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# Balancing the Independence and Accountability of the Bank of Canada

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*Balancing the Independence and Accountability of the Bank of Canada*
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# BALANCING THE INDEPENDENCE AND ACCOUNTABILITY OF THE BANK OF CANADA

## 1 INTRODUCTION

Central banks hold considerable power in their countries' economies. While their mandates vary, they generally aim to create the conditions for economic and financial stability. Their most important tools are monetary policies, which are decisions about the value of money. These include decisions about the amount of money in the economy and ways to keep inflation stable.

Most central banks hold some or all of the following powers: setting interest rates, issuing currency, regulating foreign exchange rates, regulating private banks, and acting as a lender (especially an emergency lender) for governments and/or private banks.

In light of the considerable power of central banks, lawmakers and central bankers must decide how to balance the banks' independence from political influence and their accountability to citizens. The result requires trade-offs between competing principles. On the one hand, central banks need independence, since the best policy for the economy may not align with political goals. On the other hand, in fulfilling their mandate, central banks must be accountable to citizens through their lawmakers.

There is no single, best compromise between these principles. While every country aims for the "correct" balance between its central bank's independence and accountability, the result is different for each country. Most countries have changed their practices significantly over time.[1] Since its creation in 1934, the Bank of Canada has always been mandated "to regulate credit and currency in the best interests of the economic life of the nation."[2]

This paper introduces readers to the ongoing independence-accountability debate. It focuses on the balance that the Bank has struck, and how the trade-offs that Canada has made about the Bank's independence and accountability compare with the situations in the United States and the United Kingdom.

## 2 THE CASES FOR INDEPENDENCE AND ACCOUNTABILITY

### 2.1 The Case for Independence

Central banks can be considered independent if their activities are relatively free from governmental influence.

Central bank independence yields many benefits. When independent central banks make policies, the public can be confident that the government's political goals have not unduly swayed bank decisions. For example, an independent central bank can prevent a government from lowering interest rates to boost the economy during an election at the expense of long-term output.

There is also evidence that independent central banks help create more stable financial environments. For instance, there is general agreement that central bank independence correlates with stable inflation.[3] High independence is also related to fewer and lower government deficits, especially in democratic countries.[4]

Common independence practices for modern central banks include, but are not limited to:

- allowing the head of the central bank to sit for a predetermined amount of time and putting heavy restrictions on the head's dismissal;
- appointing the head of the central bank through a non-political process;
- giving the central bank, rather than the government, the power to set and/or execute monetary goals;
- limiting the government's ability to borrow money from its central bank;
- clearly defining the central bank's mandate in law; and
- clearly defining the roles and reporting relationships of central bank officials in legislation.

### 2.2 The Case for Accountability

Given their far-reaching powers, central banks can wield a heavy (if indirect) influence on people's day-to-day lives. It is thus unsurprising that people in democratic countries tend to expect a say in their nation's monetary policy. Central banks are said to be accountable to the extent that they must answer to the government. Countries can strengthen accountability by improving transparency and oversight.

The 2008 financial crisis thrust calls for accountability into headlines around the world. In the following years, public trust in central banks dropped sharply.[5] The crisis also sparked many popular movements such as Occupy Wall Street, a grassroots protest opposing major banks' and large corporations' influence on economic policy. These movements pointed out a disconnect between ordinary people and decisions about their economy.

At the same time, many central banks gained "unconventional" powers in hopes of better managing the crisis.[6] These new policies let central banks take stronger actions during emergencies. As a result, central banks today can produce more redistributive results (outcomes that affect some groups more than others) than in the past. This makes their emergency-response policies more political.

Even "conventional" monetary policy (day-to-day policy aiming to fulfil the central bank's mandate) can involuntarily favour some groups over others. For instance, there is evidence that lowering inflation may disproportionately increase female unemployment rates.[7] By contrast, high inflation may increase the gap between rich and poor.[8] These types of outcomes highlight why governments and the public would want democratic oversight over and transparency for monetary policy.

Governments tend to have many tools to hold central banks accountable. Common accountability practices include, but are not limited to:

- appointing the head of the central bank through the political process, and allowing for the head's dismissal if the government is not satisfied;
- giving the government, rather than the central bank, the power to set monetary and/or fiscal goals;
- clearly defining the central bank's mandate in law;
- clearly defining the relationship between the government and central bank officials in legislation;
- requiring the central bank to publicly and regularly report on its decisions, methodology and finances; and
- creating standards or codes of conduct for central bank officials.[9]

# 3 THE BANK OF CANADA'S INDEPENDENCE–ACCOUNTABILITY BALANCE

The *Bank of Canada Act* sets out the Bank's mandate, powers and structure. It gives the Bank a considerable level of independence but balances the Bank's powers with accountability measures.

Most of this section focuses on the Bank's structure and powers as set out in law. In practice, there is usually a high level of coordination between the Bank and the government. The two bodies often – but not always – work toward the same goals.

## 3.1 BANK OF CANADA STRUCTURE

As the Act's preamble states, the Bank must work "in the best interests of the economic life of the nation." In other words, the Bank should be answerable to Canadians. It must also work on Canadians' behalf rather than for a particular government.

The Bank is a Crown corporation; this means the federal government owns the Bank, but the Bank works at arm's length. The Board of Directors manages the Bank's day-to-day work but does not set monetary policy. The board's Executive Committee (also known as its Governing Council) sets monetary policy and strategic direction. The Bank hires all other employees internally and regulates them as its own staff rather than as public servants.

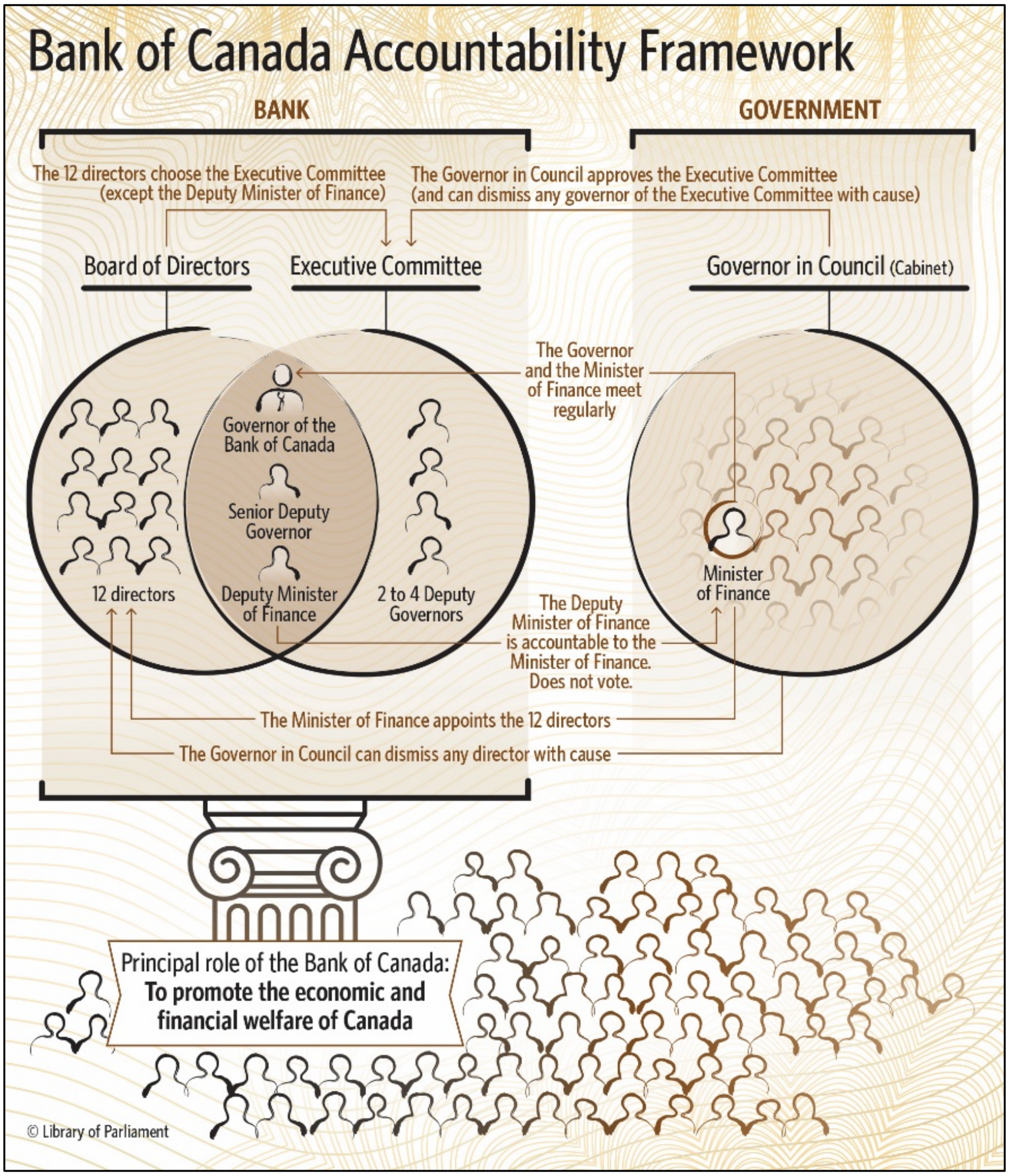
The board is made up of a governor, a senior deputy governor, 12 directors and the Deputy Minister of Finance.[10] The Minister of Finance appoints each director to the board. Directors sit for renewable, three-year terms, but the Governor in Council can remove them with cause. Senators, members of Parliament and public servants are not allowed to serve as board members. Board members have one vote each, except the Deputy Minister of Finance, who cannot vote.

One of the board's most important powers is to appoint the Bank's governor and deputy governors. However, the Governor in Council[11] must approve their choices.

The governor and senior deputy governor serve seven-year terms but may be reappointed at the end of their terms. Although the Governor in Council holds the power to dismiss the governor and senior deputy governor, it needs a valid reason to do so.[12] This ensures that the governor and senior deputy governor can work without fear of unjust dismissal, even if the government does not agree with their decisions.

The governor, the senior deputy governor, two to four deputy governors, and the Deputy Minister of Finance sit on the Executive Committee. The Executive Committee sets monetary policy by consensus but – as on the Board of Directors – the Deputy Minister of Finance has no vote. The Executive Committee must share its meeting minutes with the board. Although the board may advise the Executive Committee and evaluate its policies, the board cannot overturn the Executive Committee's decisions.

**Figure 1 – Bank of Canada Accountability Framework**



Under the Act, the Minister of Finance and the governor must "consult regularly on monetary policy and on its relation to general economic policy."[13] In practice, the two hold weekly meetings. If the Bank and the government disagree on monetary policy, the Minister of Finance may give the governor a written directive that the Bank must follow. This directive must be public, and the government must present the directive to Parliament soon after issuing it. However, to date, no minister has used this directive power.

Unlike other federal departments and agencies, the Bank submits its expenditures to its Board of Directors rather than to the Treasury Board. The Act also requires annual audits of the Bank's accounts. The Governor in Council appoints auditors on the Minister of Finance's recommendation, but the auditors must come from external firms and not from the Office of the Auditor General of Canada.

### 3.2 Bank of Canada Powers

Overall, the Bank has a high level of financial independence, meaning it has control over its budget and finances. This independence ensures that the Bank does not depend on government funds to do its work. Instead, the Act provides that the Bank be given a certain amount of capital to cover its operating costs as well as the power to generate income and build up reserve funds. The Bank earns its main source of income by issuing currency at a face value much higher than the cost of producing it. This practice is called "seigniorage."[14]

Among the Bank's most important roles is that of keeping inflation under control. The Bank's paramount inflation control tool is its power to set the "key interest rate," more commonly called the "overnight rate." The overnight rate is the interest rate at which banks may lend short-term funds to one other. Changing the overnight rate sets in motion a chain of events that affect inflation in the medium and long term.[15] The Bank sets short-term interest rates independently, but it jointly agrees with the government on long-term inflation targets through the inflation-control agreement.

Under this agreement, the Bank agrees to try to keep inflation within a certain range. The initial agreement in 1991 has been renewed every five years; its most recent renewal in October 2016 set an inflation-control range of 1% to 3%, with a Bank policy target of 2%. The aim of the agreement is to give the government and the public confidence that inflation will remain low, stable and predictable, "thus providing a climate that is more favourable to sound, sustained economic growth and job creation."[16] It also creates a clear measure of the Bank's success, for which the governor can easily be held accountable. However, if the Bank misses its target, the agreement does not formally require that it face any consequences.

Importantly, the Bank is not responsible for the government's financial stability, as in some other countries. The absence of this responsibility means that the Bank is not forced to pay for short-term government spending at the expense of long-term stability. However, the Bank can lend money to the government at the governor's discretion. The Bank can provide loans for various reasons, including financing government spending and providing emergency funds.[17]

As an independence measure, the Act limits the terms by which the Bank can lend money to the government. Loans cannot exceed one-third of the Government of Canada's annual revenue. Although the Bank effectively provides loans to the government at near-zero interest rates,[18] the government usually pays near-market interest rates on its loans.[19]

Under the Act, loan repayment times vary; the longest repayment term is 15 months or six months for emergency loans. However, the Bank has a policy to cap repayment of emergency loans at one day "to prevent the level of government deposits held at the Bank from falling below zero."[20] Under the policy, the Bank would also publicly disclose this loan. Having these limits ensures that the government cannot finance all its spending by borrowing endlessly from the Bank. Unlimited government borrowing would inevitably lead to higher inflation; the overall demand for goods and services based on the larger amount of money in circulation would grow faster than the economy's ability to produce.[21]

### 3.3 Accountability Through Transparency

Under the Act, the Bank is required to publish certain information online to ensure its transparency and, by extension, its accountability. It must post information about its assets and liabilities each week and post its balance sheet each month. It must also send its audited financial statements to the Minister of Finance every year. In addition, Canadians can request the Bank's records under the *Access to Information Act*.

Over the years, the Bank has also introduced voluntary practices to make it more transparent. For example, the Bank announces interest rate decisions on fixed dates, eight times per year, to ensure they are predictable. To help Canadians understand them, it also publishes four monetary policy reports and gives four economic progress report speeches each year.[22] The speeches give the media an opportunity to ask questions about Bank decisions.[23]

The governor and senior deputy governor usually appear many times per year before Senate and House of Commons committees, at the committees' invitation. This provides Parliament with the chance to ask in-depth questions about the Bank's decisions.

In the recent past, senior Bank officials have given public speeches more frequently and have published them online. The Bank website also publishes its committees' terms of reference. In addition, governors explain decisions in plain language to make monetary policy more understandable to all Canadians.[24] As part of its public outreach, the Bank runs a museum in Ottawa that has free admission.

## 4 CENTRAL BANK INDEPENDENCE AND ACCOUNTABILITY ABROAD

There is no consensus among academics on how best to measure central bank independence and accountability. However, the most commonly used indices in recent studies suggest that Canada requires a high level of accountability from its central bank compared with most countries. They also suggest that the Bank has relatively less independence by international standards.[25] It is worth noting that these indices measure central bank independence as set out in law, which may transpire differently in practice due to policies or institutional culture.

In general, the central banks of Organisation for Economic Co-operation and Development (OECD) countries tend to be highly independent. Many of them are empowered to set their own policies and goals. European central banks tend to be the most independent, which is mainly due to strict limits on government borrowing.[26]

Each country has chosen different trade-offs for its central bank policies to reflect its preferred balance between independence and accountability. This section highlights these trade-offs by describing relevant policies for the U.S. Federal Reserve (the Fed) and for the U.K.'s Bank of England (BoE). These central banks offer useful comparisons because they both serve economically advanced countries but have different independence and accountability practices.

## 4.1 The United States Federal Reserve

The Fed's level of independence is similar to that of the Bank of Canada. However, the two banks have very different mandates and structures. The biggest differences are the Fed's "dual mandate," its power to set monetary policy and its appointment process.

Most central banks have a single mandate: price stability. Instead, the Fed is mandated to control not only price stability – which the Fed interprets as low and stable inflation – but also unemployment rates. The Fed generally expects these two to move in opposite directions (e.g., inflation goes up while unemployment rates go down). As a result, the Fed is usually able to control both levers at once. However, price stability and unemployment rates sometimes move up or down together, so the Fed may meet one of its goals but not the other.[27] In these cases, it can be hard to hold the Fed to account.

The Fed has more independence when it comes to setting monetary policy than does the Bank. The U.S. Congress sets the Fed's mandate: "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."[28] However, the Fed is free to interpret its mandate by setting its own targets.

For most of its history, the Fed had informal targets for inflation but did not reveal formal targets publicly. Beginning in 2012, however, it voluntarily published the *Statement on Longer-Run Goals and Monetary Policy Strategy*. This statement set fixed inflation targets at 2%. At the same time, the Fed stated it would be "inappropriate" to set fixed employment targets because these assessments are "necessarily uncertain."[29]

The Fed also has distinct appointment processes. The U.S. President appoints seven members of the Board of Governors, plus a board chair and a vice chair. However, the Senate must approve these choices. Board members serve for relatively long terms of 14 years, but they cannot be reappointed if they serve a full term. The chair and vice chair – who are also board members – serve relatively short terms of four years. They can nevertheless be reappointed to their respective roles until the expiry of their term as board members.

Twelve different U.S. regions are also represented at the Fed, each through Federal Reserve banks. Each reserve bank's Board of Directors chooses its members.

Together, the Board of Governors and five reserve bank presidents (who serve on a rotating basis) form the Federal Open Market Committee (FOMC). The FOMC sets interest rates eight times per year.

Under the *Federal Reserve Act,* the U.S. President may remove any appointed member of the Board of Governors, but only "for cause."[30] However, the *Federal Reserve Act* does not define "cause." Case law on this subject is also ambiguous. According to legal scholar Peter Conti-Brown, "Removability protection does not exist for the Fed Chair, but it exists in unconstitutional form for the reserve bank presidents."[31] Under this interpretation, the U.S. President may hold central bankers to account more easily than is common in other OECD countries.

### 4.2 The Bank of England

The BoE falls around the global average for central bank independence.[32] In some respects, it has a similar mandate and a comparable ability to set policy as the Bank. However, there are significant differences. Most importantly, the BoE is highly protected from obligations to lend money to the government. On the other hand, the U.K. imposes more accountability practices on its central bank than Canada does.

The BoE has the power to lend money to the U.K. government through an account called the National Loans Fund (NLF). The government can borrow money from the NLF for various reasons, including to finance its spending or pay off debts. However, the U.K.'s *National Loans Act 1968* puts limits on the government's ability to borrow from this fund.[33]

For example, loans for government projects cannot exceed £95 billion and the U.K. Parliament must approve these expenditures. In addition, the government and the BoE must agree on interest rates for money the government holds in the NLF. Similarly, if the government creates securities to pay off debt or ensure financial stability, it can redeem them at the BoE only at market prices (before they mature). These restrictions, among others, ensure that the U.K. government is not able to finance all its spending through the central bank.

To balance this high level of independence, the U.K. has extensive oversight of the BoE. For instance, the BoE's Monetary Policy Committee (MPC) – which sets interest rates eight times per year – is required under law to publish its MPC minutes. Published decisions must record members' names and voting preferences. However, the BoE does not need to publish certain minutes if the MPC thinks that information will harm the public interest. In addition, in 2014, the BoE also announced it would voluntarily publish full transcripts of monetary policy decisions after eight years, among other transparency measures.

Regarding inflation targeting, the U.K. and Canada have similar practices. Both countries' central banks are expected to meet inflation targets, but one key difference is that the U.K. government alone sets BoE targets, while in Canada, this decision is made by the Bank of Canada in consultation with the government. Under U.K. law, the Treasury sets objectives for the MPC, which the Chancellor of the Exchequer (who is the equivalent of Canada's Minister of Finance) publishes each year alongside the budget. The U.K. government also has tools to hold the BoE accountable if inflation moves away from its target.

If inflation misses the target by more than one percentage point, the BoE governor must send an open letter to the Chancellor of the Exchequer explaining why this was the case. The letter must also say what the BoE is doing to meet the target, when it expects to meet the target, how its decisions affected – and will continue to affect – economic output, and how its approach aligns with the government's monetary policy. The BoE must send a new letter in three months if inflation is not yet on target.

## 5 TRADE-OFFS AT THE BANK OF CANADA

Comparing central bank policies elsewhere helps highlight the trade-offs Canada has made when finding a balance between independence and accountability. For instance, by international standards, Canada's appointment process for Bank officials grants them a fairly high level of independence. Nevertheless, this same process puts more limits on the government's ability to remove them from office when compared with the U.S.

These countries' approaches to inflation targeting emphasize similar trade-offs. The Fed's ability to set its own inflation targets provides it a high level of independence. By contrast, the U.K. government sets inflation targets and imposes strong oversight mechanisms on the BoE. Since Canada sets its targets through an agreement between the government and the Bank, it has found a middle ground between these two.

However, it is sometimes possible to create a high level of accountability while sacrificing very little independence (or vice versa). For example, the requirement that the BoE publish timely minutes of its banking officials' decisions can help the public to gain insight into how and why policies change. While this transparency lets the public scrutinize its central bank, the BoE does not give up its ability to make decisions.

In Canada and around the world, the debate around central bank independence and accountability continues. As with any other powerful institution, Canadians should ask themselves if they remain satisfied with the trade-offs they have made between the Bank's independence and accountability. This paper provides examples of how practices differ in other countries, but Canadians should decide which elements they value most in their own central bank.

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## NOTES

1. See Bertrand Blancheton, "Central bank independence in a historical perspective: Myth, lessons and a new model," *Economic Modelling*, Vol. 52, January 2016, pp. 101–107.
2. "Preamble," *Bank of Canada Act*, R.S.C., 1985, c. B-2.
3. Otmar Issing, "The uncertain future of central bank independence," in *Hawks and Doves: Deeds and Words – Economics and Politics of Monetary Policymaking*, ed. Sylvester Eijffinger and Donato Masciandaro, Centre for Economic Policy Research Press, London, February 2018.

4. Cristina Bodea and Masaaki Higashijima, "Central Bank Independence and Fiscal Policy: Can the Central Bank Restrain Deficit Spending?," *British Journal of Political Science*, Vol. 47, No. 1, January 2017.

5. Benjamin Braun, *Speaking to the People? Money, Trust, and Central Bank Legitimacy in the Age of Quantitative Easing*, Discussion Paper, Max Planck Institute for the Study of Societies, Cologne, Germany, 2016.

6. Quantitative easing is one unconventional policy adopted widely by central banks since the 2008 financial crisis. With quantitative easing, central banks create money and use it to buy securities. This sets in motion a chain of events intended to reduce interest rates, reduce borrowing costs, encourage lending and stimulate economic activity.

7. Elissa Braunstein and James Heintz, "Gender bias and central bank policy: employment and inflation reduction," *International Review of Applied Economics*, Vol. 22, No. 2, 2008.

8. Andrea Colciago, Anna Samarina and Jakob de Haan, *Central bank policies and income and wealth inequality: A survey*, Working Paper no. 594, De Nederlandsche Bank, Amsterdam, May 2018.

9. See also International Monetary Fund, *Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles*, 26 September 1999.

10. Deputy ministers are unelected officials, appointed by the prime minister, to lead the day-to-day operations of their departments.

11. Governor in Council decisions are made by the Governor General on the advice of the federal Cabinet.

12. Bank of Canada directors hold office during "good behaviour." This means that they cannot be dismissed for purely political reasons, but they can be dismissed for violating standards of behaviour and ethics expected of Canadian public officials. See, for example, Bank of Canada, *Code of Business Conduct and Ethics for Directors*, August 2013.

13. *Bank of Canada Act*, s. 14.1.

14. See Bank of Canada, "Seigniorage," Backgrounder, March 2013.

15. See Bank of Canada, "Monetary Policy," Backgrounder, April 2012.

16. See Bank of Canada, "The Benefits of Low Inflation," Backgrounder, May 2013.

17. The Bank of Canada may also provide a de facto loan to the Government of Canada to create money. See Penny Becklumb and Mathieu Frigon, *How the Bank of Canada Creates Money for the Federal Government: Operational and Legal Aspects*, Publication no. 2015-51-E, Parliamentary Information and Research Service, Library of Parliament, Ottawa, 10 August 2015.

18. Since the Government of Canada owns the Bank of Canada, the Bank must turn over its net revenue from government loans to the government. This has the effect of the Bank lending money to the government at near-zero interest rates because the Bank returns all interest it earns from government loans – minus the Bank's own expenses – to the government.

19. In most cases (e.g., loans for an infrastructure project), the Government of Canada uses Bank of Canada loans to pay private businesses or individuals. These businesses or individuals will likely deposit money in private banks, which will in turn deposit the funds at the Bank to earn interest. Thus, the Government of Canada pays interest to private banks (through the Bank) at the overnight rate – which is roughly the market rate – minus 0.25%.

20. Bank of Canada, *Statement of Policy Governing the Acquisition and Management of Financial Assets for the Bank of Canada's Balance Sheet*, 23 November 2018, s. 7.5.

21. See Bank of Canada, "Monetary Policy – FAQ: 4. Why doesn't the Bank of Canada just print enough money to pay off the national debt?," *Frequently Asked Questions*.

22. Another accountability tool central banks can use is "forward guidance." Central banks provide advance hints to markets about what their next interest rates will be. The Bank of Canada stopped giving routine forward guidance in 2014 in an effort to be more transparent about market uncertainties.

23. See Nicolas Parent, Phoebe Munro and Ron Parker, "An Evaluation of Fixed Announcement Dates," *Bank of Canada Review*, Autumn 2003, pp. 3–11.

24. See Stephen S. Poloz, "Let Me Be Clear: From Transparency to Trust and Understanding," Address to the Greater Victoria Chamber of Commerce, Victoria, 27 June 2018.

25. The two most common tools for measuring central bank independence are the Cukierman, Webb and Neyapti (CWN) index and the Grilli, Masciandaro and Tabellini (GMT) index. These methods place different levels of importance on the same factors, sometimes leading to very different results. Unless otherwise stated, this paper uses the most complete and most recent international dataset, coded with CWN: Ana Carolina Garriga, CBI [central bank independence] Data (database), accessed 25 September 2018; and Ana Carolina Garriga, "Central Bank Independence in the World: A New Data Set," *International Interactions,* Vol. 42, No. 5, 2016.

26. Garriga, 2016 and 2018; and Jakob de Haan et al., "Central Bank Independence Before and After the Crisis," *Comparative Economic Studies*, Vol. 60, No. 2, 2018, pp. 183–202.

27. Jeffrey M. Lacker and John A. Weinberg, "Inflation and Unemployment: A Layperson's Guide to the Phillips Curve," *Economic Quarterly*, Vol. 93, No. 3, Summer 2007, pp. 201–227.

28. United States, "Section 2A: Monetary policy objectives," *Federal Reserve Act*.

29. United States Federal Reserve, *Statement on Longer-Run Goals and Monetary Policy Strategy*, 30 January 2018.

30. United States, "Section 10(2): Board of Governors of the Federal Reserve System," *Federal Reserve Act*.

31. Peter Conti-Brown, "The Institutions of Federal Reserve Independence," *Yale Journal on Regulation*, Vol. 32, No. 2, Summer 2015, p. 257.

32. Garriga, CBI Data, accessed 25 September 2018.

33. United Kingdom, *National Loans Act 1968*.