Mr Thiessen discusses the effect on the Canadian economy of recent global financial turbulence

Remarks by Gordon G Thiessen, Governor of the Bank of Canada, to the "Chambre de commerce de la région sherbrookoise" in Sherbrooke, Quebec on 4 May 1999.

Global financial turbulence and the Canadian economy

The world economy and Canada have had to navigate some difficult straits in the past couple of years. But we have made it through. And considering the tide from the Asian financial crisis that washed around the world, the Canadian economy has coped better this time around than in the past.

With the clouds of international uncertainty gradually lifting, Canada's solid economic foundations are providing good reason to remain positive about the outlook for our economy.

Today, I would like to talk about recent economic developments and the prospects for Canada. But since much of what has been happening here recently has been heavily influenced by external events, I would also like to discuss some of the measures the international community is contemplating to prevent, or at least reduce the severity of, any future crises.

Recent developments in the Canadian economy

The financial crisis that began in Southeast Asia in mid-1997 turned out to be much more persistent and serious than anyone had expected. During 1998, the turmoil spread to Russia and Brazil, causing a great deal of nervousness and volatility in markets everywhere. This led to large outflows of capital from many emerging-market economies, rising interest rates, tighter credit conditions, and a marked slowdown in economic growth worldwide.

Canada has not been insulated from these forces. Many of our industries, including those in Quebec, have been hard hit. The most immediate impact on our economy has been the lower foreign demand for the key primary commodities we produce and a 20 per cent drop in their prices between the middle of 1997 and the end of 1998. These developments were reflected in the value of our currency, which declined sharply against the U.S. dollar.

As the turmoil in markets increased following the Russian debt moratorium last August, the Bank of Canada moved to head off signs of a potential loss of confidence in Canadian dollar investments, by raising the Bank Rate one full percentage point. The confidence of households and businesses in Canada was also affected by market nervousness and volatility, and this dampened domestic spending. Consequently, the Canadian economy expanded by just under 3 per cent through 1998 (fourth quarter over fourth quarter) compared with over 4 per cent in 1997.

Considering the seriousness of the external disturbances, this is not a bad economic outcome. And for this, we can thank our sounder fiscal position and low and stable inflation, which have helped us weather the international instability better this time around. These same factors, coupled with calmer financial markets, have allowed the Bank to lower the Bank Rate four times since the autumn (fully reversing last August's increase), and to refocus attention on the medium-term objective of keeping inflation within the 1 to 3 per cent target range. Currently, inflation is just inside the bottom of the range.

The economic outlook

As I said before, the world economic horizon is now clearer. Interest rate reductions around the world -- most recently across the euro area -- have helped to rebuild investor confidence and to calm global financial markets. This includes markets in the troubled Southeast Asian economies, where progress is being made on structural reforms and the outlook for a turnaround this year and next has improved, especially in South Korea, but also in Thailand and Malaysia. There are also signs that the financial situation in Brazil, which looked precarious in late 1998, is now stabilizing with the adoption of measures to address imbalances in the country’ s fiscal and external accounts.

What is less clear is the extent of short-term economic weakness one can expect in Latin America because of the difficulties in Brazil.

There has also been a slowdown in the pace of economic expansion in Europe. But easier monetary conditions -- that is, lower interest rates and the lower value of the euro -- should help offset some of the economic weakness there. And these lower interest rates are a positive element for the international economy as a whole.

The main question mark in the outlook continues to be the Japanese economy, which has been in recession since late 1997. Even if stimulative macroeconomic policies are pursued systematically, and progress continues on banking sector reform, it is rather unlikely that there will be much of a recovery there before the year is out.

In contrast, the U.S. economy continues to flourish, consistently outperforming expectations and with no sign of inflationary pressures. That economy ended 1998 on a much stronger note than had been expected. And the momentum of U.S. economic activity in early 1999 is greater than most forecasters had predicted. From a Canadian perspective, this is the most positive element in the current external economic environment, as anyone who sells to U.S. markets can confirm.

Strong U.S. demand for Canadian products and the rebound from major labour disruptions in Canada led to renewed vigour in our economy in the fourth quarter of 1998 which, by all indications, carried into early 1999. And this has been accompanied by healthy employment growth.

As we look ahead, steadier financial markets, employment gains, and accommodative monetary conditions should bolster spending by Canadian households and businesses. All this, coupled with sustained U.S. demand and our improved competitiveness, should continue to contribute to an expanding Canadian economy.

Since world economic and financial conditions are still fragile and since the timing of a firm recovery in primary commodity markets remains uncertain, I cannot be more specific about how strong our economy will be. But we are now looking at a somewhat more positive scenario than seemed possible last autumn -- both for the world economy and for Canada.

What to do about future crises

As much as we are all anxious to put this latest episode of global financial turbulence behind us, I hope that in one respect, at least, we won’ t soon forget it. The fact that things are getting better should not distract us from devising strategies to reduce the risks of similar crises in the future. And should there be any, we need to be better prepared to handle them and to minimize their economic fallout.

So what are some of the issues, and what is being done about them?

It would be all too easy to blame globalization and unhindered, large, cross-border capital flows for the recent financial problems, and to suggest that we retreat behind national borders and place restrictions on the flow of capital. But it would be unwise. For even though capital flows may sometimes be difficult to manage, especially for small countries, the benefits from access to a bigger pool of world savings are substantial -- when those savings are used prudently and productively. What we must do is find ways to minimize the risks, without surrendering the benefits.

There are three main areas towards which international efforts are currently directed: strengthening financial systems; ensuring that countries follow responsible macroeconomic and financial policies; and developing effective processes for managing crises when they arise.

Let’s look at these three areas. First, there is the need to encourage sound financial systems -- nationally and internationally. Some of the things being addressed here are accounting and disclosure standards, supervisory and regulatory frameworks, and bankruptcy procedures. Why do we need to strengthen these practices?

Widely accepted accounting standards are the key to communicating reliable information about a company’s financial health and to making its operations more transparent. Disclosure of accurate and timely information strengthens confidence and helps markets to make more informed judgments about the riskiness of investments. Recall that one of the main problems behind the recent difficulties was the huge amounts of funds placed in some emerging markets in Asia by investment advisers from industrial countries and by their clients, evidently without adequate information or appreciation of the risks involved. History shows than when concerns arise, lack of information causes investors to expect the worst and run for cover.

There is also a need to improve the effectiveness of regulation and supervision of banks and other financial institutions, especially in emerging-market economies. Banks are important intermediaries for moving funds around at home and abroad. But they will perform this role most effectively and soundly if they are properly supervised and if they have reason to control risk. In countries where banks have strong links to industry and/or to government, their ability to make objective credit judgments may suffer. And sometimes these relationships include provisions that protect banks from failure but do not encourage prudent behaviour.

Plans to improve global financial rules also involve strengthening bankruptcy procedures. Well-defined bankruptcy codes are important. They can provide debtors and creditors with a clear understanding of the rules for resolving defaults. And they would enable the private business sector to continue to function even in the event of a financial crisis.

So far, I have talked about institutional improvements that international bodies, like the International Monetary Fund, are helping to design and put in place through a code of “best practices”. Let me now turn to economic policies and their role in promoting greater financial stability.

One important lesson we have learned from experience -- including our own in Canada -- is that countries must, above all, follow sound and credible macroeconomic policies. This means a fiscal policy that avoids unsustainable public sector deficits and debts, and a monetary policy aimed at low and stable inflation.

But the question of a country’ s exchange rate policy is also very relevant. Recent experience highlights the importance of ensuring that financial markets have the right incentives to make sound decisions and to avoid excessive exposure to risks. When a government pegs its exchange rate to another currency, pledging to do whatever it takes to ensure that the peg holds, domestic and foreign investors tend to minimize the exchange rate risk, as long as things are going well.

The problem with a fixed, but adjustable, exchange rate is that it does not guarantee that a currency will not decline in value. Should it come under pressure, because it is fixed at a level that is inconsistent with changing fundamentals in the economy, and should markets begin to question the authorities’ pledge to the peg, domestic and foreign investors would likely rush for the exits, triggering a crisis. When you think of recent crises in Southeast Asia and in Brazil, the first thing that strikes you is that they all occurred in countries with fixed exchange rates.

I would argue that, in most of these cases, greater exchange rate flexibility would have helped to make borrowers and lenders more aware of exchange rate risks. And so I find it encouraging that some of the crisis-afflicted emerging countries have since moved towards more flexible exchange rates.

Let me now say a word about the need to devise processes for the effective management and resolution of future crises, should they occur. Right now, the International Monetary Fund is the main provider of emergency assistance to a country that runs into financial difficulties, while its private creditors are not always involved. The main, and somewhat contentious, issue here is to ensure that private lenders have the incentive to participate in crisis prevention and that they bear their fair share of the financial burden of dealing with crises.

Progress in this area has been slow, but a number of proposals are being examined that would encourage debtor countries and their creditors to work out financial problems in a cooperative manner.

Let me conclude. Thanks to a stronger foundation these days, the Canadian economy has thus far weathered the financial volatility and the global economic slowdown of the past couple of years reasonably well. And having started 1999 on a strong note, we are looking for sustained economic expansion this year.

The situation in world financial markets has improved. And the international community has been hard at work, seeking ways to strengthen the international financial architecture. There is no single, simple solution to prevent crises. Today, I have discussed some of the measures planned to provide a degree of comfort. None of them is dramatic, and much remains to be done. But I believe that these changes should help reduce future risks. Canada has a stake in building a stronger, more stable international financial system, and strongly supports global initiatives designed to achieve this.