*Opening Statement by*
*John W. Crow*
*Governor of the Bank of Canada*
*before the*
*House Standing Committee on Finance*
*19 November 1991*



I appreciate the opportunity to be with you today to comment on those proposals of the federal government — spelled out in *Canadian Federalism and Economic Union* — that have a bearing on the Bank of Canada.

In the detailed memorandum that the Bank provided a few days ago to this Committee, we aimed to set out material relating to the issues at hand in a systematic fashion. Besides describing the functions and responsibilities of the Bank, we also dealt with such broad questions as mandate, responsibility (covering matters regarding both central bank independence and the accountability regime) and governance. And in response to particular proposals, we commented upon questions concerning regional representation and transparency. We also submitted an appendix surveying how the various matters I have referred to above are treated for central banks in a number of other countries.

In the light of this material, my opening statement is relatively brief — highlighting some main features of the proposals.

My first point is to emphasize the importance of focussing on what monetary policy can realistically contribute to the economy as the basis for the Bank of Canada's monetary policy mandate. That is to say, I support strongly the emphasis in the federal government's proposals that achieving and preserving price stability should be the explicit foundation for the conduct of monetary policy. Monetary, or price, stability is the best route for monetary policy to follow in promoting Canada's general economic and financial welfare, and monetary policies that nourish inflation and inflationary expectations will damage that welfare. Furthermore, a mandate that has a clear focus on what monetary policy can achieve would improve the Bank of Canada's accountability.

My second point concerns monetary policy in the context of questions relating to regional representation. It seems important to underline, as the federal government does, that Canadian monetary policy operates in an efficient financial market with a single currency, and therefore of necessity must be set on a national basis. In other words, regionally differentiated monetary policies are technically not feasible.

The federal government's proposals include some specific suggestions in regard to regional representation — in effect confirming the tradition of a regional distribution for Bank directors; and also envisaging consultation with provinces before directors are appointed and the establishment of regional consultative panels. These suggestions may have merit from various points of view, provided it is understood that monetary policy itself cannot be regionalized.

From the Bank's viewpoint, such proposals are best judged according to their chances for improving the conduct of monetary policy — including, of course, whether they can improve the channels for the flow of information and informed discussion pertinent to monetary policy. This is the perspective from which the Bank sees the proposals for strengthening regional links, and also from which it sees the proposals to establish more regular appearances of the Governor before Parliament, and regular meetings with the federal-provincial Ministers of Finance.

BANK OF CANADA

**Memorandum on Bank of Canada Functions and Responsibilities Submitted to the House of Commons Standing Committee on Finance**

While the conduct of monetary policy has attracted virtually all the attention in the recent discussions and proposals regarding the mandate and governance of the Bank of Canada, the Bank, like most central banks, undertakes a number of different functions.

Accordingly, this memorandum begins with a brief overview of the various functions and responsibilities of the Bank of Canada, before embarking on a detailed review of the monetary policy role of the Bank. That review focusses in particular on monetary policy principles, the current institutional arrangements and some of the proposed changes relating to this function. In order to provide an external perspective on these matters, an appendix summarizes the arrangements under which central banks operate in a number of other countries.

**The Functions and Responsibilities of the Bank of Canada**

Some of the Bank of Canada's functions are spelled out in the Bank of Canada Act, while others follow directly from those explicit mandates.

**a) Monetary policy**

i) What monetary policy is

Monetary policy is the process whereby a central bank affects the economy through its influence over the expansion of money and credit. The central bank can influence the pace of monetary expansion in the economy because it is the source of the ultimate means of payment in the economy - both bank notes and the settlement balances of financial institutions. Thus, when financial institutions at the end of the day come to settle all the flows of cheques and other payments among their many clients, they undertake that settlement by the transfer of balances in and out of their deposit accounts at the central bank.

Because it can control the supply of settlement balances, the central bank has an influence on the willingness of banks and other financial institutions in turn to expand the supply of money and credit. This is the fundamental leverage, or the monetary policy instrument, that the Bank of Canada has at its disposal to influence developments in the Canadian economy.

ii) What monetary policy should aim to achieve

The broad objective of monetary policy, as with other public economic policies, must be to enhance the standard of living of Canadians. This is not an objective that gives rise to disagreement. What is less well understood, and therefore subject at times to debate and disagreement, is what in practical terms monetary policy can do to contribute to this objective.

Given the nature of monetary policy, the key practical question for the central bank can be phrased as follows: what pace of monetary expansion would be most helpful to the Canadian economy? As explained further in the next section, money is crucial to the operation of our economy. But the pace of monetary expansion needs to be limited if the value of money is to be preserved. If the supply of money is expanding more rapidly than required to meet the needs of the economy, the lasting effect will be sustained inflation. Such an erosion of the value of money undermines public confidence in money and is damaging to the economy. It follows that monetary policy has a responsibility to preserve the value of money, and that the objective of policy is most appropriately set with that principle very clearly in mind.

Awareness of what monetary policy can actually contribute to sustained good economic performance is what has led the Bank of Canada to focus on reducing the rate of inflation and eventually achieving price stability. The recent proposals of the federal government with respect to the Bank involve legislating price stability as the primary objective of monetary policy.

In addition to this issue of the fundamental orientation of monetary policy, a series of other questions regarding monetary policy and the Bank of Canada need to be addressed. What are the relative roles of the government and the Bank of Canada in the regular conduct of monetary policy? That is, what degree of responsibility should the central bank carry for monetary policy? How should the management of the Bank be held accountable for the exercise of responsibilities it has been given? What new approaches can increase the transparency of monetary policy? What is the nature and role of regional representation? All these issues will be dealt with in the following section of this memorandum.

**b) Lender of last resort**

The Bank of Canada has the power to make secured loans to banks and certain other financial institutions. There are essentially two types of situation which call for such liquidity support. "Ordinary" loans are made to those financial institutions that encounter shortfalls in their deposit balances at the Bank of Canada as a result of unexpected payment flows associated with the daily process of clearing cheques and other payments. "Extraordinary" loans are made to institutions which are solvent but experiencing difficult liquidity problems because of a loss of depositor confidence. The Bank was called on to make large "extraordinary" loans to a number of chartered banks following the failure of two Alberta-based banks in 1985. The responsibility of the Bank in making available a last-resort facility is to assist the smooth functioning of the payments system and to ensure that liquidity problems at individual financial institutions do not undermine public confidence in the stability of the financial system.

**c) The issue of bank notes**[1]

The Bank takes responsibility for ensuring that the need for notes across the country is met in an effective manner and that the notes are readily accepted without concerns about counterfeiting. This involves administrative decisions about the printing and distribution of the bank notes that the Canadian public wishes to hold as well as the eventual replacement of the notes when worn, and a good deal of research on how to design notes that guard against counterfeiting. Changes to the denomination of notes are determined by Order in Council and the Minister of Finance must approve the design of notes.

**d) The provision of banking and fiscal agent services to the federal government**

These are services that business corporations would obtain from a combination of chartered banks, investment dealers and trust companies. The services provided include the operation of the government's deposit accounts, through which flow virtually all of the government's receipts and expenditures, advice on and execution of the government's policy with respect to intervention in the exchange market, management of the foreign currency reserves in the Exchange Fund Account, advice on and arrangements for the sale of new government securities, and arrangements for the servicing of the outstanding public debt and

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1 The issue of bank notes and the banking and fiscal agency services account for the bulk of the Bank's total expenditures and employment.

its redemption at maturity. Although the Bank's role with respect to the management of the public debt is that of agent rather than principal, the Bank takes full responsibility for the integrity of the public debt records and for the payments it makes on behalf of the government for debt redemption and interest.

**e) Other functions**

- The Bank plays an advisory role in the regulation and supervision of financial institutions. To ensure close co-ordination between the Bank's lender of last resort function and the supervisory activities of the Office of the Superintendent of Financial Institutions, the Governor is an ex officio member of the Financial Institutions Supervisory Committee.[2] The Governor is also an ex officio member of the Board of Directors of the Canada Deposit Insurance Corporation.

- The Bank has taken on an important, but informal, oversight role with respect to the evolution of the payments system and other systems for netting and settling financial transactions. Apart from its strong background and interest in the functioning of the financial sector, the Bank has a special and more direct interest in this area because, as noted above, the final settlement of payments in Canada occurs on the books of the Bank of Canada. As well, the Chairman of the Canadian Payments Association is, by statute, an officer of the Bank. The Bank has been closely monitoring a number of private sector initiatives (to

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[2] The purpose of the Financial Institutions Supervisory Committee is to facilitate consultations and the exchange of information among its members on all matters relating directly to the supervision of federal financial institutions.

develop an electronic system for large value payments, to immobilize government securities and to net foreign exchange transactions) in order to ensure that these initiatives are directed towards minimizing financial system risk as well as improving efficiency.

- The Bank also acts as an adviser to the government with respect to international financial issues and helps to represent Canada at international meetings (usually under the auspices of the International Monetary Fund and the Organisation for Economic Co-operation and Development) where these issues are dealt with. Along with the Minister of Finance, the Governor attends the meetings of the Ministers and Governors of the Group of Seven Industrial Countries. The Bank of Canada is a shareholder of the Bank for International Settlements, and the Governor or the Senior Deputy Governor regularly meet in Basle with their counterparts from the other G-10 central banks.

**Monetary Policy - Principles, Current Institutional Arrangements and Recently Proposed Changes**

This section examines the principles governing the conduct of monetary policy by the central bank, as well as the current institutional arrangements in Canada and the federal government proposals for changes. A meaningful discussion of the various aspects of a central bank's corporate structure and governance requires, first of all, establishing what the central bank is expected to achieve in conducting monetary policy. Therefore, following a brief discussion of the process of monetary policy decision-making, considerable attention will be devoted to the monetary policy objective in the mandate of the central bank. The discussion then turns to the issues of central bank responsibility and accountability and their implications for the role of the Board of Directors, the relationship with the federal government, regional representation, and transparency.

**a) The process of monetary policy decision-making**

One can think of the monetary policy process as having a number of distinct dimensions: (1) decisions regarding the objective, or target, of policy; (2) decisions regarding the formulation of policy, such as the determination of an appropriate rate of monetary expansion (and the associated financial market conditions) which would put the economy on the path to the ultimate objective, or keep it there, and the required adjustments to such a track in response to shocks to the economic system; and (3) decisions regarding the implementation of the policy actions by the central bank needed to achieve the chosen track for monetary growth and financial conditions.

Decisions about the objective of policy are fundamental, and therefore long-term, in nature. However, judgements about how policy should be conducted to achieve the objective require regular reconsideration. These involve the choice of a track for monetary expansion and the financial market conditions that are consistent with that track, given an assessment of the strength of demand relative to supply in the economy. Finally, decisions regarding the settings of monetary policy instruments to bring about the required monetary and financial developments are taken as often as daily.

**b) The monetary policy objective in the mandate of the central bank**

As explained earlier, the key question for monetary policy is what pace of monetary expansion is most helpful to the development of the Canadian economy. In order to answer this question, it is useful to reflect on the role of money in our economy. The fact that we live in a monetary economy is so readily taken for granted that the central importance of this can easily be overlooked. Therefore, it is worth underlining that money has an absolutely essential function. It is the medium that links buyers and sellers, savers and investors, lenders and borrowers in all markets in all parts of the country. If our nation's economy is to work well, the money that we use needs to retain the confidence of Canadians that it 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 monetary 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.[5] The current legislative mandate of the Bank in its conduct of monetary policy is contained in the preamble of the Bank of Canada Act, which dates back to 1934. The preamble says that the Bank is "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".

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[5] The widespread and pervasive costs of inflation -- costs related to increased difficulties of making good long-run decisions, costs related to trying to cope with inflation, and costs related to the distributional effects of inflation -- are set out in detail in the second chapter of the 1990 Annual Report of the Governor to the Minister of Finance.

The government has proposed that the mandate for the Bank of Canada be clarified and that the basic objective of monetary policy should be to achieve and maintain stability in the general level of prices in Canada. In this context it may be noted that in those jurisdictions where the mandate of the central bank has been reconsidered recently, the decision has been to focus on the objective of price stability. Thus the new Act governing the Reserve Bank of New Zealand states that "the primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices". And the draft statute of the European System of Central Banks states that "the primary objective of the System shall be to maintain price stability". Indeed, there is broad agreement among economic policy makers in major countries that the appropriate objective of monetary policy is to maintain the value of money, that is, to achieve price stability.

Incorporating a clearly-expressed objective of this sort in the legislative mandate of the central bank would make it absolutely clear that the government and Parliament have decided on the appropriate goal of monetary policy and have entrenched it in legislation in recognition of the long time-frame over which monetary policy has its effects and the long-term perspective thus required in the conduct of monetary policy. It would also provide a solid basis on which to judge the central bank's performance and thus improve its accountability. A clearly-expressed objective in the legislative mandate of the central bank would increase monetary policy's credibility and would help to achieve that objective. A mandate focussed on price stability would encourage constructive discussion of monetary policy by focussing on what monetary policy by its very nature can achieve as opposed to what it cannot. For example, monetary policies that foster inflation cannot engineer increased employment over time.

There are a number of important, related issues associated with a price stability objective, such as the period over which the objective is to be achieved and the appropriate response of monetary policy when extreme shocks hit the economy. Decisions on such matters can have important short-run consequences for the economy. As a result, it has sometimes been argued that such issues should also be set in legislation. However, these matters seem to be related to specific circumstances and hence do not have the same degree of permanence as the underlying objective of policy. Nonetheless, it may well be desirable to include in legislation a process to deal with time paths for the achievement of the underlying objective, the definition of price stability, and responses to extreme shocks. The government has proposed that the Bank of Canada Act should provide for a mechanism whereby the Bank of Canada and the government agree on, and make public, the desired path toward price stability. Of course, this path could well be a reaffirmation of the current inflation-reduction targets, jointly announced on February 26, 1991 by the Governor and the Minister of Finance.

**c) Responsibility for monetary policy**

The main reason for setting up a central bank that can formulate and implement monetary policy is to have the responsibility for monetary policy somewhat removed from the rest of government -- in other words, to underline the well-established distinction between the power to spend money and the power to create it. In a similar vein, it is widely recognized that a credible, and therefore effective, monetary policy needs a medium- to longer-term perspective. Providing a degree of separateness for the central bank from the political process is justified by the need to give the central bank the capacity to take such a perspective. It is for these kinds of reasons that in most countries responsibility for the conduct of monetary policy is delegated to a central bank.

Given a mandate to formulate and implement monetary policy to achieve the objective set out in the legislation, the central bank obviously needs to have independent authority to take, with the appropriate medium- to long-term perspective, the decisions that it judges necessary in order to fulfil these responsibilities. These would be decisions that relate to the track for monetary expansion and the associated financial conditions needed to achieve the policy objective, as well as decisions about the specific actions required to bring about those conditions.

The present Bank of Canada Act does give the Bank responsibility for conducting monetary policy (in the absence of a public ministerial directive, as discussed below). The Act also provides the Bank with a substantial measure of independence to carry out that responsibility by placing the management of the Bank in the hands of a Board of Directors and by appointing the Governor and Senior Deputy Governor for terms of seven years.

For a central bank to exercise the authority it is given in monetary policy, it also needs authority in its corporate administration. Government involvement in the budgetary or personnel matters at the central bank can be used to put pressure on the central bank and undermine its capacity to take an independent approach to the conduct of policy. The Bank of Canada Act has provided the Bank with the necessary autonomy in its corporate administration.

**d) Corporate oversight: the role of the Board of Directors**

Given the responsibilities assigned to the Bank of Canada and the authority it is granted to carry out those tasks, the Bank's arrangements for corporate oversight are particularly important. For that reason the Board of Directors plays a central role in the governance of the Bank.[4]

The Board of Directors of the Bank of Canada consists of twelve outside, and therefore part-time, directors, the Governor, the Senior Deputy Governor and the Deputy Minister of Finance (the latter without a vote). The Governor of the Bank is Chairman of the Board and the Bank's Chief Executive Officer, and the Senior Deputy Governor is the alternate to the Governor.

The twelve outside directors are appointed by the Minister of Finance with the approval of the Governor in Council. Terms are for three years and may be renewed. The Board meets seven times a year. The Executive Committee of the Board consists of the Governor, the Senior Deputy Governor, the Deputy Minister of Finance and four outside directors. The full Executive Committee meets in extended session seven times a year, and there are regular review meetings (sometimes by telephone) of the Executive Committee in those weeks when neither the Board nor the full Executive Committee is meeting. Other Board committees such as those for budget and planning, audit, human resources and compensation, and for premises meet throughout the year as required.

A major role of the outside directors is to ensure that the Bank is being managed competently. They are responsible for the appointment or reappointment of the Governor and Senior Deputy Governor (with the approval of the Governor in Council) and for the appointment of other Deputy Governors, and they take an interest in all senior appointments. They set the salaries of

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[4] It is worth noting that proposals to change the governance of the Bank by putting it under the management of a full-time board of directors, or board of governors, have typically ignored the importance of oversight of the Bank's corporate activities by an independent body -- that is, a body comprising mostly people not employed by the Bank.

the Governor and Senior Deputy Governor (subject to the approval of Governor in Council). The corporate objectives and plans and annual budget of the Bank are approved by the Board, and the Board receives the reports of the external auditors on the Bank's financial statements. The broad policies to be pursued by the Bank in carrying out its non-monetary policy responsibilities are also established by the Board. In establishing these policies, the Board has paid close attention to the thrust of public policies.

Directors make an important contribution to monetary policy decisions through the information they provide on economic and financial conditions around the country, and they enhance communications between the Bank and their respective regions. At the same time, since directors are not required to be expert in the field of monetary policy (the Act indicates that they shall be from "diversified occupations") and are not full time, it would not, as a practical matter, be reasonable to look to them to conduct monetary policy, although as a group they clearly have the power to take initiatives if they choose to do so. In practice, it is the senior management of the Bank that formulates and implements monetary policy and reports to the Board and the Executive Committee at their regular meetings.

Within the Bank, consideration of monetary policy issues and the exchange of information relevant to those issues takes place at the daily meetings of the Management Committee. This group consists of the Governor, the Senior Deputy Governor, Deputy Governors, Advisers and the Secretary of the Bank. The meetings are under the chairmanship of the Governor, as the Bank's Chief Executive Officer. In the absence of the Governor, his place is taken by the Senior Deputy Governor.

**e) The accountability regime for monetary policy**

It is to be expected that the legislation governing a central bank will establish ways of ensuring that those at the central bank who are responsible for conducting monetary policy will be accountable to some elected body or individual for their decisions and actions, ideally in terms of whether they have fulfilled their mandate.

The process of accountability can provide that elected body or individual with the power to change the central bank's leadership by refusing re-appointment to the Governor. And there may well be other ways of providing accountability. For example, the elected body or individual may be given the power to reverse the central bank's decisions in extreme cases. It might well be argued that this particular example is not one of "accountability" as such but rather a limitation on the central bank's independence. In any event, it is worth emphasizing that the power of reversal should be available only <u>after</u> a decision has been taken. If the relevant body or individual had the opportunity actually to vet decisions regarding monetary policy formulation and actions of policy implementation before they were put into effect, the central bank would no longer be in a position of responsibility. In other words, it would very clearly no longer have the independence of action that it requires if it indeed is going to be accountable.

In Canada, Parliament has provided for an explicit directive power for the Minister of Finance to override monetary policy decisions of the Bank of Canada. The key section in the Bank of Canada Act with respect to the directive power is Section 14. It is in two parts.

In the first part, it requires that "the Minister and the Governor shall consult regularly on monetary policy and on its relation to general economic policy." To fulfil the provision for regular consultation, it has been the practice for the Minister and the Governor to meet on a weekly basis when possible, and more frequently when necessary. Through this process the Minister is kept well informed of the specific actions taken by the Bank to implement policy.

In the second part, this section of the Act sets out a formal procedure whereby, in the event of a disagreement between the government and the Bank which cannot be resolved through further consultation, the Minister of Finance, with the approval of the Governor in Council, may issue a directive to the Governor as to the monetary policy the Bank is to follow. The directive must be in writing, in specific terms, applicable for a specified period and published forthwith. This provision of the Act makes it absolutely clear both that the government must take the ultimate responsibility for monetary policy and that the Bank must accept immediate responsibility so long as a directive is not in effect. No directive has ever been issued. "Ultimate responsibility" has been interpreted by governments and the Bank as responsibility for the general thrust of monetary policy, not responsibility for every single action of the Bank.

Although it is not possible to foresee all of the circumstances that might give rise to a directive being issued, the most likely result would be the resignation of the Governor since a directive would hardly be necessary if the Governor could in good conscience carry out the policy favoured by the government. Therefore, for the independent status of the Bank to be meaningful, the Governor must be prepared at all times to insist on the policies which the Bank believes to be right and must be prepared to resign in the event of a directive overruling Bank policy.

The fact that the Deputy Minister of Finance is a member of the Board of the Bank and of the Executive Committee of the Board provides a formal channel of communication between the Bank of Canada and the Department of Finance. In practice, this channel is supplemented by many other channels that cover the whole range of matters on which the Bank and the Department need to keep in close contact.

The process of central bank accountability that involves giving government a role in appointing the management of the central bank is also included in the Bank of Canada Act. It takes the form of a requirement that the government approve decisions by the directors regarding the appointment and re-appointment of the Governor (and Senior Deputy Governor) every seven years.

The recent proposals by the government to amend the Bank of Canada Act seek to add to these accountability mechanisms and to the formal channels for describing and explaining monetary policy. Under these proposals, the appointment of the Governor would be subject to Senate ratification. The Governor would testify regularly before Parliament on past and future financial and economic developments, probably on a semi-annual basis. And the Governor would meet with the federal-provincial Ministers of Finance every fall to present an assessment of the state of the economy and to discuss interactions of fiscal policies with monetary policy.

**f) Regional representation**

There has been a good deal of discussion in Canada about how to ensure regional input into decisions about monetary policy. What should be made clear at the outset, however, is that monetary policy by its very character is <u>indivisible</u>. That is to say, because monetary policy operates in a single currency in an efficient financial market, there can only be a single monetary policy for Canada; it cannot be split up. Certainly, demand and supply conditions may very well differ across regions and industries. But monetary policy cannot be metered out on either a regional or an industrial basis -- either for money creation or for interest rates. The single monetary policy that is pursued in Canada must, therefore, be based on the economic picture overall -- that is to say, based on the sum of the regional situations. And this conclusion holds true no matter how the Bank is governed.

Although not required by statute, directors of the Bank have been in fact appointed (by the Minister of Finance) with the objective of ensuring regional representation on the Board. From the beginning, two directors have been appointed from Ontario and from Quebec and one director from each of the other provinces. The Executive Committee has also traditionally been selected by the Board to ensure regional representation. The directors provide information about economic and financial developments in their respective regions at each Board meeting. They also help to communicate Bank policy in their regions, typically on an informal basis. Every year one meeting of the Board is held outside Ottawa, to enable Board members to visit and meet with representatives of communities in different regions.

Up-to-date regional and industrial information is important in interpreting ongoing economic developments. As noted earlier, the assessment of the strength of aggregate demand and inflationary pressures across the country feeds into the process of determining the particular central bank actions needed. The Bank currently has good access to this essential regional information through its directors, from statistical sources and through a variety of staff contacts at all levels.

The proposals by the government to formalize both the regional representation in the appointment of directors and the flow of information through a system of regional consultative panels, chaired by members of the Board of Directors, would have the effect of providing a statutory guarantee of a regional input into the Bank's decisions on national monetary policy.

**g) Communications and transparency**

With respect to obligations on the Bank to provide information to the public, the requirements currently in the Bank of Canada Act are that the Bank must publish weekly and monthly balance sheets and that the Bank's annual financial statements and the Governor's report to the Minister of Finance must be tabled in Parliament. However, the Governor also makes frequent speeches explaining monetary policy, and the Bank publishes a wide range of information and analysis on economic and financial matters, including extracts from the minutes of the meetings of the Board of Directors. Furthermore, over time the Bank has with increasing frequency been called to appear before parliamentary committees.

The Bank has agencies in eight provinces and also stations financial market liaison people in Toronto, Montreal and Vancouver. This liaison work is supplemented by frequent visits across the country by the Governor and other senior Bank officials to make speeches and to meet with local groups.

The government's proposals provide for a number of formal channels for the Bank to communicate its policies and to explain its actions. As noted, the Governor would appear before a parliamentary committee at least twice a year and would meet with the federal and provincial ministers of finance each fall. Furthermore the regional consultative panels would provide for information flows in both directions, giving another venue for the discussion and explanation of monetary policy.

# APPENDIX

## Central Bank Arrangements in Other Countries

This appendix provides a perspective on the central bank arrangements in a number of major industrial countries.

The review is organized around the three key issues of central bank mandate, independence and accountability. As well, for those countries organized politically along the lines of a federal system the issue of regional representation in central bank decision-making is discussed. The focus is the monetary policy function of central banks.

The countries included in this review are the United States, Germany, Japan, the United Kingdom, Switzerland and New Zealand. There are also references to the proposed European System of Central Banks.

Developments in the area of central bank structures are not rapid or frequent. However, it is worth emphasizing at the outset that where change has taken place (New Zealand) or has been proposed (in Europe in connection with the development of a European central bank), it has invariably been in the direction of strengthening the monetary policy commitment to price stability.

**a) Mandate**

The legislation governing central banks in the major industrial countries can be characterized as falling into one of two groups: in one group the legislation sets out a clear, specific mandate for the central bank, while in the other group the legislation incorporates multiple objectives into the central bank mandate. It is also the case that some central banks operate without any legislative mandate and hence have no clearly expressed objective(s).

The central banks of Germany and New Zealand are mandated to achieve relatively precise objectives. German law states that the "Deutsche Bundesbank regulates the quantity of money in circulation .... with the aim of safeguarding the currency." The Bundesbank has interpreted this responsibility to mean preserving the domestic value of the Deutsche Mark, in other words, price stability. In the case of the Reserve Bank of New Zealand, its legislation states that "the primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices."[1] The draft statutes governing the proposed European System of Central Banks state that the "primary objective of the System shall be to maintain price stability."

The United States, Japan and Switzerland are examples of countries where central bank legislation establishes a multiplicity of objectives. The U.S. Federal Reserve System operates under legislation (the Federal Reserve Act) which requires it to "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." In testimony before Congressional

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1 The legislation also requires that the Minister of Finance and the Governor of the Reserve Bank of New Zealand reach agreement contractually on the specific policy target "for the carrying out by the Bank of its primary function" during the Governor's term of office. That agreement quantifies the meaning of "stability in the general level of prices", and sets out the timeframe for achieving the target. The current Policy Targets Agreement sets the price stability target as zero to 2 per cent inflation in the consumer price index, to be achieved by December 1993 and maintained thereafter.

committees Chairman Greenspan has acknowledged that the legislation governing the Federal Reserve sets forth multiple objectives for policy that have not always been consistent, at least in the short term. He has indicated his support for proposals that would "direct monetary policy toward a single goal, price stability, that monetary policy is uniquely suited to pursue." In Japan and Switzerland, legislation is general, stating that the central bank is to regulate money and credit in support of overall economic goals.[2]

The United Kingdom is almost alone among the major industrial countries in not having a central bank with its main powers, functions and responsibilities defined in law. Nowhere in legislation is the Bank of England described as the central bank of the United Kingdom and its performance of central banking functions owes more to practice and precedent than to legislation.

**b) Independence**

Legislation governing the Bundesbank states that the central bank is required to support the general economic policy of the government, but this obligation is expressly linked to the condition that it does not create insoluble conflicts with the primary task of achieving and maintaining price stability. In exercising its power the Bundesbank is independent of instruction from government. The Bundesbank Act contains no provision for resolving serious differences of opinion between the government and central bank, but it does require both parties to cooperate

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[2] In practice, the Swiss National Bank interprets its mandate to be the pursuit of price stability as the principal objective of monetary policy. According to central bank officials, the public largely agrees with its position that monetary policy should be aimed at achieving and maintaining price stability. The Bank of Japan has also been a forceful advocate of the need for long-term price stability as the primary objective of the central bank.

and to consult one another. The supreme policy-making body of the Bundesbank, the Central Bank Council, is made up of the directorate and the presidents of the eleven Land central banks. Only the members of the directorate (President, Vice-President and up to eight other persons) are nominated by the federal government. Thus the Bundesbank Act prevents the federal government from appointing a majority of the members of the Central Bank Council. Council appointments are for a term of eight years.[5]

The structure of the Federal Reserve System has also been designed to provide for a significant degree of independence in its monetary policy operations. The principal monetary policy committee, the Federal Open Market Committee (FOMC), decides policy by a majority vote of its members. The FOMC is comprised of the seven members of the Board of Governors, who are appointed by the President of the United States for a single 14-year term (subject to Senate confirmation), and five presidents of the twelve district Reserve Banks. Reserve Bank presidents are appointed by the Boards of Directors of the Reserve Banks, subject to the approval of the Board of Governors. The Chairman and the Vice Chairman of the Board of Governors are named by the President from among the members of the Board for a four-year term and are eligible for re-appointment.

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5 After the German reunification a modification of the Bundesbank Act has been proposed by the federal government. According to this proposal there will be only nine Land central banks. The Central Bank Council will consist of the President, the Vice-President, up to six further members of the directorate and the nine presidents of the Land central banks. This would mean that the district of a Land central bank comprises several small federal states. Only in the big federal states will the districts of the Land central banks and the states be identical. At the moment the amendment to the Bundesbank Act proposed by the government is being discussed in parliament.

By virtue of limitations on the government's powers to direct the Reserve Bank, legislation in New Zealand establishes effective independence for the Reserve Bank in carrying out monetary policy. While there is a Board of between 7 and 10 Directors, it is the Governor who has the explicit duty to ensure that the Bank implements monetary policy in keeping with the policy targets. Directors are appointed by the Minister of Finance for five-year terms, and their duties include monitoring the performance of the Governor in relation to the policy targets. The Governor is chairman of the Board and is appointed for a five-year term (renewable any number of times) by the Minister of Finance on the recommendation of the Board. Once established, the policy targets cannot be amended by the Minister of Finance without the concurrence of the Governor. The government retains the ultimate ability to override the existing Policy Targets Agreement by way of an Order in Council from the Governor General, directing the Bank to formulate and implement monetary policy in pursuit of an objective other than price stability. But such an Order must be published, and cannot last for longer than 12 months without explicit renewal. In other, limited, circumstances (notably dealing with the exchange rate and foreign exchange dealings), the government has the power to direct the Bank, but the Governor has the power to refuse to give effect to the direction if he considers that the direction would be inconsistent with the economic objective of monetary policy.

The Swiss National Bank also has a high degree of independence. The principal body responsible for monetary policy, the Governing Board, consists of three members appointed by the federal government for six-year terms. The relationship between the government and the Swiss National Bank is described as that of equal partners, whereby the government and the central bank must, according to law, inform each other of their intentions before taking economic and monetary policy decisions of major importance and that they must coordinate their measures.

The government may not issue policy directives to the central bank.

Similarly, under the draft statute of the European System of Central Banks, "neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body."

In Japan, the highest decision-making body at the Bank of Japan is the Policy Board. The Board is composed of seven members -- five with voting rights, including the Governor, who is appointed by the Government for a five-year term, and two non-voting representatives from the government. Although the Chairman of the Policy Board is elected from among its five voting members, it is customary for the Governor to assume the position. According to the Bank of Japan Law, the central bank is under the supervision of the Minister of Finance. In practice the Bank of Japan has been able to operate with a considerable degree of independence.[4]

In addition to independence regarding monetary policy actions, there is also the issue of budgetary independence. For the central bank to exercise the independence of authority it is given in monetary policy, it also needs authority in its corporate administration. Government involvement in budgetary or personnel matters at the central bank can be used to undermine the ability of the central bank to take an independent approach to the conduct of policy.

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[4] Government officials have confirmed (for example, in testimony before the Diet) that decision-making authority in the conduct of monetary policy, especially regarding changes in the discount rate, rests with the central bank.

Broadly speaking, most (although not all) central banks have a high degree of budgetary authority.

The U.S. Federal Reserve Board and Banks have self-financing authority and thus the Congressional appropriations process may not be used to influence Federal Reserve policies. In both Germany and in Switzerland, the central bank's budget process is independent of government control. There are, however, some specific requirements, such as basing the central bank's salary scale on those of the public service in the case of Germany, or requiring the government to sanction the salary scale in the case of Switzerland.

In Japan, the central bank law specifies that a budget for the Bank of Japan's current expenditures be submitted to the Ministry of Finance for approval. In New Zealand, the central bank's expenditures on administrative functions are determined on the basis of five-year agreements between the Minister of Finance and the Reserve Bank, subject to parliamentary ratification.

**c) Provisions for accountability**

An important element in the process of accountability is the ability of the government to refuse re-appointment of senior officials. Accountability could also involve the ability of the government to reverse central bank decisions and actions. If the central bank is to have independence in its corporate administration, there is the additional need for some form of accountability in the central bank's use of public funds. A further level of accountability involves the obligation of a central bank to inform the general public of its objective(s) and its activities.

In Germany, there is no clear line of accountability from the Bundesbank to any one elected person or body regarding its conduct of monetary policy. While up to ten positions on the decision-making Central Bank Council (including the President and the Vice-President) are held by individuals appointed by the President of the Federal Republic (on nomination by the federal government and after consultation with the Central Bank Council), the majority of positions (eleven) are ex officio held by the presidents of the Land (state) central banks. However, these presidents are not expected to pursue the interests of their Lander or to receive instructions from them. Thus in practice the Bundesbank is not directly accountable to either the Upper (state) or the Lower (federal) House of the German Federal Republic. Members of the federal government may attend and propose motions at meetings of the Central Bank Council, but they do not have voting rights and at most can ask that Council decisions be delayed for up to two weeks. Therefore there appears to be no complementary mechanism for accountability beyond re-appointment of senior officials and the possibility of changing legislation. As noted earlier, the Bundesbank's budget process is independent of government control. However, its salary structure must be tied to that of the public service and the federal general accounting office examines, ex post, the Bundesbank's expenditures. The Bundesbank's annual statement of accounts is communicated to the federal Minister of Finance. It is apparent that the high degree of independence given to the Bundesbank is based on a general consensus on the part of the German public with regard to the broad thrust of economic and monetary policy. To ensure broad support for its policies, the Bundesbank pursues an active and open information policy which might be regarded as part of a public accountability in a wider sense.

The Federal Reserve Board in the United States is accountable to Congress for all its activities. The Board of Governors of the Federal Reserve is required (pursuant to the Humphrey-Hawkins Act) to report semi-annually to Congress on the Federal Reserve's monetary policy objectives and its expectations about the performance of the economy. As well, Governors of the Federal Reserve Board, including the Chairman, are called to testify before Congress on specific issues. The budgets of both the Federal Reserve Board of Governors and the Reserve Banks are approved by the Board of Governors at a public meeting each December. Each spring two members of the Board appear before a subcommittee of Congress (House of Representatives) to review and discuss the Federal Reserve System's expenditures and budget. In addition, general Congressional oversight includes frequent audits and reviews of certain Federal Reserve (non-monetary policy) operations. The possibility of re-appointment exists for the Chairman and Vice Chairman of the Board of Governors, and for those Governors serving out a portion of a term of a previous Governor.

The Policy Board of the Bank of Japan prepares an annual report on the implementation of monetary policy, and submits the report to parliament (the Diet). In addition, the Governor and other senior officers appear before the Diet to convey the Bank of Japan's assessment of economic and financial developments. The Governor also attends ministerial meetings on economic developments in order to facilitate coordination of government and central bank policies. As noted earlier, under the Bank of Japan Law, the Finance Minister supervises the Bank of Japan and approves its budget expenditures.

In Switzerland, while the majority of the shares of the Swiss National Bank are held by the cantons and cantonal banks,[5] the main line of accountability is to the federal government. The federal government appoints the three full-time members of the Governing Board, the principal body responsible for monetary policy, and it must approve the central bank's annual report and

[5] Cantonal banks are established by the cantons and usually carry a state guarantee on their liabilities. These banks are partially exempt from federal supervision.

accounts before they are submitted to the General Meeting of Shareholders. Other bodies of the central bank play an oversight role on administrative and budgetary matters. These bodies, which are part-time, include representatives elected at the Meeting of Shareholders, but the majority of them are appointed by the federal government from the various sectors of the economy and regions of Switzerland.

In New Zealand, the Reserve Bank is required to release a monetary policy statement at least every six months, setting out the policies it intends to adopt in pursuit of its specific policy targets and the reasons for adopting those policies. The monetary policy statements are referred to a Select Committee of the House of Representatives, and the Bank is examined by the Committee. In addition to the Committee's review of the performance of the Bank, the Board of the Bank is responsible for monitoring the Governor's performance in ensuring that the Bank meets its targets. If the Governor's performance in this regard has been inadequate, the Board is obliged to advise the Minister of Finance that the Governor be removed from office by way of an Order-in-Council. The Minister may also independently come to the same view, and recommend dismissal on these grounds to the Governor General. Accountability for internal management includes being subject to a clear five-year funding agreement with the Minister of Finance and ratified by parliament.

**d) Regional representation**

The United States, Germany and Switzerland are all federal states in which provincial governments have considerable power. It is also the case that the degree of central bank independence is highest in these three countries. The structure of the central banks in these countries is characterized by a full-time governing board. While board members tend to be representative in some fashion of constituent regional units, monetary policy decisions are taken from a unified, national, point of view. In the United States and Germany, members of the governing board also have responsibility for corporate administration, whereas in Switzerland part-time directors who are not part of the monetary policy decision-making process perform this function.

In Germany, each of the Lander has its own Land central bank, which in effect is a regional office of the Bundesbank.[6] The president of the Land central bank of each of the Lander is ex officio a member of the decision-making body, the Central Bank Council. The presidents of the Land central banks are nominated by the Upper (or state) House of the German Parliament based on a proposal from the state (Land) government and after consultation with the Central Bank Council. The Bundesbank Act does not specify a residence requirement as a qualification for the presidents of the Land central banks. As noted earlier, these presidents are not expected to pursue the interests of their Lander or to receive instruction from them.

In the United States, all twelve Reserve Bank presidents attend the FOMC meetings and participate in deliberations, but only five can vote. Voting privileges are held by the president of the New York Federal Reserve Bank and by a rotating group of four of the other eleven presidents serving

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6 The Land Central Banks carry out the transactions and administrative tasks occurring in their region and are responsible for the approximately 200 branch offices the Bundesbank maintains in larger towns and cities. They are considered an integral part of the Bundesbank. The federal government owns 100 per cent of the Bundesbank capital.

one-year terms.[7] The Reserve Bank presidents are not empowered to speak just for their regions; they are expected to take a national view when voting on monetary policy. The twelve Reserve Banks are spread across the United States in a manner that reflects historical as well as geographic factors: for example, Missouri has two Reserve Banks.[8] Reserve Bank presidents are chosen by the Board of Directors of the Reserve Banks subject to approval by the Board of Governors.[9] The term is five years and reappointment is permitted. Presidents are chosen on the basis of a national search and therefore do not necessarily come from the region they represent. To promote regional diversity, it is also the case that only one Governor can come from any given Federal Reserve district. In practice, however, Governors do not always have a strong personal link to their representative district.

In <u>Switzerland</u>, the main body responsible for administrative and budgetary oversight is the part-time, forty-member Bank Council, which is made up of regional representatives appointed by the federal government and the shareholders. This body is also considered a useful forum for the exchange of information and ideas between the Swiss National Bank and

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[7] Of the four rotating Reserve Bank members, one is selected by the Boston, Philadelphia and Richmond districts; one by the Cleveland and Chicago districts; one by the Minneapolis, Kansas City and San Francisco districts; and one by the Atlanta, Dallas and St. Louis districts.

[8] The Reserve Banks are responsible for financial supervision in their regions as well as for the operation of a major part of the payments system.

[9] Commercial banks hold all the stock of the Reserve Banks, which entitles them to elect six of the nine directors on the Board of each Reserve Bank. (Three of the six are from the banking community and the other three are from the business community.) Three directors are appointed by the Board of Governors, one of whom is designated chairman and another vice-chairman of the Reserve Bank.

representatives of the Swiss economy. The Bank Council meets quarterly, whereas a ten-member subcommittee, the Bank Committee, meets monthly to carry out the oversight and control of the management of the Swiss National Bank. The Bank Committee in effect acts as the executive committee of the Bank Council.