David Dodge: Important issues related to the development of international capital markets

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Government Borrowers Forum, Montréal, Quebec, 15 May 2007.

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Thank you, it's a pleasure to welcome you here today to discuss some important issues related to our common interest in the development of capital markets throughout the world. We are all interested in seeing the continued development of international capital markets, as part of the advancement of a market-based, liberalized trade and financial regime. Let's remember that an open, market-based economic system is increasingly vital, in a world where change is driven by the development of new technologies and modes of competition; and where adjustments are occurring all the time. In such a world, price signals from markets can help us to understand what adjustments need to be made. A liberalized, market-based regime is really the best that we have found for promoting growth and prosperity, higher standards of living, and the development of a domestic economy that is flexible enough to cope with shocks.

There are, of course, many policies needed for an economy to become more flexible and market-based. But today, I want to particularly focus on the importance of local-currency bond and money markets. First, however, let me briefly outline the other necessary policies.

Fundamentally, a commitment to maintain low, stable, and predictable inflation is crucial. In most countries, that commitment is best supported by a flexible exchange rate regime, which facilitates adjustments when the inevitable shocks to relative prices, global trade, and capital flows occur. One other important policy is that governments must be fiscally responsible. This doesn't mean the books must be perfectly balanced each and every year. But it does mean that governments *must* maintain, and be committed to maintaining, a manageable debt-to-GDP ratio, and avoid running up debt that can hobble future governments, and prevent necessary adjustments. And finally, openness to global trade is of key importance to an economy's growth and prosperity.

A great deal of attention is rightly paid to these very important policies, which form the essential building blocks in an economy. But today, I want to focus on the issue of having sound local-currency bond and money markets.

First, I'll talk about the real advantages right at home that come with local-currency bond and money markets. I'll also refer to Canada's history in developing such markets, and to some elements that remain a work in progress. I hope that our experience might be of some use to authorities in many emerging market economies, which are now developing their own local-currency markets. And their efforts are bearing fruit – the outstanding stock in these emerging economies' local bond markets now exceed $4 trillion US – a four-fold increase in value over roughly the past decade. I'll also consider how these domestic markets can fit into, and do their part in stabilizing, the global financial structure.

Now, these are my personal observations which are based on 40 years experience in public finance, and as seen from two perspectives: both as a central banker, and before that, as a federal Finance department official.

Over the years, I've come to appreciate that a sound local-currency government bond market helps on three distinct policy fronts. First is the discipline that it can impose in terms of macroeconomic policies. Second, it supports economic and financial efficiency. And third, it helps in the development of a stable financial system. Let me now deal with each of these points in turn.

In terms of macroeconomic policy, a government must build credibility with its own citizens first of all. Citizens need comfort that the government bonds that they hold will keep their value; that governments won't default on their obligations, or resort to large tax increases or inflation to ease the real burden of repayment. This initial hurdle of building credibility can be difficult to get over, as many emerging markets can attest to today. But once this hurdle has been cleared, a well-functioning, local-currency government bond market brings with it the incentives for authorities to keep in place the sound policies that I mentioned in my introduction. Those policies should include monetary policy aimed at maintaining low, stable, and predictable inflation, which leads to an environment of lower interest rates – both nominal and real – and lower debt servicing costs in the future. They also include prudent fiscal policies, which then reinforce public confidence in the government and, in turn, in the domestic markets.

Of course, none of this suggests that all government borrowing must be denominated in the local currency. There will be times when a government will borrow in foreign currency, perhaps for projects that will support a future flow of foreign currency that can, in turn, help repay this borrowing. The real risk here comes when governments find themselves repeatedly borrowing in foreign currencies, to finance current domestic spending.

Let me now mention Canada's history in developing our local-currency bond and money markets, because it has parallels with the situation in which many emerging market economies now find themselves. In the 1950s, Canada was a relatively small, but very open economy that relied heavily on foreign trade, was dramatically influenced by fluctuations in commodity prices, and had a long history of foreign capital inflows to finance major projects.

The Bank of Canada's primary emphasis at that time was on the development of a government treasury bill market, to assist in the more effective implementation and transmission of monetary policy. In addition, the Finance Department, with the central bank as its fiscal agent, wanted to promote the development of a well-functioning government bond market. This would help to provide the government with low-cost and stable financing. Moreover, Canada had also moved to a floating exchange rate, and so it was even more important that our debt be issued in the domestic currency.

But the authorities also saw the financial system efficiency benefits that could flow from the development of a well-functioning government bond market. In particular, it would support development of, and access to, market-based credit for firms. The broader goal was to develop the foundation for an efficient domestic fixed-income market for private issuers.

Of course, our markets have been continually evolving, and so we have had frequent consultations with market participants. These consultations have led to the development of a well-functioning and liquid market for government debt right across the yield curve. This market provides the pricing benchmarks for all other fixed-income instruments and their derivatives, thus facilitating market access for firms seeking debt financing.

So what have we learned over the years? Well, experience has shown that in order to maintain an efficient, well-functioning local-currency debt market, it's helpful to focus on the key aspects of liquidity, transparency, regularity, and integrity in the structure of government bond and money markets. As such, our efficient government debt market contributes to overall capital market efficiency by providing key benchmark and hedging tools.

Now, in terms of financial system stability, the development of our domestic bond and money markets has led to stronger and sounder financial institutions. Stronger institutions and more complete markets facilitate better allocation of domestic savings. This increases domestic investment, and thus, encourages stronger economic growth.

Creating local-currency bond and money markets can insulate an economy from global economic shocks in two ways. First, by providing more stable and secure sources of liquidity. And second, and perhaps more important, it can allow for a better matching of the currency of obligations to the currency of receipts.

In addition to contributing to a more stable domestic financial system, the development of domestic-currency markets is important to promote *global* financial stability. Economies with a sound financial system can help to prevent shocks from spreading around the world. The Asian financial crisis of 1997-98 really helped to illustrate how a crisis can spread among economies with weak financial systems, including, in some cases, serious mismatches in foreign currency assets and liabilities. This is why policy-makers around the world have been putting a lot of emphasis on improving domestic banking and financial systems.

To develop a sound financial system requires several policy steps. The BIS Committee on the Global Financial System has outlined five key measures needed to develop deep and liquid bond markets. Allow me to list them. First, an economy must have a competitive markets structure; second, it must have liquid, benchmark bond issues; third, markets must be efficient, with low transactions costs; fourth, markets should be safe, sound and robust; and finally, it's important that there is a wide variety of market participants. I see from your program that these are issues that you will be talking about in more detail later this afternoon.

Ladies and gentlemen, I have spoken about how local-currency bond and money markets can help an economy, by giving the authorities incentives to follow good macroeconomic policies, and by supporting financial and economic efficiency. And, I've talked about how such markets can help in the development of a sound domestic financial system. This, in turn, can promote financial stability, both within a country and more broadly, in the global financial system. At the start of a conference like this, I thought it important to use my time to remind ourselves of *why* it is we need strong, local-currency bond and money markets. Speaking generally, the steps that Canada took in the past to develop its local-currency bond and money markets *may* be applicable to today's world, and to the various emerging market economies that are now trying to find their own path. But what is certain is that the original principles that guided us in creating those markets – liquidity, transparency, regularity, and integrity – are as valid today as they were 50 years ago.