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Statement by the Hon. **JAMES PETERSON**,
Temporary Alternate Governor of the Fund and the Bank for **CANADA** ,
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Statement prepared for The Honourable Jim Peterson
Secretary of State for International Financial Institutions, Canada

The current crisis in emerging markets has touched each and every one of our economies, and the risks facing the world economy are real and imminent. However, the situation can be managed if we act appropriately. In this regard, it is clear that the first line of defence against market turmoil has to be a strong macroeconomic and structural policy foundation.

The Canadian Picture

Canada has adopted a policy framework that has put public finances on a sound basis and kept inflation low. In doing so, we have laid the foundation for sustained economic growth and improved job creation, while at the same time limiting the disruptive effects of international financial turbulence.

Only five years ago, the fiscal deficit stood at $42 billion. The government said it would bring this deficit down steadily each and every year. And it did — not only meeting, but improving upon every target that was set. The deficit has now been eliminated.

Equally important, the debt-to-GDP ratio is now on a clear downward track. The government's Debt Reduction Plan will ensure that it will continue to fall. Under the Plan, the government is committed to balanced budget targets, backed by prudent economic assumptions and a $3 billion Contingency Reserve. In the years when the Contingency Reserve is not required, it will be applied to reducing the debt.

The Prime Minister has recently announced that for the current year (1998-99), any surplus that would accrue on the basis of existing programs and policies will be fully applied to the debt — in other words, the government will not be undertaking any new expenditures, beyond what has already been budgeted for. This will allow us to accelerate the reduction in our debt-to-GDP ratio.

The improvement in the fiscal situation that has been achieved contributed to stronger economic growth by reducing uncertainty and boosting confidence. The Canadian economy put in a solid performance heading into early 1998, growing by 3.7 per cent in 1997 and expanding at a similarly strong pace in the first quarter of 1998. Growth slowed to 1.8 per cent in the second quarter; although, as in the U.S., much of the decline reflected reduced inventory investment rather than lower final demand. Moreover, part of this weakness is explained by the G.M. strike, which had a major impact on automotive production in Canada and the U.S.

Nevertheless, by managing our affairs consistently and prudently, Canada's policy plan has, and will continue, to provide a strong basis for continued healthy growth.

But there is little doubt that the unsettled international environment has increased the downside risks to the Canadian economic outlook.

Indeed, Canada has been hit by the shock wave emanating from the emerging markets. The Canadian dollar fell from US$0.72 last September to about US$65 at the end of September 1998 – in part, because foreign exchange markets apparently perceive us to be much more dependent on commodity exports than in fact we are. Whatever the reason, the impact of the recent global financial turmoil would surely have been much greater if we were still running massive deficits, if our reliance on foreign lenders were still increasing, or if our interest rates were sky high and rising.

The World Economy and Canada's Six Point Plan

In the current global economic environment, there are a number of urgent policy priorities. These include helping to sustain global growth in the current crisis, responding to the needs of the poorest and most vulnerable, and reducing the risk of and improving our capacity to manage future financial crises.

In this regard, Canada has put forward a six-point program that addresses both the short-term problems raised by the current financial crisis, as well as the longer-term, underlying issues associated with open capital markets. The program includes:

1. The central banks of the developed world must pay close attention to the risk of a further slowdown in the global economy and be ready to act quickly to support continuing, sustainable growth, both at home and abroad;

2. A renewed commitment by the emerging market economies to implement the appropriate macroeconomic and structural policies;

3. Greater global attention to the needs of the very poorest countries;

4. Endorsement of measures to strengthen financial sector supervision through peer review;

5. Development of a practical guide or “roadmap” for safe capital liberalization; and,

6. Agreement to work urgently towards a better mechanism to involve private-sector investors in the resolution of financial crises, such as a standstill on debt repayment.

The first three points relate to what should be done to deal with the current financial crisis and lay the foundations for a return to sustained economic growth.

With respect to the first component of the plan, global growth prospects clearly have worsened, and the balance of risks now lies firmly on the downside. G-7 central banks need to recognize this important fact. Indeed, the presumption should be that central banks will reduce interest rates now if they can; if they cannot, they should be prepared to act quickly if the risks start to be realized and economic activity slows.

National authorities in emerging market economies must also ensure that they are taking appropriate action to restore stability and growth. Without good domestic policy on their part, no amount of effort by the international community is going to prevent periodic financial problems or promote sustainable growth.

While we have all felt the effects of the financial turmoil, the fragile economies of the world's poorest countries have been particularly hard hit, through the indirect effects of lower commodity prices and falling export demand. It is clear that we cannot ignore the real consequences for people in any crisis assistance or response package. The social implications have to be recognized up front and on a par with the economic response. The Bank, and particularly IDA, with its strong focus on poverty reduction, must lead in directly addressing concerns about the social impacts of financial crises. IDA's assistance at this time, particularly in such areas as primary health and education, is critical especially in light of the widely shared international consensus to reduce poverty by one half by the year 2015. Now, more than ever, it is important to ensure that IDA can fulfil its mandate to assist the world's most disadvantaged. To do so, sufficient resources must be available to carry out this challenge.

The fourth and fifth components of the plan aim to reduce the likelihood of future crises, while the goal of the sixth component is to make it easier to deal with crises that do arise.

Recent events have highlighted the importance of strong financial systems. At the Spring IC/DC meetings, Canada proposed a peer review process to help encourage the promotion and implementation of appropriate oversight and financial sector development. Over the summer, we have been discussing this issue at the G-7, G-22 and APEC fora and we are happy to note that the Fund and the Bank have found these proposals useful. IMF and World Bank officials have put forward specific proposals to incorporate a peer based surveillance mechanism in their work. This initiative will not prevent all chance of future crisis. However, greater information, increased transparency and a more sophisticated exchange of expertise will mean that financial crises in the future should happen less often, and be better contained.

The financial crises in Asia and Russia have also exposed some of the risks associated with open capital regimes. Our understanding of how best to manage the process of capital account liberalization is inadequate. Last May in Kananaskis, APEC Finance Ministers agreed to ask the IMF and the World Bank to study the experiences of countries that have undertaken capital market liberalization. Events since Kananaskis have only reinforced the urgency of such work. As a result, I believe the Fund and the Bank should assign a high priority to this project and report back to us in April 1999. The objective will be to codify best practice and provide policy makers in developing countries with a road map that will take them to the ultimate destination of liberalized capital account transactions – without suffering a deadly financial accident on the way.

Of course, these measures by themselves will not enable us to prevent every crisis. As a result, the international community, including the private sector, must be prepared to respond quickly and effectively when crisis resolution is required. The response should involve equitable burden sharing and limit moral hazard. In this regard, it may be necessary to consider appropriate standstill mechanisms. Ideally, a standstill would be engineered in a way that would not involve a default. What is needed is a contract-friendly cooling off period. One possibility would be for IMF members to agree to legislate an "Emergency Standstill Clause" in all cross-border financial contracts. Such a clause would be invoked only in extreme circumstances, where the withdrawal of short-term finance was severely hampering the restoration of financial stability. Given the complicated nature of this issue, the Fund could help our understanding by organizing a seminar with the private sector to try to forge a consensus on a range of measures that might be adopted.

Fund-Bank Collaboration

Achieving the goals of this plan will require greater and more effective collaboration between the Bank and the Fund. In this regard, recent experience suggests four key areas for particular emphasis:

1. Cooperation between the Bank and the Fund needs to be strengthened at all levels. It is not enough for the heads of the two institutions to meet together periodically -- staff across the institutions must also be engaged in this effort. Better sharing of data and analysis, joint preparation of policy papers and more missions representing both institutions are a good start to making this happen. Better cooperation and coordination between the two institutions is particularly important in crisis response situations in order to ensure that shorter term emergency financing does not undermine longer term development work.

2. Policy advice to member countries must be effectively coordinated. This does not mean that debate on policy issues should be discouraged, in fact I would argue the opposite. However, discussions between the two institutions must begin earlier, as programmes are being developed, not when they are completed. And, a genuine effort must be made to work out any differences in advance. In effect, it means the IMF and World Bank must be open and transparent partners in the policy-making processes. We have to "walk the talk" of transparency and good governance in our own institutions.

3. A clearer delineation of the roles and responsibilities of each institution is helpful. Generally speaking, the Fund will exercise surveillance over macroeconomic and stabilization policies, while the Bank will promote overall economic development, structural and sectoral reforms.

But we know that, in practice, overlap is sometimes unavoidable. In this respect, the proposed Liaison Committee, drawing on expertise from both the Bank and the Fund, is a step in the right direction. The challenge will be for the Committee to provide open and objective guidance, based on what is in the best interest of the country, rather than in the interests of any one institution.

4. Collaboration on financial sector reforms should be a priority. Strengthening surveillance of financial sector regulatory and supervisory regimes is a key area where the Bank and the Fund have indicated they will work together. Canada strongly welcomes these actions.

Partnership

Of course, the Bretton Woods Institutions can not work in isolation. They must co-operate more broadly with other international organizations, including the regional banks and the World Trade Organization, as well as the private sector, bilateral donors and with developing country partners. The strong emphasis by the Bank on the theme of partnership is particularly welcome; the trick will be to put partnerships into action on as broad a front as possible.

Let me conclude by noting that the global nature of the current crisis requires global solutions. Only by working together can we bring a degree of stability to international financial markets and aspire to return the world economy to a buoyant and sustainable growth path. While the outlook may look daunting, I am confident that, through imagination and flexibility, we will ultimately be able to meet this challenge.