

Chapter 19

Banking, finance and insurance

19.1 Banking

19.1.1 The 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 for regulating "credit and currency in the best interests of the economic life of the nation", and conferred on it specific powers for discharging this responsibility. Through the exercise of these powers, the Bank broadly determines the combined total of the most common forms of Canadian money held by the community — chartered bank deposits and currency. Revisions to the Bank of Canada Act, 1934, were made in 1936, 1938, 1954 and 1967, and are included in RSC 1970, c.B-2.

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 control the rate of expansion of the total assets and deposit liabilities of the banking system as a whole. The Bank Act, which regulates the operation of the chartered banks, requires that each chartered bank maintain a stipulated minimum average amount of cash reserves, calculated as a percentage of its Canadian dollar deposit liabilities, in the form of deposits at the Bank of Canada and holdings of Bank of Canada notes. The minimum cash reserve requirement, which came into effect under the legislation beginning February 1, 1968, is 12% of demand deposits and 4% of other deposits. The ability of the chartered banks as a group to expand their total assets and deposit liabilities is therefore limited by the total amount of cash reserves available. An increase in cash reserves will encourage the banks as a group to expand their total assets (which consist chiefly of loans and marketable securities) with a concomitant increase in their deposit liabilities; a decrease in cash reserves will bring about a decline in their total assets and deposit liabilities as they seek to restore their cash reserve ratios.

The chief method by which the Bank of Canada alters the level of cash reserves of the chartered banks over time, and through them the total of chartered bank deposits, is by purchases and sales of government securities. Payment by the central bank for the securities it purchases in the market 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. Conversely, payment to the central bank for securities it sells causes a reduction in the cash reserves of the chartered banks and requires them to reduce their holdings of assets and deposit liabilities.

The influence the Bank of Canada exerts on credit conditions (i.e. on interest cost and other terms of borrowing in financial markets) stems from its ability to limit the growth of bank credit and of the community's holdings of bank deposits and currency. The growth rate of the banking system is one of the factors exerting an important influence on the level of interest rates and other terms of access to credit prevailing in financial markets generally. Current credit conditions (and expectations about future trends in such conditions) in turn have an influence on business and household decisions to spend or to save. Many other factors have an important effect on spending decisions and the behaviour of the economy is subject to such influences as economic and financial developments abroad; the investment, price and wage policies of business firms in Canada; and the character of public policies at all levels of government with regard to expenditure and taxation. In using the powers at its disposal, the Bank attempts to bring about credit conditions appropriate to both domestic and external conditions. Its operations must be based, not on any simple mechanical formula, but rather on continuous observation and appraisal of the constantly changing prospects for the economy as reflected in the complex pattern of economic and financial developments.

In a technical sense, the powers that the central bank possesses allow it to exert a strong influence over economic activity but, in practice, the range through which credit conditions can be permitted to vary is necessarily limited. Changes in credit conditions in Canada affect the position of some groups in the economy much more than that of others, and this uneven impact is bound to inhibit the central bank's operations. Furthermore, interest rates in Canada cannot change greatly in relation to those abroad without producing large capital movements