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# Follow the Money: A Canadian Perspective on Financial Globalization

## Introduction

Thank you for inviting me to speak to you today. The movement of goods, services, people and money across international borders has always been controversial and seems to be becoming more so by the day. In this context, Canada needs to be fully engaged in the global dialogue. As a medium-sized country, we can only have an impact on this dialogue by bringing new ideas and careful analysis to the table. This is where the Centre for International Governance Innovation's contribution continues to be particularly vital.

Today, I would like to focus on one aspect of globalization: international capital mobility.

I'll start by opening up some basic questions associated with capital mobility and then review key trends in capital flows over the past few decades. I'll discuss the benefits and challenges of being open to capital flows and the policy tools that are being deployed by some countries to manage them. Finally, I'll take you through Canada's experience and the factors that have enabled us to conduct an effective monetary policy in the face of free capital mobility.

## Capital Flows: Servant or Master?

It is striking how perceptions of international capital mobility differ across countries.

In Canada, we take our ability to move funds across our borders for granted. Canadian investors hold US equities. Snowbirds open US bank accounts and run up bills on US credit cards. Canadian banks fund themselves in New York. Canadian companies borrow and issue shares in US markets. And our governments sell bonds to foreign central banks and other foreign investors.

There are, of course, certain types of transactions that are periodically a source of controversy—notably, foreign investment in Canadian real estate and certain foreign acquisitions of Canadian companies. But for the vast bulk of the capital

I would like to thank Mark Kruger for help in preparing this speech.

flowing across our borders, in both directions, most of us don't give it a second thought.

To draw the bigger picture: capital flows in and out of Canada in response to broader economic trends. At the present time, Canada is going through a complex adjustment to lower prices for oil and other commodities in the face of persistently weak demand for our non-commodity exports. We have had to rely on domestic demand to keep our economy growing. In that context, Canada as a whole is spending more than it earns from the rest of the world—a current account deficit. Capital is flowing into Canada, in various forms, to finance that deficit. The inflows are accommodating the needed economic adjustments that are taking place.

The experience of many emerging-market and developing countries has been quite different. Many of these countries have, at some time, faced the economic devastation of capital account crises, when sudden halts in foreign capital, often accompanied by capital flight by domestic residents, forces the economy through wrenching adjustments. In such episodes, capital flows take on a life of their own: they become a driver, rather than an enabler, of economic decisions. They can raise significant concerns for both economic and financial stability.

In many of these countries, capital flows are seen as driven mainly by external forces, in particular, the monetary policies of the major advanced economies. In the eight years since the global financial crisis, ultra-low interest rates and unconventional monetary policy in the United States, the euro area and Japan have created incentives to search for yield, which have led to large surges of foreign investment in many emerging-market economies (EMEs). There are concerns that these flows are not sustainable—that when monetary policies in the advanced economies return to normal, the flows could reverse in a disruptive way, particularly for those EMEs with weaker domestic fundamentals. We had a hint of that with the “taper tantrum” in 2013.<sup>1</sup> In the same vein, over the past week, market interest rates and capital flows worldwide have shifted sharply, along with changing perceptions of the direction of the economic policies of the United States.

Financial globalization raises another question: Can a central bank still conduct an effective monetary policy to fit its own circumstances and objectives? International capital mobility has given rise to a “global financial cycle” through which asset prices, longer-term interest rates and capital flows in many countries tend to move together. But long-term interest rates and asset prices are key transmission channels through which monetary policy affects the national economy. If these channels are compromised, policy could become less effective.

In Canada, we have been living with an open capital account for several decades. But our flexible exchange rate gives us room to conduct an effective

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<sup>1</sup> The term “taper tantrum” refers to how markets reacted in 2013 to comments by Federal Reserve Chairman Ben Bernanke that the Fed might slow down, or taper, the rate of bond purchases, which are part of its quantitative easing (economic stimulus) program.

monetary policy that is consistent with domestic conditions and promotes the economic and financial welfare of Canadians. In many other countries, however, there are legitimate concerns that their monetary policies may be overwhelmed by the global financial cycle. In this light, some have even argued that capital controls are a precondition for monetary policy independence.

In contrasting the Canadian experience with that of EMEs, we could conclude that capital flows are a good servant but a bad master. Being open to global capital flows is beneficial when it serves residents by creating a wider range of opportunities to save, invest and borrow. But it is harmful if it becomes a controlling influence on the economy and curtails the country's freedom to chart its own course. So how can a country learn to live with capital flows, to reap the benefits while insulating its economy from their effects and maintaining its policy independence?

## Overview of the Trends

Before I talk about recent trends, let's start with some basics—what we mean when we talk about gross and net capital flows.

Gross private *inflows* refer to net purchases of domestic assets by foreign residents. They are defined as the sum of foreign direct investment, portfolio inflows, derivatives inflows and other investment inflows (which include trade credit and bank lending). (Gross *outflows* are the reverse, net purchases of foreign assets by domestic residents.)

Gross flows, then, measure the extent and form of cross-border investment. They include foreign direct investment (FDI)—say, an American company buying a Canadian gold mine; portfolio flows—such as a Hungarian investor buying Ontario government bonds; and other flows—for example, a Canadian pension fund carrying out derivatives transactions in London.<sup>2</sup>

The net capital flow is the sum of these gross inflows and outflows and any change in the country's official reserves. This is a key macroeconomic variable: it is the mirror image of a country's current account balance, the difference between domestic savings and investment. Indeed, a net capital inflow is the way in which a current account deficit is financed.

Now, let me turn to the global trends.

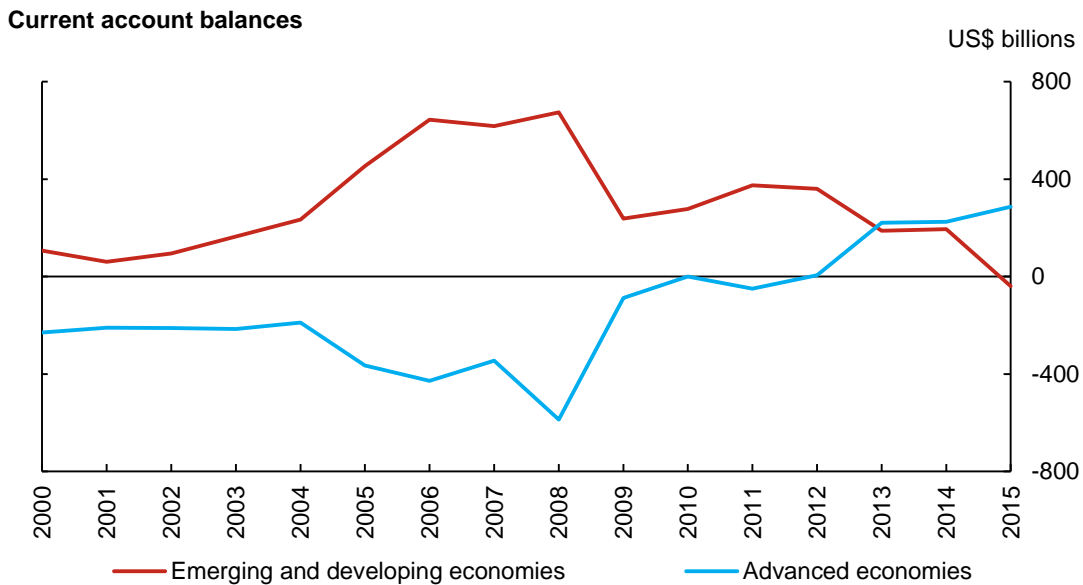
For much of the past decade and a half, advanced countries ran current account deficits and received funding from emerging-market and developing countries (**Chart 1**). This seems odd, since rapidly growing emerging economies surely had vast needs for investment—creating opportunities to earn much higher yields than those offered by investments in advanced countries. This counterintuitive flow of funds corresponds to large differences in national savings. In particular, while Chinese households and firms save a lot, those in the United States do not. These differences in savings rates, in turn, reflect a combination of factors,

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<sup>2</sup> FDI is distinguished from portfolio flows because it involves a resident of one country having effective control of real assets in another.

including the different stages of development of these countries' financial systems.<sup>3</sup>

### Chart 1: Poorer countries lent to richer ones for most of the past 15 years

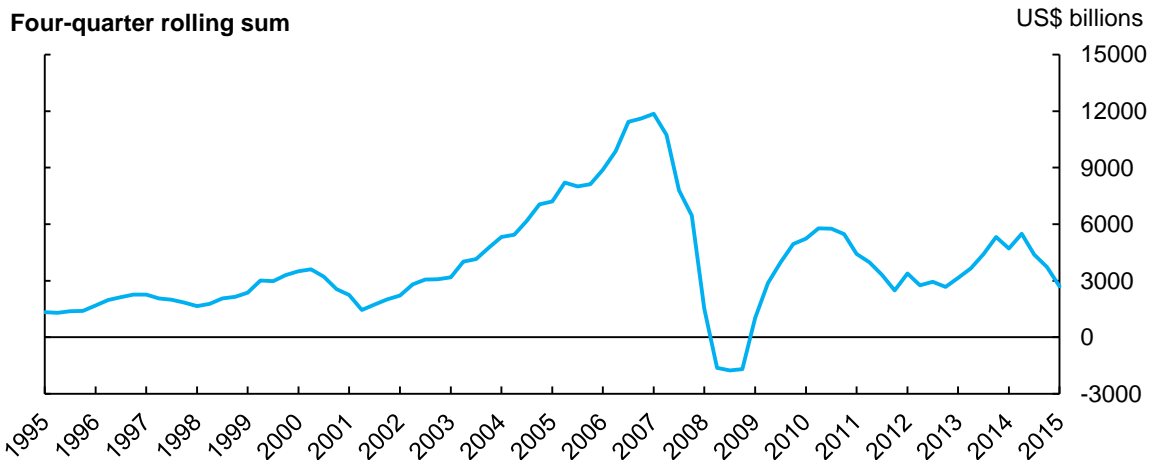


Sources: International Monetary Fund, *World Economic Outlook*, and Haver Analytics

Last observation: 2015

Over the same period, we saw a massive expansion in gross flows, a testament to rapidly increasing global financial integration. This process has been anything but smooth. Global gross flows more than tripled in the early 2000s, from just over US\$3 trillion in 2000 to close to US\$12 trillion in 2007 (**Chart 2**). The flows fell sharply in 2008–09 during the global financial crisis, recovered somewhat in 2010 and remain well below pre-2008 highs.

### Chart 2: World gross capital flows peaked in 2007



Sources: International Monetary Fund Balance of Payments Statistics and Haver Analytics

Last observation: 2015Q4

<sup>3</sup> This channel is analyzed in, for example, E. G. Mendoza, V. Quadrini and J. V. Ríos-Rull, "Financial Integration, Financial Development, and Global Imbalances," *Journal of Political Economy* 117, no. 3 (2009).

The composition of gross capital inflows also shifted considerably over this period (**Chart 3**). FDI has been the most stable form of capital flows, since it tends to be driven by longer-term corporate decisions. Portfolio flows are easier to liquidate than FDI and thus are often more volatile. Other flows, mainly banking flows, have been the most volatile of all. Bank lending is procyclical, rising in good times and falling in bad times. This is not only because banks respond to the attractiveness of lending opportunities, which are themselves procyclical, but also because they typically lever up to increase lending during booms and de-leverage during downswings.<sup>4</sup> After the global financial crisis, global bank lending dropped off sharply, since banks needed to repair their balance sheets and comply with more-stringent regulatory capital requirements.

So how does Canada fit in?

We have traditionally been a capital importer. Our current account balance—the difference between how much we invest and how much we save—has typically been in deficit to the tune of 2–3 per cent of GDP. We have depended on external financing to fund this gap. In the early 2000s, strong foreign demand and high commodity prices raised our national incomes, and we ran current account surpluses for a number of years. During those years we exported capital to the rest of the world (**Chart 4**). Since the global financial crisis, foreign demand has been on a weaker track and commodity prices are lower. Our current account is again in deficit and, once more, we are relying on capital imports from the rest of the world.

## **Benefits and Challenges of Financial Globalization**

As I've already mentioned, opening up an economy to capital flows brings both benefits and challenges.

### **Benefits**

The benefits of financial globalization are similar to those of free trade. Open borders create opportunities for transactions that benefit both parties because of their differences in endowments or preferences. For example, a country where a large share of the population is of working age can benefit from being able to channel its savings to other countries—a net capital outflow. As the country's population ages further and more of its citizens retire and start to draw on their savings, foreign assets are liquidated, generating a capital inflow from the rest of the world.

Cross-border investments, which give rise to gross capital flows, enable investors to diversify risk. Canada's pension funds have, for example, used international opportunities to effectively provide more-secure retirement income for Canadians.

FDI brings other benefits, since it bundles financing and know-how. This helps residents of the investing country use these capabilities where they can be most

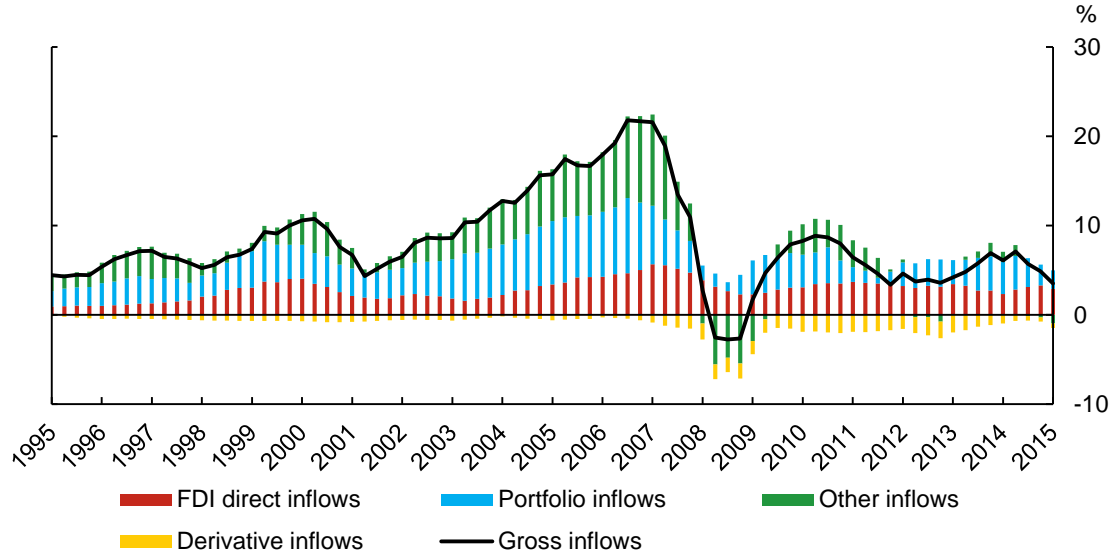
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<sup>4</sup> See Committee on International Economic Policy and Reform, *Banks and Cross-Border Capital Flows: Policy Challenges and Regulatory Responses*, September 2012.

productive and creates opportunities in the recipient country. Over the years, Canada has benefited from sizable flows of FDI in both directions.

### Chart 3: Banking flows are the most volatile capital flows

Per cent of group GDP, four-quarter moving average

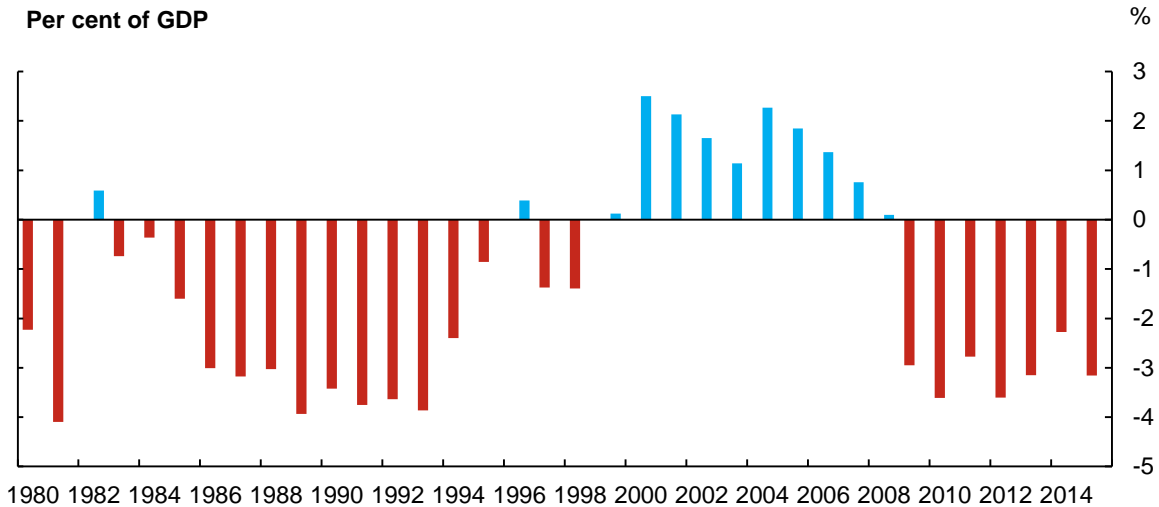


Source: IMF World Economic Outlook, IMF Balance of Payments Statistics, Haver Analytics and Bank of Canada calculations

Last observation: 2015Q4

### Chart 4: Canada's current account balance is once again in deficit

Per cent of GDP



Source: IMF World Economic Outlook

Last observation: 2015

Being open to capital flows can also have collateral benefits. It can catalyze competition, promote the development of the domestic financial system and provide a force for better governance. For example, foreign financial institutions can bring a healthy dose of competition, boosting the quality and bringing down the cost of financial services. An open capital account can also lead to improved corporate governance as companies bring their practices in line with what is required to attract and retain foreign investors. In the same vein, some countries, including Poland, the Philippines, Thailand and Malaysia, have used foreign inflows as a tool to broaden their investor base and develop domestic equity and

bond markets.<sup>5</sup> To the extent that these forces are at work, they should contribute to stronger productivity growth and higher living standards throughout the economy.

While these potential benefits of capital mobility are real, they are hard to pin down empirically. That is partly because they materialize over a longer time period.

## Challenges

At the same time, the challenges associated with financial openness are only too easy to identify. Take the examples of Mexico and Thailand in the 1990s and of Greece in the mid-2000s. The experiences of these countries taught that financial flows from abroad can fuel macroeconomic and financial imbalances that later unwind in a destructive way. A capital inflow surge can encourage unsustainable spending by domestic households, companies and government; this unsustainable spending is mirrored in a current account deficit. A sudden stop in those inflows—particularly if accompanied by capital flight, where a country's own residents move their assets abroad—results in a crisis that forces an abrupt contraction of domestic spending.<sup>6</sup>

Inflows of capital are often associated with a buildup of financial system vulnerabilities, which can have important consequences for financial stability. This is particularly the case where the domestic financial system is lacking the ability to efficiently intermediate large gross flows.

To the extent that there are weaknesses in a country's financial system, opening the capital account can feed those weaknesses and result in a larger buildup of imbalances. These can include currency, maturity and liquidity mismatches: in some instances, where liquid short-term banking flows denominated in foreign currencies are used to finance longer-term domestic currency lending, you get all three. Waves of foreign capital can also fuel credit booms, which are associated with mounting leverage and deteriorating credit quality. When the flows reverse, these vulnerabilities can amplify the effects on the domestic economy, in some cases triggering a wave of bankruptcies.

In theory, exchange rate flexibility should mitigate the risks associated with large net capital inflows. This was framed by Robert Mundell as a trilemma: a country cannot have an open capital account, a fixed exchange rate and an independent monetary policy; but with a flexible exchange rate, it can use monetary policy to

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<sup>5</sup> E. S. Prasad and R. G. Rajan, "A Pragmatic Approach to Capital Account Liberalization," *Journal of Economic Perspectives* 22, no. 3 (2008):149–172; R. B. Johnston, S. M. Darbar and C. Echeverria, "Sequencing Capital Account Liberalization: Lessons from the Experiences in Chile, Indonesia, Korea, and Thailand," IMF Working Paper No. 97/157 (November 1997); M. Rodlauer and P. N'Diaye, "IMF and PBC Joint Conference on Capital Flows Management: Lessons from International Experience, Summaries and Presentations," IMF, 20 March 2013.

<sup>6</sup> K. J. Forbes and F. E. Warnock, "Capital Flow Waves: Surges, Stops, Flight, and Retrenchment," *Journal of International Economics* 88 (2012): 235–251, distinguish between episodes of surges and stops (respectively, sharp increases or decreases in foreign inflows) and flight and retrenchment (respectively, large increases and decreases in domestic outflows).

stabilize its economy in the presence of international capital flows.<sup>7</sup> Consider the case of a country experiencing capital inflows. Its currency would rise in value, which—other things being equal—would have a negative effect on its net exports and on economic activity more generally. The country’s central bank, tasked with stabilizing the economy, would typically respond with a lower policy interest rate. The combination of a stronger currency and lower domestic interest rates would make foreign investments in the country less attractive, thus attenuating the capital inflows.

However, it doesn’t always work this way. Many countries do not allow their currencies to adjust fully. Indeed, credit booms typically occur in countries with fixed and managed exchange rate regimes.<sup>8</sup>

It is also possible that, even with a floating exchange rate, appreciations can perversely encourage further capital inflows, exacerbating the problem. This occurs through the “risk-taking channel.”<sup>9</sup> If domestic borrowers have local currency assets and foreign currency liabilities, an appreciation increases the value of their domestic assets and makes their balance sheets look stronger. This increase in perceived creditworthiness could lead to the provision of more foreign currency loans as capital inflows through the banking sector increase.

In a similar vein, it has been argued that, even with a floating exchange rate, a country’s financial conditions depend primarily on a global financial cycle, limiting a central bank’s ability to use monetary policy independently to influence its economy. One scholar thus argues that Mundell’s trilemma boils down to a dilemma: “Independent monetary policies are possible if—and only if—the capital account is managed, directly or indirectly, via macroprudential policies.”<sup>10</sup>

The most familiar examples of international capital flows enabling the buildup of domestic economic and financial imbalances come from EMEs. But this is not just a developing-country issue: think of the United States before 2008. The distorted incentives and regulatory weaknesses in the US financial system during that period are well known. In that context, the ability to borrow cheaply, at global interest rates reflecting high savings rates in China and other EMEs, contributed to a growing financial bubble. This pattern, and the ensuing financial crash in the world’s most sophisticated financial system, had many elements that are familiar from EMEs in the past.

To sum up, while there are known benefits to financial openness, a country can reap those benefits only if it avoids some important pitfalls. If a country has major distortions in its financial system, perhaps reflecting weaknesses in regulations, opening the economy to capital flows may just feed those distortions. To turn this

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<sup>7</sup> R. A. Mundell, “Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates,” *The Canadian Journal of Economics and Political Science* 29, no. 4 (1963): 475–485.

<sup>8</sup> E. G. Mendoza and M. E. Terrones, “An Anatomy of Credit Booms: Evidence from Macro Aggregates and Micro Data,” National Bureau of Economic Research Working Paper No.14049 (May 2008).

<sup>9</sup> H. S. Shin, “Exchange Rates and the Transmission of Global Liquidity” (speech at Bank of Korea-IMF Conference, Seoul, 11 December 2015).

<sup>10</sup> H. Rey, “Dilemma Not Trilemma: The Global Financial Cycle and Monetary Policy Independence,” London Business School, CEPR and NBER, August 2013.



around: a country may need to achieve a certain level of financial system soundness and standard of governance before it can fully reap the benefits of capital mobility.

Based on this logic, a number of researchers have suggested that there is a threshold: capital flows are beneficial only once a country has reached a certain degree of institutional and financial sector development.<sup>11</sup> Where those conditions are lacking—say, when financial regulation is inadequate or property rights are not fully protected—financial openness invites instability and, on the whole, can be detrimental to economic growth.<sup>12</sup> Above that threshold, capital flows can provide broader benefits, which can support rising living standards.

The threshold suggests that countries may choose two distinct strategies. One is to try to manage or control capital flows, or at least to cushion the economy and financial system from their impact. The other approach is to try to achieve the threshold. Of course, these strategies can be complementary if a country effectively manages capital flows to buy time to strengthen its domestic system.

## Capital Controls

The international view of capital controls has shifted over time. Most advanced economies maintained pervasive restrictions on capital movements during the period following the Second World War, but they opened their borders to capital flows during the 1960s through to the early 1990s. Liberalization was generally seen as irreversible: as one observer said, “You can’t put the toothpaste back in the tube.”<sup>13</sup>

While many developing countries maintained capital controls, the Washington Consensus saw liberalization as the right destination—albeit with important issues concerning pace and sequencing.<sup>14</sup> In contrast—and based on extensive international experience—capital control measures were viewed as distortionary and ineffective.

The role of capital controls is being reassessed in light of the experience of both the crisis and the subsequent capital flow surges associated with the monetary policies of the major advanced economies. In this context, capital controls are often viewed as a type of macroprudential tool to limit the resulting buildup of vulnerabilities. Used in combination with other macroprudential tools, it could give monetary policy a freer hand in maintaining domestic macroeconomic and price stability.

The reassessment is reflected in international discussions. In the autumn of 2011, G20 finance ministers and central bank governors drew up non-binding

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<sup>11</sup> G. Bekaert, C. R. Harvey and C. Lundblad, “Does Financial Liberalization Spur Growth?” *Journal of Financial Economics* 77, no. 1 (2005): 3–55.

<sup>12</sup> E. S. Prasad, R. G. Rajan and A. Subramanian, “Foreign Capital and Economic Growth,” *Brookings Papers on Economic Activity* 1 (2007): 153–230.

<sup>13</sup> Remarks by Morris Goldstein in presenting “Determinants and Systemic Consequences of International Capital Flows,” International Monetary Fund Occasional Paper 77 (March 1991).

<sup>14</sup> The so-called Washington Consensus refers to the idea of combining macroeconomic stability, trade and financial liberalization, and privatization.

“Coherent Conclusions for the Management of Capital Flows Drawing on Country Experiences.” These conclusions accepted that capital controls could be appropriate, provided they were temporary, targeted and transparent.<sup>15</sup> This was complemented by the development by the International Monetary Fund (IMF) of an “institutional view” that characterizes the role of capital controls as part of the macroeconomic policy tool kit.<sup>16</sup>

However, capital controls, like tariffs on trade, have spillovers to other countries. This suggests a need for governance similar to that for trade restrictions. The Organisation for Economic Co-operation and Development (OECD) countries have entered into a legally binding agreement—the Code of Liberalisation of Capital Movements—which is also open to adherence by non-OECD countries.

The G20 has established a working group on international financial architecture, which is focusing on managing the risks stemming from capital flow volatility. This group has highlighted a need for better data on the composition of capital flows to better identify currency and maturity mismatches. It is also supporting analytic work that draws lessons from countries’ experiences in capital flow management. A broader goal is to complete the global financial safety net—the set of financing arrangements available to countries faced with unexpected reversals of capital inflows. For example, the group is exploring the scope for contingent debt instruments such as GDP-linked bonds that would provide insurance to countries that may be faced with adverse shocks.<sup>17</sup> These measures to strengthen the safety net should make it less necessary for countries to resort to controls on capital outflows.

The emerging global consensus is that capital controls can be used under some circumstances to mitigate the buildup of financial vulnerabilities. But they should not be used to compensate for inconsistent or inappropriate macroeconomic policies. Their effectiveness varies and typically diminishes over time. For example, research at the Bank of Canada has found that capital control actions have only a limited impact on net capital inflows, monetary policy autonomy or the exchange rate.<sup>18</sup>

Finally, if controls are used to shore up an unsustainable exchange rate peg, they may exacerbate rather than stem volatility. This is the classic “one-way bet” scenario: the strategy creates the expectation that the exchange rate will eventually adjust, thereby inducing additional speculative capital flows.

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<sup>15</sup> This view was elaborated on in a 2011 speech by M. Carney, “The Paradigm Shifts: Global Imbalances, Policy, and Latin America” (speech to the Intern-American Development Bank, Calgary, Alberta, 26 March 2011).

<sup>16</sup> See IMF, *The Liberalization and Management of Capital Flows: An Institutional View*, 14 November 2012, available at [www.imf.org/external/np/pp/eng/2012/111412.pdf](http://www.imf.org/external/np/pp/eng/2012/111412.pdf).

<sup>17</sup> See “G20 Agenda towards a More Stable and Resilient International Financial Architecture,” available at [www.g20.org/English/Documents/Current/201609/P020160914405291681904.pdf](http://www.g20.org/English/Documents/Current/201609/P020160914405291681904.pdf).

<sup>18</sup> G. Pasricha, M. Falagiarda, M. Bijsterbosch and J. Aizenman, “Domestic and Multilateral Effects of Capital Controls in Emerging Markets,” Bank of Canada Staff Working Paper No. 2015-37 (October 2015).

## Living with an Open Capital Account

To summarize the argument so far: capital controls are available as a tool to cope with volatile capital flows—but they are, at most, a second-best tool. Over the past 20 years or so, many EMEs have adopted a different approach: they have taken action to prepare their financial systems and economies to cope with the free movement of capital. They have put their fiscal deficits onto a sustainable track, established credible frameworks for fiscal and monetary policy, developed deeper and more-liquid domestic financial markets and stronger financial systems, and tackled structural issues that impede growth. All of these actions reduce their vulnerability to capital flows.

In some respects, Canada’s experience has been similar. Around the time of the Mexican peso crisis in the 1990s, our dollar was sometimes called the “northern peso.” Our exchange rate and borrowing costs were buffeted by changing market perceptions of the financial strength of our governments and our banks.

That wake-up call caused us to put our house in order. In the wake of the failures of some small financial institutions, Canadian policy-makers strengthened the regulation of our financial system, taking the prudent, principles-based approach that today underpins the soundness of the system. The federal government cut the deficit and now has fiscal room to manoeuvre. And the Bank of Canada has adopted a clear target for monetary policy and has established its credibility around this target.

These actions have not completely insulated the Canadian financial system from the global financial cycle. Canada’s market-determined interest rates are heavily influenced by global term premiums—as examined in recent Bank of Canada research.<sup>19</sup> Despite that influence, however, the Bank of Canada retains the ability to affect those interest rates and other aspects of financial conditions in Canada.

One key element is the country risk premium. The currencies and assets of many EMEs contain risk premiums that reflect their creditworthiness compared with that of the United States. These risk premiums can be time-varying and correlated with the global financial cycle: they rise during “risk-off” periods and they fall during “risk-on” periods.<sup>20</sup> Canada’s credit risk premium has been reduced to a very low level as a result of our strong economic and financial fundamentals, which underlie our AAA credit rating (**Chart 5**). As a result, our asset prices and interest rates are less affected by the global financial cycle.

Many of Canada’s large gross flows of capital tend to be offset by other flows—contributing to our overall resilience. IMF research has shown that such offsetting flows are characteristic of countries with sound policy, well-regulated institutions, flexible exchange rates and open capital accounts—all of which are features of

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<sup>19</sup> G. Bauer, G. Pasricha, R. Sekkel and Y. Terajima, “The Global Financial Cycle, Monetary Policies and Macroprudential Regulations in Small, Open Economies,” Bank of Canada Staff Working Paper No. 2016-38, (August 2016).

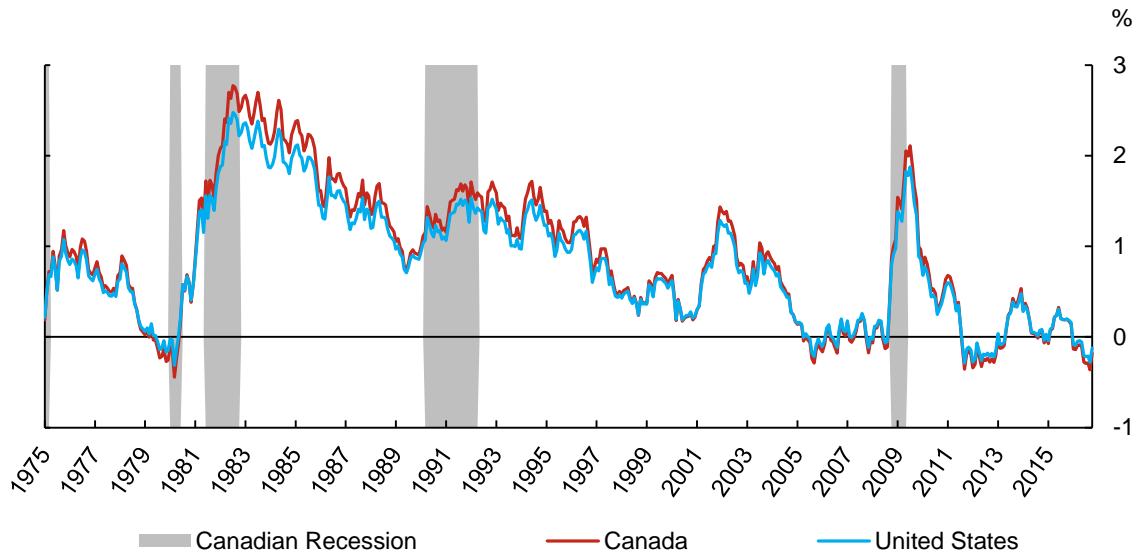
<sup>20</sup> B. S. Bernanke, “Federal Reserve Policy in an International Context,” (paper presented at the 16th Jacques Polak Annual Research Conference, Washington, DC, 5–6 November 2015).

Canada.<sup>21</sup> In contrast, capital controls may reduce resilience by impeding such offsetting flows.

Another factor that works in Canada's favour is that (unlike many EMEs) it is able to borrow in its own currency. This means that our national balance sheet does not have an excessive currency mismatch. Where such mismatches are important, exchange rate depreciations can be contractionary because the balance-sheet effects of a weaker currency inflate the size of national liabilities, overwhelming the expenditure-switching effects through the trade channel. In contrast, a depreciation of the Canadian dollar tends to support the Canadian economy. For example, the substantial depreciation of the Canadian dollar during the past few years has helped to cushion the Canadian economy by making our non-commodity exports more competitive. Being able to borrow in one's own currency, in turn, is a benefit of having a strong track record of sound macroeconomic and financial policies.

### Chart 5: Canada's risk premium has been reduced to a very low level

Risk premium on 10-year government bond yields in Canada and the United States, monthly data



Sources: Bank of Canada and C.D. Howe Institute

Last observation: October 2016

The credibility of Canada's monetary policy framework, together with our floating exchange rate, also gives us more room to respond to shocks that are likely to have a differential impact on the Canadian economy than on the United States.<sup>22</sup> For example, last year the Bank of Canada cut the policy interest rate twice, to help cushion the Canadian economy from the collapse of oil prices. We were confident that inflation expectations would remain well anchored despite the depreciation of the Canadian dollar that was occurring.

<sup>21</sup> IMF, *World Economic Outlook*, "Chapter 4, The Yin and Yang of Capital Flow Management: Balancing Capital Inflows with Capital Outflows," October 2013

<sup>22</sup> M. Obstfeld, "Trilemmas and Trade-offs: Living with Financial Globalisation," BIS Working Paper No. 480, Monetary and Economic Department, January 2015.

The global financial cycle and policy actions by the Federal Reserve can have important implications for Canada. These are, of course, factored into the Bank of Canada's monetary policy decisions. As a concrete (but still hypothetical) example, suppose the Federal Reserve were to make an upward adjustment to its policy rate. Such a tightening in US monetary policy would affect Canada through two main financial channels. It leads to higher market interest rates globally and thus in Canada (in a sense, a tightening effect for Canada). But it also leads to a stronger US dollar, which increases the competitiveness of our exports (in a sense, a stimulative effect for Canada). It is important to note that the economic setting for such an interest rate move also needs to be taken into account: the Fed's rate move would likely be made in response to a strengthening US economy, which is itself typically favourable for our exports.<sup>23</sup> The Bank of Canada would thus clearly need to take the net effects of the Fed's move into account, alongside many other factors, in making Canadian monetary policy. We could directly observe the effects on interest rates and exchange rates prior to making a policy decision. And certainly, we would not consider the implication of such a move by the Fed in any mechanical way.

The Bank of Canada's track record—delivering low, stable and predictable inflation for the past 25 years, in the face of many shocks affecting our economy—attests to Canada's ability to pursue an effective monetary policy in a world of globalized capital flows. We are free to adjust our policy interest rate in the context of Canadian economic conditions—and, in particular, do not need to move in step with the Federal Reserve. And that policy rate is transmitted effectively to stabilize the Canadian economy.

## **Conclusion**

I began these remarks by noting that Canadians have learned to live with an open capital account. That goes for policy-makers, too. While global interconnections are a major factor in gauging the effects of our policies, they do not circumscribe our ability to set our own course.

But the variety of international experience and our own past remind us that our resilience has been hard won; that, even now, not all countries are ready to benefit from financial globalization; and that we should be supportive of other countries as they take actions to safeguard their own economic and financial stability. A stable world is something from which we can all benefit.

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<sup>23</sup> B.S. Bernanke, "Federal Reserve Policy in an International Context." These effects are also discussed in Bank of Canada, *Monetary Policy Report*, October 2012.