Remarks by Gordon Thiessen
Governor of the Bank of Canada
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Globalized Financial Markets and Monetary Policy

Globalization -- that is, the growing integration and interdependence of national economies -- is changing dramatically the economic landscape. Countries are trading more goods and services, an increasing number of firms now operate across national borders, and savers and borrowers have greater access than ever before to global financial markets. Over the past decade, world trade has grown twice as fast as world output, foreign direct investment three times as fast, and both currency trading and share trading about ten times as fast.

Not everyone agrees that all this is good for individual national economies or for the world community at large. Among those who take a dimmer view of globalization one concern is that the increased influence of international financial markets is eroding the ability of national governments to set their own macroeconomic policies. They also worry that powerful financial markets may be the main cause of crises such as those in Mexico in 1994-95 and in Southeast Asia in 1997.

You will probably not be surprised to hear that I do not share these negative views. And today, I would like to discuss one particular aspect of globalization -- how national monetary policies work in an environment of globalized financial markets. I will draw heavily on Canada's own experience to support the view that monetary policy can continue to function effectively in this increasingly integrated world.

Canada has a long history of being open to global markets for goods, services and capital. This interaction with the rest of the world has proven very successful, in my view, and has benefited Canadians and our foreign partners enormously through the years.

With open international markets, Canadians have been able to sell their products and services abroad and to enjoy a wide variety of imported goods, some of which could not readily be produced at home. And we have been able to set up businesses and pursue investment opportunities abroad. Even more importantly, we have been able to use foreign savings to finance the large investment projects that were necessary to develop our industrial infrastructure and to increase our production potential, especially in the resource and manufacturing sectors. We have also had access to technological innovations and processes developed elsewhere. This has allowed us to combine new capital equipment and a skilled labour force more efficiently, thereby improving productivity and, thus, our incomes and standards of living.

Nonetheless, there are concerns in Canada, as well as elsewhere, about the rapid increase in international financial flows and the implications thereof. How does the free movement of capital affect the conduct of national monetary policies?

Capital mobility and the implications for monetary policy

The growing integration of national financial markets, as evidenced by the dramatic growth in the volume of cross-border capital flows since the early 1970s, has no doubt changed the environment in which national economic policies are conducted. Globalization tends to bring such policies under closer market scrutiny and to uncover and draw attention to any deep-seated economic problems that may exist. But I would not conclude from this that we have become captives of the markets and that we have lost control of our national monetary policies, as some argue.

First, let us be clear as to what "having control" over one's own monetary policy actually means. When people talk about an independent or autonomous monetary policy, they often take it to mean the ability of a central bank to set domestic interest rates without being influenced by developments outside national borders. This is not realistic -- unless of course a country is completely cut off from the rest of the world! The moment a country wants to make use of foreign savings, or invest a portion of its domestic savings abroad, a link between domestic and foreign interest rates is inevitable. As a major user of foreign capital, Canada has long lived with interest rates that are closely related to those in the United States and other foreign financial markets.

But even with integrated financial markets, there is still room for monetary policy independence via exchange rate movements. Thus, monetary policy autonomy requires a flexible exchange rate regime. With a fixed exchange rate, the national authorities essentially adopt the monetary policy of another country -- the country whose currency serves as the anchor. If interest rates go up in the anchor-currency country, interest rates will also have to rise sufficiently in the country with fixed exchange rates to ensure that the peg is maintained. Thus, if monetary policy is focused on a fixed exchange rate, the central bank cannot at the same time pursue a domestic objective.

In the case of the European Union, where member countries have decided to adopt a single currency -- the euro -- they have essentially opted to give up the potential for an independent national monetary policy and to transfer the policymaking power to a supranational agency -- the European Central Bank (ECB). Of course, the ability of the ECB to follow an independent European monetary policy will require that the euro float against other major outside currencies, such as the U.S. dollar and the Japanese yen.

Thus, in a world of open and integrated financial markets, the exchange rate is a major channel through which monetary policy actions are transmitted to the economy. Moreover, it is movements in the exchange rate that permit domestic interest rates to diverge from their foreign counterparts for a period of time. For example, an increase in official interest rates by the central bank, in response to demand and inflation pressures in the economy, leads to a stronger currency, which also works to restrain those pressures. At the same time, the appreciation of the currency creates the conditions for other domestic rates to follow the rise in official rates, to levels that may now be above those prevailing abroad. This is because the exchange rate is now seen to be above its expected value and is thus likely to decline in the future. Under these circumstances, financial markets will bid up domestic interest rates to compensate for the anticipated decline in the external value of the currency.

Having clarified the issue of monetary policy independence, I would now like to discuss the effects of increased capital mobility on the conduct of monetary policy. A higher degree of capital mobility enhances still further the role of the exchange rate in the monetary transmission process. This is not a bad thing. It just means we have to ensure that we always take the exchange rate into account when considering the

monetary policy stance that is appropriate for our domestic economic circumstances. That is why in Canada we have developed the concept of "monetary conditions" to keep track of the combined effect on the economy of movements in both interest rates and the exchange rate.

With a flexible exchange rate system, the increased role of the exchange rate in the monetary transmission mechanism also means that it is crucial that investors' expectations of future currency movements are firmly anchored by clear and credible domestic macroeconomic policies.

Thus, the central bank must have a strong commitment to preserving the internal value of the currency by keeping inflation low. That is why in Canada we have adopted explicit targets for inflation-control. But this is not enough. The fiscal situation must also be seen to be under control. Otherwise, as fiscal deficits and debts keep accumulating, investors will come to fear that inflationary policies will be used in the future to reduce the burden of debt.

Canada's experience during the Mexican currency crisis of 1994-95, and more recently through the Asian problems, is very instructive in this regard. The Mexican crisis focussed the spotlight on our fiscal problems at the time, consequently driving risk premiums in our interest rates sharply higher. During the recent Asian crisis, however, with our public finances in better shape, and with clear, strong policy commitments by both the fiscal and monetary authorities, financial markets have been more stable and our longer-term interest rates have been falling.

Of course, pressures on the exchange rate can also be triggered by so-called "real shocks." In Canada, such shocks are frequently associated with swings in world prices of primary commodities. In cases like these, a flexible exchange rate can act as a "shock absorber," allowing some of the necessary adjustments to the shock to take place through movements in the value of the currency.

Canada's long-standing preference for flexible exchange rates has been driven largely by the benefits such rates offer in facilitating adjustments to external shocks. This is an important consideration for us, given our strong reliance on international trade and foreign savings. As a major exporter of primary commodities, Canada has often been hit by sharp swings in the world prices of these products which, in turn, have caused

large capital movements. Indeed, the decisions to float our exchange rate in 1950 and again in 1970 (after a short period of fixed exchange rates), were related to strong inflows of foreign capital associated with a surge in commodity prices. In both cases, we chose to allow the Canadian dollar to float up, rather than try to maintain a fixed exchange rate and risk a destabilizing inflationary monetary expansion.

Overall, I am persuaded that a flexible exchange rate regime is the best way for a country to take advantage of today's integrated capital markets and to deal with the external shocks that arise from time to time.

Exchange rate fluctuations: Is taxing currency transactions the solution?

Some critics have argued that integrated international financial markets have given rise to large, short-term speculative flows of capital that can cause unwarranted exchange rate pressures. Such speculative transactions, they say, disrupt domestic macroeconomic policies, result in temporary misallocations of resources, discourage trade, and encourage further unproductive financial transactions as businesses and individuals seek to protect themselves.

Based on these arguments, some people have resurrected the idea of discouraging currency transactions using a tax similar to the one proposed by Professor James Tobin in the 1970s.

The case for taxing global financial transactions rests on the notion that such a tax will discourage short-term flows, which are viewed as destabilizing, without affecting longer-term flows that are presumed to be desirable and based on fundamentals.

But short-term flows are by no means all undesirable and destabilizing. And there is no way of discriminating between useful flows and destabilizing speculative ones. For example, because foreign trade and investment inflows and outflows are not always fully offsetting, short-term capital flows are typically needed to balance out a country's external accounts. These capital flows occur in response to actual and anticipated movements in the exchange rate, and thus serve to smooth out exchange rate fluctuations. Because such flows are often driven

by small differences in perceived rates of return at home and abroad, they could well be discouraged by a transactions tax. On the other hand, speculative flows that actually "bet" on a sharp movement in a currency, have rather large expected returns and are unlikely to be discouraged by the tax. In the end, a transactions tax would likely increase, rather than decrease, exchange rate volatility, as well as reduce market liquidity and raise the cost of capital.

Needless to say, where financial market fluctuations reflect changes in domestic macroeconomic policies that put investors at greater risk than before, the tax would be aimed at treating the symptoms rather than the cause of the problem.

In all, I find the case for a tax on currency transactions completely unconvincing.

Promoting greater financial market stability

If a tax is not a good idea, how else can we promote greater stability in international financial markets and reduce potential disruptions to domestic policymaking?

I have already talked about the value of a flexible exchange rate system in facilitating adjustment to "real" shocks and allowing national authorities to pursue an independent monetary policy. Flexible exchange rates can also be helpful in moderating the size of, and aiding in the adjustment to, capital flows.

In addition, governments are increasingly coming to the realization that the issue of international financial stability is best addressed <u>not</u> by retreating into isolation or by falling back on distorting, costly restrictions, but rather through sound and transparent domestic economic policies.

International co-operation can also help. It can help by encouraging countries to pursue national policies that lead to economic stability, thereby reducing the risk of sudden changes in market sentiment and sharp exchange rate fluctuations. And it can help by setting widely accepted standards for transparency and disclosure. Such standards should support more informed market judgments about the riskiness of investments, especially in emerging market economies, and thus help avoid the crises that can be triggered by the sudden uncovering of problems.

Following the G-7 Halifax Summit in 1995, a series of international initiatives to improve the functioning of financial markets have been undertaken, mainly under the auspices of the International Monetary Fund and the Bank for International Settlements. These initiatives seek to enhance the transparency and disclosure of economic and financial data, strengthen the surveillance of national and global financial systems, develop mechanisms for support in times of crisis, and provide training in financial sector supervision.

Recognizing the importance of these efforts, Canada has recently proposed the creation of a new international process to provide "peer review" of national financial regulatory and supervisory systems. Efficient and prudently managed national financial systems can reduce the risks, and maximize the benefits, of international capital flows. In this regard, national supervisory authorities need to ensure that financial institutions have appropriate risk-management systems in place to help minimize risks, particularly with respect to mismatching of maturities and currencies. This would make it easier to cope in the event that short-term inflows switched to outflows. One of the main problems in Asia was that domestic financial institutions were borrowing short-term, in foreign currency, to invest in illiquid domestic assets.

Concluding thoughts

To summarize, globalization has been broadly beneficial to the world economy. International financial markets have facilitated access by borrowers to a larger pool of global savings and have enhanced investment opportunities for savers worldwide.

Yes, international capital flows have at times disrupted national financial markets. But such episodes more often than not were caused by unsustainable domestic policies and pointed to the need for adjustment.

In view of the overall benefits of greater access to global capital markets, it would not serve us well to restrict the free flow of funds. The best way to maximize the benefits of financial globalization and reduce the risks of disruptions to national macroeconomic policies is to ensure that these policies are sound and sustainable. In addition, financial systems need

to be prudently managed and supervised -- both nationally and internationally.

Here in Canada, we are following this advice in our domestic macroeconomic policies. And we are also strongly supporting and contributing to global initiatives designed to promote financial market stability worldwide.