, which contains the Eighth Report to the House".

At 2:05 o'clock p.m., the Committee adjourned to the call of the Chair.

Susan Baldwin
Clerk of the Committee

Minutes of Proceedings

MONDAY, FEBRUARY 24, 1992
(44)

[*Text*]

The Standing Committee on Finance met *in camera* at 2:00 o'clock p.m. this day, in Room 269, West Block, the Acting Chairman, René Soetens, presiding.

Members of the Committee present: Steven Langdon and René Soetens.

Acting Members present: David Bjornson for Greg Thompson, Don Blenkarn for Clément Couture, Pat Sobeski for Brian White and John Manley for Diane Marleau.

In attendance: *From the Research Branch of the Library of Parliament*: Basil Zafiriou and Marion Wrobel, Senior Analysts.

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At 2:05 o'clock p.m., the Committee adjourned to the call of the Chair.

Susan Baldwin
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LE MANDAT ET LA RÉGIE DE LA

BANQUE DU CANADA

PREMIER RAPPORT DU SOUS-COMITÉ SUR LA BANQUE DU CANADA
HUITIÈME RAPPORT DU COMITÉ PERMANENT DES FINANCES

Février 1992