One implication of the extensive foreign participation in Canadian financial markets is that economic events which take place outside Canada can have an immediate and/or more intense Canadian impact. The Japanese asset deflation that began in 1989 caused Japanese investors to reconsider their positions abroad, including their holdings of Canadian securities. The Japanese retrenchment continues. In September 1993, Japanese holdings of Canadian bonds declined to C$45 billion from C$49 billion a year earlier.

3. THE ECONOMIC POLICY IMPACT OF FINANCIAL INTEGRATION

As a proxy for an economy with internationally integrated financial markets, consider a situation of flexible exchange rates and mobile capital.[7]

3.1 Monetary Policy

The monetary policy transmission mechanism works in two steps:

- First, a change in the money supply causes a change in interest rates and the exchange rate.
- Second, a change in interest rates and the exchange rate causes a change in aggregate demand.

With flexible exchange rates and mobile capital, monetary policy becomes more effective. If the central bank restricts money supply growth and domestic interest rates rise, foreign capital will enter the country -- attracted by higher returns -- and the currency will appreciate. Higher interest rates reduce output in interest-sensitive sectors of the economy and the currency appreciation reduces output in tradeable goods.

As tradeables have expanded to account for a larger share of GDP, the trade sector has become relatively more important in the transmission of monetary policy. The interaction between rising interest rates (or falling rates), an appreciating currency (or a depreciating currency) and the reduction (or increase) in aggregate demand has grown in importance.

[7] A flexible exchange rate regime is key to the analysis which follows.