



BANK OF CANADA
BANQUE DU CANADA

Policy Options to Deal with Challenging Liquidity Conditions Going Forward

Presentation at
“The Global Financial Crisis – Central Bank
Responses in the Western Hemisphere”

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* The views expressed here are my own, and do not necessarily reflect the views of the Bank's Governing Council.

Outline

- Two types of liquidity
- Where liquidity is needed
- The central bank as liquidity provider
- Instruments for providing liquidity
- Principles to guide the provision of liquidity
- Lessons from the Canadian experience

Two types of liquidity

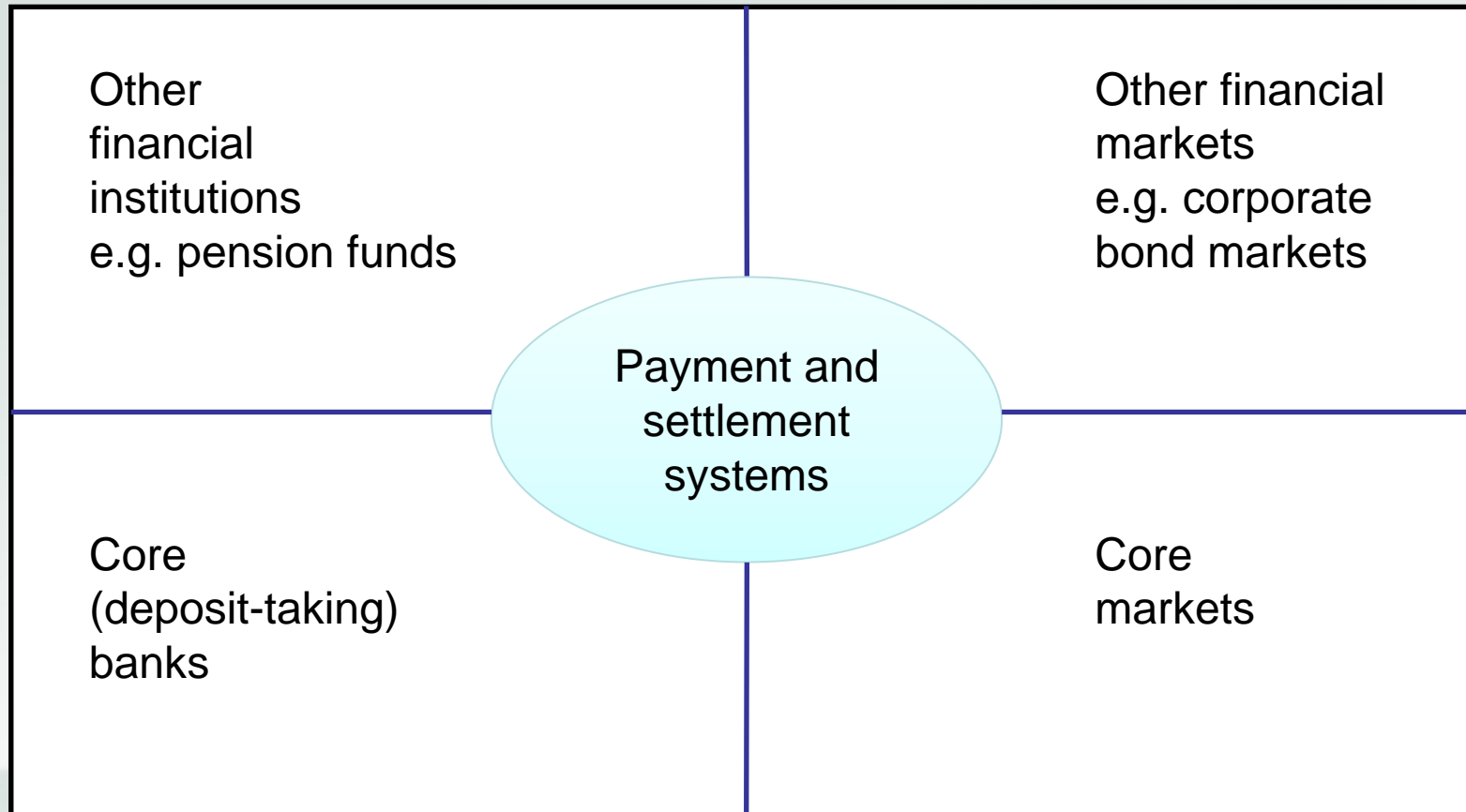
Bank liquidity

- Access to deposits
 - Requires bank to honour deposit contract
- Access to bank loans (deposit creation)
 - Requires reasonable quantities, terms and conditions

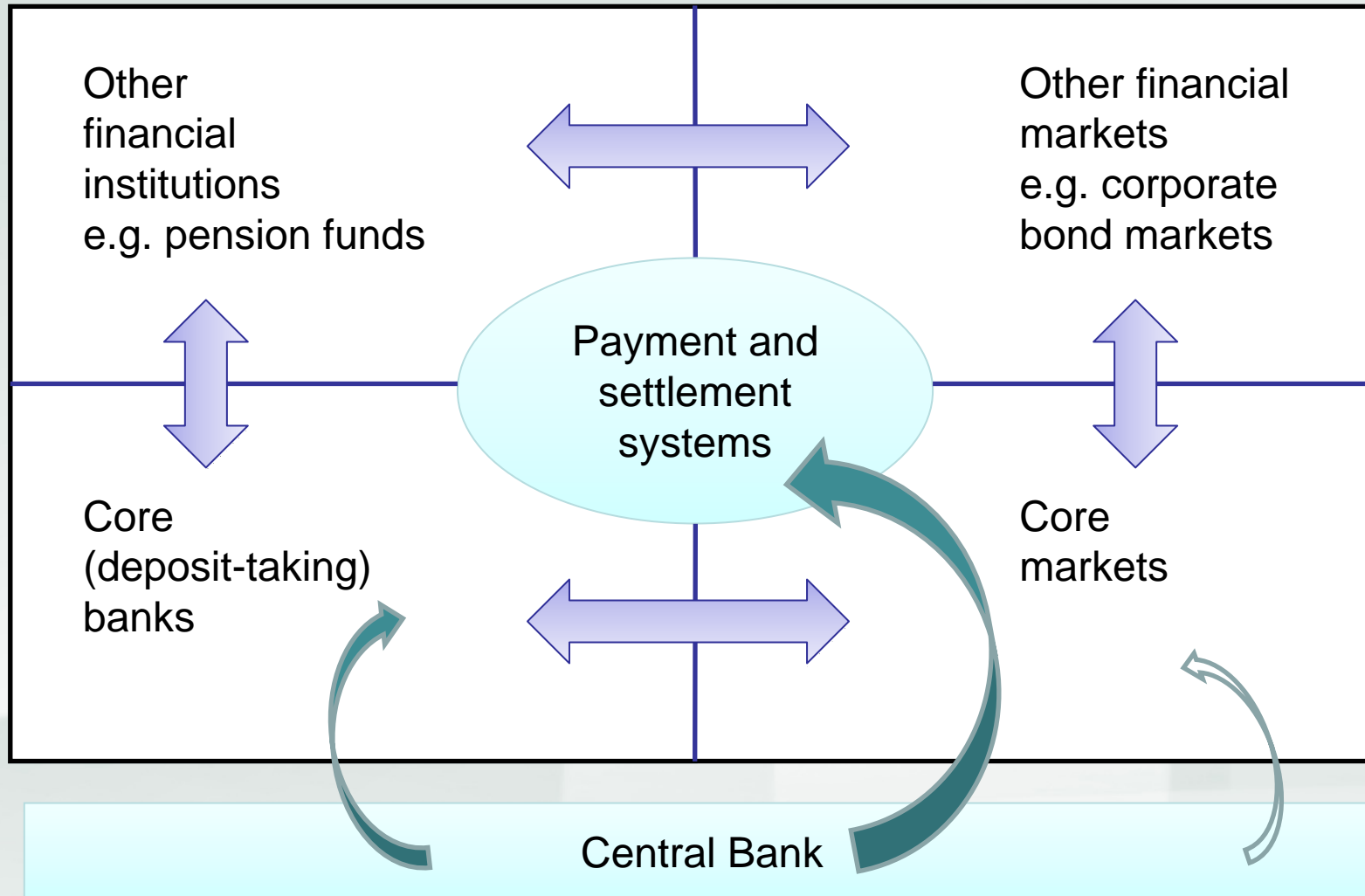
Market liquidity

- Access to markets
 - Requires sufficient transactions volume to generate predictable asset prices

Where liquidity is needed



The central bank as liquidity provider



Instruments for bank liquidity

- **Increase the term of lending**
 - From over night to...*
 - Extend term to 1, 3, and 6 months
 - Increase frequency of auctions
- **Relax the restrictions on collateral quality**
 - From government treasury securities to...*
 - Private sector money market instruments
 - Foreign treasury securities
 - Commercial bank loan books
- **Expand the list of counterparties**
 - From core deposit-taking banks to...*
 - All members of payment system
 - Investment banks
 - All regulated money market participants

Bank of Canada strategy

- Concentrate on banks first
- Provide sufficient liquidity to satisfy demand by banks
- Focus on money market securities
- Adjust term, collateral, and counterparty
- Take collateral in the form of securities traded in functioning markets *and* securities traded in distressed but sustainable markets

Bank of Canada Liquidity Facilities Introduced Since Q4 2007

	Announced	Amount Offered	Peak Volume Outstanding**	Acceptable Collateral	Approved Counterparties
Term PRA	12 Dec 07	\$2 to 12 billion	\$37.8 billion	SLF eligible: GOC securities, NHA-MBS, CMBs, other government guaranteed securities, provincial bonds, BAs, CP, ABCP, BDNs, corporate bonds, UST	Primary Dealers and direct participants in the Large Value Transfer System
Term Loan Facility (TLF)	14 Oct 08	\$2 billion	\$3.2 billion	Non-mortgage loan portfolios	Direct participants in the Large Value Transfer System
Term PRA for Private Sector Money Market*	14 Oct 08	\$1 billion	\$25 million	BAs, BDNs, CP, ABCP	Primary Dealers and federally / provincially regulated market participants who demonstrate significant activity in private money markets
Term PRA for Private Sector Instruments	23 Feb 09	N/A	N/A	BAs, BDNs, CP, ABCP and corporate bonds	Federally / provincially regulated market participants who demonstrate significant activity in private bond and money markets

* This facility will be replaced by the Term PRA for Private Sector Instruments at a date to be determined; until that time, this facility will remain operational

** In cash value terms

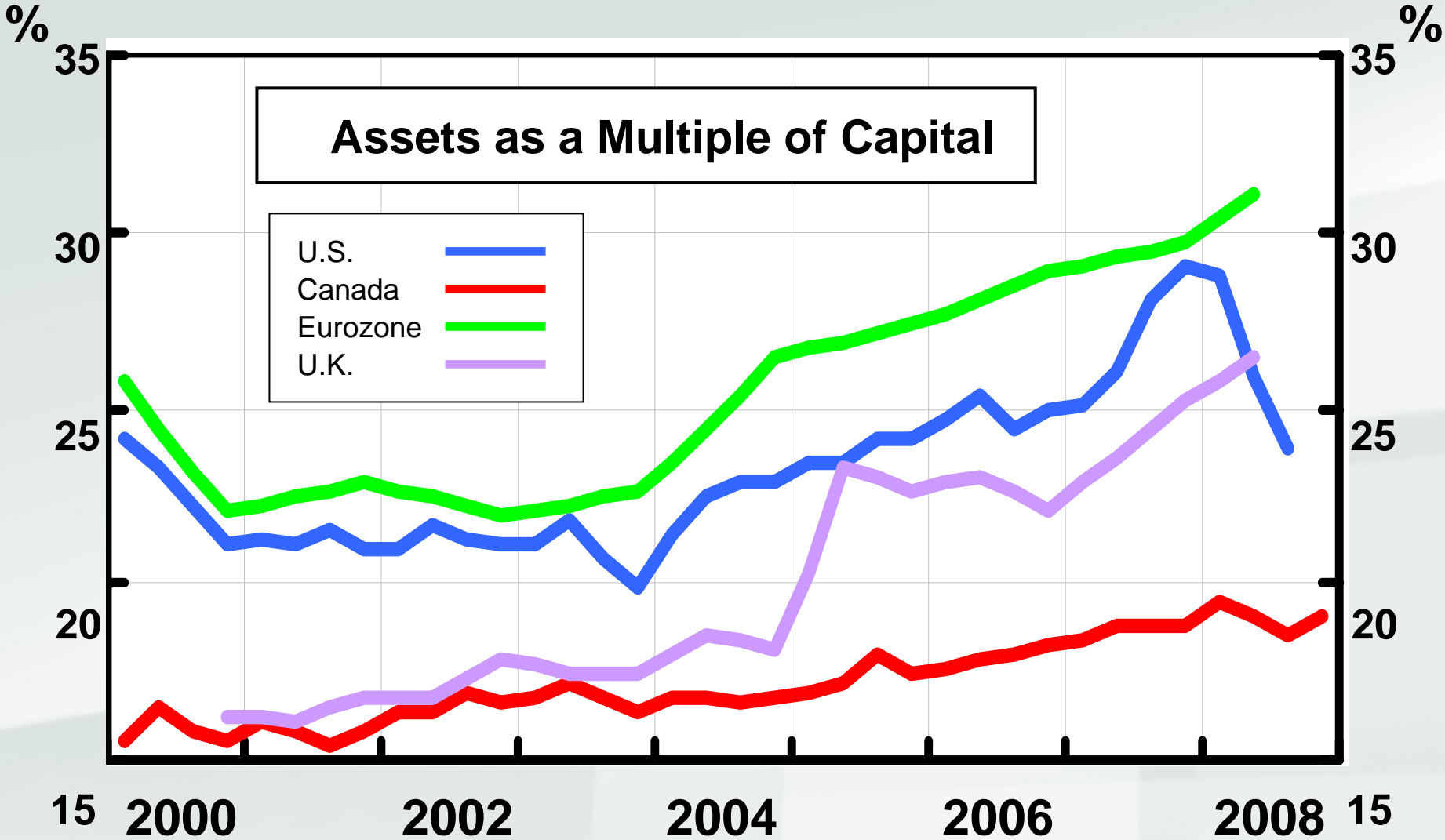
Principles to guide intervention

- Intervention should be targeted to events of system-wide importance
- Intervention should be commensurate with the severity of the problem
- Use the right tools, market-based transactions for market problems and loans for institution specific problems
- Intervene at market determined prices where possible to minimize distortions
- Actively mitigate moral hazard by methods such as limited, selective intervention, coinsurance, and the promotion of sound liquidity-risk management methods

Lessons from Canada

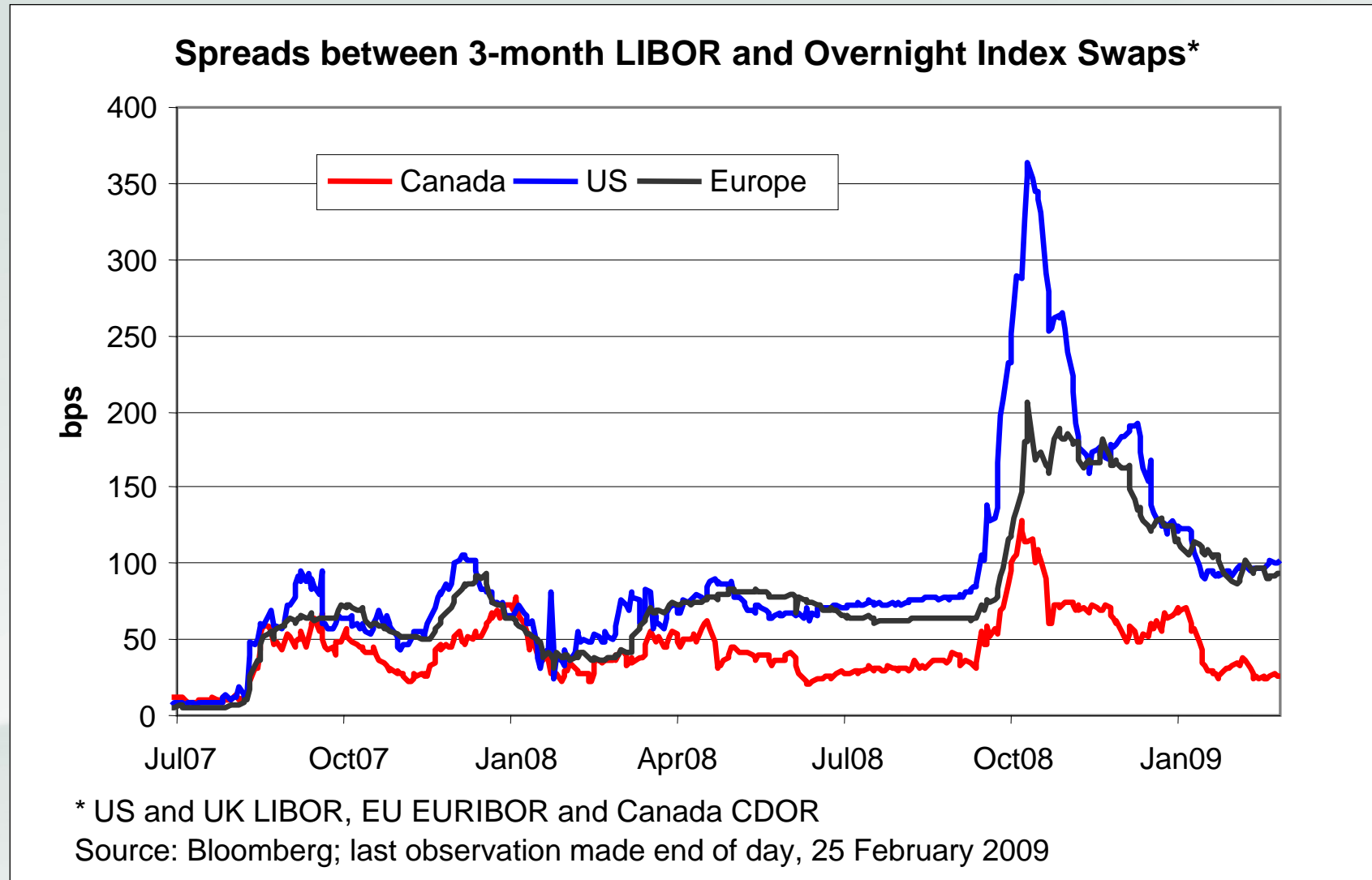
- 1) A problem-free, well-functioning payments and settlement system is not sufficient to prevent liquidity problems in financial markets (from spilling over into the economy)
- 2) A solvent and liquid banking system is not sufficient to prevent liquidity problems in financial markets (from spilling over into the economy)
- 3) A liquid and well-functioning foreign exchange market is not sufficient to prevent liquidity problems in domestic-currency financial markets

Canadian banks a strong position



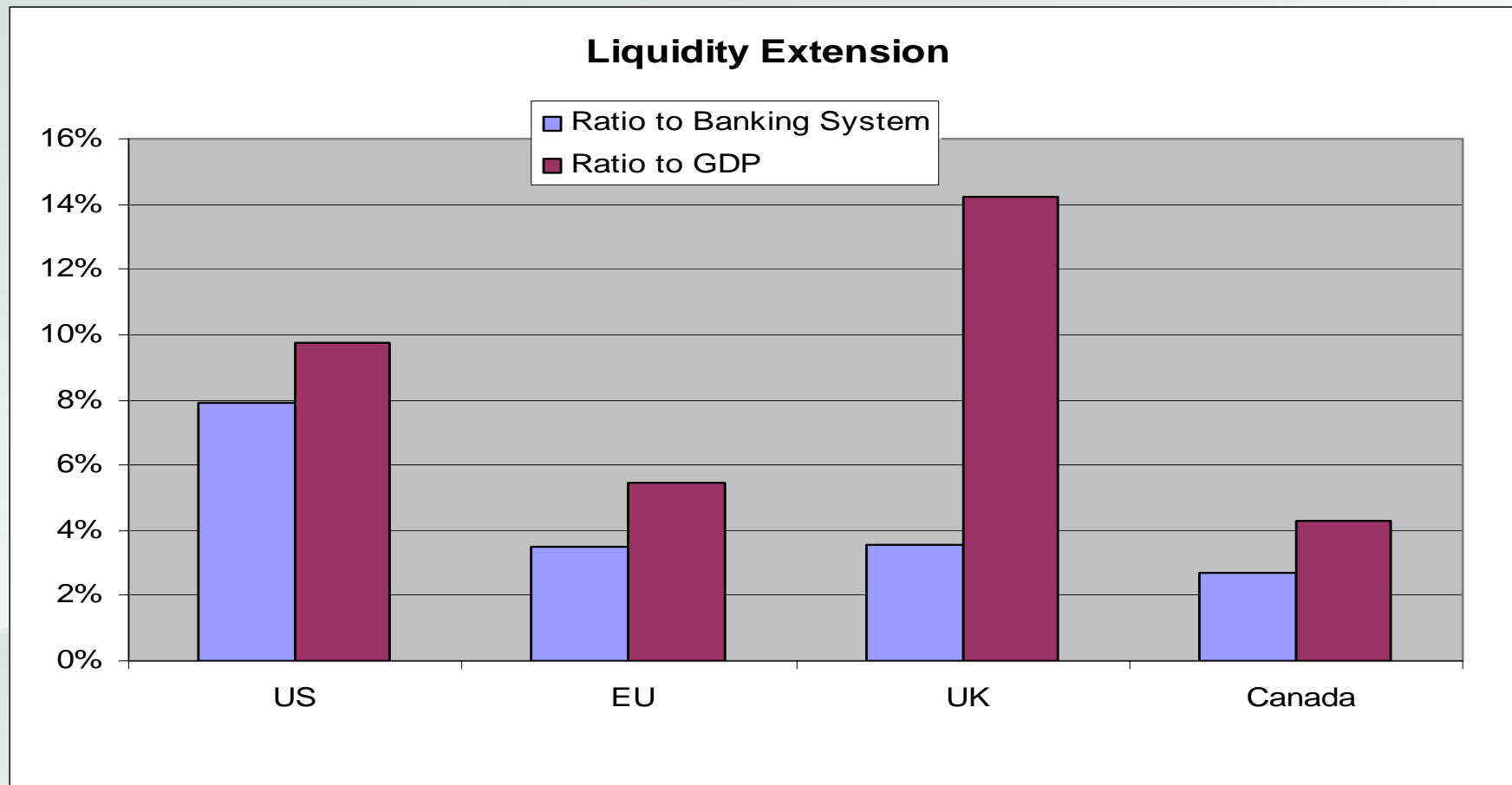
Source: Bloomberg and bank financial statements.

Financial fallout: Bank funding costs rise



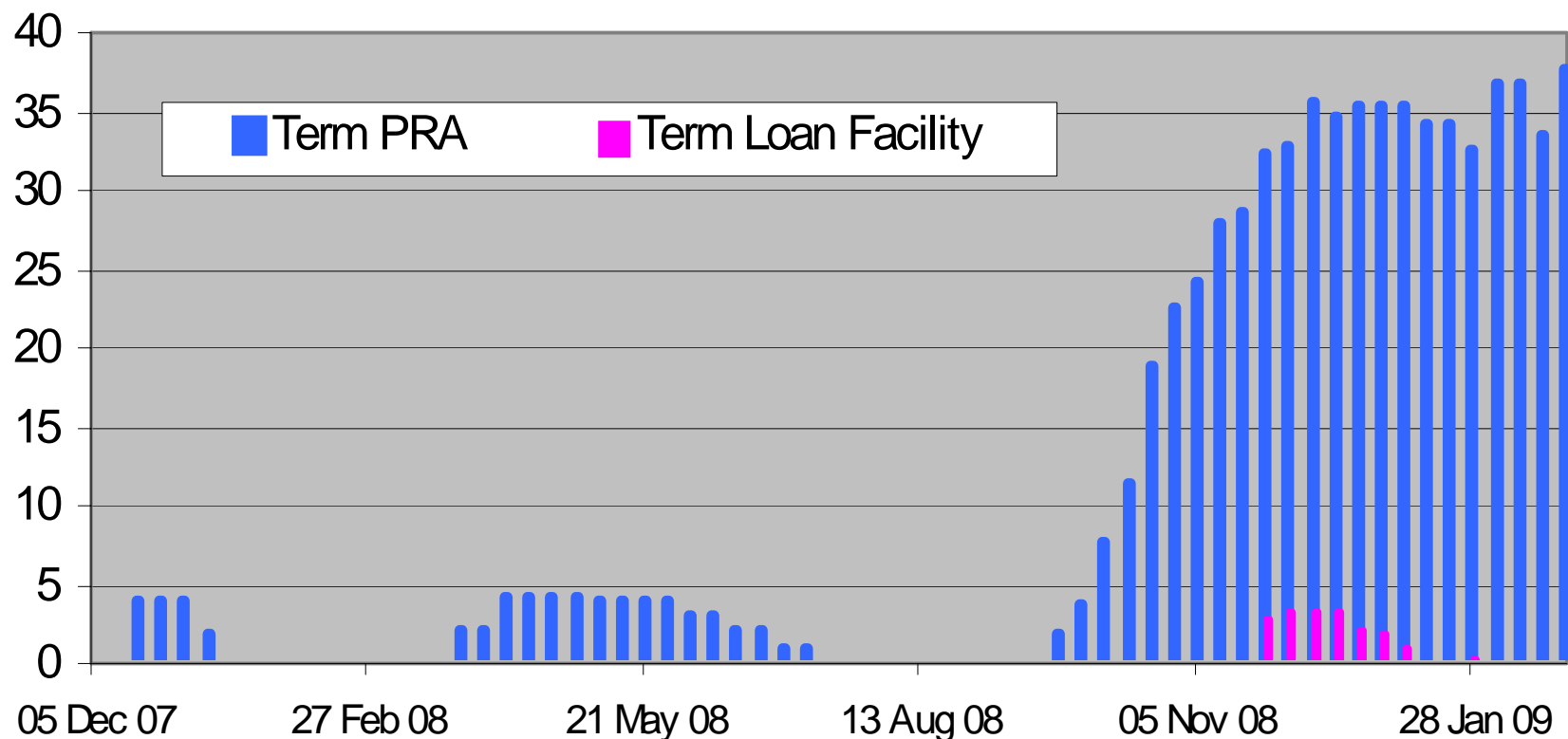
Liquidity provision

Liquidity extension relative to banking system in various countries (USD \$B)



Weekly Par Value Outstanding at BoC Liquidity Facilities*

\$CAD (billions)



* Outstanding values as of Wednesday each week; final value is for 25 February, 2009

Source: Department of Finance, Bank of Canada

Lessons from Canada

- 4) Markets and regulators want banks to be more liquid in periods of financial turbulence, even though the banks are well capitalized
- 5) Liquid core financial markets are critically important to financial stability
- 6) Working with government is important since liquidity risk and credit risk are intertwined