Mr Thiessen reports on the future of the Canadian financial sector, the economy and monetary policy

Remarks by Mr Gordon Thiessen, Governor of the Bank of Canada, to the Mennonite Savings and Credit Union Kitchener, Ontario 22 March 1999.

I am delighted to be with you this evening to celebrate the 35th annual meeting of the Mennonite Savings and Credit Union. On this occasion, I propose to speak about the Canadian economy and monetary policy. But given this audience, I thought I might start with some remarks on the future of the Canadian financial sector – a subject that has certainly grabbed its share of headlines over the past year!

In December 1996 the Minister of Finance appointed a Task Force to assess the current situation and the future prospects of the Canadian financial services sector, and to make recommendations for change. In early 1998, while this inquiry was still on, four of Canada’s six largest banks announced plans to merge. The Task Force submitted its report (the MacKay Report) last September. In December 1998 the Minister of Finance, having taken into account that report as well as assessments of the proposed mergers by the Office of the Superintendent of Financial Institutions and the Competition Bureau, decided not to allow the mergers. The Government is now examining the issues facing the financial services sector and, in the course of 1999, it intends to present its proposals for modifying the relevant regulatory framework.

The Bank of Canada is one of several agencies in Ottawa that provide advice to the Minister of Finance on the appropriate legislative framework for the financial industry. Because of this, I am not in a position to comment on specific proposals for change. But what I can do is offer some general comments on the broad issues involved in ensuring an efficient and sound financial industry in Canada as we strive to adapt to ongoing worldwide changes in the provision of financial services.

Potential reforms of the Canadian financial system

Canadian financial institutions are among the best providers of financial services in the world. These days, they are operating in an intensely competitive global marketplace, teeming with change spawned by rapid advances in technology and innovative new financial products. These powerful forces have transformed the way financial institutions around the world operate and the way they market and deliver their services.

Globalization creates both opportunities and challenges. We must make sure that Canadian financial institutions can compete effectively in both domestic and international markets, and that they can offer Canadians innovative, world-class financial services. The MacKay Task Force says this means we should enhance competition in the financial services industry. How? Primarily by reducing restrictions on existing providers of those services and by encouraging new players to enter the field.

Members of this audience know that one of the proposals for strengthening the position of existing participants is to give credit unions the option to form cooperative banks. More generally, provided prudential concerns can be resolved, the Task Force suggests that the regulation of credit unions be re-examined to encourage them to become more active, dynamic competitors within the financial industry.

We would all agree that consumers of financial services are best served when there is effective competition among financial institutions. A strongly competitive financial industry will provide customers with the best deals for loans, deposits, insurance, and so on. Such an industry would also be more innovative and should provide a wider range of services.

But the appropriate legislative framework for financial services cannot be one that simply maximizes competition without regard for the safety and soundness of the industry.

Why all this concern about safety? And why do we regulate this particular industry more closely than virtually all others?

There are two main reasons. First, the financial industry is the repository for the wealth of a large number of small savers. For most of these savers, it is very difficult and costly to make a personal judgment of the risks involved in doing business with a particular bank, credit union, or insurance company.

The second reason has to do with what we call systemic risk, or contagion. This refers to the risk that problems in one particular financial institution will be transmitted to others. Contagion can occur when depositor nervousness about one institution spreads to others. As well, since the payments system links financial institutions closely together, the failure of one institution can potentially lead to serious losses for others.

Governments have addressed safety concerns by imposing capital requirements on financial institutions, restricting their ability to engage in risky activities, supervising their adherence to risk-reducing practices, and setting up deposit insurance. To limit contagion, central banks have the power to make liquidity loans to financial institutions in the payments system. And most central banks in industrial countries have been involved in initiatives to minimize the potential for systemic risk in their payments systems.[1]

When depositors feel ‘protected’, however, they are less inclined to monitor the riskiness of financial institutions. Thus, governments feel a greater need to regulate to reduce the risks of institutional failure. This tends to have side effects which could potentially restrict competition.

What then is the scope of increasing competition, by encouraging new players and by reducing restrictions on existing ones, without undermining the safety and stability of the system? Clearly, there can be a tension between the goals of fostering greater competition within the financial sector and of preserving safety and stability. To find a balance between the twin objectives of efficiency and safety has always been a challenge for governments when they examine proposals to change the regulatory framework for the financial system.

I do not mean to make this sound like an impossible task. There are bound to be some changes that can help promote competition without adding substantial risk to the system. More generally, though, I believe that we need to examine ways that could ease the tension between efficiency and safety. For example, if we are to encourage the entry of new financial institutions as a means of promoting greater competition, perhaps we should also consider a more formal, explicit policy of ‘early exit’ when an institution runs into trouble.

One possible approach would be that when institutions reach some minimum level of capital, they would be required to recapitalize themselves or find a merger partner within a short period of time. Otherwise, and well before they became insolvent, they would be sold or wound up by the regulatory authorities. Such an approach might help reduce risks to depositors, to the deposit insurance system, and to other creditors of financial institutions. This is not a new idea. The United States has already moved in that direction and so have we in Canada, to a certain extent. But there may be room to move further down this path and, in so doing, to provide managers of financial institutions with stronger incentives to avoid getting into financial difficulties.

To summarize, I agree with the MacKay Task Force that encouraging new participants and reducing restrictions on existing players in the financial industry would benefit customers through improved service and lower costs. But this may have the potential to increase risks for the financial system. So we need to look at ways to avoid having these risks add to the costs of deposit insurance and to the

1 In Canada, under the Payment Clearing and Settlement Act, the Bank of Canada has been given formal oversight responsibility for ensuring that appropriate arrangements are in place to manage and control systemic risk in major clearing and settlement systems.

costs for other users of financial services. One approach, as I mentioned, is to move further towards ‘early exit’ arrangements for troubled financial institutions. Such arrangements might not be easy to implement. But if we could move in this direction, there might be more scope to benefit from enhanced competition without exposing users of financial services to unacceptable risks or compromising the stability of the system.

I would now like to turn to our economic situation and monetary policy.

The state of our economy

The past year has been a trying one, both for the world economy and for Canada. Still, considering the seriousness of the global difficulties we have been facing, the Canadian economy has coped much better than expected, and certainly better than in the past. This is because it is in sounder shape now than it has been for many years. Canadian businesses have been investing in new technology to increase productivity and efficiency. Governments are no longer draining national savings to finance huge budget deficits. And with the Bank of Canada’s commitment to inflation control targets, inflation is low and stable.

But what about our economic prospects as we look ahead?

Let me start with the financial climate. Global financial markets have been calmer recently compared with the turbulence last autumn after Russia declared a debt moratorium. Cuts in official interest rates around the world since then, and the success of some emerging market economies in addressing their problems, have clearly helped. International investors’ fears have abated, and markets seem to have regained a sense of their ability to assess risks and discriminate among borrowers.

When it comes to the world economic environment, there is still uncertainty out there. But there are also positive elements in the picture.

One area of uncertainty is the financial problems in Brazil and the extent of related economic weakness in Latin America more generally. If the Brazilians follow through on their fiscal adjustment program and limit the inflationary fallout from the depreciation of their currency, financial market pressures should ease, and growth in Brazil should resume next year.

But the foremost uncertainty in the outlook continues to centre on Japan, where the economy remains in a slump. Nevertheless, if present efforts at bank reform continue, and if stimulative macroeconomic initiatives are pursued systematically, the Japanese economy should begin a gradual recovery, perhaps by late 1999.

The economic expansion in the other industrial countries, which together account for about half of world output, should remain relatively well sustained. In Europe, economic activity has softened, but interest rate cuts since the autumn and the easing of global financial strains should help support confidence and domestic spending in coming months.

The most positive element, certainly from a Canadian perspective, has been the remarkable performance of the United States. That economy ended 1998 on a much stronger note than had been expected, growing at an annual rate of 6% in the fourth quarter of 1998. Thus, its underlying momentum going into 1999 is much greater than most had supposed. This is confirmed by some of the advance data for early 1999. So even if growth slows, as expected, the US economy should continue to operate at high levels.

There are also signs that the sharp economic downturns in some of the Asian countries most affected by the financial crisis are bottoming out. The economy of South Korea has started to expand, and in Thailand economic activity seems to have stabilized. However, a broad-based recovery in the region has yet to take hold and will depend, to an important degree, on economic conditions in Japan.

Here in Canada, the impact of the global turbulence since the summer of 1997 was felt mainly through the lower demand for the key primary commodities we produce and the 20% decline in their prices between mid-1997 and end-1998. But consumer and business confidence were also affected, and that dampened domestic spending. Consequently, the Canadian economy expanded by just under 3% through 1998 (fourth quarter over fourth quarter) compared with over 4% in 1997.

However, after some weakness through last summer and early autumn, our economy showed renewed strength recently. Helped by buoyant US demand, easing global financial strains, and the rebound from major labour disruptions, economic activity grew at an annual rate of 4.6% in the final quarter of 1998. And this was accompanied by robust, broad-based employment gains through the closing months of 1998 and into early 1999.

With world economic and financial conditions still fragile and the timing of a firm recovery in primary commodity prices uncertain, projections for 1999 remain tentative. But with recent healthy employment growth, domestic spending should continue to contribute to an expanding economy. And sustained US demand, coupled with our improved competitiveness, should continue to bolster our exports. Altogether, we are looking at a somewhat more positive scenario than seemed possible last autumn.

The response of monetary policy to international turbulence

Let me now say a few words about how the Bank responded to the exceptional global events of the past couple of years.

As commodity prices tumbled, we became less well-off as a nation. Distressing as that is, it is a reality Canada had to face. And our currency moved downwards, reflecting – not causing – the drop in our economic prosperity and the need to adjust.

When shocks like this hit us from time to time, movements in the external value of the Canadian dollar help ‘buffer’ the shock and smooth the process of adjustment. If the currency is not allowed to move, the adjustment will drag out and cost more in terms of losses in output and employment.

However, the relatively orderly depreciation of our currency through to July 1998 accelerated following the Russian crisis last August. And Canadian longer-term interest rates rose sharply at a time when comparable US rates were falling. To us at the Bank, this signalled a potential loss of confidence in Canadian dollar assets, which we moved to head off by raising the Bank Rate by 100 basis points. In so doing, we sought to limit the harmful effects of financial volatility on confidence by temporarily placing particular emphasis on calming markets.

The situation has improved since then. Interest rates have been cut in all major industrial countries, and a measure of stability has returned to world financial markets. With this, concerns in Canadian markets have diminished, allowing us to unwind three-quarters of last August’s increase in the Bank Rate. Calmer financial markets should now make it possible for the Bank to refocus attention on its medium-term policy objective of keeping the underlying trend of inflation inside the target range of 1% to 3%.

In conclusion, let me say that, given the financial market volatility and the global economic slowdown of the past couple of years, our economy has coped relatively well. And we begin 1999 on a positive note. This is testament to Canada’s improved basic economic foundation these days. And it gives me reason to remain positive about our future despite lingering international uncertainties.