BANK OF CANADA



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

to the

Treasury Management Association of Canada
Calgary, Alberta
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I am pleased to have been invited to speak to the Treasury Management Association today. "Steering for Success", the theme you have chosen for your conference this year, would have been a great title for my speech. It certainly describes well what we, at the Bank of Canada, see as the essence of our mission with respect to monetary policy.

Since I do not have a good title that suggests all the issues I want to cover, let me just mention them to you. I propose to talk about the focus of monetary policy and how the Bank directs its operations to achieve its objectives and thereby contribute to the economic well-being of Canadians. I would also like to give you an update on the economy and our recent policy operations. I will close with a few remarks on the Bank's involvement in the ongoing changes in the clearing and settlement systems, another area where I believe "steering for success" is of the essence.

**The focus of monetary policy**

The objective of Canadian monetary policy is to promote good economic performance through price stability. Since 1991, the Government of Canada and the Bank of Canada have made a formal joint commitment to price stability. And to make this commitment clear and credible, it has been backed up with a set of specific inflation-control targets. The current target calls for the rate of inflation to be held within a range of 1 to 3 per cent (with a midpoint of 2 per cent) through to the end of 1998. By then, the government and the Bank have committed to decide on a target that represents an appropriate definition of long-term price stability.

But why price stability, and why so much official preoccupation in Canada with this concept? Let me begin by saying again that, at the Bank of Canada, we do not see price stability as a goal for its own sake, but rather as a means to achieving our ultimate objective -- contributing to a well-functioning, productive Canadian economy.

I doubt that there is a need to dwell on the many benefits of price stability or the heavy costs involved in "living with inflation". Many of you will have heard it all before. Let me just say that to get a sense of the insidiousness of inflation, one need only recall the experience of the 1970s and 1980s, when high inflation led to recurrent bouts of speculative activity, and a boom-bust economy, with no gains in productivity.

I am not arguing that price stability will eliminate the economic cycles altogether, because it will not. However, I believe that, with monetary policy committed to maintaining confidence in the value of money, Canadians will be in a better position to make good economic decisions. And this will lead to better overall economic performance and more moderate cyclical fluctuations than we have experienced in the past.

Well, how have we been doing recently with respect to inflation? First, let me remind you that the inflation-control targets are set in terms of the consumer price index (CPI). However, for operational purposes, the Bank monitors a "core" measure of the CPI, which excludes short-lived fluctuations in the rate of inflation arising from movements in the volatile food and energy components and from changes in indirect taxes. On this basis, the trend of inflation has been within our target bands for the past four years.

This core measure of inflation moved into the upper half of the target range in the first half of 1995. However, most of the upward pressure on prices during this period has been temporary, mainly reflecting the effects of the past depreciation of the Canadian dollar and the sharp rise in world prices of industrial materials in the past year. In part because of the waning effects of the depreciation, inflation is now moving back towards the middle of the target range, as the Bank predicted earlier this year. Overall then, Canada has had a good price performance in recent years.

**The Economy**

What about Canada's record in terms of economic expansion? And what does it presage for inflation and the trend of economic growth in the future?

The Canadian economy expanded very rapidly in 1994. Thus, a slowing in economic activity in 1995 was to be expected, and it was probably desirable for the expansion to moderate to a more sustainable pace. However, the economy slowed much more in the first half of 1995 than we had anticipated. A number of unexpected developments contributed to this. Export volumes, which had been growing robustly through 1994, fell back sharply in the first half of 1995, mainly because of the marked slowdown in the pace of economic expansion in the United States. Canadian households responded very quickly to the run-up in short-term interest rates that was necessary in late 1994 and early 1995 to sustain confidence in the Canadian dollar in the face of market turbulence. It would seem, too, that some of the results of fiscal tightening actions by Canadian governments have shown up sooner than expected. In all these circumstances, Canadian consumers have been hesitant to spend.

Nonetheless, the prospects for the Canadian economy remain positive. Economic activity in the United States is picking up, and world prices for most of the major primary commodities that Canada exports (other than energy) remain firm at high levels. Moreover, the good fundamentals that have been underpinning the economy over the past several years -- improved productivity, effective economy-wide cost control and strong competitiveness -- are still in place. Thus, I expect that the Canadian economy will show signs of renewed strength before year-end. At the same time, the level of economic activity will be lower at year-end and the margin of slack in the economy greater, than we anticipated six months ago.

The persistence of excess capacity in the Canadian economy and effective cost-control by businesses will continue to exert downward pressure on inflation in coming months. As a result, we expect inflation to decelerate towards the midpoint of the target range by year-end and to move into the lower half of the band in 1996, in the absence of further shocks.

Looking further ahead, this success on the inflation front and the Bank's commitment to keeping inflation under control, provide a sound basis for sustainable economic expansion in Canada. However, we must recognize that the Canadian economy is still going through some important, much-needed structural adjustments. And these adjustments will likely have a significant impact on the character of the economic expansion for a while. I am talking, in particular, about the need to correct the economic imbalances of recent years -- specifically, our large public sector deficits and the resulting high levels of public and external indebtedness. Government restraint is a key part of this correction. I am pleased to say that our various governments have made a good start this year in this direction, although more remains to be done to ensure fiscal positions stay on an improving track.

All this means that total domestic spending may be held back while this essential restructuring, and the implied transfer of resources from the public to the private sector, is under way. Thus, it is likely that we will have to look to the external sector for a while yet to provide a good part of the overall stimulus to the economy.

**Monetary conditions and policy actions**

Having talked about the focus of monetary policy, and about the recent record and outlook for inflation and the economy, I would now like to give you an account of our recent policy actions.

In an open economy like Canada's, with a flexible exchange rate system, monetary policy actions influence the economy through both interest rates and the exchange rate. The Bank, therefore, focusses on the concept of "monetary conditions" to assess the combined effects on the economy of movements in short-term interest rates and the exchange rate.

For operational purposes, we set a desired path for monetary conditions, consistent with our assessment of the economic outlook and the requirements of our inflation-control targets, and then direct our policy operations to achieving this path. However, there are times when the focus of our operations has to be shifted temporarily to maintaining confidence in financial markets. That is because financial markets do not work well without a firm base of confidence in the future value of money and financial assets in Canada.

Early this year, we were faced with a situation that required taking action to resist an undermining of confidence in the Canadian dollar. This was at a time when turbulence in world financial markets, domestic political uncertainty and, especially, investor concerns about the sustainability of the fiscal positions of Canadian governments had resulted in higher risk premiums across the interest rate spectrum and downward pressure on the currency. To stabilize these markets, the Bank raised its target range for the overnight rate five times during January and February, by a total of 250 basis points.

Since then, the federal and most provincial governments have taken major steps to put their fiscal positions onto a more sustainable track. These initiatives have been welcomed by the financial markets. As well, with the easing in demand pressures in the United States and a more moderate pace of economic expansion in the major overseas economies, international interest rates have trended downwards. This has been helpful for heavily-indebted borrowers like Canada.

Against this background, long-term interest rates in Canada came down, and the exchange rate tended to strengthen throughout the summer. And the Bank was able to unwind most of the runup in short-term interest rates that occurred in late 1994 and early 1995. Between May and August, we lowered our target for the overnight rate seven times, by a total of 175 basis points, to the present range of 6 - 6 1/2 per cent.

This past month, with the referendum campaign in Quebec getting under way, financial markets have once again been nervous and volatile. In such circumstances, the Bank's prime responsibility is to take actions to calm and stabilize financial markets. So far, we have done so by intervening, as we normally do, to smooth fluctuations in the exchange market for the Canadian dollar and by holding our target range for the overnight rate constant.

There is no doubt that financial market pressures that result in deviations from the desired path of monetary conditions complicate the conduct of monetary policy. However, such deviations should be only temporary, and they should not throw us off course in the medium term. Indeed, by helping to reassure savers and investors, our actions to stabilize markets should enable market participants to focus more clearly on the medium term and on the sound basis our commitment to price stability provides for investments in Canada.

**The Bank's role in clearing and settlement systems**

I would now like to turn briefly to the changing landscape of Canadian clearing and settlement systems. As users of these systems, we all share an interest in ensuring that Canada has efficient, competitive and, above all, safe and sound arrangements in place.

From the Bank's point of view, the clearing and settlement of payments is an integral part of our central banking responsibilities. This is because it is the Bank's job to provide the means of final settlement among financial institutions for payment transactions in our economy. As a result, the Bank also has a responsibility as a lender of last resort for the Canadian financial system. Hence, our interest in strengthened arrangements to reduce the potential for problems in clearing and settlement systems.

The increased concern in recent times about these matters stems from the massive increases that have taken place in the value of transactions flowing through the financial system. Given the processing lags involved in a payment system that is still very much geared to settling paper-based transactions, there is a risk that something could go wrong (say, a participating institution fails), before the settlement of these transactions is final. Moreover, the expanded linkages between domestic and foreign financial systems have increased the risk that problems in one area of the financial system will spread elsewhere, here and abroad. This is what we refer to as "systemic risk".

The Bank has been supportive of initiatives to set up automated systems that will speed up the clearing of transactions and reduce the risk associated with settlement lags. But these systems also have the effect of concentrating large numbers of transactions in a single clearing house. It is important, therefore, to ensure that appropriate control mechanisms are in place in these new automated clearing systems to contain risks associated with the possible failure of a participating institution and to arrest any potential ripple effects through the financial system.

The Bank has participated in international discussions on clearing and settlement arrangements to establish agreed standards for risk controls and has worked to the same end at home with various private sector groups. We have worked with the Canadian Payments Association on the large value transfer system (LVTS), with the Canadian Depository for Securities on the debt-clearing service, and with Multinet on netting arrangements for foreign exchange transactions.

So far, we have worked with these groups informally. Under Bill C-100, which is now before the House of Commons, the federal government proposes to give the Bank a more formal and explicit role in the oversight of clearing and settlement systems involving payments, with the objective of controlling systemic risk. In this way, the Bank would also be more accountable for its role in this domain. This is very much in line with the role played in this area by other central banks in industrial nations.

Briefly, the proposed legislation will give the Bank powers to supervise and approve risk-control arrangements in those clearing and settlement systems that pose potential systemic risks. It will also allow the Bank to provide a guarantee of settlement to participants in the large value transfer system (LVTS) being designed by the Canadian Payments Association. Any claim on this guarantee is extremely unlikely, given the major commitment to cover losses on the LVTS by the private sector participants. Finally, the legislation will permit the Bank of Canada to offer participants in clearing and settlement systems the possibility of holding interest-earning special deposits at the Bank, as a means of meeting their collateral requirements under these systems. These deposits are intended to address concerns about the cost of pledging other forms of collateral.

In closing, let me reiterate the importance for Canada of having well-designed, sound clearing and settlement systems. The benefits to users of financial services and to the economy in general are extensive. And, in an increasingly international market in financial services, with other industrial countries already well into the process of developing better systems, we cannot afford to fall behind and jeopardize our ability to compete.