BANK OF CANADA



# The Bank of Canada and the Money Market

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

to the
Toronto Money Market Association
Toronto, Ontario
26 April 1989



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**THE BANK OF CANADA AND THE MONEY MARKET**

I bring fraternal greetings to this inaugural meeting of the Toronto Money Market Association. The money market is an area that receives daily -- indeed at times minute by minute -- attention from us and I welcome the opportunity to talk about it in some depth. Although the Bank of Canada's perspective, given its responsibilities, is rather special, I am sure that you and we have much to share.

The money market is at the very heart of the process by which the Bank implements monetary policy. Our day-to-day activities are geared towards affecting developments in the overnight and other short-term areas of the market. Actions taken to shift yields in the money market have an effect across the financial system and into the real economy.

We also have a somewhat separate interest in the money market that reflects our role as fiscal agent for the Government of Canada. We provide advice to the Government, and conduct its borrowing operations. As you know, the Government in recent years has made great use of the money market, both as a regular source of financing, building up a substantial stock of debt in treasury bills, and to bridge temporary cash shortfalls. As well, the Government has been regularly offering, through auctions, a portion of its cash balances on a short-term basis.

Given these two roles, our approach towards the money market cannot be the same as that of the firms and organizations for which you work. We are the only participant with monetary policy responsibility. We also are the only participant with a fiscal agency role for the Government, the largest user of the market, whose scale of operations is quite capable of affecting overall market conditions. Other market participants strive to maximize investment returns or trading profits and to minimize borrowing costs against a set of interest rates over which, individually, they have essentially no direct influence. Understandably, those participants have a different focus from ours.

Despite these differences all of us can agree on at least one thing -- and that is the enormous value of having the efficient, resilient and highly developed money market that now exists in this country. The Bank of Canada is certainly of this view. For example, without a broad and deep market, our fiscal agency role would have been much more difficult recently, given the record amount of Government of Canada treasury bill offerings and the increase of over one quarter in the stock of bills during the past year. It also would have been more difficult to accommodate smoothly the large swings in bill offerings from one week to the next, and the issue of cash management bills on short notice, that have resulted from the tighter management in recent years of Government cash balances.

The Bank also needs a well-developed market for the effective transmission of its own policies. I can perhaps make this point most clearly by looking back some thirty years, to the period when the money market was in an early stage of development and linkages among the various financial sectors were weak. At that time, in gauging the effects of our policy actions we felt we had to factor in not only the influence of interest rate changes, but also such elements as what happened to the amount of bank liquidity and whether investors were shortening or lengthening the term of their financial assets. Now, I am happy to say, the efficiency of the market is such that concepts resting on the non-price rationing of funds or market segmentation need no longer be part of our thinking.

The money market of today -- with an annual turnover of $1 trillion -- has reached this stage of development with a lot of care from the Bank of Canada. The origins of the market trace back to the 1950s, when the Bank designated a group of investment dealers as "jobbers", granting them access to purchase and resale agreements (PRA) with the Bank in order to encourage their role as market intermediaries.

By the late 1960s and early 1970s, the money market as we know it now really started to take shape. A key event was the removal via the 1967 Bank Act of interest rate ceilings on bank lending and the distortions that this restriction had caused at times. This was followed by a reduction in the chartered banks' secondary reserve requirements, curtailing the influence of a captive bank market in holding down artificially the yields available on treasury bills. Around this time a "special" call loan market was evolving, providing broader and more flexible overnight sources of financing for market participants. As a result of such developments, as the Canada treasury bill stock expanded sharply during the 1970s, market forces also became stronger and more resilient. This produced more competitive yields for treasury bills, which in turn brought into the market a wide range of institutional and retail investors.

In more recent years the Bank of Canada has taken further technical steps to improve the market's operation. The way in which chartered bank reserve holdings are calculated was changed from a simple average of daily balances to a weighted average, eliminating the nuisance of the sharp drop in overnight rates that used to occur each weekend. And a few years ago we changed the bookkeeping for the settlement of payments flows through the central bank. This effectively eliminated clearing settlement float and the need for market participants to devote as many resources to the routing and timing of payments.

This audience will have a good general awareness of how the Bank of Canada operates within the money market, so I can be fairly concise in my exposition on this point. Still, let me reemphasize that most of our activity is directed towards the overnight market, and that for the transmission of our monetary policy actions we take advantage of the market links between the cost of financing in this market and various other short-term interest rates. These include of course the three-month treasury bill rate, to which the Bank Rate is currently tied.

The tool we use most often to affect overnight rates is the day-to-day adjustment of the amount of cash reserves provided to the banking system. Early each evening we decide on a cash setting, taking account of the amount of reserves apparently being demanded by the banks, in order to bring about the conditions that we would like to see develop in the overnight market. The resulting impact of the cash setting on the financing rate paid by investment dealers, and therefore on their willingness to hold inventories, often will get us to, or close enough to, the interest rate range that we had in mind.

However, there are times when the cash reserve management proves less precise than we would like. On such occasions in recent years we increasingly have used market transactions, which are reversed one day later, as a means of more directly and immediately influencing the overnight rate. These transactions have mainly been "special" PRA -- our purchase of government securities to be resold the next day. More recently, we have begun to carry out as well what we call SRA -- sales with an agreement to repurchase.

We started using special PRA in 1985 to offset on occasion technical upward rate movements that occurred in the overnight market. But with experience we began to see benefits in using these transactions to ease undue upward rate pressures on a more regular basis. Similarly, SRA has come into more frequent use to counter excessive rate pressures in a downward direction. Unlike traditional PRA, the Bank sets the rate, amount and timing of these transactions. This, not surprisingly, gives us a higher profile in the overnight market. We have accepted this as a necessary reality if we are to signal our intentions efficiently.

While we have been placing a greater emphasis on transactions at the one-day term and on a repurchase basis, we have not abandoned the use of outright purchase and sale of treasury bills. However, we have tended to reserve such transactions for occasions when our actions in the overnight market appear to require special reinforcement. These transactions with the market, whether for cash or in trade for other treasury bills, generally are undertaken to indicate more directly that the interest-rate movements of the day are proceeding farther and faster than seems appropriate.

So much for the mechanism. Now I want to step back a little and look at the monetary policy consequences more broadly.

Let me begin with a note of caution. I would not want this description of the mechanism to be taken to suggest that the Bank can dictate the level of interest rates in this country. While, unfortunately, many people seem to believe that we move them around at will, I need not belabour the point with this audience that financial markets have a crucial say in this matter. The Bank of Canada can, does, and will continue to exercise leadership. As I said at the beginning, ours is the institution with monetary policy responsibility, and we aim to discharge that responsibility. But the essence of financial markets is that they embody hardboiled views of savers and borrowers about future financial values. If the Bank's actions do not prove to chart a credible course, then they will have no lasting effect on interest rate levels. This is true even in the shorter-term area of the market, where our influence is the most direct and the least tempered by market expectations.

A particular factor that can complicate the Bank of Canada's activities is the inevitable and important interaction between the money and foreign exchange markets. To affect the money market is, in principle, to affect the exchange market as well. Therefore, both interest rate levels and the exchange value of the Canadian dollar have to be seen as elements in the way monetary policy is transmitted. And since events in either the money or exchange market can easily trigger a response in the other market, we may find at times a combined shift occurring in these markets that we view as too extreme.

Especially during periods of exchange market volatility, this process has at times made us very watchful to ensure that in seeking a change in interest rates, we do not trigger an exaggerated movement in the exchange rate. On other occasions we have had the difficulty of coping with developments in the exchange market that have set in motion pressures on interest rates. Earlier in the 1980s, there were several instances when a sharply weakening dollar forced short-term interest rates higher than we, at least, felt should have been completely necessary in the circumstances.

Another complication, again often involving this interaction between the money and exchange markets, has been the difficulty that the market has had at times in interpreting our actions. The pronounced tendency of the Canadian dollar to slide, with the resulting inflationary impact, was a continual influence on monetary policy and the money market through to the mid-1980s. And as a result, the money market appeared to condition itself to react almost automatically to changes in the exchange value of the dollar. Under the changing circumstances of recent years, which have included the strong recovery of the dollar and intensifying demand pressures in the economy, the market has had to adjust its readings of our activities. This initially seemed to cause some misunderstanding which, I trust, no longer exists.

I will continue with some of the other difficulties that market participants seem to have at times in interpreting our actions -- and that we ourselves have at times in understanding the behaviour of the market.

Sometimes the timing of our actions is questioned, especially where there may be no particular event to which an initiative by the Bank can be tied and the market is taken by surprise. On this point you should perhaps bear in mind that our decisions are based on virtually continuous monitoring of economic and financial data. And, simply put, this evaluation process leading to our actions may not end on any particular day nor necessarily be concluded with any specific piece of information.

Another point relates to the occasional perceptions of inconsistency in our actions when, after exerting pressure on rates in one direction, we then shift rather quickly to the opposite direction. This usually results from having set in motion a process that tends to overshoot the range that we had in mind for an interest rate change, and we take steps to limit the move. It can also occur because a new development has come into play, suggesting that a pause, or even change, in the thrust of our actions would be appropriate. While we would love to have perfect foresight, in its unavoidable absence we, like you, have to respond to contingencies as they unfold, and this can at times give rise to the appearance of an uneven approach on our part.

The very nature of the Bank's role and that of other participants in the money market will frequently lead to diverging interests. At times the Bank will be trying to moderate momentum in the market, in effect spoiling your party. At other times we will stir up what is a peaceful market for you. On our side, we may have trouble in understanding why the market is sometimes so stubborn in its response after we have shown our hand, perhaps leaving itself vulnerable to losses. Some frustrations between the Bank and the market are, realistically, bound to occur. But we seem to get along well overall, and we no doubt can minimize those frustrations that do arise by trying to understand each other's position as best we can. We listen to you, and I hope that this discussion will help to further the dialogue between us. I also encourage you to read our, mostly my, speeches and the Bank's published minutes. Through them we try to explain the basis for our actions, and that should be helpful.

Now I would like to peer ahead to see how our operating instruments might evolve further. You are aware that the Government has announced its intention to phase out the cash reserve requirements on chartered banks. The Bank of Canada has considered carefully how it would conduct its operations under such a regime, and we have released two discussion papers on the topic, the most recent of these appearing in early February of this year. Some of you may have been involved in the meetings held to discuss our zero-reserve approach to the implementation of monetary policy. In any case, it perhaps is worth stressing that while differences in detail will exist, the day-to-day management of the supply of settlement balances to the directly clearing institutions will be quite similar to the present arrangement. Our preference for a diffuse, market-oriented mechanism continues to apply, and we do not have to give it up with zero reserves. We also expect our presence in the market with special PRA and SRA to continue to be important.

Looking still further into the future, the Canadian payments system appears to be evolving towards a situation in which paper cheques settled on the existing basis will coexist with a large-value electronic payments system with same-day settlement. We think that the increase in the use of the large-value payments system will be gradual, in other words no abrupt switching away from certified cheques for large value transactions. However, eventually, as the electronic payment system comes to have a major share of the total value of payment flows in the system, it will probably become necessary to restructure further, and likely more radically, the way in which policy is implemented. But we expect this to be some while away. I might add here that in the first of the discussion papers that I mentioned above, released in October 1987, we sketched two possible scenarios for the process of monetary policy implementation in a Canadian same-day settlement environment.

Also on the horizon is a new system to clear and settle money market transactions that is being developed by the Canadian Depository for Securities. This project has drawn on joint resources from the banking, trust company and investment dealer industries, and the Bank of Canada has been closely involved for some time. When the system is operational, all major money market instruments will be immobilized in the custody of CDS. Transactions will settle instantaneously by book-entry transfers of securities in the computer-based accounts of CDS against a net payment to or from CDS at the end of the day. Before the shift to this new way of settling money market transactions can occur, the Bank and other participants will need to be satisfied that risks associated with settling transactions in this new system have been identified, and that appropriate safeguards have been developed. Naturally, federal and provincial regulatory authorities will also be interested in these risk-related matters. We are hopeful that the efficiencies promised by this new system will be realized in the near future.

In moving towards a conclusion, I would like to comment briefly on a distinction that seems to be frequently misunderstood. This is the difference between, on the one hand what I have described today, activities that we undertake through the markets, and on the other hand the broader objectives of our policy. There is a tendency to view interest rates and exchange rates as being the goals of monetary policy. For those of you who work minute-by-minute in the flow of money market transactions, there would be a particular temptation to think in these terms. However, it is fundamental to bear in mind that interest rates and the Canadian dollar are not in themselves our objectives. Our basic objective is using monetary policy to secure moderate monetary expansion, thereby contributing to broad price stability as an important condition for sustained economic progress.

Finally, I am keen to emphasize the importance that we attach to our intelligence gathering from the money market. Through our people in Toronto, Montreal and Vancouver, highly detailed perceptions of the ebb and flow of short-term financial developments are passed on as they occur in the market. Without your readiness to share views with our colleagues on a regular basis, we would find it much harder to take each day the necessary decisions. We rely a lot on the quality of the information you provide, and we are grateful for it.