David Dodge: The Bank of Canada and financial stability

Remarks by David Dodge, Governor of the Bank of Canada, to the Montreal Society of Financial Analysts, Montreal, Quebec on 20 March 2001.

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I am pleased to be in Montréal today. Last month, in my first public speech as Governor of the Bank of Canada, I talked about our contribution to good economic performance through low, stable, and predictable inflation. I also stressed the importance of frank dialogue with financial markets and the general public in helping the Bank formulate and implement monetary policy successfully, particularly at times of increased uncertainty.

While monetary stability through low inflation is crucial to good economic performance, our economy cannot function properly unless it is also supported by an efficient and stable financial system. And as the world economy becomes increasingly interconnected, sound macroeconomic policies and sound financial systems across all countries are even more essential.

Today, I would like to talk about the Bank's contribution to financial stability at home and abroad. I will also comment briefly on the current economic situation.

Canada as an international player

As an open economy, Canada is very much affected by what goes on in the rest of the world. So we have more than a passing interest in promoting a sound and robust international environment.

Since more than 80 per cent of our foreign trade is with the United States, it is developments in that country that have the most profound impact on our economy. Recent experience, however, has shown that even events in faraway places can reverberate back home. The Mexican peso crisis of 1994–95 and the Asian financial crisis of 1997–98 are cases in point. In both instances, Canada was sideswiped by those events.

If this somehow leaves the impression that globalization - the increasing integration of economies and financial markets - has been of questionable value, I hasten to add that this is not how I see it. On the contrary, I believe that globalization has been, and will continue to be, a source of opportunity and growth for Montréal, for Canada, and for the rest of the world.

Recent episodes, however, have highlighted certain vulnerabilities in the global financial system. And we must deal with them, if the benefits of economic and financial integration are to be fully realized by everyone in today's "global village." Let me tell you what the Bank is doing to promote financial stability.

The importance of sound financial systems

In addition to pursuing monetary stability through a low-inflation policy, all central banks, including the Bank of Canada, have a responsibility to promote the stability and soundness of their country's financial system.

A market economy, like ours, cannot function well without the support of a strong financial system. Sound financial institutions, a robust financial infrastructure, and efficient financial markets are necessary to facilitate transactions and to properly channel savings into investments. For an economy to perform well, individuals and businesses must be confident that money and financial claims can be reliably and efficiently created, held, transferred, and settled.

Now, if the arrangements that are in place do not work properly, the financial system can turn into a channel through which shocks are amplified as they are transmitted from one part of the system to the next and also beyond national borders. Whether such shocks are of an economic nature or whether they originate in the financial system itself, they can end up having an important impact on the economy as a whole.

So there are good reasons why countries should ensure that their financial systems work well and that they do not trigger or spread instability domestically and internationally.

The Bank's contribution to domestic financial stability

In Canada, the Bank shares the responsibility for financial stability at the federal level with three other entities - the Office of the Superintendent of Financial Institutions, the Canada Deposit Insurance Corporation, and the Department of Finance. Various provincial bodies also play an important role.

The Bank focuses its attention mainly on macro financial stability issues, leaving the principal responsibility for micro issues to the other entities. The Bank's overriding concern is to ensure that the financial system is sound and that it works efficiently. In this context, we provide liquidity to the system, in both ordinary and extraordinary situations. We give policy advice to the federal government on the design and development of the financial system. Through our oversight of major clearing and settlement systems, we act to make sure that the failure of a participant does not lead to domino effects and to generalized instability. And we provide banking services to these systems and to their participants. Finally, we collaborate with other domestic and international bodies that work on financial-stability issues.

Thanks to the collective efforts of all those charged with the promotion of financial stability in Canada, we have a financial system that is efficient and robust. And, as recognized by the International Monetary Fund (IMF) in 1999, it complies with all major international standards.

But the financial landscape is constantly changing. Under pressure from greater global competition, and with the benefit of new information technology, more sophisticated financial products are being developed, and new ways to deliver financial services are continually being devised.

What does this mean in terms of the Bank's commitment to financial stability? It means that we, and the other federal and provincial agencies responsible for the health of our financial system, must monitor these developments and understand their potential implications for financial stability. And we must continue to strengthen the ability of our financial system to withstand shocks. Moreover, since, despite our best efforts, there will be rare occasions when difficulties will develop, it also means devising effective, cost-efficient ways of resolving problems. Because even if the probability of such difficulties is low, the consequences could be major.

The bank's contribution to global financial stability

Let me now turn to the ongoing efforts to reform the international financial architecture and tell you about the Bank's involvement in this area.

In the aftermath of the financial crises of the 1990s, new international bodies have been created, and existing ones strengthened, to help identify and deal with weaknesses in the global financial system.

The Bank of Canada has been an active participant in several international forums where issues of financial stability are debated. And we have worked closely with other members to develop frameworks for the prevention, management, and resolution of international crises.

I would highlight in particular our participation in two new international groups formed in 1999 - the Group of Twenty and the Financial Stability Forum. The Group of Twenty, currently chaired by Finance Minister Martin, brings together national authorities from both industrial and major emerging-market economies to discuss key issues that are important for the proper functioning of the global economy. Such issues include exchange rate regimes, good practices on transparency in fiscal, monetary, and financial policies, and the role of the private sector in crisis resolution. The Financial Stability Forum is responsible for identifying system-wide vulnerabilities and has dealt with such issues as offshore financial centres, capital flows, and international financial standards and codes.

The bank's focus in fostering global financial stability

Given our expertise, the Bank's focus in international forums has been, and will continue to be, on three key issues - exchange rate regimes, financial-system infrastructure, and private sector involvement in crisis resolution.

In light of our long experience with ***flexible exchange rates*** and our strong reputation in inflation targeting, a number of emerging-market central banks have asked for, and received, assistance from the Bank in developing and operating policy frameworks based on inflation targets. We expect this to continue in the future.

In the area of ***financial-system infrastructure***, parallel to our work on the oversight of major payments systems and the provision of liquidity in Canada, we have been studying these issues from a global perspective as members of various committees at the Bank for International Settlements. And we have been contributing to the development of standards for the sound operation of such systems.

The Bank has also been closely involved in international efforts to reduce the risks associated with the settlement of foreign exchange and securities transactions.

Finally, there is the issue of private sector involvement in crisis resolution. We all recognize that, even with the best prevention efforts, we will not totally eliminate the possibility that foreign economic and financial disturbances will affect national economies around the world. In the event of an emergency, the international community has agreed to new assistance facilities for distressed IMF member countries. IMF resources, however, are not limitless. So there is a need for the private sector to play a key role in the resolution of crises.

Greater clarity about the size of available official assistance is essential to encourage private sector debtors and creditors to work together to find solutions in difficult circumstances. And although we hope that most situations could be resolved voluntarily, it is important to recognize that, under certain conditions, an orderly standstill (a temporary suspension of debt-service payments) may be appropriate to give a distressed debtor country some breathing space in which to take steps to address its problems.

Broad international consensus on limits to official lending and on standstills is still lacking. So we will continue to work away at these issues.

Before summing up my main points today, I would like to give you a quick update on the Canadian economy.

Recent economic developments

In assessing the near-term course of the Canadian economy, we are all facing a number of uncertainties. The most important relates to the abruptness and extent of the slowdown in the U.S. economy.

The fact that the recent economic data for North America are mixed adds to this uncertainty. While these data confirm a slowing in the pace of activity, some have come in weaker, and some stronger, than expected. This is certainly the case here in Canada. But even in the United States there have been both negative and positive reports.

In the United States, the number of positive indicators, while not decisive, provides some hope that the end of the slowdown may not be far off. We continue to believe that U.S. economic growth will rebound in the second half of the year, supported by the decline in interest rates and by the moderation in energy prices. The exact timing of the U.S. recovery, however, remains uncertain and will depend importantly on how consumer confidence evolves in that country.

Here in Canada, the latest national accounts data, which incorporate revisions to the growth profile in the first three quarters of last year, show that the level of economic activity was not quite as high at the end of 2000 as we had estimated earlier. And, based on more recent indicators, the pace of economic expansion in the first quarter of 2001 will be slower than in the final three months of last year.

We can see this clearly in the automobile industry, where there have been production cutbacks mainly in response to weaker demand and excess inventories in the United States. Electronic goods and telecommunications products are two other areas where activity has slowed - although from very high levels - and where world production has been running ahead of demand.

All three are high-profile sectors. So naturally they attract a lot of attention, especially in parts of Canada where there is a heavy concentration of these industries. But to keep things in perspective, there is still considerable strength in a number of other areas that are important to our economy. For example, investments in the energy sector and orders in the aerospace industry here in Quebec are extraordinarily strong. Or take retail sales other than autos, or housing, or non-residential construction: in all those areas, and in most other service industries, the level of activity remains high.

When we considered the balance of this evidence earlier this month, we concluded that there was, in the near term, room for greater monetary stimulus without putting pressure on capacity and inflation. Therefore, we lowered the Bank Rate by 50 basis points on 6 March, bringing the total decline since January to 75 basis points.

In taking this action, we also considered the uncertainties attached to the timing and extent of the expected recovery in the United States and their implications for growth of total demand in Canada. The Bank continues to believe that the reduction in our interest rates and rising disposable incomes, bolstered by recent tax cuts, should help to support the expansion of domestic demand in Canada in the second half of the year.

This additional stimulus to economic activity is consistent with keeping the core rate of inflation close to the 2 per cent midpoint of the 1 to 3 per cent inflation-control target range. As for total CPI inflation, we still expect it to move down to about 2 per cent in the second half of 2001, assuming world oil prices remain at about current levels.

Thus, as we look ahead through this year and into the next, we remain positive about the prospects for the Canadian economy. But, given the uncertainties, we will continue to closely monitor developments at home and abroad.

Concluding thoughts

Let me now conclude.

The growing interdependence of national economies, massive capital flows, and new sources of potential risks in a globalized environment have brought into full relief the importance of sound macroeconomic policies and robust and efficient financial systems.

Canada's monetary policy approach of inflation targets, a flexible exchange rate, and policy transparency has proven its worth through the difficult times of the past decade.

Canadians can also take pride in a financial system that is universally acknowledged as sound and efficient. To keep it that way, we must ensure that as financial markets evolve, those of us charged with financial stability evolve with them.

The Bank of Canada will continue to work closely with its domestic and foreign partners to strengthen financial stability at home and abroad. For to paraphrase John Donne: these days, no country is an island!