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Bank of Canada Governor Outlines Principles for Liquid Markets

NEW YORK, NEW YORK – Central banks have been more active in providing liquidity support for key markets throughout the recent financial market turbulence because well-functioning markets are important for the conduct of monetary policy and the efficient operation of the economy, Bank of Canada Governor Mark Carney said today in a speech to the New York Association for Business Economics.

Governor Carney spoke of the principles that central banks should follow to support liquidity in markets. These include limited, selective intervention and the promotion of the sound supervision of liquidity-risk management – principles to which the Bank of Canada has adhered in its provision of liquidity support.

By following the principles, central banks can maximize the effectiveness of their interventions and minimize the risk of moral hazard – that the interventions might encourage behaviour that would increase the likelihood or severity of a future crisis.

To determine whether actions to support market liquidity are appropriate, the Governor said, a central bank "should ask itself four questions: First, is the impairment of the market temporary or permanent? Second, will the instruments at its disposal be effective? Third, what net benefits could come from intervention? Fourth, what are the likely costs?"

The events of last summer have challenged the belief that central banks could adequately support markets by allocating liquidity through commercial banks, or by altering liquidity in payments systems, noted Governor Carney. The financial system will be more stable, and the effects of monetary policy actions more predictable, if the central bank directly supports liquidity in markets when appropriate.

"Central banks and other authorities should be as concerned about the distortions and inefficiencies created by overly easy financing conditions, rapid credit growth, and excess confidence about future market liquidity as those created by a lack of liquidity," the Governor added. He suggested that policy-makers consider the promotion of macro-prudential regulations that could serve to restrain pro-cyclical credit creation among banks and market makers.