BANK OF CANADA

The Bank of Canada and financial markets

Notes for remarks by
John W. Crow
Governor of the Bank of Canada

At the annual convention of the
Association de planification fiscale et financière
Montreal, Quebec
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Let me begin my remarks by noting the modification to the title of your Association. The change, from "planification successorale" to "planification financière", is a fortunate one. For one thing, you will be spared my views on estate planning. And, for me, it offers a welcome opportunity to share with you some thoughts on financial matters.

To be somewhat more specific, rather than talking about current policy, I would like to take advantage of this audience's extensive financial background to review where and how the Bank of Canada fits into the Canadian financial system.

Perhaps the first point to be made in this regard is that while central banks around the world do have some broad functions in common, how they relate to their respective financial systems is not governed by any set formula. So, for example, while some central banks are supervisors or regulators of important segments of the financial industry -- deposit-taking institutions in particular -- it is worth emphasizing at the outset that this is not the case here in Canada. The Bank of Canada is not a supervisor or regulator.

This does not mean that we do not keep a close eye on what goes on within the system. The Bank has a strong interest in the maintenance of stable and efficient financial and payments systems. Monetary policy is most effectively transmitted to the economy if the financial sector is healthy and efficient. Moreover, with its responsibilities as the ultimate provider of liquidity to the financial system, the Bank takes a keen interest in how financial institutions are faring as well as in their supervisory and regulatory framework.

Even though the Bank of Canada is not in charge of supervision or regulation, the Bank's special position enables it to make an important contribution to the oversight of the Canadian financial system. Let me mention, for example, the Bank's membership on the Financial Institutions Supervisory Committee that has been set up to facilitate the exchange of views and information among federal agencies on the supervision and prudential regulation of financial institutions. As well, an officer of the Bank chairs the Canadian Payments Association, and I am on the boards of the Canada Deposit Insurance Corporation and the Federal Business Development Bank. In its capacity as the federal Government's fiscal agent, the Bank of Canada is also actively involved with the Canadian Depository for Securities. At the international level, the Bank is a shareholder and participant in the work of the Bank for International Settlements. In July, the G-10 group of countries and Luxembourg reached an important agreement at the BIS on a programme for bringing about a convergence of national measurement and standards for capital adequacy of international banks. This provides a good example of how such international dealings can impinge on what happens within our financial system.

Let me also add that, because of its various roles, the Bank of Canada is exceptionally well-placed to follow and assess not only structural aspects of our financial system, but also the fluctuations in financial markets that draw so much attention nowadays.

In my remarks so far, I have underlined the Bank of Canada's institutional links to the Canadian financial system and its concern that it be a healthy one. At the moment our financial system is in the throes of a major restructuring, an exercise that has proven to be as arduous and contentious as anyone anticipated it would be. This evening I do not propose to review the difficult issues that have arisen. But I will emphasize that the restructuring and opening up of the financial sector in Canada does not necessarily imply or call for less regulation. It calls for different regulation. The so-called "Four Pillars" are not being replaced by a legislative structure in which anything goes. The reasons for this are not hard to find.

The financial sector is in important respects different from most other kinds of activity in the economy. The sheer volume of funds lodged in or passing through the financial system, together with the high degree to which financial institutions are leveraged, gives rise to the possibility of large and rapid losses. These can have far-reaching consequences for the entire economy. It is, therefore, in the public interest to ensure that risks of a systemic nature are kept to a manageable minimum and that confidence in the integrity of the financial system is maintained. Indeed, it is telling that the very words "confidence" and "integrity" are words that find ready currency in regard to the financial sector, but are used quite rarely in regard to other sectors of economic activity. At the same time, there is a clear interest in gaining for Canadians the benefits of a highly competitive financial system. The task is to achieve as fully competitive a system as possible without sacrificing the confidence and integrity that are vital for it to work properly.

I would like now to turn from matters in which the Bank's role is largely advisory to those in which it plays a direct role.

Let me begin by noting that earlier I referred to the Bank of Canada as being the provider of liquidity to the financial system. More precisely, the Bank of Canada is the supplier of the ultimate means of payment or settlement in Canada. This has two fundamental consequences.

The first is that we are in a position to act as lender of last resort to banking institutions -- a role common to central banks around the world. This role involves two kinds of operations. One is overnight lending to banking institutions to finance shortfalls in their reserve balances at the Bank of Canada arising from unexpectedly large adverse swings in their cheque clearing or other settlement operations. Such lending is a fairly routine operation. However, a second type of lending operation, for which we received quite a lot of publicity a few years ago, consists of extraordinary advances to institutions experiencing persisting liquidity problems as a result of a loss of depositor confidence. Such operations are intended to prevent the failure of a solvent but illiquid institution -- giving it breathing space in which to reorder its affairs. The fact that we stand ready to provide such advances to solvent institutions will also tend to head off contagion -- that is, where a loss of confidence in one deposit-taking institution spreads to other like institutions.

This capacity to supply liquidity, combined with our close institutional links to the financial system, also enables the Bank to contribute in an important way to its overall stability. For example, in the stressful and uncertain circumstances of the stock market crash of a year ago, the Bank greatly stepped up its monitoring of day-to-day developments and reverberations in all parts of the Canadian financial sector -- not just banks. It also sought to ensure, through the rapid provision of additional general liquidity to Canadian financial markets, that the stock market problem did not lead to a damaging loss of confidence in those financial markets and in the economy in general.

The second basic implication of the fact that the Bank of Canada supplies the ultimate means of payment is that the Bank has the leverage to conduct monetary policy effectively. Major deposit-taking institutions must ultimately use deposits at the Bank of Canada to clear and settle the daily flow of cheques and other payment items among them. By controlling the overall availability of funds to make these settlements, the Bank is able to influence very short-term market interest rates in a direct manner. Our influence on longer-term rates is much less direct since such rates also embody market expectations about the future. Indeed, the Bank's direct influence on market rates diminishes progressively as the term of the instrument lengthens.

It probably needs emphasizing that even with the planned elimination of statutory reserve requirements on chartered banks, the Bank will retain the policy leverage it requires. Major deposit-takers will still need to settle their bilateral payment balances using deposits at the Bank of Canada, and we will still be able to control the availability of those settlement deposits. Exactly how the system will look without reserve requirements -- there is in fact a range of workable variations on the same basic theme -- is a subject which we have been discussing with, and getting feedback from, the institutions that will be affected.

In broaching the topic of monetary policy, I am aware that it seems to mean a lot of different things to different people. So before I finish I would like to spend a little time exploring what the Bank of Canada can and cannot do, as well as what we should and should not do.

Perhaps the first point to emphasize is that although the Bank can and does influence financial conditions, it does not control them. The simple fact is that we operate in financial markets, and as I have already indicated there are always two sides, and many forces, in any market. Given this two-way street the impact of our actions depends heavily on market expectations, reactions and the forces generated by other policies. I need hardly stress that on the other side of the market there are international as well as domestic influences at work at any given moment.

Let me also note that since market conditions incorporate participants' assessments of current and expected policy actions, the market gives policymakers a form of "quote" on their performance. So, although market expectations may at times get carried away, or overshoot, over time they provide an unbiased and unsentimental feedback to which policymakers do well to pay attention.

In any event, the important question for the Bank of Canada and for Canadians is what should be done with the influence that the Bank of Canada does have.

Cutting through all the technical and tactical issues that arise in conducting policy, the fundamental point to underline is that whatever else monetary policy is called upon to do, it will not be ultimately successful unless it fosters confidence -- confidence in the value of the money Canadians spend, save and invest.

In day-to-day public commentary, monetary policy is often equated with an interest rate policy or an exchange rate policy. Indeed, there are many who would say if that is not what monetary policy is about, then it should be. This seems to reflect a widely-held view that someone should be controlling interest rates and the exchange rate -- and keeping them both low. It also reflects the fact that in thinking about their financial affairs people naturally tend to focus on what has been happening to interest rates and the exchange rate and not on such general, and less concrete, considerations as the pace of monetary or credit expansion or the course of total dollar spending in the economy.

Certainly, there is no question that interest rates and the exchange rate are crucial elements in the transmission of monetary policy and, as my mail continually underlines for me, important factors in all kinds of economic decisions. And of course the Bank of Canada monitors very closely indeed what is happening to interest rates and the exchange rate.

However, despite their visibility and importance, interest rates and the exchange rate should not, themselves, be seen as the objectives of monetary policy. The fact of the matter is that the strategic decisions on monetary policy are more profoundly based on, and therefore more readily appreciated in terms of, the path over time of monetary expansion and total spending in the economy.

Let me underline this point by focussing on the difficulty of looking at monetary policy through the prism of interest rates. Clearly, most people -- certainly borrowers at least -- prefer to have lower rather than higher interest rates. But what exactly can monetary policy do to achieve and sustain low interest rates? A policy that sought to achieve lower rates through a burst of rapid monetary expansion would be self-defeating. The inflationary pressures to which such a policy would inevitably give rise would not escape the attention of lenders. Very quickly, interest rates would rise -- not fall -- as inflation fears began to dominate. This example should amply illustrate the point I made earlier -- that financial markets are a two-way street in which the views and expectations of market participants exert an enormous influence on financial conditions.

In formulating and conducting monetary policy it is therefore essential that we take its effects on such expectations into account. If monetary policy is to achieve a sustained lowering of interest rates it must work to promote confidence and stability in the value of the money we use. The only way in which monetary policy can foster that confidence is by working to ensure that the pace of monetary expansion is consistent with the non-inflationary expansion of the economy.

As regards the relationship between monetary policy and the exchange rate, the story is perhaps even more complex. The behaviour of the exchange rate reflects not only shifting market perceptions of the current and anticipated evolution of our interest rates as compared with those in other countries, but also relative import and export prices, relative productivity and relative investment opportunities. Over the longer term, the evolution of the exchange rate will depend crucially on our productiveness and inflation performance vis-à-vis our trading partners and rivals. It is important to recognize the relative nature of such influences since the exchange rate is by definition a ratio -- the market's evaluation of one currency relative to another. And, this being the case, the behaviour of the exchange rate does not solely depend on what happens in Canada. What I can say, however, is that pursuing the central objective of domestic monetary stability is the surest means we have of maintaining confidence in our money's external value.

In my comments this evening I have aimed to outline the role of the Bank of Canada in relation to the financial system. Ensuring a healthy financial sector is important, not just for the firms in the industry but for the whole Canadian economy. Similarly, providing Canadians with a money they can trust is not a goal that stands by itself.

It is the surest thing we can do to help the Canadian economy to perform as strongly as possible.