

# The Bank of Canada: Moving Towards Transparency

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- *During the 1990s, the Bank of Canada made several changes that transformed its conduct of monetary policy. These changes are part of an evolution in the Bank's approach that has continued since the 1970s.*
- *During the 1960s and 1970s, policy decisions were made in an environment characterized by instrument opaqueness and goal opaqueness, which tended to shield the Bank's operations from scrutiny and accountability.*
- *Since the 1970s, the Bank has moved towards transparency and openness by rejecting multiple policy instruments and adopting a single, well-defined goal of inflation control.*
- *A recent survey shows that the Bank of Canada is in the middle range of central banks with regard to its transparency.*
- *The significant developments that have occurred in central banking and monetary policy since the 1960s have benefited the public. However, central banks should not assume that the costs and benefits are obvious to everyone, but should continue to support research on the benefits of low and stable inflation and continually inform other policy-makers and the public of their results.*

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Over the past decade, the Bank of Canada has transformed its conduct of monetary policy by focusing on an explicit inflation-control target, establishing a Governing Council for decision-making, announcing a target overnight interest rate, and adopting fixed action dates for making policy changes.<sup>2</sup> These changes are part of a continuing evolution in the Bank's approach that has taken place since the 1970s.

## The 1960s and Early 1970s: Opaqueness

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The Bank of Canada operated much differently in the late 1960s than it does today.<sup>3</sup> A most notable difference was the apparent efforts made by the Bank in earlier years to shield its operations from scrutiny. It did this through a combination of instrument and goal opaqueness, as part of a policy approach characterized by general, and mostly unnecessary, secrecy.<sup>4</sup> Acheson

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2. Jenkins (2001) describes the Bank's measures to improve transparency and accountability as well as its approaches to communication.

3. This section is based on papers written by the author with Keith Acheson in the early 1970s.

4. Goodfriend (1986, 90) concludes his critique of the arguments for central bank secrecy as follows: "Given the inconclusiveness of the theoretical arguments and the presumption that government secrecy is inconsistent with the healthy functioning of a democracy, further work is required to demonstrate that central bank secrecy is socially beneficial."

and Chant (1973) used the theory of bureaucracy to interpret this approach as a device to avoid scrutiny and accountability. Max Weber, who originated the theory, argued that the administration of bureaus (that is, agencies and departments within government) “always tends to be an administration of ‘secret sessions’: in so far as it can, it hides its knowledge and actions from criticism” (Gerth and Mills 1946, 233).<sup>5</sup>

*Instrument opaqueness* refers to a manner of conducting policy that makes it difficult for outsiders to observe and understand the Bank’s policy actions. At the Bank of Canada, this was achieved by using multiple policy instruments, with an emphasis on instruments that are opaque, such as moral suasion. In addition, the Bank offered little guidance as to the significance that it attached to each of these instruments and the purposes to which they were directed.<sup>6</sup>

The use of multiple policy instruments makes it difficult for observers to form an overall view of the thrust of policy because different instruments can be used for different purposes at any time. In the 1960s, the Bank used variations of the secondary-reserve ratio, transfer of government deposits,<sup>7</sup> open market operations, and changes in the bank rate as active policy instruments. In addition, from 1954 to 1967 the Bank had, but never used, the power to change (within limits) the statutory cash-reserve requirement. This reliance on multiple instruments contrasted with the economic wisdom of the day on the conditions required for effective monetary control. The late Harry Johnson, a prominent Canadian economist, observed (1968, 977–78), “In the actual practice of central banking, however, reliance is placed on additional instruments and techniques of control over the commercial banks. From the point of view of the theory of monetary control, these additional controls are unnecessary.”

In addition to using many instruments, the Bank favoured those that were opaque. Opaque instruments do not leave clear tracks, making it difficult for observers to document their use, and even more difficult to assess their effects. The Bank’s use of moral suasion, rather than more direct policy action, to ensure the compliance of financial agents during this period

5. Other key contributors to the literature on bureaucracy include Downs (1967), Niskanen (1971), Selznick (1948), and Tullock (1965).

6. In contrast, the Bank now makes it clear that the target overnight interest rate is its key instrument.

7. See the Glossary for an explanation of these instruments.

Table 1

**Examples of the Use of Moral Suasion: 1946-69**

Year	Purpose
1946	Limit on government security holdings of chartered banks to 90% of Canadian personal savings deposits
1948	Limit on term loans
1951	Limit on total loans Limit on term loans
1955	Limit on term loans in amount exceeding \$250,000 Minimum liquid-asset ratio
1956	Limit on lending to consumer finance companies Special consideration to small borrowers
1957	Encouragement to mortgage loans Restrictions on term lending
1958	Term loan agreement revised to \$2,000,000 ceiling
1959	Term loan agreement revised to \$1,000,000 ceiling
1965	Accommodation to finance companies Request to discourage U.S. subsidiaries from switching to Canadian sources of funds because of U.S. balance-of-payment guidelines
1967	Agreement on maximum interest on term deposits Request to refrain from extending credit for the purchase of gold
1968	Request to discourage use of bank credit to make abnormal transfers of funds or to replace funds normally obtained from parent companies by U.S. subsidiaries Request to restrict the outflow of funds through certain currency deposit transactions
1969	Ceiling on “swap” deposits accepted by chartered banks Special regard for borrowers in less prosperous areas of the country Special attention to loan applications from small businesses without alternative sources of credit

Source: Adapted from Chant and Acheson (1986, 114)

illustrates the point. Table 1 shows that the Bank of Canada had agreements with chartered banks in 12 of the 23 years between 1946 and 1969, indicating that, during this time, the Bank made considerable use of moral suasion. Yet the Bank’s own reference to how it used moral suasion indicates how difficult it would have been to track either its use or its effects. According to the Bank (1962, 37), moral suasion consists of a “wide range of possible initiatives by the central bank designed to enlist the co-operation of commercial banks or of other financial institutions in pursuit of some objective of financial policy.” Such actions (1962, 38) range from “general exchanges of views” to “efforts by the central bank to achieve, through suggestion, discussion and persuasion, specific changes . . . in policies or practices of private financial organizations.”

Even though secrecy does not contribute to the effectiveness of moral suasion, Governor Rasminsky, testifying in 1963 before the Royal Commission on Banking and Finance (BoC 1964, 54), was reluctant to reveal details of how it was employed by the Bank:

Commissioner Brown: “Have you had any experience with the use of moral suasion?”

Governor Rasminsky: “Yes.”

CB: “Has it been . . . ?”

GR: “I have been satisfied with the results, yes.”

CB: “I gather that you prefer not to . . .”

GR: “I think that the experience is so recent—I mean, it is obviously an experience within the last eighteen months, Mr. Brown, and if you don’t mind I would prefer not to discuss the details.”

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*Goal opacity* refers to a central bank’s failure to identify its specific goals in order to provide a basis for evaluating its performance. The Bank practised goal opacity by pursuing multiple goals without making clear statements about its priorities regarding those goals.<sup>8</sup> Table 1 shows that the varied purposes of moral suasion, which included encouraging mortgage financing for housing, as well as support for small business and regional development, went far beyond the recognized concerns and capacities of monetary policy.

Finally, the overall degree of secrecy adopted by the Bank exceeded whatever level might be considered necessary for conducting monetary policy effectively. Both the Bank and the Minister of Finance, for example, refused to disclose details of the arrangements through which certain investment dealers, known as jobbers, qualified for special lines of credit on favourable terms.<sup>9</sup> The Bank would not disclose the names of the jobbers, the size of the lines of credit, the terms for qualifying as a jobber, or the criteria for determining their lines of credit. In reply to a question in Parliament, the Minister of Finance declared, “Because of the banker-client relationship that is involved and

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8. James Coyne, the Governor from 1955 to 1961, was adamant, however, in his claim that monetary policy could do nothing to prevent unemployment in the long run. In this respect, he led most economists.

9. See Fullerton (1962) for details of the role and privileges of the jobbers.

because the number changes from time to time the Bank has not made a practice of publishing the names of such jobbers.” (Canada 1969, 2067) This approach left the Bank effectively unaccountable for determining who would benefit from these special privileges.

Notable progress has been made since the 1970s in removing these obstacles to the accountability of central banks. In both its goals and operations, the Bank has shifted away from opacity towards greater openness and transparency. In terms of operations, the Bank has discarded many of its former policy instruments, including secondary-reserve requirements, reliance on moral suasion, and variable statutory cash-reserve requirements. It has also taken responsibility for the target overnight rate (and the bank rate, which is 25 points above it) and has identified the target overnight rate as its primary policy instrument. The Bank also makes it clear that the primary purpose of other instruments, such as auctions of government deposits and repo operations, is to ensure that the level of balances in the Large Value Transfer System is adequate to achieve the desired interest rate target.

Since the public’s primary concern with the performance of policy should be its outcome—performance with respect to goals rather than how they are attained—an even more significant factor has been the Bank’s increased accountability for a single, well-defined goal. The movement towards this position began in the mid-1970s with the adoption of monetary targets and a clearer focus on long-run price stability and culminated in the adoption of the inflation-control target in 1991.

## Sources of Greater Openness

What broad trends in society and the economy motivated these changes towards openness and accountability? At least some of the actions of any instrument of government such as a central bank will be determined by its status as a bureau. But a bureau acts subject to its knowledge and to the constraints created by its environment, which in turn depend on the public’s knowledge and preferences. What, then, has changed?

### From fixed to flexible exchange rates

The movement away from a fixed exchange rate removed a substantial obstacle to openness. Simply put, fixed exchange rates are an enemy of openness. They give investors one-sided wagers when the currency faces likely devaluation or revaluation. Investors bear little risk betting on any changes, since they reap substantial gains when they occur and face only

small losses when they don't. Central banks cannot be consistently open under fixed exchange rates. Signs of weakness could provoke a flurry of self-fulfilling, one-sided wagers among investors. Even disclosure of strength is not feasible because its absence at other times would imply weakness.

An interesting example of the degree of secrecy necessitated by fixed exchange rates is provided by the experience of the head of the Netherlands Bank who, at his government's prodding, phoned the Bank of England on Friday 18 September 1931 and asked whether the gold value of his bank's sterling balance was safe. After receiving assurances that it was, the Netherlands Bank supported the Bank of England by not converting its sterling balances to gold. The British government effectively abandoned the gold standard the next Monday, plunging the value of the pound from US\$4.87 to US\$3.40. The Netherlands Bank lost its capital, and its head lost his job (Yeager 1976).

Flexible exchange rates differ markedly in their scope for openness. Under fixed rates, a central bank must often struggle against the crowd in carrying out policy. In contrast, under flexible exchange rates a credible anchor such as an inflation target shifts the balance. Markets can contribute to reaching the target if things get off course. Openness and transparency in this case facilitate the achievement of the target.

## Experience

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Governments and the public came to understand, through the experiences of the 1970s and early 1980s, that inflation might not have been the panacea that many initially thought it would be. The first doses of inflation in the early seventies may have been euphoric. For some, this unexpected inflation substantially reduced the real value of their mortgages. But the euphoria was short-lived. Inflation quickly became

identified with higher-than-normal rates of unemployment, the so-called "stagflation." These experiences stimulated the economics profession to reconsider its analysis of inflation and to reassess its costs.

## Economic knowledge

The evolution of economic knowledge itself has contributed to openness by narrowing the goals of central banks, providing a clearer framework for assessing the stance of policy, and lowering expectations of what can be accomplished.

Several developments have clarified expectations about the ability of central banks to pursue multiple goals. Tinbergen's (1956) recognition of the relation between targets and instruments showed that multiple goals cannot be achieved through the use of one instrument. This was followed by the work of Friedman (1968) and Phelps (1967, 1968) denying the existence of any long-term trade-off between inflation and unemployment. These developments together prepared the intellectual groundwork for central banks to focus on the single target of controlling inflation while choosing a suitably long horizon that would help to maintain the stability of output as inflation returned to the target following a shock.

Similarly, greater awareness of the distinction between real and nominal interest rates<sup>10</sup> also increased transparency. In the 1960s and 1970s, announcements by the Bank of Canada of its policy stance had frequently been unclear and ambiguous. Rising interest rates combined with rapid monetary growth could be characterized as tightness by referring to interest rates, or as ease by referring to monetary growth. Such different interpretations were possible because of the general failure to distinguish between real and nominal interest rates.

The difference between real and nominal interest rates has a long history in economics, dating most notably to the work of Irving Fisher (1930). Nevertheless, it was the experience of the 1970s, when the need to take account of inflationary expectations in interpreting

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10. Nominal and real interest rates differ by a component that covers expected inflation. Nominal interest rates reflect the monetary returns received by bond-holders. In times of inflation, part of this return is eroded by the decreased purchasing power of the bond. Real interest rates equal nominal interest rates less this inflation premium and indicate the actual purchasing power gained from holding the bond. For example, with a nominal interest rate of 6 per cent and an expected rate of inflation of 2 per cent, the bond's value in terms of purchasing power decreases by 2 per cent and the expected real rate of interest is 4 per cent.

interest rates became evident, that made the bulk of the economics profession aware of the distinction. This awareness also contributes to greater accountability.

Finally, there was greater appreciation among economists that efforts to direct credit to specific uses were both ineffective and inefficient. The earmarking of credit for a purpose cannot ensure that credit will be used for that purpose. There need not be any correspondence between the instruments through which funds are raised and the uses to which these funds are put. Cheap mortgage credit can certainly lead to more borrowing, but homeowners may use the funds to spend more on cars or holidays. In addition, greater skepticism developed concerning the ability of governments to intervene to provide better allocation of credit than was achieved in the market.

### **Greater openness in government**

The increasing transparency of the Bank of Canada has also coincided with a worldwide trend towards openness and accountability within government. Governments themselves have seen the advantage of being more open, and the public has demanded it. In Canada, this openness has been reflected in regular reviews of key policies by parliamentary committees and the passage of freedom-of-information legislation. Such legislation leaves central banks and other government departments and agencies with an interesting choice: release information at a time and in the form it chooses, or wait to present it in response to a formal request.

### **What More Can Be Done?**

Since the 1970s, the Bank of Canada, along with other central banks, has come a long way towards increased openness. Nevertheless, a recent survey of central banks by Eijffinger and Geraats (2002) suggests that the Bank of Canada ranks in the middle of the pack in terms of transparency, losing points for neither publishing the forecasts that shape its policy nor releasing the minutes and voting records of its governing body.<sup>11</sup>

Eijffinger and Geraats observe that all central banks make numerous forecasts for inflation, output, or both available in some form. The Governing Council of the

Bank of Canada already provides much information in its *Monetary Policy Report and Updates*, which contain (i) a narrative description of the projected path of inflation, including when inflation is expected to return to the 2 per cent target, (ii) a projection of real GDP growth for the first and second halves of the current and the next year, (iii) a narrative description of the future path of the output gap, and, recently, (iv) a broad indication of the general direction of the target overnight rate. The Council decides on the content of these narrative descriptions and projections on the basis of technical forecasts prepared by the Bank's staff and other information.

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There is a strong case for the publication of the staff forecasts used by the Governing Council in order to foster better understanding of policy and to enhance accountability. Such publication would help observers to form their own views and enable them to better anticipate Bank policies. While the extent and nature of the information in these forecasts would be beyond the capacity of many observers and critics, a substantial core of observers can evaluate and understand it. Publication would itself be educational and would raise the general level of sophistication with respect to monetary policy. People would be able to pick and choose according to their interests and abilities, as they do now with the *Monetary Policy Report*.

These staff forecasts would be most useful if the Bank published them in the form in which they are supplied to the Governing Council. The alternative—the Governing Council publishing forecasts in its own name—would require the Council to shape the staff forecasts to accord with its own view of the economy. It is important for accountability, however, that the public understand the inputs that the Council receives for its decisions: publication allows the public to judge both the quality of the inputs and the quality of Council's use of them.

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11. In a recent paper, Winkler (2000) suggests that the issue of transparency in central banks is sufficiently complex that it may not be adequately captured by these types of measures.

An argument against publishing staff forecasts is that staff might try either to meet the Council's preferences or to seek safety by conforming to consensus forecasts. Regardless of the validity of these somewhat contradictory concerns, publication of the forecasts should be accompanied by periodic review of forecasting performance conducted by outsiders, with the results made public. In light of these reviews, the Bank would have to assess the value added from the resources it devotes to its own independent forecasting. The ability of the Bank to conduct its own alternative macroeconomic risk analysis should be an important part of the assessment.

The case for publishing the minutes and the voting records of the Governing Council is not strong. While, arguably, release of minutes might increase understanding of policy, review of the minutes published by other central banks leaves questions about their usefulness, especially if forecasts are also published.

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The publication of voting records presents potential difficulties that more than offset any benefits to be gained from increased transparency.<sup>12</sup> Publication would clearly increase the individual accountability of members of the Governing Council. But this change would require the Governing Council to alter its consensus approach to decision-making. The change would extend beyond voting to the way in which the consensus view about the future evolution of policy, as captured in the *Monetary Policy Report and Updates*, would be expressed. Such steps towards increasing

12. Alan Blinder (1997) argues that central bankers should disclose their votes in the same way as jurists. The parallel is not exact. Judges are appointed for life. In addition, their views need to be identified, since the reasoning of legal judgments may be crucial in determining precedents. It matters whether justices find defendants not guilty because the law did not apply, or because the law did apply and there is insufficient evidence to convict. One may create a precedent, whereas the other may not.

individual accountability might also create pressures for change in the process for appointing members of the Governing Council. This poses the danger of substituting away from knowledge and expertise in selecting monetary policy decision-makers and in the conduct of monetary policy

Any increase in accountability must be balanced against the problems raised by the disclosure of minutes and voting records in a federal state. Clearly, the Bank must be continually informed of regional conditions in setting its policies. But past regional concerns have gone further: there have been pressures to use monetary policy for regional purposes. In these circumstances, the disclosure of minutes and voting records could pose significant dangers by creating identifiable regional pressures on monetary policy.<sup>13</sup>

Review of the practices of other central banks in industrialized countries shows an interesting comparison between federal and unitary states with respect to their disclosure of voting records. Table 2 shows that the Federal Reserve alone among central banks in federal states discloses voting records, while four other central banks do not. In contrast, all four central banks in unitary states disclose voting records in some form.

Table 2

**Disclosure of Voting Records**

	Disclosure	No disclosure
Federal states	United States	Australia Canada Switzerland Europe
Unitary states	Japan New Zealand Sweden <sup>1</sup> United Kingdom	

1. Eijffinger and Geraats classify the Riksbank as not providing voting records. Board minutes, however, identify members with reservations about the Riksbank's decisions and state that all other members present agreed with the decision.

Source: Eijffinger and Geraats (2002) and Sveriges Riksbank

13. The suggestion that monetary policy should be directed towards regional interests appeared in policy discussions in the early 1970s, at the time of the first Quebec referendum in May 1980, and during the Meech Lake talks of the early 1990s. See Acheson and Chant (1971) for a discussion of the infeasibility of regional monetary policy.

## Central Banking: The End of History?

Francis Fukuyama used the term “the end of history” to refer to the possibility that political systems had evolved to the point where one successful system dominated and displaced others. Despite the substantial progress with respect to accountability and transparency over the past 30 years, this condition has not been achieved in central banking. While central banking may have advanced from an art to the status of a respectable practice, it still remains short of being a science. Controversy still swirls around the question of whether the inflation-control objective is too narrow. Does it apply beyond rising prices for goods and services to rising prices for corporate stocks or housing? As well, the question remains whether the progress with respect to accountability and transparency will be permanent. The answer depends on the degree to which the changes have been based on innovations in knowledge and understanding rather than on developments in the broad political and economic environment in which central banks operate.

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The distinction can be illustrated by referring to recent trends in inflation. The quantity theory linking inflation to excess monetary growth is one of the longest-standing results in economics. It leaves unanswered why we have had episodes of rapid and slow monetary growth through the fiat money era. Understanding must go well beyond recognizing increases in the quantity of money as the proximate cause of inflation to the political and economic forces that ultimately govern money growth.

Changes based on better understanding are most likely to be enduring, while those following developments in the political and economic environment may be less durable. Even the latter will differ in durability, according to their sources. Developments in account-

ability and transparency that reflect greater openness in government may tend to be more permanent than those that do not.<sup>14</sup> The commitment to simple operating targets focused on observable variables such as the overnight rate will likely evolve, but in a knowledge-driven way.

The least-enduring aspect of the Bank’s policy may be its inability to maintain its primary commitment to a goal of low and stable inflation in the face of possible dilution of both public and government support for this objective. Present economic conditions eerily resemble those of the early 1970s. Equity markets have been weak, showing no gains over several years; there is continuing international conflict; and governments have identified many priorities for additional spending. At the same time, the public may no longer fully appreciate the costs of inflation. It is now 11 years since we have had annual average inflation above 3 per cent, and 19 years since annual average inflation has been above 6 per cent. The 50 per cent of the labour force under the age of 39 have not experienced annual average inflation of 10 per cent over their working lives.

Much of the progress in central banking took place in a period when governments were generally reducing their direct interventions in markets. A possible outcome of many aspects of the current turmoil may be greater government involvement in markets. A central bank objective must have the government’s backing to be credible. But if investment and growth are feeble, governments may be increasingly tempted to pressure central bankers to abandon their commitment to price stability in an effort to bolster longer-term economic performance.<sup>15</sup> Experience suggests that the outcome would be higher inflation without any benefit of stronger growth.

In the face of these threats, what can central banks do? In fact, central banks do not have many tools to counter them. They certainly should not treat the benefits

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14. Nevertheless, Alan Greenspan recently stated, “Since I have become a central banker, I have learned to mumble with great coherence.” See Walsh (2001, 1).

15. In July 2002, New Zealand’s Finance Minister announced his desire to rewrite the Reserve Bank’s 0 to 3 per cent contractual target to “adopt a more flexible approach to inflation,” to echo the Australian example. The Reserve Bank of Australia had adopted a medium-term objective of 2 to 3 per cent based on the two declared goals in the Reserve Bank Act (1959): stability of the currency and maintenance of full employment. As a result, New Zealand authorities revised the Policy Targets Agreement of 17 September 2002 to raise the floor of the target range from 0 to 1 per cent. In addition, it appeared to downplay price stability by shifting emphasis from a goal of “sustainable employment” fostered by price stability to one of “full employment,” to which price stability can contribute. See New Zealand (1999, 2002).

of the present state of affairs as obvious to others. They need to continue to support research on the costs and benefits of low and stable inflation and to continually inform other policy-makers and the public of their results. The evolution of central banking and mone-

tary policy has been substantial and to the benefit of the public. A significant likelihood exists that this progress may be threatened. Central banks must be committed to ensuring that this progress endures.

## Glossary

**Fiat money:** Money (i.e., bank notes and coins) that is not backed by gold or silver but is legal tender by government declaration. The intrinsic value of fiat money is divorced from its monetary face value (i.e., the value stated on it), which rests on public confidence in the issuing authority—usually the central bank. All money in circulation in Canada is fiat money.

**Governing Council:** The decision-making body of the Bank of Canada, consisting of the Governor and Deputy Governors. The Governing Council takes collective responsibility for the Bank's affairs, including formulating and implementing monetary policy.

**Liquid-asset ratio:** Minimum ratio of liquid assets, defined as day-to-day loans, Treasury bills, and excess cash to deposits that banks would maintain on a daily average basis, based initially on an agreement reached between the Bank of Canada and chartered banks in 1955 that led, in 1968, to the statutory secondary-reserve ratio.

**Moral suasion:** The central bank's use of its moral authority to gain voluntary compliance from banks and other financial institutions with respect to changes in their activities.

**Secondary-reserve ratio:** Legally based liquid-asset ratio that in March 1968 replaced the informal liquid-asset ratio. Changes in the secondary-reserve ratio were actively used as an instrument of policy until 1976. The secondary-reserve ratio was eliminated with the phase-out of the statutory reserve ratio in 1992.

**Statutory cash-reserve ratio:** A minimum ratio that banks were required to maintain between their holdings of currency and deposits at the Bank of Canada and their outstanding deposits. The details changed over time with respect to the minimum level of required cash, averaging over reserve period vs. daily minimum, and the treatment of different types of deposits. The requirement was phased out beginning in 1992.

**Transfer of government deposits:** A technique of monetary policy through which reserves available to the banks are altered when the central bank transfers government deposits between its accounts at the central bank and its accounts at the commercial banks.

Source: Shearer, Chant, and Bond (1984), except for the definition of fiat money, which is adapted from the definition listed in the Glossary on the Bank of Canada Web site ([www.bankofcanada.ca](http://www.bankofcanada.ca)).



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