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Communiqué

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Quebec needs a special fund to avoid secession-related financial crisis, warns C.D. Howe Institute

The Quebec government must amass a sizable stock of funds to backstop its banking system before the next referendum if it wants to minimize financial turbulence and provide greater assurance that Quebecers can continue to use the Canadian dollar after secession, says a *C.D. Howe Institute Commentary* released today.

The study, entitled *Walking the Tightrope: Canada's Financial System between a "Yes" Vote and Quebec Secession*, focuses on the role of federal institutions after a "yes" vote but before actual independence — an awkward period when the Bank of Canada and the Canada Deposit Insurance Corporation (CDIC) would still be operating in Quebec, but when their mandates would be time-limited. Faced with an imminent change of legal regime in Quebec, the Bank and the CDIC would find it hard to play their normal role of supporting financial institutions that became short of liquid funds. In the event of a flight of capital, their inability to act could weaken financial institutions headquartered in Quebec, scaring depositors and other banks alike, and intensifying the crisis. The best chance of preventing such a vicious circle from developing is for the Quebec government to be ready with the necessary funds.

The authors of the study, David Laidler, a professor of economics at the University of Western Ontario and an Adjunct Scholar of the C.D. Howe Institute, and William B.P. Robson, a Senior Policy Analyst at the Institute, argue that Quebec needs to build up a stock of funds to support its financial system well in advance of a referendum. Otherwise, they say, nervousness around secession could prompt a flight of funds from Quebec. If such a flight began, it could put Quebec banks, and perhaps even the Quebec government, under financial pressure and also create a crisis for the Canadian dollar. These circumstances would make a separate currency appear attractive, a prospect that, in turn, could intensify the crisis and create a self-fulfilling prophecy.

The authors maintain that alternatives to a Quebec war-chest, such as joint agreements between the federal and Quebec governments over financial regulation, are unlikely because advance preparations along these lines would be so politically awkward for Ottawa. It therefore falls to the Quebec government to begin setting aside the necessary funds early, before secession-related concerns become an obstacle to its borrowing, and to publicize widely its readiness to deal with any movements of funds before the referendum, to build confidence among depositors and financial institutions.

In the authors' view, advance preparation and publicity are critical because confidence in financial institutions would likely be fragile if Quebecers voted to secede. "With a sufficiently large stock of funds in place, there is some hope of avoiding a financial crisis during the period between a 'yes' vote in a referendum and independence. Without one, that hope looks vanishingly small" they conclude.

This publication continues the C.D. Howe Institute's postreferendum research agenda, which comprises two *Commentary* series. One series is "The Secession Papers," which, in the light of the results of the 1995 Quebec referendum, aims to assist Canadians to "think about the unthinkable." Papers already published in this series are *Coming to Terms with Plan B: Ten Principles Governing Secession*, by Patrick J. Monahan and Michael J. Bryant with Nancy C. Coté; *Looking into the Abyss: The Need for a Plan C*, by Alan C. Cairns; *Ratifying a Postreferendum Agreement on Quebec Sovereignty*, by Peter Russell and Bruce Ryder; and this study by David Laidler and William B.P. Robson.

Complementing this effort is another series, "The Canadian Union Papers," which focuses on ways to enhance Canada's political, economic, and social union. Papers published in this series are: *Securing the Canadian Economic Union: Legal and Constitutional Options for the Federal Government*, by Robert Howse; *Drawing on Our Inner Strength: Canada's Economic Citizenship in an Era of Evolving Federalism*, by Daniel Schwanen; *Language Matters: Ensuring That the Sugar Not Dissolve in the Coffee*, by John Richards; *Time Out: Assessing Incremental Strategies for Enhancing the Canadian Political Union*, by Roger Gibbins; and *Citizen Engagement in Conflict Resolution: Lessons for Canada in International Experience*, by Janice Gross Stein, David R. Cameron, and Richard Simeon, with Alan Alexandroff.

Both series are being published under the supervision of David Cameron, a political scientist at the University of Toronto.

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Le Québec a besoin d'une caisse spéciale pour éviter une crise financière en cas de séparation, prévient une étude de l'Institut C.D. Howe

Le gouvernement québécois devra accumuler une quantité importante de liquidités pour soutenir son système bancaire avant le prochain référendum, s'il veut minimiser les remous financiers et fournir une assurance accrue à l'effet que les Québécois pourront continuer à utiliser le dollar canadien après la séparation, affirme un *Commentaire de l'Institut C.D. Howe* publié aujourd'hui.

L'étude, intitulée *Walking the Tightrope: Canada's Financial System between a "Yes" Vote and Quebec Secession (Sur la corde raide : le système financier du Canada entre un vote du « Oui » et la séparation du Québec),* se penche sur le rôle des institutions financières dans l'intervalle qui suivrait un vote du « Oui », mais qui précéderait l'indépendance elle-même — un moment difficile où la Banque du Canada et la Société d'assurance-dépôts du Canada (SADC) fonctionneraient encore au Québec, mais où leur mandat serait de durée limitée. Confrontées à un changement imminent du statut juridique au Québec, la Banque du Canada et la SADC auraient de la difficulté à remplir leur rôle habituel, qui consiste à venir en aide aux institutions financières à court de liquidités. Si une fuite des capitaux devait se produire, leur incapacité à agir pourrait affaiblir les institutions financières basées au Québec, semer la panique chez les déposants comme chez les autres banques, et aggraver la crise. Le meilleur moyen d'empêcher un tel cercle vicieux de se produire consiste à ce que le gouvernement québécois soit déjà muni des liquidités nécessaires.

Les auteurs de l'étude, David Laidler, professeur d'économique à l'University of Western Ontario et attaché de recherche de l'Institut C.D. Howe, et William B.P. Robson, analyste de politique principal à l'Institut, soutiennent que le Québec doit se constituer un inventaire de liquidités qui soutiendront son système financier bien en avance du référendum. Autrement, disent-ils, l'inquiétude que soulèverait la séparation pourrait entraîner une fuite des liquidités hors Québec. Si elle se produisait, elle pourrait exercer des pressions financières sur les banques québécoises, et même sur le gouvernement, et plonger le dollar canadien dans une crise.

Dans ces circonstances, une devise distincte pourrait avoir un certain attrait, une éventualité qui pourrait aggraver la crise et donner lieu à une prédiction qui se réalise.

Les auteurs soutiennent que les alternatives à une caisse spéciale du Québec, comme les ententes conjointes entre les gouvernements fédéral et québécois concernant la réglementation du secteur financier, sont improbables car il serait extrêmement difficile pour Ottawa de prendre des mesures préparatoires en ce sens. Il incombe donc au gouvernement québécois de commencer à mettre de côté les fonds nécessaires longtemps à l'avance, avant que les préoccupations liées à la sécession ne constituent un obstacle à ses emprunts, et de rendre publique sa disposition à répondre à tout mouvement de fonds avant le référendum, afin d'instaurer la confiance chez les déposants et les institutions financières.

Selon les auteurs, une bonne préparation et une bonne publicité sont essentielles car la confiance envers les institutions financières serait probablement fragile si les Québécois optaient pour la séparation. « Doté des liquidités nécessaires, le gouvernement aurait bon espoir d'éviter une crise financière dans l'intervalle entre un vote du "Oui" au référendum et l'indépendance. En l'absence de celles-ci, cet espoir est très mince », de conclure les auteurs.

Ce document poursuit le programme de recherche postréférendaire de l'Institut C.D. Howe, qui englobe deux séries de *Commentaires.* L'une des séries est intitulée « Les cahiers de la sécession » et, à la lumière des résultats du référendum québécois de 1995, se veut d'aider les Canadiens à « concevoir l'inconcevable ». Parmi les documents déjà publiés dans cette série, figurent *Coming to Terms with Plan B: Ten Principles Governing Secession,* par Patrick J. Monahan et Michael J. Bryant, avec la participation de Nancy C. Coté, *Looking into the Abyss: The Need for a Plan C,* par Alan C. Cairns, *Ratifying a Postreferendum Agreement on Quebec Sovereignty* par Peter Russell et Bruce Ryder, ainsi que la présente étude de David Laidler et William B.P. Robson.

Parallèlement à cette série, en figure une autre intitulée « Les cahiers de l'union canadienne », qui porte sur les moyens d'améliorer l'union politique, sociale et économique du Canada. Parmi les documents déjà publiés, figurent les suivants : *Securing the Canadian Economic Union: Legal and Constitutional Options for the Federal Government,* par Robert Howse, *Drawing on Our Inner Strength: Canada's Economic Citizenship in an Era of Evolving Federalism,* par Daniel Schwanen, *Language Matters: Ensuring That the Sugar Not Dissolve in the Coffee* par John Richards, *Time Out: Assessing Incremental Strategies for Enhancing the Canadian Political Union* par Roger Gibbins, et *La participation des citoyens au règlement de conflits : les leçons de l'expérience internationale pour le Canada,* par Janice Gross Stein, David R. Cameron et Richard Simeon, avec la collaboration d'Alan Alexandroff.

Les deux séries sont dirigées par David Cameron, un politicologue de l'Université de Toronto.

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Walking the Tightrope:

Canada's Financial System between a "Yes" Vote and Quebec Secession

by

David Laidler and William B.P. Robson

Despite the separatist proposal that an independent Quebec would continue to use the Canadian dollar, fear that Quebec might eventually adopt its own currency threatens a flight of funds from Quebec in the event of a "yes" vote in a referendum on independence. A severe flight could produce a credit crunch in Quebec, threaten the stability of financial institutions, or even cause fiscal crises — events that could make a separate currency more attractive to Quebec, and thus bring the monetary union to an end in a self-fulfilling prophecy.

Coping with this challenge during the period between a "yes" vote and actual independence — when pre-existing laws and practices would continue, but in time-limited form — would likely prove impossible for existing federal institutions: the Bank of Canada, the Office of the Superintendent of Financial Institutions, and the Canada Deposit Insurance Corporation. Advance agreement with the government of Quebec on regulatory authority and security of collateral would be highly unlikely for political reasons. Without such agreement, federal institutions would find their obligation to protect taxpayers in the rest of Canada a formidable obstacle to the task of supporting financial institutions exposed to secession-related problems.

It therefore falls to the government of Quebec to position itself to head off a financial crisis. The key requirement would be a war-chest, raised well in advance, that was big enough to meet the demands of its financial institutions for liquidity support and of its depositors for effective insurance coverage. Only if such funds are available, and known to be available, could the government of Quebec hope to avoid a financial crisis during the period between a referendum and secession.

Main Findings of the Commentary

- Continued use of the Canadian dollar is a central element in the secessionist program for an independent Quebec. A sovereign state can, however, always introduce its own currency. Individuals, businesses, and financial institutions will be wary of this possibility, not only in the aftermath of secession, but also in the runup to it.
- Doubts about the monetary union's durability after secession threaten a vicious circle. Nervousness among depositors about their money, among lenders about their loans, and among financial institutions about the robustness of interbank markets might produce a credit crunch in Quebec and a plunging dollar, perhaps even bank failures and fiscal crises. By making a separate currency more attractive to Quebec, these pressures would intensify the nervousness that created them in the first place.
- Preserving the currency union would require preventing such a vicious circle from developing. Awkwardly, this challenge would arise during the possibly protracted period between a "yes" vote and actual independence, when pre-existing laws and administrative practices would continue in force, but would be obviously about to expire.
- Without advance preparation, the task of coping with a flow of funds out of Quebec, or worse, would fall largely on existing federal institutions. The Bank of Canada might encounter demands for funds to support financial institutions and the payments system. The Office of the Superintendent of Financial Institutions might be asked for judgments about solvency. And the Canada Deposit Insurance Corporation might face demands for payouts and for loans to troubled institutions or to its Quebec counterpart, the Quebec Deposit Insurance Board. Without advance agreement on regulatory authority and security of collateral, these institutions would find that their obligations to protect taxpayers in the rest of Canada conflicted with the task of supporting financial institutions exposed to secession-related problems.
- Since advance agreements on regulation and collateral would appear to abet the separatist cause, the government of Canada is highly unlikely to pursue them. It therefore appears that the government of Quebec, whose jurisdiction would continue to run after independence, would be wise to position itself to support the financial system during this period.
- The key requirement for Quebec is a war-chest of Canadian dollars big enough to provide liquidity support and deposit insurance to exposed financial institutions. Such a war-chest would be large, it would need to be raised in advance of a referendum to avoid the financing difficulties and higher interest rates that may arise afterward, and its existence would need to be publicized widely, to ease the nervousness of depositors, lenders, and financial institutions that might otherwise prompt a flight of funds.
- The key role of confidence in financial matters makes energetic advance preparation and publicity critical. With a sufficiently large stock of funds in place, there is some hope of avoiding a financial crisis during the period between a "yes" vote in a referendum and independence. Without one, that hope looks vanishingly small.

The separatist program for an independent Quebec involves the use of the Canadian dollar by the prospective new country. The reasons are straightforward. Custom and experience are powerful forces in monetary affairs, and most Quebec residents seem to prefer conducting transactions and storing wealth in Canadian dollars. Furthermore, should Quebec secede, monetary continuity would help maintain financial stability in particular and promote economic efficiency in general, both in a newly independent Quebec and in the rest of Canada (ROC).

Obstacles to Maintaining the Currency Union

Yet no matter how sincere and emphatic the separatist commitment to continue using the Canadian dollar — or the ROC dollar, as it would be after secession — and no matter how desirable that outcome might now seem on all sides, there are reasons, by now well known,[1] for doubting that a currency union between the two new countries would survive.

A national currency issued by a national central bank is not merely a symbol of sovereignty; it is a tool of economic management. Governments can, depending on circumstances and policymakers' time horizons, use this tool to pursue inflation targets, influence short-term interest rates and the exchange rate, and support the banking system with potentially unlimited supplies of funds in the event of crisis. Numerous circumstances, both immediately after secession and in the more distant future, might prompt a future independent Quebec government to establish its own currency. Transitional pressure on its financial system, persistent balance of payments problems, major divergences in economic fortunes or policy between an independent Quebec and the ROC — one or more of these might make a new currency, which would be a currency of uncertain value, attractive to the Quebec government. This possibility would always exist, and households, businesses and policymakers on both sides of the new border would never forget it.

Furthermore, important parts of Canada's financial infrastructure would cease to exist on Quebec's independence unless negotiations launched well in advance of secession proved fruitful, a prospect made doubtful by serious political obstacles, and all but impossible if secession occurred through a unilateral act by Quebec. Independent Quebec financial institutions would very likely lose access to key elements of Canada's payments system and to the lender-of-last-resort facilities provided by the Bank of Canada, while their depositors would face an uncertain deposit insurance regime. These considerations would, in and of themselves, create nervousness in both an independent Quebec and the ROC.

If nervousness stemming from any of these considerations prompted a movement of funds out of an independent Quebec on any scale, or a deterioration of financial conditions in the Canadian monetary union as a whole, the attractiveness of maintaining the currency union in the eyes of an independent Quebec would decline. This decline would, in turn, provoke further reactions on the part of asset holders, and so on. The prospect of a breakdown of the monetary union might thus trigger the chain of events that would bring the breakdown about.

The Unique Challenge of the Postreferendum Period

Modern financial technology makes it easy for expectations about the future to influence current behaviour. There is, therefore, a strong possibility that a chain of events tending to undermine the currency union could begin before actual secession, when independence would appear inevitable to holders of money and other financial assets.

The uncertain and volatile period between a "yes" victory and actual independence would present particular difficulties of this kind. During this interval, which might be quite protracted, existing federal laws and institutions would remain in place and existing regulatory relationships would remain in effect, but their ultimate durability would be in serious question. At the same time, efforts to prevent Canada's dissolution in some quarters and to negotiate it in others would add awkward political elements to the situation. The technical difficulties and policy dilemmas involved have not so far attracted the attention they merit in discussions of the economic consequences of Quebec secession — hence this *Commentary*.

Preview of Conclusions

Our first key conclusion is that federal politicians and institutions are ill placed to address these difficulties. There is not likely to be advance planning in Ottawa to preserve the monetary union after secession since, particularly if it involved potential co-management of financial infrastructure by the two successor states, such planning would appear to abet the separatist cause. In the absence of advance planning, the Bank of Canada and the Canada Deposit Insurance Corporation (CDIC) would find it difficult to act. Extending support to Quebec's financial system in the absence of enforceable agreements with the Quebec government about its own obligations could expose ROC taxpayers to sizable losses, so the guarantees the Bank and the CDIC currently offer to the financial system would acquire an expiry date once separation became imminent.

Our second key conclusion is that it therefore falls primarily to the Quebec government, whose jurisdiction would not be interrupted by independence, to work out and publicize plans for providing locally the transactions and insurance services to the financial sector that are currently available from federal institutions. If it is serious about preserving the Canadian monetary union while achieving political independence, the Quebec government must start to address these matters now, not leave them to be addressed in the charged environment of a referendum campaign and its aftermath.

Dimensions of the Problem

As recent events in Asia remind us, financial crises are multifaceted and tend to develop rapidly as changing expectations about future events influence present behavior. In preparation for detailed discussion of financial developments surrounding a Quebec secession, it helps therefore to start with an outline of political and economic possibilities.

Some Scenarios

On the political front, a number of events must happen before secession. Several are familiar and regularly attract attention: the separatists must first win the next Quebec election; they must then call a referendum; and then they must win it. The next stage in the process is murkier. Either negotiations between Quebec and the federal government (almost certainly involving, formally or informally, other provincial governments) would result in agreed terms of separation, or a period of no or fruitless negotiations would precede a unilateral declaration of Quebec independence. It is this last stage, with its profound uncertainties and unsettled political and legal environment, that is most challenging to think through.

On the economic front, various authors have devised secession-related scenarios, ranging from business as usual at one end to utter disaster at the other. In general, the former envision easy maintenance of the currency union; the latter, an immediate and damaging

Table 1: ***Possible Financial Consequences of Quebec Secession***

Scenario	A+	A	A–	B+	B	B–	C	D	D–
Shift of deposits from Quebec	N	Y	Y	Y	Y	Y	Y	Y	Y
Weakness or failure of banks in Quebec	N	N	Y	Y	Y	Y	Y	Y	Y
Fiscal problems of the Quebec government	N	N	N	Y	Y	Y	Y	Y	Y
Currency crisis	N	N	N	N	Y	Y	Y	Y	Y
Weakness or failure of banks in the ROC	N	N	N	N	N	Y	Y	Y	Y
Fiscal problems of governments in the ROC	N	N	N	N	N	N	Y	Y	Y
Fiscal crisis in Quebec	N	N	N	N	N	N	N	Y	Y
Fiscal crisis in the ROC	N	N	N	N	N	N	N	N	Y

collapse. Given the uncertainties involved, it makes sense to consider a range of possibilities, as in Table 1, which identifies various possible events as either occurring (Y), or not occurring (N). Reading from the top left-hand corner, the table moves downwards through events of greater seriousness, which combine to produce, moving from left to right, scenarios of increasing unpleasantness.

Inspired by the "B-movie scenario" label that some critics have applied to our earlier writing on this subject, we give letter grades to various points on this spectrum, ranging from an A+ situation in which the currency union's survival would scarcely be in question, to a D situation in which it would vanish in a matter of days or even hours. The progression from one to another situation is more continuous than a series of letter grades suggests, but Table 1 nevertheless highlights key events bearing on the union's chances of survival.

At the positive extreme, reflected in the first column of the table, Quebec's prospective and/or actual accession to independence might have negligible adverse financial or fiscal consequences: an A+ outcome, in which there was no appreciable movement of deposits out of Quebec. Less positively, as we move to the right (and start to factor in some of the more problematic developments listed vertically in the table), some capital flight might occur. If this flight were large enough, it might threaten the operations of one or more financial institutions in Quebec by draining them of liquidity.

If the disruption of credit markets in Quebec became serious enough, it could put the Quebec government under fiscal pressure as it faced demands for emergency loans or grants. Rating agencies might react to a deteriorating economic and financial environment by downgrading Quebec government debt, which would increase its borrowing costs and potentially restrict its access to credit.

The table shows a run on the (still common) currency as a further adverse event. In reality, downward pressure on the dollar would likely accompany the developments just described — indeed, moving from A+ to D would likely involve increasingly severe pressure — as both Canadian and foreign holders of Canadian-dollar assets sought the shelter of a more secure currency. There are two reasons, however, for thinking of a severe currency crisis as a quantum deterioration.

First, the Bank of Canada's usual response to weakness in the dollar's external value prompted by loss of confidence is to make dollars scarce, buying them in foreign exchange markets and choking their creation with high short-term interest rates. The adverse effect of higher interest rates on borrowers can put financial institutions under further pressure as prospects for loan repayment deteriorate.

Second, as the Asian crisis has recently reminded us, currency crises can be very damaging to financial institutions with large, un-hedged foreign-currency debts or a pronounced reliance on new foreign-currency deposits to fund their lending, adding the threat of insolvency to the illiquidity pressures just mentioned.

Moving further across and down Table 1, a more intense crisis could threaten the stability of financial institutions elsewhere in Canada and put fiscal pressure, including possible rating downgrades, on the federal government and perhaps provincial governments as well. And if the deterioration proceeded far enough, we would reach the right-hand side of the table — and encompass most or all of the negative developments listed: the Quebec government and conceivably the federal government could have trouble rolling over debts and have to approach creditors with rescheduling plans.[2]

Such outcomes are surely much worse than B scenarios, so we award them D ratings. Events a couple of years ago in Mexico and more recently in Asia hint at what the more difficult scenarios envisioned here might entail. As these examples also remind us, markets may overshoot in such cases, with currencies falling further, interest rates rising more, and economies suffering more in the short run than later on. Such temporary moves might warrant a grade of E or F, and they can leave long-lasting scars, as when a severely depressed currency bankrupts a basically sound business with heavy, unhedged short-term foreign-currency debts. The prospect of longer-term recovery for the economy overall, however, suggests stopping at D–.

Whatever the precise letter grade, the key point is that the currency union would likely not survive such events. In a financial crisis, the government of an independent Quebec would find the extra policy leverage of a separate currency — such as the ability to inject newly created money into staggering banks and the option of exchange-rate devaluation — extremely attractive.[3]

Political Twists

On quick examination, the unpleasant slide from A toward D makes seemingly clear the key challenge facing the two sides in the awkward interval between a "yes" vote in a referendum and actual separation: do anything necessary to stay around A. There are, however, considerations that make this easier said than done.

For a start, in the period between a "yes" vote and actual secession, some in the ROC would urge allowing the consequences of a capital flight to take their course in Quebec, expecting the movement toward secession to lose momentum even at that late date. We do not dwell on this line of argument here. It is not clear that such a tactic would succeed. Even if it did, it would hardly prepare the way for a lasting reconciliation between the two parties. It would, however, likely have advocates in the ROC, adding a highly awkward factor to the ROC's deliberations.

More generally, the earlier a drain of deposits began, the more scope there would be for the policy response to it to affect other developments. These would, in turn, tend to hasten or slow the flow of money. For example, the handling of any financial instability occurring during pre-independence negotiations could influence the remainder of the negotiations. During the possibly quite lengthy period between a referendum and independence, Ottawa's power over monetary arrangements would give its negotiators a bargaining lever with which to seek concessions from Quebec in other areas.

The Canadian Financial System

The possibility of monetary complications emerging in the runup to a Quebec secession and becoming intertwined with the politics of the process reflects the fact that there is more to the Canadian monetary union than a common currency. The monetary system is a means of effecting transactions of all sorts — for transferring funds between individuals as they trade with, and grant credit to, one another, both directly and through the mediation of financial institutions.

Many transfers of funds involve cash. Banknotes and coins have a couple of unique features that make them attractive to users. As liabilities of the Bank of Canada — rather than, say, of a private financial institution — cash is uniquely secure. And they are legal tender, which means that, in the absence of explicit agreements to do otherwise, individuals and businesses accept them within Canada.

Most transfers, however, involve moving funds between chartered banks, trust companies, *caisses populaires*, and other financial institutions — for example, when a customer uses a debit card and funds move from an account at the card-issuing bank to the retailer's account at a different bank, or when the retailer uses a cheque drawn on that account to pay a supplier. Such transfers between institutions occur through the Automated Clearing Settlement System (ACSS) operated by the Canadian Payments Association. A subset of 13 financial institutions, known as "direct clearers," plays a central role here. They use deposits held at the Bank of Canada to settle transactions both among themselves and on behalf of the other participants, known as "indirect clearers."[4] Deposits at the Bank of Canada are very like cash. They are uniquely secure because the institution at which they are held cannot fail and can provide funds in unlimited amounts, and participants in the clearing system have not the slightest doubt that they will be accepted in discharge of obligations.

In the current context, these details of clearing and settlement in Canada matter because such systems work smoothly only when each participant has assurance that all others will honor their obligations. Direct clearers pay close attention to the financial condition of other direct clearers, as well as that of the indirect clearers for whom they act. If the soundness of a direct clearer came into question, others would try to reduce their exposure to it, by ceasing to give immediate credit for cheques drawn on it, for example. If the financial condition of an indirect clearer came into question, the direct clearer that acted for it might start asking for collateral, or compensatory balances, in connection with any exposure the direct clearer assumed on its behalf. If the direct clearer's concerns became deep enough, it could, with 24 hours' notice, end its relationship with the indirect clearer.

Financial institutions involved in the ACSS not only know that their counterparties are financially sound: they also know that the Bank of Canada will provide temporary advances to cover potentially large end-of-day overdrafts in the settlement accounts of individual direct clearers that arise from normal day-to-day variations in the timing of transactions. These loans prevent sound institutions from getting into trouble because of temporary liquidity problems. The Bank's willingness to cover these overdrafts depends partly on the direct clearers' being subject to regulation and inspection by various supervisory agencies: the Office of the Superintendent of Financial Institutions (OSFI) in the case of federally chartered or incorporated institutions, and provincial agencies in the case of the Alberta Treasury Branches, credit unions, and *caisses populaires*. Furthermore, such overdrafts must be fully collateralized: the Bank knows that if, despite its vigilance, it makes loans to an institution that subsequently fails, it has first claim on the collateral pledged when it covered the overdraft, and it has recourse to the courts in recovering its funds. (Other clearing systems and interbank markets in Canada, and their relationship to the ACSS, are discussed in Box 1.)

The Impact of Secession on the Financial System

Although the extent of the disruption caused by a Quebec secession would depend on negotiations after a successful referendum, these arrangements would certainly change with secession. Once Quebec was independent, *all* financial institutions operating there would be regulated by its authorities and subject to its laws. These institutions and laws might initially be very similar to those of the ROC, and the formal regulatory environment affecting Quebec-based institutions already subject to provincial regulation might also change very little. It is nevertheless hard to see how — in the absence of a comprehensive agreement on matters such as the regulation of financial institutions and collateral arrangements — the Bank of Canada could have sufficient confidence in the actual application of the laws and regulations of an independent Quebec to treat its financial institutions in the ACSS in the same way the province's institutions are now treated. Without an explicit agreement negotiated in advance, financial institutions based in Quebec that currently have direct-clearer status would therefore lose it on independence.

Losing direct access to the ACSS and the services it provides would not, in the long run, be a crippling blow to residents of an independent Quebec. There are other avenues for carrying on Canadian dollar transactions among financial institutions. As long as a direct-clearer ACSS member remained confident in it, a financial institution in an independent Quebec might be able to access the ACSS as an indirect clearer through subsidiaries or through branches (if secession occurred after proposed reforms are implemented to allow foreign banking through branches in Canada). As well, depending on an independent Quebec's attitude toward branch banking, current branches of Canadian institutions located in Quebec could become branches either of ROC financial institutions or of their subsidiaries in an independent Quebec, with access to the ROC payments system through their ROC head offices or parents.

At the same time, the whole range of credit arrangements among financial institutions that support their exchanges of securities, foreign exchange, and Canadian dollar assets outside the payments system would be reorganized to function like those currently existing among institutions based in different countries. Ultimately, such a system would be less efficient than current arrangements within the Canadian monetary union, but there are countries (Liberia and Panama, for example) that use other countries' currencies; an independent Quebec using the ROC dollar would simply be a bigger and much more sophisticated example of such an arrangement.

In the runup to independence, however, disruptive forces might prevent such an arrangement coming into being in the longer run. In particular, an independent Quebec's financial institutions' prospective loss of access to the ACSS would create problems. As secession became imminent, financial institutions based in the ROC would become less willing to expose themselves to credit risks associated with institutions inside Quebec. As noted in Box 1, this reluctance would probably manifest itself first outside the payments system, where financial institutions would be able, often quietly, to draw back from riskier transactions by trimming the overall size of their exposures, cutting their links with smaller and weaker-looking partners, or changing the terms on which they would grant credit. Inside the payments system, participants would hestitate to take any defensive steps only so long as they

Box 1: *Other Clearing and Settlement Systems and Their Links to the ACSS*

The Automated Clearing Settlement System is the linchpin of Canada's infrastructure for financial transactions. The bulk of its activity, in terms of volume, relates to retail transactions — cheques, bank drafts, and the like. Financial institutions also transact with each other in many other ways. Some — such as the Debt Clearing Service operated by the Canadian Depository for Securities Limited, which handles transactions in federal government bonds and treasury bills, and Multinet, which handles foreign exchange transactions — are centralized; others are decentralized. Currently, however, actual payments related to dealings carried out in these other systems go through the ACSS.

The legal and financial uncertainties of secession probably would begin to impede transactions outside the ACSS before they showed up in the ACSS itself. When the Northland Bank and Canadian Commercial Bank got into trouble in 1986, for example, they continued to participate in the ACSS even after losing their ability to conduct many other kinds of interbank business. The ACSS seems an apt focus for this investigation, however, because of the Bank of Canada's intimate involvement in its operations and its key role in daily reconciliation of outstanding obligations of Canada's principal financial institutions (extenders of credit in the Debt Clearing Service, for example, must be direct clearers). Simply put, the ACSS is the most robust element in the Canadian financial system. An institution that loses access to it will encounter, or will likely already have encountered, difficulties participating in other systems.

The Canadian Payments Association will soon have a new Large Value Transfer System (LVTS) in place that will provide finality of settlement for the more sizable transactions that now pass through the ACSS. (LVTS participants will be required to have settlement accounts at the Bank of Canada.) From the perspective of this *Commentary*, the LVTS matters because it will put a large portion, by value, of the transactions now occurring through the ACSS into a system where counterparty risk will become a more active concern of other participating financial institutions, and they will have greater latitude in dealing with it. (The LVTS will have two streams of payments: "tranche 1" payments fully collateralized by pledges from the sending institution to the system as a whole; and "tranche 2" payments limited by the bilateral lines of credit institutions extend to each other.) If legal and financial uncertainties prompt doubts about the soundness of institutions exposed to secession or the quality of collateral such as Government of Quebec bonds, the LVTS is, like other systems outside the ACSS, likely to become a more costly and difficult environment for those institutions. The significance of the ACSS as the "last, best" link in Canada's payments system grows when institutions are driven to funnel more of their business through it as they become less able to deal in the LVTS and other non-ACSS systems.

A final point of interest about non-ACSS systems is that the 1996 *Payment Clearing and Settlement Act* gave the Bank of Canada extensive powers to intervene in systems that appear to pose important risks for the financial system as a whole. In a 1997 guideline on the Bank's proposed uses of these powers, the first criterion listed under its minimum standards for a sound system was: "Clearing and settlement systems should have a well-founded legal basis under all relevant jurisdictions." Whether the Bank would react to secession-related concerns by intervening in non-ACSS systems under the act is unclear. Nonetheless, if it chose to do so, many of the same were sure that the Bank of Canada was willing to continue in its backstopping role, making the Bank's reaction to the legal and financial uncertainties of secession critical.

How might the Bank of Canada act? It would have two related problems to ponder.

First, it would need to consider the financial stability of financial institutions exposed to developments in Quebec. It would be one thing for the Bank to cover normal liquidity shortfalls and quite another for it to provide extended support to institutions that seemed headed for insolvency. Second, it would need to make decisions about both the quality of collateral put up by exposed institutions and its ability to collect after secession. The more severe the problems of exposed institutions became, and the more doubtful the Bank was of its ability to realize collateral pledged against the loans it made, the less willing it would be to support them. And as the Bank's willingness diminished and it began, for example, to advance cash through purchase and resale agreements (of Government of Canada securities) rather than loans, the more nervous other ACSS members and depositors would become.

Anatomy of a Crisis

As Table 1 suggests, varying degrees of nervousness can have different effects. Let us begin with something closer to the A end.

Shifts of Funds between Branches of the Same Institution

Initially, nervous depositors might only move funds out of branches of particular financial institutions in Quebec into branches of the same institutions in the ROC. Such a movement of funds within an institution would not affect its overall liquidity or the size of its assets and liabilities and would not, therefore, appear to present an immediate policy problem. It could, however, affect the riskiness of the institution's balance sheet. Canadian banks currently tolerate sizable mismatches between their assets and liabilities in various regions as a normal consequence of their role in matching saving and investment opportunities across the country. Although such mismatches are not alarming when a common legal framework and currency apply everywhere, the prospect of Quebec secession would change this situation in important ways.

Quebec-based assets would be threatened with a new legal framework and possible future redenomination in a new currency of unknown value. The total amount of exposed assets is uncertain, but as of mid-1997, Canada's chartered banks had $85 billion of Canadian-dollar assets (other than cash) booked in Quebec. Since the equivalent figure for liabilities was $71 billion, assets subject to secession-related impairment exceeded similarly exposed liabilities by $13 billion.[5] In an A environment, banks might view this gap without much alarm, but even in this rosy scenario, it seems unlikely they would let it grow. So a movement of funds out of Quebec, even if only to branches of the same institutions in the ROC, would likely produce downward pressure on the amount of credit extended in Quebec: a lending slowdown or even a credit crunch.

Drains of Deposits from Particular Institutions

Drains of funds that disproportionately affected the liabilities of specific institutions would present a more difficult problem. Depositors might move their funds out of institutions headquartered in Quebec only, or out of institutions headquartered elsewhere in Canada that seemed disproportionately exposed to secession-related risks or volatility in the financial system generally. Either way, the banks affected would have problems with both their liquidity and the overall size of their balance sheets.

If deposits began to move on any scale, even institutions with assets of unimpeachable quality might have trouble selling them fast enough to meet their depositors' demands for funds. If the quality of some of the assets themselves was impaired by the prospect of secession, sales over any reasonable time horizon could become impossible. Such developments would quickly manifest themselves in reduced access for the exposed institutions in interbank markets (as described in Box 1). These difficulties would begin to spill over into the payments system. Given the potential for problems in the financial system to propagate, affecting other financial institutions and credit markets more generally, it is easy to see why this A– scenario could lead to something worse in short order.

Coping in Principle

Until the moment of Quebec independence, there would continue to be an array of federal agencies with mandates to help financial institutions cope with the difficulties just described.

The Role of the Bank of Canada

The Bank of Canada, a Crown corporation, can trade in certain securities and lend to financial institutions on good collateral. These powers enable it to supply financial institutions with funds so that no solvent institution, faced with a temporary shortfall, need fail for want of an immediate buyer for otherwise sound assets. The very existence of these powers reduces the probability of such a drain, moreover, by elimi-nating the incentive for depositors to withdraw funds from institutions they think solvent, but whose liquidity they doubt.

The Role of the Superintendent of Financial Institutions

The Bank of Canada's mandate relates to liquidity problems. It is intended to prevent temporary shortfalls from triggering system-wide problems, not to support unsound institutions. The Bank does not, furthermore, itself make judgments about solvency. This is mainly the task of the OSFI, a federal agency that, in turn, works closely with the CDIC in making such judgments about federally incorporated institutions. (The Bank has the power, if it wishes, to request the OSFI to undertake a special examination of an institution, a right it has never exercised.)

The Role of the CDIC

The CDIC, though privately funded through premiums paid by member institutions, is responsible to the federal government for its operations.[6] In pursuit of its fundamental goal of promoting the stability of the Canadian financial system, the CDIC has wide-ranging powers to deal with unsound and/or insolvent institutions. Its core function is to protect depositors, particularly small ones, from the consequences of an institution's closing its doors. It guarantees deposits at member institutions against losses up to $60,000. It also has discretion to compensate bigger losses in situations where doing so might reduce the cost of liquidating a failed institution. Equally important for this discussion, it can also arrange, or make, loans to institutions in difficulty and assist in the takeover of their business by a sound competitor.[7]

As with the Bank of Canada's lender-of-last-resort powers related to liquidity problems, the CDIC's safety net reduces depositors' incentive to withdraw funds from institutions whose soundness they doubt. It thus enhances the recovery prospects of institutions in difficulty and eases an orderly windup of those beyond recovery. It also reduces the chances of contagion in the rest of the system in the wake of one institution's difficulties.

Coping in Practice

Real-life financial crises — even ones arising from the functioning of markets, let alone from the dissolution of a country — present decisions less clear-cut than the foregoing account suggests. Liquidity and solvency problems are harder to distinguish in practice than in principle. To take the most obvious example: the difficulty of selling assets quickly may mean that an institution with positive value as a going concern will have negative value if wound up. Judgments about the worth of assets are also difficult to make when the environment affecting them is changing. Real estate, for instance, is obviously sensitive to the local economy and to political risks, of which secession is a particularly dramatic example.

It can also take some time for the true extent of an institution's problems to become evident. For example, the difficulties of the Northland Bank and Canadian Commercial Bank — both of which ultimately collapsed in 1985 — initially appeared to the Inspector General of Banks (the immediate predecessor of the OSFI) merely to stem from lack of liquidity. Shutting down an institution, moreover, can inflict damage on its depositors, creditors, workers, and owners. Regulators and their political masters are naturally wary of taking such action.

Particular Problems of Quebec Secession

The Bank of Canada, the OSFI, and the CDIC were not designed to deal with financial instability arising from a political crisis of the magnitude Quebec secession would create. Con-sequently, it is not clear whether, and how, they would respond to its demands or how the key decisions would be made.

The Federal Government's Options

This lack of clarity about the roles and actions of federal agencies would be unlikely to change prior to the uncertainties following a "yes" vote for Quebec independence.

Obstacles to Advance Preparation

One key impediment to advance planning for the financial events that might follow a "yes" vote is uncertainty about how large and quick the reaction might be. The relatively calm financial environment immediately before the October 1995 referendum — a vote that polls had shown was going to be close — seems to support the argument that business would go on much as usual on the morning after the vote and that Ottawa could deal with anything that did happen on an *ad hoc* basis. Also weighing in favor of a do-nothing stance is fear that visible advance preparation would intensify any movement toward secession.

Yet one could also contend that the consequences of an actual "yes" vote would be much more serious than those of the "no" of the October 1995 referendum, however close it was. Moreover, the experience of that near miss likely would make depositors and financial institutions quicker to react next time. In the face of such conflicting tendencies, the do-nothing stance might prevail by default.

Even if knowledge of the likely market reaction to a "yes" vote were more precise, however, neither the federal government nor any agency answerable to it would likely take pre-referendum measures to guarantee the post-secession continuation of access by Quebec-based financial institutions to Canada's existing financial infrastructure. Particularly if such measures involved co-management of financial infrastructure by the two successor states, they would appear to encourage a "yes" vote. For identical reasons, advance preparations for the interim period between a "yes" vote and actual secession — discussions between Ottawa and Quebec City regarding collateral and judgments about financial institu-tion solvency, for example — are also highly unlikely.

It appears then that, in the awkward interval between a "yes" vote in a referendum and actual secession, Canada would have substantially the same financial infrastructure and regulatory environment that it now has.

The Problematic "Save-the-Monetary-Union-at-All-Costs" Strategy

Under those circumstances, federal politicians might try to stop a flow of money out of Quebec by short-circuiting normal procedures. They might, for example, lean on the OSFI to soften judgments about a Quebec-based institution's solvency by assuming that secession would not occur, and pressure the Bank of Canada to alleviate the institution's liquidity problems, despite possible doubts about the quality of its collateral.

As already noted, others might urge letting Quebecers "twist in the wind," hoping to weaken the secessionists' negotiating position. Even leaving this argument aside, however, there would be key reasons not to throw money at the problem. Suppose, for example, that secession went ahead and an institution that had received support failed while Bank of Canada loans made against Quebec government securities were still outstanding. The ROC's central bank could be left holding collateral of greatly impaired value. At worst, literally tens of billions of dollars in loans made to exposed financial institutions could turn to losses after secession if collateral pledged were to lose value or become inaccessible.[8]

The ROC electorate would not likely support such an operation long enough for the response to be effective in preventing a move-ment toward D, since its costs would be too uncertain and it would appear to appease sep-aratists. Its principal beneficiaries, moreover, would be residents of Quebec — immediate authors of the crisis and soon-to-be residents of a foreign country.

The Reactions of Federal Institutions on Their Own

What if, on the other hand, elected politicians left it to the Bank of Canada, the OSFI, and the CDIC to cope with the crisis?

The Bank of Canada

The Bank of Canada's first reaction, as always in cases of liquidity problems, would be guided by two aims: to preserve the overall viability of the financial system; and to protect from losses its shareholder, the federal government (and through it Canadian taxpayers). Although last-resort loans presumably would be available to any institution suffering liquidity problems, the collateral requirements against such loans to exposed institutions could become more stringent, since not all securities would be equally attractive in the face of imminent secession.

The Superintendent of Financial Institutions

The position of the OSFI — the judge of the solvency of federally incorporated financial institutions and the agency whose judgment the Bank of Canada would formally seek if such an institution appeared to be in trouble — would be very difficult. The value of key parts of financial institutions' portfolios of assets in Quebec (such as the over $35 billion in mortgages held by chartered banks) would be sensitive to secession, making guesses about the likelihood of secession's actually occurring important in judging institutional solvency. Other assets, such as claims on other financial institutions, would be vulnerable to financial turbulence, giving an element of self-fulfilling prophecy to any assessment the OSFI made. Further complicating the OSFI's position would be the damage to public confidence — and possible consequences for the presecession negotiations — that acknowledgment of its difficulties in making judgments might create.

The CDIC

The CDIC, which presumably would continue covering new deposits at member institutions in Quebec until the moment of secession, would find itself in a position similar to that of both the Bank of Canada and the OSFI.[9] Any substantial flow of funds out of institutions in Quebec could result in calls on the CDIC for loans. It need not make such loans since it has the power to cancel the contracts of institutions it deems insolvent. But it would find those judgments difficult to make.

The CDIC would also find some of its usual tools hard to use. Once Quebec was firmly committed to independence, the CDIC could hardly, for example, arrange the takeover of a Quebec-headquartered institution in difficulty by one headquartered elsewhere in Canada. Even arranging a takeover by another headquartered in Quebec might encounter resistance from the Quebec government. The CDIC would also be unlikely to offer any *de facto* guarantees above the $60,000 deposit insurance limit, as it oriented itself more toward protecting its members and taxpayers in the ROC from losses. These considerations might also preclude the possibility of the CDIC's making last-resort loans on its own account to institutions in difficulty.

In short, the extent of the protection offered by the CDIC against losses encountered by institutions in Quebec and against financial instability more generally would be severely eroded by a "yes" vote long before actual indecence shut down its operations in Quebec.

The Quebec Government's Role

To sum up, the search for ways in which existing federal institutions might cope effectively with a drain of deposits from Quebec financial institutions is frustrating. Key integration and backstopping functions that now underpin Canada's financial system would erode or disappear altogether if Quebec seceded. This fact would increase the stress on the payments system as other markets spanning the incipient border seized up. And it would inhibit Bank of Canada, OSFI, and CDIC actions during the period between a referendum and formal independence.

As depositors became aware of the constraints on these institutions, their nervousness would increase, making a drain out of Quebec — and a move from an A+ scenario toward less comfortable territory — more likely. On the federal side, the political obstacles to measures that would allow these institutions to act over the crisis period appear formidable. Even if the approach of secession lessened the constraint against appearing supportive of separatism, it would simultaneously increase fears of being left "holding the bag."

The search for a credible backup for Quebec institutions that is not time limited may, then, be more fruitful on the Quebec side of the border. The Quebec government would be better placed to provide such guarantees because its jurisdiction would continue to run in Quebec after independence. Moreover, at least one institution that could offer a measure of backup in the event of separation already exists — the Quebec Deposit Insurance Board (QDIB).

Deposit Insurance

By law, the QDIB already insures retail deposits in Quebec, although overlap between its coverage and that of the CDIC has resulted in agreements between the two institutions as to which stands first in line in which cases. After secession, the QDIB would naturally expand its operations to the whole Quebec system. A secessionist Quebec government that intended to maintain the currency union could announce well before a referendum that, should a continuation of current Canadian monetary arrangements prove impossible, the QDIB would assume full responsibility for all deposit insurance in Quebec, with the backing of the financial resources of the Quebec government behind it.

As an important accompanying step, the Quebec government could prepare to provide the necessary support. The QDIB currently maintains a line of credit with the CDIC, which, in turn, has access to the federal treasury and thus ultimately to the money-creating power of the Bank of Canada. This arrangement, however, would not endure past secession and would therefore lose credibility before that event. Well before the uncertainties of the postreferendum period threatened difficulty in raising funds, the Quebec government would need to set aside a stock of Canadian dollars sufficiently large to provide a credible substitute backstop.

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Backstopping Banks in an Independent Quebec

As for clearing and settlement arrangements, an independent Quebec could facilitate, perhaps through its existing credit-union structure, a system that would reduce its financial institutions' need for access to the ACSS in dealing among themselves. A further stock of Canadian dollars held by the newly established clearing-house of an independent Quebec could deal with the end-of-day shortfalls that would occur in transactions internal to Quebec. A much larger stock — which, again, would be much easier and cheaper to raise in advance of the referendum — would be needed to deal with shortfalls that might occur in transactions with the ROC. Since the clearing house could not create new Canadian dollars, it could never provide as complete a backstop to the clearing system as that currently available from the Bank of Canada, so the amount would need to be large.

As with the war chest needed for credible deposit insurance, it is hard to put a figure on the exact amount of money needed. In qualitative terms, the sum would need to be big enough to engender confidence in its capacity to serve as the reserve base for an independent Quebec's financial system, not just in tranquil times but in the more difficult and possibly protracted circumstances that would surround secession. If it could not engender such confidence, there would always be the prospect that a credit crunch might induce Quebec to establish its own currency to inject funds into its banks. This prospect would make more likely the drain of funds out of Quebec that would create such a crunch in the first place.

Publicizing the New Arrangements

Since confidence in the durability of the monetary system is critical to its maintenance, a further key element in Quebec's advance planning is dissemination of information about the new arrangements. Stories of the Quebec government's financial preparations ("le plan O") around the October 1995 referendum began circulating only after the event and appear to have focused on supporting the government's finances rather than the financial system.[10] At the time of the referendum itself, there was no information at all of the kind that would give households and businesses, inside Quebec as well as outside, confidence in the security of their assets.

Holders of deposits in Quebec-based financial institutions need to know that effective insurance coverage would be maintained after secession. Financial institutions in Quebec and in the ROC need to know, in advance, what resources would be available to ensure that cheques did not bounce after secession. One of the highest-profile ways the Quebec government could provide such assurance would be for it to report, as part of its regular fiscal policy pronouncements, its progress toward building up the necessary reserves of cash — although, as just noted, it is hard to be sure exactly how much would be needed.

Some Final Points

The unpleasant scenarios we have outlined in this *Commentary* may never, and need never, occur. Quebec secession is not a foregone conclusion, and even if it happened, both sides might muddle through and preserve the currency union. Still, scenarios deserving of a B or worse rating, as outlined in Table 1, are all too likely without concerted, visible action to prevent them.

It is hard to see how the federal government could do anything substantive in advance without appearing to give comfort to the separatist cause. Nor would the key federal institutions — the Bank of Canada, the OSFI, and the CDIC — be able to act decisively on their own accounts. Circumstances following a separatist referendum victory would force them into a defensive posture in which limiting losses to ROC taxpayers began to take priority over supporting exposed financial institutions.

The Quebec government is the only player to which one could look for decisive action in advance. The general outlines of that action are clear. Quebec should establish institutions that would allow its financial system to function smoothly during the volatile period surrounding a possible secession. It should amass sufficient reserves of Canadian dollars to underpin confidence in the system and publicize those arrangements widely.

The same feedback that makes fear of financial crisis a powerful cause of the very thing that is feared also works in reverse. Wide-spread public knowledge of a well-planned framework within which the Quebec authorities would respond to any financial crisis would do much to allay the fears that might otherwise set a crisis in motion. In the absence of such a framework for action, it is hard to see as credible any promises by a secessionist Quebec government to engineer a smooth transition to independence, with no disruptions to the operations of a financial system that would continue to be based on the Canadian dollar.

Notes

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1 David E.W. Laidler and William B.P. Robson, *Two Nations, One Money? Canada's Monetary System following a Quebec Secession*, The Canada Round 3 (Toronto: C.D. Howe Institute, 1991); William B.P. Robson, *Change for a Buck? The Canadian Dollar after Quebec Secession*, C.D. Howe Institute Commentary 68 (Toronto: C.D. Howe Institute, March 1995); and Michel Demers and Marcel Côté, "Is a UDI Feasible? The Economic Impact of a Conflict of Legitimacy" (October 1997, mimeographed), especially section III, "Capital Flight."

2 Events such as those described under the C and D scenarios would have broader ramifications. Weaker fiscal positions on one or both sides would make negotiations about division of existing federal debt more difficult and, relatedly, would cause both domestic and foreign lenders to shun borrowers on both sides of the prospective new border, or to demand much higher interest rates for lending to them. By damaging the financial health of business in both an independent Quebec and the ROC, C and D events might also weaken support, at least in some sectors, for maintaining liberal trading arrangements within the old Canadian economic space or with outside trading partners.

3 Shoring up banks with injections of newly created currency would not end a crisis since financial institutions (and nonfinancial businesses as well) in an independent Quebec would be short of currencies, including the ROC dollar, that Quebec could not print. But the ability to devalue, thus gaining a competitive edge in trade and making Quebec's assets cheap enough to tempt capital back in, would be very useful. For more on this point, see Robson, *Change for a Buck?*

4 "Clearing" refers to a receiving institution's presentation of an instrument such as a cheque to the institution on which it is drawn for payment, and to the netting out and reconciliation of obligations among the institutions involved. "Settlement" refers to the transfer of funds by a debtor institution from its own account at the Bank of Canada to that of a creditor institution. See Clyde Goodlet, "Clearing and Settlement Systems and the Bank of Canada," *Bank of Canada Review*, Autumn 1997, p. 51.

5 Caution is needed in drawing firm conclusions from such figures, for several reasons. Chartered banks are only a subset of Canadian financial institutions. Figures that break down chartered bank assets and liabilities by region show large unallocated amounts on both sides of the balance sheet, some of which might, if allocated according to the location of the owner/debtor, affect the apparent distribution among provinces (see *Bank of Canada Review*, Autumn 1997, tables C5, C6). It is nevertheless likely that several individual institutions have mismatches between their exposed assets and liabilities in Quebec that would demand attention from their management if secession appeared imminent.

6 In addition to its private sector members, the board of directors of the CDIC includes the governor of the Bank of Canada, the deputy minister of finance, and the superintendent and deputy superintendent of financial institutions.

7 Such action can help eliminate fire sales, which also protects the interests of uninsured creditors.

8 The currency union originally envisioned between the successor Czech Republic and Slovakia when Czechoslovakia dissolved broke down under such circumstances. For a period, the Czech central bank provided massive support to Slovakia's banking system. When doubts about repayment multiplied, however, the bank ceased lending, and the currency union collapsed. See Robson, *Change for a Buck?*, notes 5, 24.

9 It is not clear what would happen to CDIC coverage after secession. Insurance on term instruments such as guaranteed investment certificates might continue until the end of their terms. Coverage on demand and saving accounts most likely would cease.

10 "Parizeau veut témoigner devant la CAI," *La Presse* (Montreal), February 3, 1998.

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