

# **MONEY AND MONETARY POLICY IN CANADA**

## **MODULE 9: MONETARY POLICY IN CANADA**

**“Money and Monetary Policy In Canada” by Gary Rabbior**  
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## 9.1 THE PRIMARY OBJECTIVE OF MONETARY POLICY

**Economic Insight:** Goal of the Bank of Canada – maintain a low and stable inflation environment

On October 24, 2016, the Government of Canada and the Bank of Canada issued a joint statement saying:

The primary objective of Canada's monetary policy is to promote the economic and financial welfare of Canadians by contributing to sustained economic growth, rising levels of employment and improved living standards.

The Bank and the government believe that the best way to achieve this objective is to maintain low and stable inflation in a predictable environment. By doing so, the Bank can help preserve the value of our money as people plan, and make decisions, for the future.

Since the Bank was founded in 1935, different approaches have been taken to monetary policy. This is true of central banks around the world. Over time, with the accumulation of experience and expertise, the Bank of Canada's monetary policy actions and priorities have changed.

**Facts and Figures:** The Bank of Canada was established in 1935

### The Focus of Monetary Policy Shifted from the Money Supply to Targeting Inflation

In the not too distant past (i.e., the 1980s) there was a great deal of focus on how to manage the supply of money in the economy, with the appropriate monetary conditions to accomplish



General conditions of price stability tend to enhance the chances of achieving economic progress.

the goal of price stability. That changed, though, and the Bank of Canada's monetary policy priority shifted to targeting a stable rate of inflation in the economy. The Bank adopted inflation targeting in 1991 and then set the target at 2% in 1995.

We have noted some important points about monetary policy in other modules. It will help to review and emphasize some of those again here in this module, which focuses on the implementation of monetary policy.

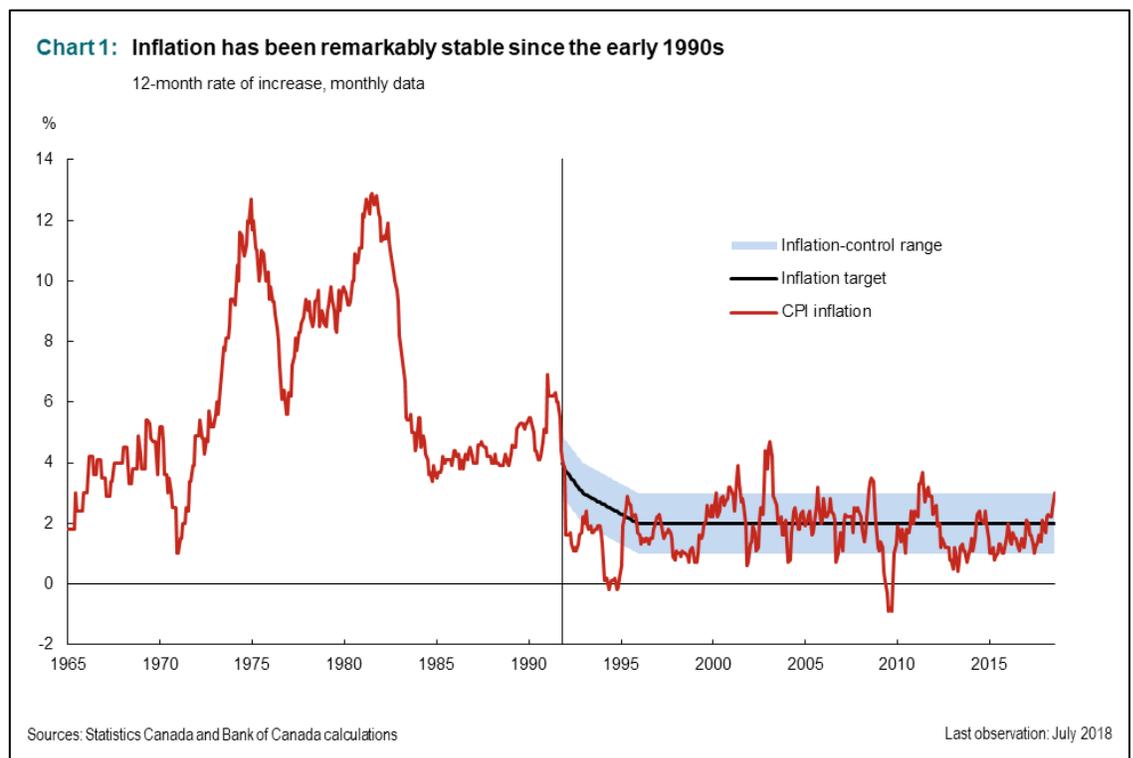
## 9.2 THE INFLATION-CONTROL TARGET

**Economic Insight:** The Bank of Canada's target for inflation is 2%

### A 2% Rate of Inflation—and a Target Range of 1% to 3%

The first key point to emphasize is that to focus on inflation targeting, the Bank needs a target. The inflation-control agreement establishes a target rate of inflation of 2% with a control range of 1% to 3%. To achieve this target, the Bank focuses its monetary policy actions on influencing short-term interest rates in the economy to affect spending, saving, borrowing and investing—and through them, the level of production in the economy. To influence interest rates and affect the level of economic activity, the Bank focuses on changing the target for the overnight rate, or what is now referred to as the *policy interest rate*.

This has proven to be a successful strategy for the Bank in its efforts to achieve price stability: over the years since 1991, the rate of inflation has seldom moved outside the target range, and then only for brief periods. (Chart 1 will illustrate this.)



## The Relationship Between the Bank of Canada and the Federal Government

At times in the past, there was concern about what would happen if the views of the Governor of the Bank of Canada on the appropriate monetary policy differed from those of the government— particularly the Minister of Finance. For the good of the economy, monetary and fiscal policy need to work together.

In Module 4, we discussed the Coyne Affair of 1959–60, when such a difference of opinion happened. Today, the chances of a disagreement between the Bank and the government on monetary policy measures are quite remote. Why? Because every five years the Bank of Canada and the government renew their agreement on what the inflation target will be. The most recent agreement was struck in 2016. At that time, it was agreed that

- the inflation target will continue to be set using the 12-month rate of change in the total consumer price index (CPI);
- the inflation target will continue to be set at 2%, with a 1 to 3% control range; and
- the agreement will run to December 31, 2021, when a new agreement will be put in place.

Note that although the target is based on the total CPI, the Bank uses more detailed information to monitor prices in the economy. Below, we'll look at how the Bank monitors changes to the average level of prices.

### **Economic**

*Insight: The Bank of Canada also focuses on managing inflation expectations*

### **Economic**

*Insight: The most common measure of inflation is the consumer price index*

### **Economic**

*Insight: The Bank of Canada's focus is on the "core" rate of inflation*

## Managing Inflation Expectations—Communication Is Important

Because of the Bank of Canada's commitment to an inflation target of 2%, it also gives priority to clear, regular and transparent communication with the public. The 2% target helps to anchor people's inflation expectations and provides a stable financial environment in which they can make their financial decisions. If people can have confidence that inflation will stay within the 1% to 3% range, they can concentrate on other factors that may affect those decisions.

## How the Bank of Canada Gets Its Inflation Information

The most common measure of inflation is the consumer price index, or CPI. The CPI measures the changes over time in the prices of a selected "basket" of goods and services (from a broad range) that consumers are likely to buy.

Many different factors can affect the CPI. Weather that affects crop yields, for example, can influence food prices. Or global economic developments may push up the price of oil and energy sources, which can cause a rise in the CPI.

**Economic Insight:** The Bank has selected 3 means of measuring core inflation as its source of price information

**Economic Insight:** The Bank of Canada and the Government of Canada enter into five year agreements on the target rate for inflation

While the Bank of Canada is keenly interested in these situations and their impact on inflation, the inflationary pressure the Bank watches most closely is whether prices are rising because of a narrowing of the output gap in the Canadian economy. Remember that the output gap is the amount of slack in the economy—that is, the gap between what the economy is producing and what it is capable of producing. A global price shock such as rapidly rising oil costs that pushes up the CPI isn't reflecting the state of Canada's economy but rather the global economic events in energy markets. Similarly, the price impact on the CPI from weather affecting crop yields and food prices is not a reflection of productive activity in the Canadian economy or a narrowing of the output gap.

Although the Bank monitors and considers factors such as global price shocks or rising prices due to such things as the weather, monetary policy decisions should not be guided by those factors. Those decisions should be most influenced by overall pressures on spending and what is happening in general to prices in the economy, and on output levels in Canada—how current activity measures up against the economy's capacity and the output gap.

So, to guide its policy decisions, the Bank has focused on the core rate of inflation. The core rate is the one statisticians use to account for changes in prices in areas such as energy. That is, some of the price increases of the more volatile items in the CPI basket, such as food, are excluded from the calculation. Instead, the core rate tries to identify price changes resulting from general changes in the economy.

But there are different ways of measuring price changes to guide policy decisions. Therefore, over time, the Bank has looked at these other ways to get the best available information on price changes and inflation in the economy.

From 2001 to 2016, the Bank monitored CPIX, which is an index of prices that excludes eight of the most volatile items in the CPI basket. The excluded items include fruit, oil, natural gas, mortgage interest, intercity transportation and tobacco products. In recent years, however, the Bank found that this means of measuring inflation was not giving it the best guidance on price changes. So, the Bank made a change to try to make sure it keeps inflation within the target range.

In 2017, the Bank selected three different measures of core inflation: CPI-trim, CPI-median and CPI-common. Each measure has its own limitations but, used together, they provide high-quality price information.

In deciding to use these measurements, officials at the Bank considered a few key factors. Specifically, each measure provides a good balance across four main criteria:

1. It loosely tracks long-run changes in the CPI;
2. It is less volatile than the total CPI and gives better insight into price changes that are persistent;
3. It helps to explain the underlying factors affecting inflation; and
4. it is easy to understand and explain to the public.

That last point is perhaps a little debatable—at least for those who are not statisticians. But here we will simply say that the three measures give the Bank of Canada insight into price changes—and the factors that are leading to those price changes. They also help the Bank to understand which factors are likely to be more persistent or to last for a short time. This helps make for more informed monetary policy.

In summary, the Bank of Canada and the federal government agree every five years on the inflation target and the desired range for the rate of inflation. The agreement focuses on the total CPI, but in making monetary policy decisions the Bank of Canada focuses on more detailed price information that it gets from three alternate ways of looking at prices and price changes in the economy.

The agreement between the Bank and the Government is yet another way of maintaining people's confidence in the value of their money for their economic and financial decision-making.

So, we now know what the Bank of Canada hopes to achieve—and the challenges it can face in making monetary policy decisions. The next question is, once it decides what policy should be pursued, how does the Bank go about implementing that policy?

## 9.3 THE TRANSMISSION MECHANISM FOR MONETARY POLICY

We introduced the policy interest rate (PIR) in Module 7. As a reminder, the PIR is the interest rate charged by one bank to another for one-day or overnight loans for settlement purposes. It is also the key interest rate for implementing monetary policy.

**Economic Insight:** The primary tool of monetary policy is the Bank's ability to affect the overnight rate of interest

The *transmission mechanism* for monetary policy is the process by which changes in the Bank of Canada's policy interest rate work their way through the economy to affect spending, borrowing, saving and investing—and, ultimately, the rate of inflation. As you might imagine, this is not a precise science. The Bank doesn't just change its policy interest rate and achieve a predictable outcome. That would be nice—but it is not the case.

The Bank can't control how people, businesses and institutions react to changes in interest rates. From history and detailed analysis, it can have a good idea of what may happen. But the process is a complex one—and the Bank can never be certain that changes in the policy interest rate will achieve the impact on inflation that was targeted.

### Changing the PIR to Affect Economic Activity

**Economic Insight:** The target overnight rate of interest is referred to as the "policy rate of interest"

By changing the policy interest rate, the Bank of Canada influences other short-term interest rates in the economy, including those on consumer loans, car loans, mortgages, etc. And by influencing interest rates, the Bank of Canada can influence spending in the economy. The actions of the Bank also affect the spending by consumers on various assets, such as housing, stocks and bonds.

As changes in interest rates affect spending, this, in turn, can affect prices. For example, if the Bank raises the PIR, and this leads to higher mortgage rates, that can increase the amount people will need to pay for housing (if they have to use a mortgage to pay for it, which most people do). The higher cost of mortgages can then lead to lower spending by consumers.

So, the Bank of Canada can influence the economy through changes in its policy interest rate.

In making changes to the PIR, the Bank aims to affect economic activity and prices through four main channels:

- commercial interest rates such as those charged and paid on mortgages, consumer loans and deposits;
- the exchange rate;
- asset prices, such as the prices for housing, stocks and bonds; and
- expectations of future inflation.

Now let's look at a concept that is a bit more complex but provides further insight into how the Bank of Canada conducts monetary policy.

### **The Neutral, or Natural, Rate of Interest**

In 1898, Knut Wicksell noted in *Interest and Prices* that: "There is a certain rate of interest on loans which is neutral in respect to ... prices, and tends neither to raise nor to lower them."

What is this rate of interest, which we will call the neutral rate of interest (although it is sometimes called the natural rate)? From the Bank of Canada's view, it is good to have a sense of what that neutral rate is, because that knowledge can help with monetary policy decisions.

Before trying to identify the neutral rate, the Bank must keep in mind the aspects of our economy that in which it is particularly interested:

- the outlook for inflation and the current output gap (Can there be more spending without inflationary pressure?);
- the impact of any shocks that the economy is experiencing now or the chance that it might experience them in the near future.

In trying to determine the neutral rate of interest, it is necessary to assume that no shocks have occurred to rock the boat. Such shocks may happen, but they can't be considered in the determination .

Knowing what the neutral rate represents does not mean it is easy to measure or identify. It's not. That is why central banks such as the Bank of Canada employ talented and experienced people who can best estimate this. The Bank can then use that estimate to make its policy interest rate decisions.

**Economic  
Insight:** *The natural or neutral rate of interest helps guide monetary policy decisions*

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## **9.4 USING THE NEUTRAL RATE OF INTEREST TO GUIDE MONETARY POLICY**

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Let's see how this works in practice. Suppose the Bank wanted to reduce the level of spending in the economy—that is, to “tighten” monetary policy—to achieve its goal of price stability at 2%. As one would assume, any increase in the PIR, even if it is currently below the neutral rate, will reduce spending, since that is the usual response to an increase in interest rates. If the level of spending is currently higher than the Bank considers consistent with the neutral rate (the economy operating at potential and price inflation stable at 2%), then making the policy rate higher than the neutral rate would reduce spending in the economy—hopefully to the desired level and one appropriate for the economy's potential.

The Bank would take this policy step if it thought spending levels were starting to push the economy beyond its potential and that issues with inflation above its target level were looming.

Alternately, moving the PIR below the neutral rate would indicate that the Bank saw the economy as below its potential and could handle more spending without inflation becoming a problem.

Having a general sense of what the neutral policy rate is could also help observers get a read on the Bank's monetary policy objective by noting whether the policy rate was currently above or below the neutral rate.

### **What Is the Neutral Interest Rate in Canada and How Can It Provide Information on Current Policy?**

The current estimate by the Bank of Canada is that the neutral rate—consistent with the economy operating at its potential and with price inflation stable at an interest rate of 2%—is between 2.5% and 3.5%.

So, if the Bank's policy interest rate is below that level, we can assume that the Bank sees the economy as not operating at its potential: there is an output gap, and more spending can be encouraged without the economy experiencing inflation outside of the Bank's target and range for inflation.

Why might the PIR be set below the neutral rate? Let's look at the financial crisis of 2008 and the long recovery period that followed.

**Economic Insight:** *Canada came through the financial crisis of 2008 better than most countries*

As we have noted, global economies experienced a major downturn as a result of the financial crisis. Global financial markets faced severe problems, and there were even fears of their potential collapse. That didn't happen, but the shock to global economies was very severe.

As we also noted, the shock to Canada's economy was not as bad as that experienced by many countries around the world—but it was severe nonetheless. A significant output gap arose. That is, there was a substantial gap between the economy's potential output and the current level of actual output. In short, the economy was able to handle considerably more spending and production without inflation becoming a problem.

This implies that when it came to monetary policy, a PIR below the neutral rate to encourage spending in the economy would be in order. And that is reflected in what the Bank actually did.

As economic conditions and the outlook deteriorated, the Bank lowered its PIR to .25%. Recall that the Bank's assumption is that the neutral rate of interest is between 2.5% and 3.5%, so the .25% PIR was below the neutral rate. Setting the PIR at that rate indicates three things: that the Bank saw a need to boost spending and production, that there was a considerable output gap in the economy, and that spending and production could increase without causing inflationary problems.

The Bank left the PIR at .25% for quite some time before starting to gradually raise it as economic conditions normalized.

**Economic Insight:** *Clear communication with the media and the public is very important to the Bank of Canada*

### **The Importance of Clear Communication—And Forecasting Expertise**

The changes the Bank of Canada made to the PIR did not come out of the blue or at uncertain times for the media and the public. In implementing its policy, the Bank has established a communications strategy of making regular announcements—eight times a year on scheduled dates—on whether it will make any change to the policy interest rate. This helps the Bank to be transparent about its monetary policy and does not leave people wondering when the next announcement may be. Markets—and everyone else—know exactly when it will be.

When making these announcements, the Bank also shares its projections for the economy and how relevant factors might influence its policy decisions. It draws on expertise to help it make informed and accurate projections while identifying possible risks to its assumptions. The Bank puts a priority on projections and forecasts, and it is well regarded for its ability to do so.

It would be nice if the economy always played along and if events could generally be stable and predictable. Of course, that is not the case, as illustrated so clearly by the financial crisis in 2008.

[Since this was a notable event in our economic history, it is worthy of some additional background. You can review a bit of this history in Box # 9.1 [Reader – see text in Red that follows later].

### Risks That Can Affect Bank Forecasts and Projections

What are some of the risks that can affect the Bank’s projections and forecasts? They include the following:

- changes in the growth rates of a major trading partner such as the United States;
- a significant shift toward protectionism in a major trading partner that could affect Canadian trade;
- changes in commodity prices, such as world prices for oil;
- changes in the level of business investment in Canada;
- changes in household spending levels; and
- natural disasters, such as the Alberta wildfires affecting Canada’s economy or the economies of our major trading partners.

**Economic Insight:** There are some extraordinary measures available to the Bank in extraordinary times

### Unconventional Monetary Policy in Extraordinary Situations

The financial crisis that hit in 2008 provides an opportunity to look at another aspect of monetary policy. The crisis, and its impact on economies around the world, was calamitous. Stock markets plunged, financial institutions and businesses were significantly affected, unemployment rose, and global uncertainty increased dramatically. This created a very uncertain environment for investors, who naturally hesitated to invest. This led to further economic slowdowns and challenges.

Exceptional times called for exceptional measures. In 2009, the Bank of Canada set what is called the *effective lower bound* of interest rates at one-quarter of a percentage point (0.25%). The Bank believed that lowering interest rates any further would impair the effective functioning of markets. During the years of economic recovery, the Bank’s policy interest rate remained at .25% to support spending and investment in a recovering economy.

You might think interest rates could not go much lower than that. But, with the aftermath of the crisis so severe and the recovery so slow in parts of the world, some central banks actually experimented with a *negative interest rate*—yes, an interest rate that is less than zero. Why was this even possible to consider?

In the past, it was assumed that negative interest rates wouldn’t work. After all, a negative interest rate would be like going back in time to when savers were actually willing to pay a price to have their money stored by goldsmiths.

**Economic Insight:** There is the possibility of implementing a negative interest rate policy

The following is from the Bank of Canada article [“Framework for Conducting Monetary Policy at Low Interest Rates.”](#)

In principle, nominal interest rates cannot fall below zero because investors can always earn a zero nominal return by holding currency. In practice, however, the nominal return for holding currency is negative, due to storage, transportation, insurance and other costs associated with securing and storing bank notes, particularly in large quantities. These costs make it possible for nominal interest rates to fall somewhat below zero.

So, as it works out, it may be possible to charge a cost to savers, via negative interest rates, because people have concerns about storing their money themselves, keeping it safe and insuring it against loss. Having your money in an account at a financial institution will do that for you. Your money will be stored, it will be protected, and up to \$100,000 of it will be insured. So, it is possible that people are willing to pay the price that comes with a negative interest rate for the benefits they receive.

Sweden, Denmark and Switzerland all experimented with negative interest rates during this time, to support their efforts to boost spending and economic recovery. After all, if there is a cost for leaving your money on deposit at a financial institution, you might choose to spend it instead.

Another extraordinary measure a central bank can take is to buy assets—in the process, raising asset prices, putting more money into the economy, lowering longer-term interest rates and, ideally, boosting spending and production. Such actions can also bolster confidence in the value of assets—confidence that might be shaken in very difficult economic times. That is what happened in the United States when the Federal Reserve bought up large quantities of assets and significantly increased the amount of money in the economy.

**Economic Insight:** *Central banks can also buy assets in extraordinary times to provide stability to markets*

### **The Bank of Canada is Also Concerned with Lower Levels of Inflation—and Possible Deflation**

Another point to emphasize is that the Bank of Canada is equally concerned about both the upper and lower limits of the range for the rate of inflation. The Bank aims to keep prices from rising above the 3% level—but it is equally concerned about prices falling below the 1% lower limit. Rising inflation rates erode the value of our money and lower confidence in its future value. But declining inflation rates—moving below 1% and lower—can lead to “deflationary expectations,” which can be equally bad for the economy.

So, the Bank of Canada will pursue its policy actions to keep inflation within that target range, ideally at around 2%.

**Economic Insight:** *The Bank of Canada is also concerned with inflation levels below its target – and deflation*

## The Bank of Canada Is Particularly Concerned About the Output Gap

**Economic Insight:** An important focus for the Bank of Canada is the “output gap” in the economy

What else is the Bank of Canada concerned about as it implements monetary policy to achieve its price stability goals? An important factor, as we have seen, is the current state of the economy—and the relationship between potential output and the level at which the economy is currently operating. Is there a significant output gap, or is the economy operating at or nearing, its full short-term potential?

As we have seen, the closer the economy is to its potential capacity, the greater the risk that more spending will trigger a rise in inflation. Because the Bank wants to have a sense of where the economy is operating in relation to its output potential, it analyzes the output gap closely.

## Monetary Policy Actions Take Time to Affect the Economy

**Economic Insight:** The Bank of Canada is always forward-looking when considering policy action

As we noted above, the Bank looks beyond where the economy is currently operating, to its potential. It looks to the future, to where things are headed, to understand how any policy actions might affect the economy. Monetary policy changes usually take about six to eight quarters (18 to 24 months) to achieve their full impact on the economy. That is why the Bank has to focus even more attention on the future than the present. And it keeps a careful eye on the factors that are changing in the economy and might have an impact down the road.

The Bank of Canada is not the only one implementing policy to affect the economy. The government, specifically the Department of Finance, implements fiscal policy—the government’s taxing and spending policies.

**Economic Insight:** There is a time lag between policy implementation and policy impact

## A Flexible Exchange Rate Enables Independent Monetary Policy

As we noted in Module 8, maintaining a flexible exchange rate enables the Bank of Canada to pursue an independent monetary policy most suited to Canada’s economic circumstances. If we adopted a fixed exchange rate policy, the Bank would not have this independence and would need to take steps to keep the international value of our money at a specific level. Adopting a fixed exchange rate policy would mean our Canadian dollar would move relative to another currency, such as the U.S. dollar. So, if changes occurred in the United States that affected our exchange rate, we would have to make changes to keep the currency exchange rate at the set level. The change in the United States would force us to change.

With a flexible exchange rate, the Bank can pursue an independent policy and let the exchange rate adjust to the change.

The “framework” the Bank uses for implementing monetary policy is to target inflation at 2% with a range of 1 to 3% and allow the exchange rate to be flexible to adjust to market forces.

Now that we have reviewed how the Bank implements policy and the factors it considers in making decisions about monetary policy, we can look at how are those decisions made—and who makes them.

### The Decision-Making Process

Who decides monetary policy? The Governing Council—made up of the Governor of the Bank, the Senior Deputy Governor and four Deputy Governors—makes those decisions, but other groups also play a role:

- the Monetary Policy Review Committee (MPRC)
- the four economics departments at the Bank of Canada
  - Canadian Economic Analysis
  - International Economic Analysis
  - Financial Stability
  - Financial Markets

Decisions are made through a five-step process.

1. A presentation of the staff projection is made to Governing Council consisting of a base-case scenario and key risks and alternative scenarios.  
A major briefing is made to Governing Council, drawing on the research and expertise of all four economics departments.
2. Final policy recommendations are made by the head of either the Canadian Economic Analysis Department or the International Economic Analysis Department, based on the updated outlook. The entire MPRC then discusses tactical and policy considerations included in a note provided by the Financial Markets Department, and each member except Governing Council members provides a policy recommendation.
3. Deliberation takes place, and, ultimately, decision-making by Governing Council.
4. The decision is communicated to the public.

As we mentioned above, eight times a year the Governor and Senior Deputy Governor hold a press conference to share the Bank of Canada’s policy interest rate decision—to leave the PIR as is or to make a change. On four of those occasions, they provide an outlook for the economy based on all the Bank’s analysis and data collection.

These announcements share with the public the collective thinking of those at the Bank with regard to the economy—where it is, where it is headed and the outlook for price stability. Such communication leaves no doubt regarding the Bank’s assessment of the economy and what actions, if any, might be needed to maintain stable prices and achieve the Bank’s objective.

## 9.5 DIFFERENT CHOICES FOR MONETARY POLICY: HOW AND WHY DO ECONOMISTS DIFFER?

Some economists may question the Bank's decisions, since people may differ for many reasons in what they see as the most appropriate monetary policy decisions and actions. Why might there be differences of opinion?



*The opinions of professional analysts and others can vary regarding what the most appropriate monetary policy actions should be.*

For one thing, there may be differences with the Bank about monetary policy objectives. For example, some economists may believe that promoting employment should outweigh the Bank's focus on inflation. Others may think that the Bank should focus on the levels of targets that could be set—such as a target price level or the level of output in the economy—rather

## 9.5 DIFFERENT CHOICES FOR MONETARY POLICY: HOW AND WHY DO ECONOMISTS DIFFER?

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than on a *rate-of-change target* such as the rate of inflation, which measures price level changes. Still others might differ with the Bank in terms of the actual target—e.g., an inflation rate of 2%.

Opinions may also differ on how quickly inflation needs to be returned to target. Some may feel the level of output in the economy is more important than returning the economy to the targeted rate of inflation. And, as you might suspect, some economists may disagree with the Bank's forecast, or what factors might affect the economy, or the extent to which the economy might be vulnerable to certain shocks or other changes.

Making decisions about monetary policy is not an exact science and can be open to debate and discussion. Through the media, Canadians may well hear of those who differ with the priorities and actions of the Bank. Recognizing the realities of change over time, the Bank goes through a transparent review and renewal process every five years, providing an opportunity for change if change is judged to be appropriate.

The reality is, though, that in recent years the Bank of Canada has generally achieved what it has set out to do.

We started this module with a summary of what the Bank sees as its primary objective, and it is worth concluding with that objective:

The primary objective of Canada's monetary policy is to promote the economic and financial welfare of Canadians by contributing to sustained economic growth, rising levels of employment and improved living standards.

This brings us to the end of our look into the world of monetary policy—and particularly the role and actions of the Bank of Canada. We hope it has given you a better understanding of this important policy area, because monetary policy has a significant effect on the Canadian economy and the well-being of Canadians—today and in the future.

## 9.5 DIFFERENT CHOICES FOR MONETARY POLICY: HOW AND WHY DO ECONOMISTS DIFFER?

### **Box 9.1:**

Many factors came together to cause the financial crisis in 2008. A major factor, however, arose from the U.S. housing market. In the years leading up to the crisis, lower mortgage rates and other incentives encouraged home buying, which surged as a result.

Many of the mortgages issued to these buyers, as well as car loans and other debts, were packaged into investments called mortgage-backed securities—even though many of the securities contained debts other than mortgages. Several institutions invested in these mortgage-backed securities and sold large numbers of them.

But many of those issuing mortgages were not doing a thorough job of checking the creditworthiness of those who were taking on the mortgages. Mortgages were being issued to many people who would not be able to afford their mortgage if interest rates rose. Putting no money down also meant that buyers had little, if any, equity in their houses. Unfortunately, if the value of the house fell by even a modest amount, they would find themselves with a house in which they had no equity but that was now worth less than what they paid for it. At the same time, many mortgages were initially issued with low interest rates. But eventually rates rose, increasing the cost of the mortgage for the home buyers.

The situation became dire when U.S. housing prices began to fall. The excess house buying, the many questionable mortgages that were issued and the decline in U.S. house prices laid the foundation for the financial crisis.

In the United States, you can literally walk away from a house and leave it to the institution holding the mortgage. So, when people found they had no equity in a house that was lower in value and had a more costly mortgage, they simply walked away so that they no longer had to make mortgage payments.

As many homes were abandoned, house prices declined more and more. As a result, even more people walked away from their homes to escape unaffordable mortgage payments. And on it went.

As a result, the mortgage-backed securities that institutions had bought in large quantities declined rapidly in value. Because the securities were worth far less than they had paid to invest in them, the institutions experienced huge losses. In some cases, the drop in value was so great that the future of some major financial companies was in doubt. Their liabilities (what they owed) exceeded their assets (what they owned). When two major financial companies did fail, their failures affected many others because the world is so interconnected financially. The failure of those two companies thus spread around the financial world.

Some financial institutions had invested heavily in mortgage-backed securities and, with their failure, found that their asset base was severely eroded. Many financial institutions were at risk in countries around the world. Some failed. Some were assisted by their central banks.

In Canada, we benefited from a well-regulated banking system and strong financial institutions. Canada and Canadian financial institutions did not completely escape the fallout from the financial crisis. But actions taken by the federal government and the Bank of Canada helped stabilize the economy over time and move it back toward a more normalized growth path.

Canada weathered the financial storm much better than most other countries—and our financial system remains strong today. In fact, it is held up by some as a model for others.