Towards a Made-in-Canada Monetary Policy: Closing the Circle

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- *From its inception, the Bank of Canada had the option of following either the British or American model as it developed approaches to the instruments it uses for monetary policy.*
- *Although some aspects of the Bank's early monetary policy, such as the role of discount facilities, the use of moral suasion, and the need to develop a money market reflect the British example, some important differences shaped a distinctly Canadian approach.*
- *Faced with a rudimentary money market, the Bank relied on transfers of government deposits to manage bank liquidity, thus developing a monetary policy instrument that bypassed the money market. It also adopted lagged reserve requirements and on two occasions floated the Bank Rate.*
- *In response to the development of an active and vibrant money market and superior communications and payments systems, and the resulting enhanced transparency, a number of initiatives undertaken since the 1980s have strengthened the Bank's influence over its short-run operating target, the overnight interest rate.*

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I want to discuss how, through its 70-year life, the Bank of Canada has developed and adopted distinctive approaches to the instruments its uses for monetary policy. My starting point will be the origins of the Bank, when the government had the option of following one of two dominant models: the long-established Bank of England and the more recent Federal Reserve System of the United States.

Initial Influences

In the 1930s, the Bank of England and the Federal Reserve approached monetary policy in quite different ways. Both operated in well-developed, liquid money markets. The British, however, had developed intricate market arrangements built around discount houses that specialized in trading money market securities and whose existence was sustained by the Bank of England's avoidance of direct transactions with banks.[1, 2] The Federal Reserve, in contrast, dealt with banks and with securities firms in conducting its open market operations. The Bank and the Federal Reserve also differed in their views of the proper use of their discount facilities. While bank use of the Bank of England's discount window was the exception, banks' access to the Federal Reserve was a normal part of their reserve management. Finally, the two traditions differed in their overall philosophy: the Bank of England leaned heavily on "informal," or non-market, techniques, particularly moral suasion, while the Federal

1. The discount houses imparted an almost club-like atmosphere to central banking. Officials from the discount houses rotated through the senior management positions at the Bank, including the post of Governor, for relatively short terms, until the pattern was broken by Montagu Norman, who stayed as Governor for 24 years.

2. The avoidance had its limits: the Bank would deal with banks when the discount houses lacked maturities desired by the Bank.

Reserve primarily used market measures such as open market operations.

The matter of which tradition to follow was decided very early, possibly by default. Lord Macmillan, who had headed the United Kingdom's Commission on Finance and Industry, chaired Canada's Royal Commission on Banking and Currency, which recommended the creation of a central bank.[3] The British influence continued when J. A. C. Osborne, a former Secretary of the Bank of England, was seconded to be the first Deputy Governor of the Bank of Canada in order to provide "someone with extensive central banking experience, that is, someone from abroad" (Watts 1993, 23). Osborne served in this capacity from 1934 to 1938. Another influence was the extensive correspondence maintained between Graham Towers, the first Governor of the Bank of Canada, and Montagu Norman, the Governor of the Bank of England.

Finding Its Way

At the start, all appearances seemed to favour the Bank adopting a British approach to monetary policy. In the event, it took some time for the Bank to develop any approach. Confronted with the halting recovery from the Depression, the Bank spent its first years intent on providing adequate liquidity to the chartered banks. The Bank set its Bank Rate at 2 1/2 per cent when it opened its doors in March 1935 and kept it there for almost nine years, before lowering it to 1 1/2 per cent in February 1944. It raised the rate for the first time six years later, in 1950.

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3. One other commissioner was a former director of the Bank of England. In addition, the Chairman was assisted by an adviser who had been involved in the establishment of other central banks in the empire. The adviser was responsible for drafting Chapter 5, "The Existing Canadian Financial System and the Establishment of a Central Bank" (Watts 1993, 11).

Neither the British nor the American experience could prepare Canadian central bankers for the conditions under which they conducted monetary policy. Both the Federal Reserve and the Bank of England operated in liquid money and security markets. The Canadian money market in the 1930s, in contrast, was rudimentary: the first treasury bill tenders were held just days before the Bank opened for business. Moreover, although reference was made in the Bank's early annual reports to the desirability of broadening the treasury bill market, it was slow to develop, in part because the Bank was faced with other concerning issues, including the slow recovery from the Depression, continued high unemployment, and financial difficulties experienced by some of the provinces (Watts 1993, 34). Another factor was strong demand from the chartered banks for treasury bills. Neufeld was able to declare years later that "there was always a demand for bills at the Banks, and in fact in only that limited sense could it be said that a bill market existed in Canada before 1954" (1955, 38).

Cash reserves

The Bank also departed immediately from the Bank of England's practice of having no formal cash reserve requirement by establishing a minimum daily cash reserve of 5 per cent of deposits, a departure recommended by the Macmillan Commission. Watts (1993) suggested that the requirement had been intentionally set low at the outset relative to banks' cash-holding practices. In practice, the banks maintained actual cash reserves at levels around 10 per cent of deposits, a tendency that was not surprising, given the difficulties for day-to-day cash monitoring posed by their far-flung branch system and the absence of an active money market.

The government adopted a distinctly Canadian approach to reserve requirements in the revisions to the Bank Act of 1954. At that time, the Bank of Canada was given the authority to vary the minimum ratio between 8 and 12 per cent (Watts 1993, 98). More significantly, the calculation of required reserves was drastically changed. Both deposits and the note component of reserves for any month were to be calculated on the basis of the average of the Wednesday values for the preceding month. The remaining component of reserves, deposits held by the chartered banks at the Bank of Canada, was to be maintained on a daily-average basis over the month. This method of determining reserves reduced uncertainties for the banks, giving the Bank greater scope for managing the reserves available to the chartered banks.

The details of the cash reserve requirement have been altered several times since 1954. The requirements were lowered and set at different levels for different types of deposits in 1967; two reserve-averaging periods for each month were added in 1980; and, finally, the reserve requirement was gradually reduced to zero between 1992 and 1994. Nevertheless, the distinctive reserve-averaging period remained a feature of the Bank's approach until extensive changes were made in 1999 when the Large Value Transfer System (LVTS) was introduced.

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Transfer of government deposits

In the absence of a developed money market, the Bank also adopted a different monetary policy instrument that bypassed the money market. The Bank did so by actively managing the government's deposit balances between itself and the chartered banks. While a significant portion of these transfers represented the neutralization of the liquidity effects of government receipts or disbursements, there was also a monetary policy component whereby movement of deposits added to bank liquidity by increasing bank claims on the Bank of Canada, while transfers from the banks to the Bank had the opposite effect. The Bank's use of this technique was distinctive in that it turned management of government-deposit balances into an active instrument to bring about changes in bank liquidity.

The transfer of government deposits remained a significant instrument for the Bank well into the 1990s,[4] in part because of their immediate effect on liquidity compared with the settlement delays of market transactions. How these balances were transferred evolved with changes in the government's deposit arrangements. In 1986, the Receiver General introduced competitive auctions for government deposits in excess of day-to-day operating needs. These auctioned deposits, which ranged in maturity from overnight to seven days, shrank the pool of funds transferred daily. However, these deposit transfers were important as a monetary policy instrument until the introduction of the LVTS.

4. Use of this instrument has never been completely abandoned, but currently it serves in only a marginal capacity.

The Bank Rate

The Bank of Canada firmly followed the British Bank Rate practice by discouraging borrowing by banks and regarding it as a sign of weakness. The rarity with which discount windows were used reduced the Bank Rate to being primarily a signal of the Bank's intentions. At times, even this limited role posed problems for the Bank. Rate changes are a blunt instrument for conveying the Bank's intentions and cannot convey subtle messages.

These deliberate abstentions from setting the Bank Rate were distinctly Canadian.

On two occasions, the Bank, apparently judging the costs of ambiguity as more than offsetting the value of the signal, did away with the explicit signal altogether. From 1956 to 1962 and again from 1980 to 1996, the Bank Rate was tied to the 3-month rate established at the most recent treasury bill auction, relieving the Bank from making discrete changes. These deliberate abstentions from setting the Bank Rate were distinctly Canadian.

Closing the Circle

The conditions facing the Bank in the 1990s had evolved significantly from the past. The money market emerged as active and vibrant after years of hesitant growth following its forced feeding in the 1950s; the banks' branches were now linked through advanced information technology; and an electronic payments system handled the bulk of payments by value.

The "made-in-Canada" approach to policy consists of a series of initiatives taken through the 1990s to take advantage of these changes in order to sharpen the Bank's monetary policy instruments. These initiatives altered reserve requirements; changed the Bank's use of government deposit transfers; and transformed the role of the Bank Rate. Overall, these measures strengthened the Bank's influence over its short-run operating target, the overnight interest rate.

The first step was the reform of the cash reserve requirements. Long recognized as a tax on banking services, the cash reserve requirement was phased out between 1992 and 1994. Instead of holding positive reserves, banks were expected to maintain zero clearing balances over the reserve-averaging period. At the same time, incentives to meet the zero cash requirement were strengthened by balancing the costs of holding deficits and excess balances. These price incentives eliminated the Bank's reliance on moral suasion to discourage borrowing from the central bank (Howard 1992).

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The Bank moved next to give greater guidance to market participants with respect to its intentions. While the overnight rate had been central to the Bank's focus, its influence on market rates took place indirectly through operations in the market for treasury bills or through managing the availability of cash to the banks. Moreover, the Bank Rate, since 1980, had been tied to the rate for 3-month treasury bills, leaving market participants uncertain whether rate movements were shaped by the Bank's intentions or by market pressures. By the mid-to-late 1980s, the Bank began offering Special Purchase and Resale Agreements (SPRAs) and Sale and Repurchase Agreements (SRAs) to influence the overnight rate. In 1994, the Bank added clarity and emphasized its focus on short-term rates by adopting an explicit 50-basis-point operating band for the overnight rate, the limits of which were reinforced by the SPRAs and SRAs. Though this range was not publicly announced (as a fixed Bank Rate would be), changes in the range would quickly become apparent to market participants through observing the Bank's operations in money markets. The Bank made the target range for the overnight rate still clearer in 1996 when it returned to fixing the Bank Rate, setting it as the upper limit of the operating band for the overnight rate.

The introduction by the Canadian Payments Association in 1999 of a new electronic payments system, the LVTS, made immediate clearing and settlement possible for large transactions, allowing further changes in the Bank's monetary policy techniques. Control of the overnight rate was strengthened by several measures. The midpoint of the operating band, unless specified otherwise, served as the Bank's operating target rate, and the Bank planned to reinforce the target through its SPRA / SRA technical operations if the market traded above or below that rate. The Bank also revamped its approach to reserve management: the level of clearing balances was to be maintained at roughly zero,[5] typically confining government deposit transfers to neutralizing the impact of public sector flows. Arrangements for government deposit transfers for preceding-day value were replaced by same-day settlement. As well, given the fact that Canadian banks knew with certainty their positions at the end of each business day and had a period to trade surpluses and deficits with each other before final settlement of their LVTS clearing balances at the Bank of Canada, the need for a reserve-averaging period to smooth fluctuations was eliminated.

Conclusion

The founders of the Bank of Canada looked to the British example from the beginning. Some aspects of the Bank's approaches reflect this choice, including the role of the discount facility, the use of moral suasion, and the need to develop money market institutions. In many important ways, however, the development of central banking in Canada followed its own distinctive path. The Bank delayed for 20 years turning seriously to the development of the money market and instead relied on transfers of government deposits to manage

5. These balances are typically maintained at $50 million. For further information, see Howard (1998) and Clinton (1991).

bank liquidity. It also adopted lagged reserve requirements and on two occasions floated the Bank Rate. The initiatives over the 1990s, in a sense, closed the circle. The changes reflected both the monetary authorities' policy needs and the changing environment brought about by the new payments arrangements and a highly sophisticated money market. Many of the monetary policy arrangements that had reflected earlier features of the Canadian financial system were replaced by new measures designed to give tighter control over the overnight rate. The reforms of the 1990s were a coming of age in the evolution of a "made-in-Canada" approach to the conduct of monetary policy.

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