BANK OF CANADA

Notes for remarks by Gordon G. Thiessen Governor of the Bank of Canada

to the

Canadian Payments Association Conference
Montreal, Quebec
20 June 1995

Not for publication before 20 June 1995
1:15 p.m. eastern daylight time

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I am delighted to have been invited to speak at your "Visions and Value" Conference. I assume that your invitation reflects the recognition that the central bank plays an important role in the area of payments and has a stake in a good clearing and settlements system. And so I hope that you will indulge me if I say a few words on this topic later.

But mainly what I would like to do today is to review the recent economic record and tell you what the Bank of Canada has been doing to sustain the economic expansion.

The Economy

The question that seems to be on the minds of most people these days is whether the slowing in the pace of economic activity in the first part of this year is likely to persist. Put another way, what are the economic prospects for the balance of 1995? The perspective that I would like to share with you today is one that puts the recent economic developments in a broader framework -- a framework that involves an assessment of the underlying factors at work, including the stance of monetary policy.

Here is how I see the situation. The slowing in the pace of economic expansion in early 1995 has been somewhat greater than we had anticipated. There are a number of things going on. There has been an easing in exports after the very robust growth of the second half of last year. Economic activity in the first quarter of 1995 was also affected by the rail and port strikes. And Canadians responded rather quickly to the run-up in interest rates in late 1994 and early 1995, and to the actual and expected cutbacks in the public sector. But let me remind you that this rather sharp response to a large temporary rise in interest rates has happened before -- most recently in late 1992 -- and turned out to be short-lived.

The other point to keep in mind, is that some slowing in the rate of economic expansion is not a bad thing as we move closer to the capacity limits of the economy. As I have said on previous occasions, all economies have limits to their capacity to grow in the short run. And expansion at the rates we experienced last year, when output grew by about 5 1/2 per cent between the last quarter of 1993 and the last quarter of 1994, is simply not sustainable. What we need is growth at a steady, reasonable pace -- a durable expansion that will continue to take up the remaining margin of unused capacity in the economy and support good employment and income growth without the risk of a resurgence in inflation.

Does it look like we are going to be successful? As you know, there are wide bands of uncertainty around most economic predictions. But I am encouraged by the fact that the good fundamentals that have been moving the economy along over the past year are still in place. I am talking about the improvements we have seen in productivity, cost control and competitiveness. Put these together with a generally favourable external economic environment for Canada and the recent easing in domestic interest rates; and yes, you could say that I am still optimistic that the Canadian economy will continue to expand in 1995. However, it will expand at a more moderate rate than the unsustainable pace of last year.

The role of monetary policy

But what is the Bank of Canada doing to promote sustained economic growth?

Like the central banks in virtually all industrial countries these days, the Bank of Canada believes that it can best promote good economic performance with a monetary policy that aims to preserve confidence in the value of money. And money will retain its value only if prices remain stable -- in other words, only if it is not undermined by chronic inflation.

The federal government and the Bank of Canada made a joint commitment to price stability in 1991, a commitment that was renewed in 1993. This undertaking took the form of explicit inflation-control targets. The current target is expressed as a range of 1 to 3 per cent for the period from end-1995 through to end-1998. The government and the Bank also agreed to decide by 1998 on a target band that would represent an appropriate definition of long-term price stability.

While the targets are set in terms of the total consumer price index (CPI), I would like to emphasize that, in its conduct of monetary policy, the Bank of Canada focuses on a core measure of the CPI which excludes the volatile food and energy components and the effects of changes in indirect taxes.

Core inflation in Canada has declined significantly since the targets have been in place; and it has been consistently within a range of 1 1/2 to 2 per cent over the last three years.

There are some special factors currently at work that are pushing prices up, so that our measure of core inflation is now above the centre of the band. And it may remain there for the next little while. The sharp increase in world commodity prices and the effects on prices of the past depreciation of the Canadian dollar are the two main sources of upward pressure. But there are also forces working in the opposite direction. Some of the earlier depreciation of the Canadian dollar has been reversed recently. And even though the amount of excess capacity in the economy is expected to decline further, the remaining margin of slack will continue to put downward pressure on prices in 1995. So, we expect core inflation to move back towards the middle of the target range later in the year. Overall, the outlook for inflation remains favourable and consistent with our targets.

Of course, as central bankers, we must keep a watchful eye on inflation at all times. This is because monetary policy actions have their effects on prices with a long lag. If inflation is not to get away on us again, the Bank must make every effort to recognize as early as possible any indications that signal the emergence of generalized upward pressures on prices down the road; and we must take corrective measures promptly. But let us be clear on one point. The circumstances that would require such action would be signs that the economy is approaching the limits of its productive capacity, that shortages of skilled labour are developing with resulting wage pressures, and so on. That is why I have repeatedly stressed that one must look through any short-term wiggles, any temporary increases in inflation that reflect special factors, such as those I noted before, and focus instead on the underlying rate of inflation. And on this basis, let me say again, that there is little reason at this time to think that our inflation targets are at risk.

While the Bank of Canada has been vocal in stressing the benefits of Canada's recent hard-won status as a low-inflation country, evidently not everyone has been persuaded. I mentioned earlier some of the benefits that have materialized, such as improved productivity, cost control and competitiveness. However, our interest rates have not turned out to be as low, nor our currency as firm, as might have been expected from our good inflation performance.

Instead, financial markets have reflected concerns among domestic and foreign investors about the risk to the value of their investments. Over the last couple of years or so, investors have at times been uncertain about political developments in Canada and nervous too about financial turbulence in other parts of the world. But the overriding concern has been about Canada's persistently rising level of public debt relative to its GDP. As a result, we have been paying high risk premiums in our interest rates and the Canadian dollar has been weak.

Encouragingly, there has been an improvement recently in sentiment toward Canadian assets. I believe this is largely the result of a more positive assessment by the markets of our fiscal outlook, after the steps taken by the federal and provincial governments this year to put their finances onto a sustainable path.

This improved market tone has contributed to a firmer Canadian dollar and a decline in interest rates at all maturities -- an encouraging step toward a desirable rebalancing of the mix of monetary conditions in Canada. This rebalancing toward lower interest rates and a stronger dollar would be consistent with a continued, more-broadly based, expansion in the months ahead. Not that the strong export-led growth of the past year or so has been unhelpful; for it has also led to a substantial narrowing of the deficit on our balance of payments and has therefore reduced our use of foreign savings. But the high interest rates prevailing over much of the past 12 months have constrained such interest rate-sensitive sectors as housing and motor vehicles from contributing much to a strong economic recovery. And this combination of high interest rates and a low Canadian dollar also involves potentially significant costs for the economy in the longer run. High interest rates restrain investment and increase debt-service costs for all debtors, including governments. And a weak dollar may encourage investments in export and import-competing industries, some of which may prove misguided if the currency strengthens appreciably in the future.

But how can we sustain investor confidence in the Canadian dollar over time and ensure that domestic interest rates are as low as possible? Above all, governments must follow through with their announced fiscal restraint measures, show concrete progress, and make further sustained efforts on this front in the future. The Bank must also ensure that monetary policy delivers low inflation. These are the policies that will provide an environment conducive to continued, solid economic expansion.

With this, I would now like to turn briefly to the changing world of Canadian clearing and settlement systems.

A sound payments system for a sound economy

I do not need to tell this audience how central a role the payments system plays in all modern economies. And neither do I need to point out that an efficient and sound payments system provides significant benefits to all users and contributes importantly to the overall performance and competitiveness of the financial system. I am sure that you are well aware of these benefits. After all, isn't this why many members of the Canadian Payments Association have been hard at work in recent years to make the changes that are necessary to improve the efficiency, safety and soundness of the Canadian payments system? But it might be helpful if I underscored just how crucial a good payments system is to the central bank and what the Bank has done and will be doing to help along the development of such a system for Canada.

The clearing and settlement of payments is very much a part of central banking in Canada. This is because the final settlement of the process of clearing payments among financial institutions takes place through transfers of funds among deposit accounts that financial institutions hold at the Bank of Canada. The Bank uses its ability to expand or contract the supply of these settlement balances as its main instrument for implementing monetary policy. This is why the Bank counts on well-functioning clearing and settlement systems to create an environment in which monetary policy can be carried out effectively.

The Bank is also the ultimate source of liquidity to the financial system through its responsibility as lender of last resort. Thus, the Bank has a strong interest in a well-functioning payments system -- a system that recognizes and manages risk in a way that helps avoid systemic problems. Because the settlement of payments is at the heart of the day-to-day operation of a monetary economy, the spill-over effects in the event that something goes wrong with the clearing process inside a poorly-designed system could be quite serious. And the potential seriousness of these effects has been growing with the large increases that have taken place in the values of payments flowing through the financial system and the expanded linkages between domestic and foreign clearing and settlement systems.

For these reasons, the Bank of Canada has been highly supportive of international and domestic initiatives to manage and contain risk in major clearing and settlement systems.

In this context, we need a well-designed electronic payments system for large value transactions. Canada lags behind many other industrial countries in this regard. Without such a system, there will continue to be risks for domestic financial institutions and negative effects for their competitiveness. Consequently, I am pleased to see that the Canadian Payments Association has taken a major step by calling for proposals to build a large value transfer system -- the LVTS. The LVTS will provide certainty of settlement for financial institutions, which will eliminate the risk in our current arrangements that settlement will not take place because the clearings have to be unwound. And this will permit financial institutions to offer same-day finality of payment to users.

The Bank of Canada has been working actively with the industry to design the LVTS and make sure that appropriate risk-control mechanisms are built in to protect the integrity of the payments system. To meet concerns of the industry about the cost of the collateral that financial institutions must provide to ensure that the LVTS will work properly, the Bank has agreed to operate special interest-earning accounts. And to make sure that the LVTS will always be able to settle, even in the unlikely event that a number of financial institutions are unable to do so on the same day, the Bank is prepared to provide a guarantee of settlement. This guarantee will be in addition to the commitments made by the industry. Finally, the Bank is going to have to change the way it implements monetary policy once the LVTS is up and running, and accounts for a large proportion of payment values.

As you know, the federal government now proposes to give the Bank a more explicit role in the oversight of major clearing and settlement systems to ensure that appropriate arrangements are in place to address systemic risk. I welcome this initiative. Such a role is in line with that played in this area by other central banks in major industrial countries and consistent with the informal role we played in the past.

You can see now why the Bank has a stake in, and strongly supports, well-designed initiatives to strengthen the efficiency and soundness of major clearing and settlement mechanisms, both domestically and internationally. The benefits to users, financial institutions and the economy are considerable. We look forward to significant progress in this area over the next two years.