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## **How the Bank of Canada Creates Money for the Federal Government: Operational and Legal Aspects**

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# HOW THE BANK OF CANADA CREATES MONEY FOR THE FEDERAL GOVERNMENT: OPERATIONAL AND LEGAL ASPECTS

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*The process by which money is created is so simple that the mind is repelled.*

– John Kenneth Galbraith

## 1 INTRODUCTION

This paper explores the operational and legal aspects of how, by buying newly issued federal government bonds and treasury bills, the Bank of Canada creates money<sup>1</sup> for the federal government. Information about how private commercial banks create money is also provided.

In June 2011, as part of the debt management strategy<sup>2</sup> included in its 2011 Budget, the Government of Canada announced its intention to borrow \$35 billion over the next three years in order to increase its deposits with financial institutions and the Bank of Canada by about \$25 billion and to increase liquid foreign exchange reserves by US\$10 billion. The intention of this “prudential liquidity plan,” as it is known, is to ensure that there are sufficient liquid assets to cover at least one month of the federal government’s net projected cash flows, including interest payments and debt refinancing needs.

The government justified this plan by stating that liquid financial assets “safeguard its ability to meet payment obligations in situations where normal access to funding markets may be disrupted or delayed,” and that this “supports investor confidence in Canadian government debt.”<sup>3</sup> In response to the government’s June announcement, in October 2011 the Bank of Canada announced its intention to increase from 15% to 20% its minimum purchases of federal government bonds.<sup>4</sup> As explained in this paper, the Bank of Canada’s purchase of federal government bonds is a means by which the Bank creates money for the Government of Canada. The Government of Canada may elect, as it did in the context of the prudential liquidity plan, to keep this money in its deposit account with the Bank rather than spend it.

## 2 HOW THE BANK OF CANADA CREATES MONEY FOR THE FEDERAL GOVERNMENT

The Bank of Canada helps the Government of Canada to borrow money by holding auctions throughout the year at which new federal securities (bonds and treasury bills) are sold to government securities distributors, such as banks, brokers and investment dealers. However, the Bank of Canada itself typically purchases 20% of newly issued bonds and a sufficient amount of treasury bills to meet the Bank’s needs at the time of each auction.<sup>5</sup> These purchases are made on a non-competitive basis, meaning that the Bank of Canada does not compete with the distributors at auctions. Rather, it is allotted a specific amount of securities to buy at each auction.<sup>6</sup>

In practical terms, the Bank of Canada's purchase of government securities at auction means that the Bank records the value of the securities as a new asset on its balance sheet, and it simultaneously records the proceeds of sale of the securities as a deposit in the Government of Canada's account at the Bank – a liability on the Bank's balance sheet (see Appendix A). No paper evidence of a bond, treasury bill or cash is exchanged between the Government of Canada and the Bank of Canada in these transactions. Rather, the transactions consist entirely of digital accounting entries.

Since the Bank of Canada is a Crown corporation wholly owned by the federal government, the Bank's purchase of newly issued securities from the federal government can be considered an internal transaction. By recording new and equal amounts on the asset and liability sides of its balance sheet, the Bank of Canada creates money through a few keystrokes. The federal government can spend the newly created bank deposits in the Canadian economy if it wishes.

Despite the fact that the Bank of Canada's creation of money for the federal government is achieved through de facto loans from the Bank to the government, the Bank's governing law, the *Bank of Canada Act*,<sup>7</sup> does not explicitly empower the Bank to make loans of this nature.<sup>8</sup> Rather, the Act gives the Bank the power to “buy and sell securities issued or guaranteed by Canada or any province” (section 18(c)) as well as the power to “accept deposits from the Government of Canada and pay interest on those deposits” (section 18(l)). Those two provisions, taken together, appear to empower the Bank to create money through the direct purchase of Government of Canada securities at debt auctions.

### **3 MONEY CREATION IN THE PRIVATE BANKING SYSTEM**

Private commercial banks also create money – when they purchase newly issued government securities as primary dealers at auctions – by making digital accounting entries on their own balance sheets. The asset side is augmented to reflect the purchase of new securities, and the liability side is augmented to reflect a new deposit in the federal government's account with the bank.

However, it is important to note that money is also created within the private banking system every time the banks extend a new loan, such as a home mortgage or a business loan. Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money (see Appendix B). Most of the money in the economy is, in fact, created within the private banking system.

A key similarity between money creation in the private banking system and money creation by the Bank of Canada is that both are realized through loans to the Government of Canada and, in the case of private banks, loans to the general public.

One difference between the two types of money creation is that there is no external limit to the total amount of money that the Bank of Canada may create for the federal government.<sup>9</sup> In contrast, the amount of money that a private commercial bank is permitted to create depends on the amount of the bank's equity relative to its assets.

The limiting rules, known as “capital constraints,” are set by the banking regulator in guidelines.<sup>10</sup> Another difference is that the creditworthiness of the borrower is the key factor in the decision by a private commercial bank to provide a loan to a private entity, while this is not a factor in the Bank of Canada’s decision to lend money to the government.

## 4 CONCLUSION

Both private commercial banks and the Bank of Canada create money by extending loans to the Government of Canada and, in the case of private commercial banks, lending to the general public. The Bank of Canada’s money creation for the Government of Canada is an internal government process. This means that external factors, such as financial markets dysfunction, cannot cause the federal government to run out of money.

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## NOTES

1. For the purpose of this publication, “money” means bank deposits.
2. Government of Canada, “[Annex 2: Debt Management Strategy for 2011–12 \(June 6, 2011\)](#),” in *The Next Phase of Canada’s Economic Action Plan: A Low-tax Plan for Jobs and Growth*, 6 June 2011.
3. Department of Finance Canada, “[Government of Canada Will Complete Funding of Prudential Liquidity Plan Ahead of Schedule](#),” News release, 14 February 2013.
4. Bank of Canada, “[Changes in Minimum Bank of Canada Nominal Bond Purchases at Auctions](#),” Notice, 19 October 2011.
5. Bank of Canada (19 October 2011); and Bank of Canada, [Statement of Policy Governing the Acquisition and Management of Financial Assets for the Bank of Canada’s Balance Sheet](#), 24 August 2011, p. 4.
6. Bank of Canada (24 August 2011), p. 3.
7. [Bank of Canada Act](#), R.S.C. 1985, c. B-2.
8. The *Bank of Canada Act* empowers the Bank of Canada to:
  - “make loans or advances for periods not exceeding six months to the Government of Canada ... on taking security in readily marketable securities issued or guaranteed by Canada” (s. 18(i)); and
  - “make loans to the Government of Canada ..., but such loans outstanding at any one time shall not, in the case of the Government of Canada, exceed one-third of the estimated revenue of the Government of Canada for its fiscal year, ... and such loans shall be repaid before the end of the first quarter after the end of the fiscal year of the government that has contracted the loan” (s. 18(j)).

However, it appears that neither of these two provisions, which require loan repayment within a specific and relatively short time frames, provides authority for the type of loans the Bank makes to the federal government by buying a portion of all new federal government securities, which the Bank holds until maturity.

## HOW THE BANK OF CANADA CREATES MONEY FOR THE FEDERAL GOVERNMENT

9. There may be internal government constraints on the Bank of Canada in the form of laws, passed by Parliament, that regulate borrowings by the Government of Canada. There are also practical constraints. For example, large amounts of new money, if spent in the Canadian economy, would lead to inflation. However, money created and not spent, such as the \$35 billion created for the prudential liquidity plan, does not cause inflation.
10. In Canada, the banking regulator is the Office of the Superintendent of Financial Institutions [OSFI]. See OSFI, [Table of Guidelines](#) for more details. Although capital constraints are set out in guidelines rather than in law or regulation, the guidelines are effectively mandatory for banks.

## APPENDIX A – MONEY CREATION AS AN INTERNAL PROCESS WITHIN THE FEDERAL GOVERNMENT

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This chart illustrates the impact on the balance sheets of the Bank of Canada and the Government of Canada when the Government of Canada issues new securities and these are purchased directly by the Bank of Canada.

Balance sheet	Type of entry	
	Asset	Liability
Bank of Canada	New Government of Canada securities purchased	New deposit from the Government of Canada
Government of Canada	New deposit at the Bank of Canada	New Government of Canada securities issued



## APPENDIX B – MONEY CREATION IN THE PRIVATE BANKING SYSTEM

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This chart illustrates the impact on the balance sheets of a private commercial bank and a private entity when the bank provides a new loan to the private entity.

Balance sheet	Type of entry	
	Asset	Liability
Private commercial bank	Loan to private entity	Deposits created for the private entity
Private entity	Deposits at the commercial bank	Loan from the commercial bank