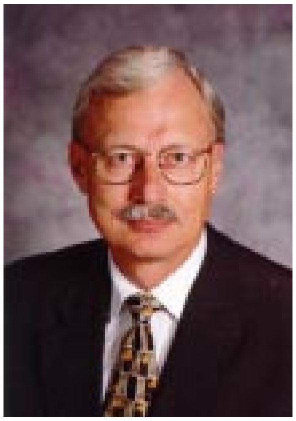
Gordon Thiessen



Statement from the Governor

Canada's economic performance improved considerably in 1999. In fact, it was much better than many Canadians had expected, considering the international difficulties we have had to face. Those difficulties began with the Asian financial crisis in mid-1997 and continued through the autumn of 1998 in the aftermath of Russia's default on its debt payments.

Why did we do so well last year when, in the past, Canada has typically had difficulty coping with adverse international shocks?

An important reason is that Canada's economic policy foundation is stronger today than it has been in several decades. There are two cornerstones of this foundation. One is the improved fiscal positions of governments that have led to a declining ratio of public sector debt relative to the size of our economy. The second is an environment of low and stable inflation that is expected to persist, given the Bank of Canada's target for inflation control.

For most of the 1990s, Canadian monetary policy has been based on an explicit target for controlling inflation. And I believe we are seeing the benefits of this framework. A clear objective for monetary policy and the Bank's firm commitment to that objective have helped to moderate fears of a resurgence of inflation. Inflation targeting has also helped the Bank to take timely action in response to changing economic and financial conditions and has improved our accountability for those actions. But most important of all, achieving a target of low and stable inflation is the best contribution that monetary policy can make to a productive, well-functioning economy.

A crucial part of our monetary policy framework focused on inflation control is Canada's flexible exchange rate regime. Without a flexible exchange rate, we could not have Canadian targets for inflation control. Moreover, exchange rate flexibility encourages and facilitates the necessary adjustments when the Canadian economy is hit by economic and financial disturbances. But this process works effectively only with the kind of solid economic policy foundation we now have.

Nonetheless, there will be times when large movements in the Canadian dollar may be a source of anxiety for Canadians. Indeed, the sharp decline in the external value of our dollar at the peak of the international financial crisis in 1998 was distressing to many. And it carried with it a potential loss of confidence among savers and investors in Canadian dollar assets.

But that was a highly unusual period of intense uncertainty and turbulence. Viewed more broadly from the perspective of how well the Canadian economy has come through the difficulties of the past couple of years, the adjustments in our currency were mainly orderly and illustrated the effectiveness of the exchange rate as a shock absorber. A good measure of its success in this role is that Canadian interest rates have remained lower than comparable U.S. rates, apart from the period of turbulence, reflecting our lower inflation rate and the greater room for economic expansion in Canada. In the past, a depreciation of our currency has frequently fed fears of inflation and has led to interest rate increases.

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The downward movement of the Canadian dollar from mid-1997 to the end of 1998 was largely a response to the sharp decline in world prices of the primary commodities that Canada exports. Our economy had to adjust to this reality; the exchange rate decline facilitated a shift in activity from the primary sector to manufacturing and other export sectors. It also provided an additional incentive for these sectors to take advantage of a strong U.S. economy. Because of these adjustments, the Canadian economy continued to expand during 1998 and recorded a substantial pickup in 1999.

During 1999, the global economy began to show signs of recovery. This was the result of steps taken by emerging-market economies to address their problems and of earlier reductions in interest rates by central banks in most industrial countries. And with the U.S. economy continuing to expand rapidly, commodity prices began to recover. By mid-1999, the Canadian economy had regained a strong momentum. Over the four quarters of 1999, the economy expanded by about 4 per cent, and 425,000 net additional jobs were created. By year-end, our economy was operating at close to full capacity, the trend of inflation was well inside the Bank's 1 to 3 per cent target range, and the Canadian dollar had rebounded to around 69 U.S. cents.

One lesson from this experience is that the present monetary policy framework—inflation-control targets and a floating exchange rate—is working well. During 1999, there were a number of proposals to adopt a different framework, based on a fixed exchange rate or monetary union with the United States. Proponents of such change need to explain how their alternatives would have worked better.

Important steps have been taken to increase the information available on international financial flows and on the financial positions of emerging- market economies. These initiatives are designed to make international markets work better.

Another lesson from the global turbulence of the last couple of years is the importance of international co-operation to reduce the likelihood of future crises and to establish mechanisms that would help us to manage better if crises do occur. Since mid-1997, the international community has worked hard to identify and promote ways to strengthen the international financial system. Important steps have been taken to increase the information available on international financial flows and on the financial positions of emerging-market economies. These initiatives are designed to make international markets work better. The importance of an appropriate exchange rate regime is now widely recognized. Many emerging-market economies have adopted, or are considering adopting, floating exchange rates as well as inflation targets to help them manage their economies. And emerging-market economies are now actively involved in new international forums, such as the Group of Twenty countries and the Financial Stability Forum. The activities of these two groups and the role played by Canada are described in more detail on page 36.

Let me now turn to the future and what we should expect from the Canadian economy. I am sure there are a number of questions and concerns on the minds of Canadians. Will the present economic expansion continue? Will living standards improve? By how much can our unemployment rate come down on a sustained basis?

A crucial element in all of this will be our economic productivity. Productivity in Canada has been rising steadily, but we have not narrowed the gap with the higher level of productivity in the United States since the early 1970s. And in the last few years, Canada has not shared in the sharp improvement that has taken place in U.S. productivity.

There are a number of positive signs. Our productivity growth has improved recently, and Canadian businesses have been investing heavily in machinery, equipment, and technology. These investment trends are similar to what occurred much earlier in the United States.

You can be certain that any decision by the Bank of Canada to adjust interest rates will be designed to ensure that our economy continues to expand in a sustainable way.

Uncertainty about the future growth of productivity raises an important issue for Canadian monetary policy. How much growth can we expect in the economy's production capacity? On the one hand, our low-inflation environment and the Bank of Canada's commitment to maintaining it give us more room than we have had for some time to explore the economy's full potential. However, because of the current strong momentum of the economy and the high levels of activity, the Bank must be careful to avoid approaching capacity limits too rapidly. We do not want to trigger bottlenecks and shortages that can put unnecessary pressure on inflation. Because of the time it takes for monetary policy to have its full impact on the economy, we can best achieve and maintain full potential if we approach capacity constraints gradually and carefully. This is likely to be the focus of Canadian monetary policy in the period ahead.

You can be certain that any decision by the Bank of Canada to adjust interest rates will be designed to ensure that our economy continues to expand in a sustainable way. I cannot stress enough that the preservation of a low and stable inflation environment in Canada is the major contribution that monetary policy can make to help our economy achieve its full potential.

I would also like to highlight several of the Bank's other activities in 1999.

Planning for the century date change was one of the Bank's main priorities during 1999. Bank staff worked with numerous groups from the Canadian financial sector. The necessary steps were taken to ensure that the Bank's critical systems were year-2000 ready. The Bank also put in place contingency plans, including arrangements to deal with possible liquidity needs of the financial system. And the Bank worked closely with financial institutions to prepare for possible increases in the demand for currency around the end of the year. These collaborative efforts paid off, and the Canadian financial system made a smooth transition to the year 2000.

PHOTO: BALFOUR PHOTOGRAPHY

Senior Deputy Governor Malcolm Knight and Beverly Ruddy from Banking Operations check out the new signature on a bank note.

Canada's new electronic system designed to handle large-value Canadian dollar payments began full operation in February 1999. Known as the Large Value Transfer System (LVTS), it now forms the core of the national payments system. This system is fully risk-proofed and represents a milestone in promoting the safety and soundness of Canada's financial network.

In 1999, the Bank also continued work on developing a new series of bank notes. Our efforts focused on taking full advantage of advanced security features that have been developed to deter counterfeiting. The Bank consulted widely with various groups on possible design themes for the new notes, the first of which will be issued in 2001.

I would also like to mention the retirement in 1999 of the Bank's Senior Deputy Governor, Bernard Bonin. During five years as Senior Deputy Governor and five years as a Deputy Governor, Mr. Bonin brought new insights to the Bank and made an important contribution to its restructuring.

Our new Senior Deputy Governor is Malcolm Knight, whose appointment by the Bank's Board of Directors was approved by the government, effective July 1999. Mr. Knight has spent most of his career at the International Monetary Fund, and all of us at the Bank appreciate the skills and experience he brings to his role as chief operating officer.

Finally, I would like to express my gratitude to the Bank's staff, who coped with the year's challenges with skill, creativity, and some very long hours.