The Money Supply

BACKGROUNDER

Some people ask why the Bank of Canada can't directly increase or decrease the money supply at will, since it regulates the supply of paper currency in circulation.

The answer is that the bank notes issued by the Bank represent only a small portion of all the money circulating in the economy at any one time. The amount of money in circulation can be measured in a number of different ways. The different measures are called monetary aggregates. For example:

The currency (bank notes and coins) in circulation plus personal chequing accounts and current accounts at chartered banks, are referred to as **M1.**

A broader measure, **M2**, also includes personal savings accounts and other chequing accounts, term deposits, and non-personal deposits requiring notice before withdrawal.

But banks are not the only providers of deposit facilities, so an even broader measure of money is provided. **M2+** includes all deposits at non-bank deposit-taking institutions, money-market mutual funds, and individual annuities at life insurance companies.

An even broader measure still, **M2++**, also includes all types of mutual funds and CSBs.

Interest rates control money supply

Commercial banks and other financial institutions provide the greater part of assets used as money through loans made to individuals and businesses. In that sense, financial institutions are creating money.

The Bank of Canada manages the rate of money growth indirectly through the influence it exercises over *short-term interest rates*. When these rates change, they carry other interest rates—such as those paid by consumers for loans from commercial banks—along with them. When interest rates rise, consumers and businesses are apt to hold less money, to borrow less, and to pay back existing loans. The result is a slowing in the growth of **M1** and the other broad monetary aggregates.

Bank monitors money supply growth

Indicators such as **M1** provide useful information about changes that are occurring in the economy. The availability of money and credit must expand over time, and the Bank of Canada is responsible for ensuring that the rate at which more money is introduced into the economy is consistent with long-term stable growth.

The bank's economic research indicates that the growth of **M1** provides useful information on the future level of production in the economy. The growth of the broader monetary aggregates is a good leading indicator of the rate of inflation.

The objective of the Bank of Canada's monetary policy is to support a level of spending by Canadians that is consistent with the Bank's goal of *price stability*. This is defined as keeping inflation within the *inflation-control target* band. By influencing the rate at which the supply of money and credit is growing, total spending on goods and services in the economy can be stabilized.