CHAPTER 18
BANKING, FINANCE AND INSURANCE

18.1 Banking

18.1.1 Bank of Canada

Canada's central bank, the Bank of Canada, began operations on March 11, 1935, under the terms of the Bank of Canada Act, 1934, which charged it with the responsibility 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 possible within the scope of monetary action and generally to promote the economic and financial welfare of Canada. The act does not specify the methods that the Bank should use but it confers certain powers that, with provisions in other legislation, enable the Bank to exercise a broad controlling influence over the growth of money and credit in Canada, and thereby to affect levels of spending and economic activity. Revisions to the act were made in 1936, 1938, 1954, 1967 and 1980.

The provisions of the Bank of Canada Act enable the Central Bank to determine the total amount of cash reserves available to the chartered banks as a group and in that way to influence the level of short-term interest rates. The Bank Act, which regulates the chartered banks, requires that each chartered bank maintain a stipulated minimum average amount of cash reserves, calculated as a percentage of deposit liabilities. Under the 1980 Bank Act revision this cash reserve requirement is 10% of reservable Canadian dollar demand deposits, 2% of reservable Canadian dollar notice deposits plus an additional 1% of the amount by which a bank's reservable Canadian dollar notice deposits exceed $500 million, and 3% of reservable foreign currency deposits. Cash reserves may be held as deposits at the Bank of Canada (or, with that Bank's approval at a chartered bank), holdings of Bank of Canada notes, and holdings of coins with a face value of $2 or less that were current under the Currency and Exchange Act. The ability of the chartered banks as a group to expand their total assets and liabilities is therefore limited by the total amount of cash reserves available.

A decrease in cash reserves tends to cause short-term interest rates to rise, making it more costly for the public to hold non-interest-bearing deposits and currency. An increase in cash reserves would put downward pressure on interest rates and indirectly induce the public to hold more money. Control of excess reserves thus provides some control over the growth of the money supply.

There are two primary methods by which the Bank of Canada can alter the level of cash reserves of the chartered banks. The technique employed more often is the transfer of government deposits between the Central Bank and chartered banks. The second method is the purchase or sale of government securities.

The transfer of government deposits from the Bank of Canada to chartered banks or the payment by the Central Bank for the securities purchased adds to the cash reserves of the chartered banks as a group and puts them in a position to expand their assets and deposit liabilities. The more direct method of increasing bank reserves is the transfer of government deposits to chartered banks. Such transfers, which the bank is authorized to make as the fiscal agent of the federal government, do not involve any immediate effect on security prices and yields in financial markets.

If the Bank of Canada wishes to decrease the reserves of the chartered banks, it may either transfer government deposits from accounts at the chartered banks to the government's account at the Central Bank or sell government securities in the market.

In recent years, the aim of monetary policy has been to reduce the rate of inflation while achieving satisfactory levels of economic activity. From 1975 to November 1982, the Bank sought to attain these objectives through a gradual but significant decline in the trend rate of growth of the money supply defined as the