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Notes for Remarks for a Dinner
hosted by
The Canadian Society of New York
The Pierre Hotel, New York
Tuesday, April 26, 1988

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It is a great pleasure for me to be addressing The Canadian Society of New York this evening. It may also be more fitting than you realize, inasmuch as the city of New York contributed in an indirect but significant way to the establishment of the Bank of Canada. In the years before the passage of the Bank of Canada Act in 1934 there was persistent debate as to whether Canada really needed a central bank. What seems to have tipped the balance in our favour was the observation by Prime Minister Bennett that when Britain went off the gold standard -- and I quote -- "I learned to my surprise that there was no direct means of settling international balances between Canada and London, that the only medium was New York and the value of the Canadian dollar would have to be determined in Wall Street. I made up my mind then and there that this country was going to have a central bank..."

Some fifty years later, Canada's international financial relationships and their implications for our economy remain a subject of central importance. This evening I will spend most of my time looking at some aspects of those relationships and what they mean for Canada's economy and Canadian monetary policy.

The financial system in Canada, as elsewhere, has been undergoing major structural change in recent years. I will not dwell on the deep causes of this change, but will merely note that on the domestic side it follows from Canada's policy decision to eliminate many of the barriers to competition between the traditional so-called "four pillars" of our financial services industry -- banks, trust companies, insurance companies and securities firms. This is what we might call financial-financial integration, and is to be contrasted with financial-nonfinancial integration. Americans will not be surprised to hear that this ongoing, complex transformation of the domestic financial structure, though desirable, has also raised many contentious issues.

Alongside these domestic changes, the Canadian financial industry has also been increasingly caught up in the general globalization of financial services. This globalization has involved both a trend towards an increased presence of foreign financial firms on the home-turf of Canada's financial institutions, and a substantial participation by Canadian firms in foreign markets. Naturally enough, the reassessments made in the aftermath of the October stock market crash have dictated some reining in of earlier enthusiasms and expansionist designs, but the international trend is nonetheless clear. Whatever structures the financial industry in Canada or elsewhere takes on -- whatever kind of distribution prevails between financial supermarkets and specialized institutions -- international links are here to stay and will no doubt become more notable still.

Of course, provisions in the recent Canada - U.S. trade agreement covering financial services represent a further step towards opening up domestic financial markets to

foreign competition, on a bilateral basis. In the Canada - U.S. case these financial services arrangements are based on a "national treatment" principle. This treatment would in fact seem generally more interesting to nations in regard to agreements on financial services than the other principle, "reciprocity". This preference probably reflects the fact that liberalization of trade in financial services is more accurately described as opening up of the domestic financial services sector to investment by foreigners rather than liberalization of the services themselves.

In any event, this kind of opening up and integration of markets for financial services is a natural follow-up to the post-war liberalization of trade in goods under the auspices of the GATT that has been so beneficial to the world economy. For consumers of financial services, increased competition and easier access to foreign financial institutions offers the potential for a wider menu of financial instruments at more attractive rates. For financial institutions themselves, easier entry into foreign markets brings new growth opportunities. This is all to the general good.

However, an interesting and worthwhile question is whether, as part and parcel of the increasingly cosmopolitan nature of domestic financial markets, countries risk losing control over their financial destiny. I will look at this question from various angles, but essentially from a Canadian perspective -- that is to say, from the perspective of an economy that is already quite open and one that, while quite large, is far from being the largest.

In some countries, the entry of foreign financial institutions into the domestic market has raised concerns

that the authorities' ability to exercise direct control over the magnitude and allocation of credit in the economy could be impaired. The widespread concern in the 1960s and 1970s about the influence of Euromarket activities on domestic financial transactions is a good instance of this. In Canada's case, such concerns have no practical relevance since the direct control of credit, or perhaps I should say the attempt at direct control, has not been a policy tool for many years. Rather, for both pragmatic reasons and for reasons related to our view of how financial markets function most efficiently, we have relied on our ability to influence asset prices -- that is, market interest rates and the exchange rate -- as the method of transmitting monetary policy. Let me quickly add that the fact that monetary policy influences interest rates and exchange rates is not meant to suggest that private savers and investors do not have their say in full measure as well. Indeed, financial markets continually remind us that we do not operate in a vacuum, and that stocks of financial assets will only be held at yields that seem reasonable to the holders.

This brings me to a second and much more fundamental issue than that related to credit controls and the like. This issue is focussed not so much on the globalization of the financial industry, in the sense that individual institutions operate across different national boundaries, as on the fact that the markets themselves are internationally integrated. The issue then is broader -- international capital flows, hot money, asset market integration. And the risk may be characterized as one of lurches in exchange rates that are extreme and therefore unwelcome. We all know these to be difficult problems. However, that is not to say that we do not have the means and resourcefulness to deal with them.

In Canada we have a lot of experience in this area. Large cross-border capital flows -- in either direction -- and swift changes in market sentiment are nothing very new. They are phenomena we have lived with and worked our way through for many decades. The simple fact is that we regard the benefits of open international capital markets as far outweighing the occasional difficulties that sudden surges of capital may bring.

I might also point out that even though financial markets can overshoot, and exchange markets seem particularly prone to such dramatics, they nevertheless do supply us with a quote on economic performance and policy that is about as unbiased as we are going to get. Furthermore, the kinds of extreme swings in exchange rates that have been the source of so much preoccupation are best seen as a reflection of domestic and international policy imbalances. In this light, markets are to be viewed as doing the best they can in difficult circumstances. To blame unwelcome exchange rate movements and capital flows on the flexibility of the system rather than on the underlying causes is a bit like impaling the messenger.

However, the question remains: Does the trend towards increasing global integration of financial markets mean that Canada will lose control over its monetary destiny? The short answer is no. But let me give you a slightly longer answer.

The key point is that as long as financial institutions in Canada -- of whatever nationality -- settle claims against each other in Canadian dollars, the Bank of Canada will maintain its leverage over economic behaviour by virtue of its control over the availability and

price of those settlement balances. When Canadian banks' non-interest bearing reserve requirements are eliminated we shall still have the leverage we need. As many of you may be aware, the removal is essentially needed for equitable treatment of similar institutions in the transformation of the Canadian financial system to which I briefly referred earlier.

Ultimately, therefore, and even with a very open financial system, Canada will retain control in the fundamental sense over monetary policy. We have the means to control the pace of monetary expansion in Canada, and therefore the extent to which our money will hold its value. In saying this I am glossing over a lot of important technical questions as to how best to manage money, but I also think that those technical issues, important and interesting as they are, should not be allowed to obscure the necessary underlying goal of monetary policy. Maintaining the confidence of citizens in the national currency by preserving its domestic value is not something to be taken lightly, and certainly not to be taken for granted. It is the vital contribution that Canadian monetary policy can make to the sustained well-being of the Canadian economy.

In stressing domestic confidence in the value of the currency as the long-run focus of monetary policy, I do not mean to downplay the importance of the external value of our currency -- the exchange rate. Given the extent to which the international economy is intertwined with the Canadian economy, the behaviour of the exchange rate matters a great deal. We surely need to pay attention to it, even if it is not the target or even the central guide of policy.

Let me make a further qualification. While it is tempting to the market observer to ascribe exchange rate developments entirely to domestic policy, in particular monetary policy, there are other actors on the scene.

Thus, a key positive factor in the rise that we have seen in the exchange value of the Canadian dollar against the U.S. dollar in the past year has been the improvement in the prices of a range of Canada's main commodity exports after several years of weakness. Our international terms of trade went up in 1987 for the first time in several years. A particularly welcome feature of this improvement has been its contribution to the strengthening of economic conditions across the country after an earlier economic expansion primarily concentrated in Ontario and Quebec.

The impact on the Canadian dollar of the Canada - U.S. trade agreement is not straightforward to analyze. The basis for the agreement is that there will be a beneficial economic impact on both sides of the border as trade is undertaken to mutual advantage. The consequences over time, if any, for the U.S. - Canada exchange rate are therefore bound to be somewhat ambiguous, although the rise in the Canadian dollar in recent months has been seen by some observers as resulting in part from improved Canadian economic prospects stemming from the trade agreement.

Let me also note that in gauging the impact of exchange rate developments on the Canadian economy there is a tendency in Canada, and perhaps here in the United States as well, to focus narrowly on the bilateral exchange rate against the U.S. dollar. This is very natural in view of the close trading links between our countries. But Canada also

trades with and competes against countries other than the United States. So in judging how Canada's overall competitive position is evolving, it is important to take account of movements of our dollar against these other countries' currencies. In this regard I will note that while our dollar has appreciated against its U.S. counterpart by over 10 per cent since March 1985, it has declined by roughly 40 per cent over the same period against a basket of the currencies of our other major trading partners. With such a decline against the currencies of countries overseas, it is evident that our competitiveness in relation to our overseas trade partners has improved markedly in recent years. This is becoming apparent in Canada's exports and bilateral trade balances. Our position in the U.S. market in competition with overseas countries has also shifted. The international adjustment process is still in business, even if it does not always work as rapidly as close observers of each month's trade statistics would like to see.

Before concluding, let me comment briefly on what seem to me to be the main features of Canada's domestic economic performance.

The most striking feature has been the strength of spending right through 1987 and, still more to the point, into 1988. Total dollar outlays in the economy at the end of last year were almost 11 per cent higher than a year earlier -- a pace that is clearly stronger than can be sustained for very long. At the same time, it has been good to see a better balance of economic activity develop among Canada's various regions, a resurgence of business investment, and marked employment increases all across the country. The proportion of the working age population employed is at historic highs, reflecting the strength of economic activity

and a dramatic increase in the participation of women in the labour force.

The vigour of demand has of course spilled over into a substantial increase in imports and, in particular, a surge in imports of machinery and equipment. Offsetting the impact on our trade balance have been continuing strong increases in our exports. They stem in part from the robust growth of demand in the economies of our major trading partners and, in part, from the improvements that I noted earlier in the prices of many of Canada's important commodity exports.

With this momentum in demand, the Canadian economy, as well as the economies of the United States and other major countries, has proven far more buoyant since the October stock market break than most observers expected. Thus, monetary policy in Canada has needed to be firm. It has been directed as a matter of priority at ensuring a sustainable pace of monetary expansion and overall demand in the face of tightening markets and the dangers of inflationary spillover. In other words, we want to help sustain a durable economic expansion by resisting effectively -- that is, in a timely manner -- generalized cost-price pressure.

Throughout these remarks I have emphasized the openness of Canada's economy. We have always had an open economy -- more open to the world than that of many countries. With the increasing integration of the world's financial markets, the Canadian economy and, indeed, virtually every economy is becoming yet more open. Greater openness increases the scope for spillovers from one economy to another, and these are a source of concern and a spur to

efforts for international economic coordination. Such efforts are complements -- necessary complements but still complements -- to those made to ensure that sound policies are pursued at home.

Finally, and in the context of this last point, let me return very briefly to Prime Minister Bennett's argument for establishing a Bank of Canada. I have it on excellent authority that Graham Towers, first Governor of the Bank, remarked that to him setting up a central bank for the reason of avoiding settling sterling balances through New York did not make much sense. And indeed, in the act of Parliament that governs us we are charged "to regulate credit and currency in the best interests of the economic life of the nation". This broad mandate seems just as good today as it was in 1934.