Gordon Thiessen

Statement from the Governor

This past year has been difficult and worrisome for many Canadians. The crisis that began in Southeast Asia in 1997 turned out to be more persistent and serious than expected. During 1998, it spread to other countries, resulting in nervous and volatile financial markets throughout the world. This led to large outflows of funds from some developing countries. Overall, the expansion of the world economy slowed during 1998 and is expected to slow slightly more in 1999.

All too often during the year, however, assessments of the international situation and its implications for Canada were too pessimistic. Given the seriousness of the difficulties, we have coped with them better on this occasion than in the past. I believe that is because our economy is operating from a firmer base than it has for many years. Canadian businesses have invested in new technologies, governments are no longer absorbing savings to finance deficits, and inflation—with the benefit of the Bank of Canada's policy of inflation control—has been low and stable.

Nevertheless, the decline in the external value of the Canadian dollar through much of 1998 was a source of dismay for many Canadians. So it is important for the Bank of Canada to explain what happened and why.

In Canada, unlike other major industrial countries, we tend to make extensive comparisons of our prices, asset values, and incomes with those of another country—the United States. Thus, when the U.S. dollar was strong against virtually all world currencies during much of 1997 and 1998, many Canadians interpreted the Canadian dollar's decline in relation to the U.S. dollar as a reduction in their economic well-being. In reality, this general strength of the U.S. dollar had little to do with Canada but reflected the good performance of the U.S. economy and the attractiveness of U.S. investments in times of international crisis.

Other sources of downward pressure on the Canadian dollar were more specific to Canada, however. The international financial crisis had its most immediate impact on Canada through a sharp decline in the prices of the primary commodities that we export. While commodities make up a declining share of exports, they still represent over 10 per cent of the total production of our economy. So as commodity prices tumbled more than 15 per cent during the year, the economy was hit hard, especially in British Columbia. Not surprisingly, the Canadian dollar moved downwards in response.

This part of the depreciation in the value of our currency, related to the fall in the international prices we receive for our commodity exports, did reflect a decline in the economic prosperity of Canadians. But the cause was weak commodity prices rather than the currency itself.

The international community is taking steps to ensure that financial markets will have access to better information, that financial institutions will be better regulated, and that any future crises will be managed more effectively to limit their spread.

For the most part, the decline in our currency through to the end of July was orderly. In August, however, the crisis spread to Russia, and investors around the world became concerned about how much further it would spread. Financial markets became disorderly, and in Canada there were signs of a potential loss of confidence in Canadian dollar investments. The Bank of Canada acted quickly to head off such a possibility with a sharp increase in the Bank Rate.

Since then, official interest rates around the world have been coming down. And many of the fears among international investors have diminished. As a result, most of the dire predictions made during the early autumn of a "credit crunch," world recession, and deflation have moderated or been withdrawn. In Canada, the Bank Rate has come down, reversing three-quarters of its August increase.

Nonetheless, many developing countries were badly hit by the crisis. In addition, Japan, the world's second largest economy, is in recession and global economic activity is expanding more slowly. As a result, many Canadians are asking what is being done to prevent a further spread or a recurrence of the events of the summer and autumn.

There is no single, simple solution that would prevent such crises. But in the international community, a number of initiatives have been taken, and a series of changes are

Bank representatives at a meeting of G-10 Governors in Basle:
L-R: Hans Tietmeyer, Deutsche Bundesbank; Don Stephenson and Bernard Bonin, Bank of Canada; and Jean-Claude Trichet, Banque de France

beginning to be implemented. None of them is dramatic, and much remains to be done. Nonetheless, the international community is taking steps to ensure that financial markets will have access to better information, that financial institutions will be better regulated, and that any future crises will be managed more effectively to limit their spread. I believe these changes, which are discussed in more detail in this report, will help reduce future risks.

In the midst of all these international concerns, an important event for the Bank passed almost unnoticed. Early in 1998, the joint agreement between the federal government and the Bank on the objective of monetary policy was reaffirmed and extended. The target for monetary policy will continue to be to hold inflation inside a range of 1 to 3 per cent. This target was extended to 2001, when it will be reassessed with the objective of defining long-term price stability. It is important to underline that setting a target for inflation control does not mean that monetary policy ignores broader economic objectives. Low and stable inflation is the best contribution the Bank can make to encouraging a more efficient and productive Canadian economy as well as one that is more stable, avoiding large fluctuations in incomes and employment. This is the third agreement between the Bank and the government since formal targets were introduced eight years ago. I believe this reflects a growing consensus on the appropriate role of monetary policy.

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Later in this report, we discuss the Bank's continued success in holding the trend of inflation inside our target range through 1998. As I noted earlier, low inflation was one of the factors that helped the Canadian economy cope with the adverse international environment of the past year. While the growth of economic activity slowed markedly from the strong pace of 1997, the net increase in the number of jobs during 1998 was a remarkable 450,000, a substantially larger gain than in 1997.

We also discuss the year-2000 challenge and explain the actions we have taken to prevent potential disruptions to the Bank's operations. These actions should reassure the financial institutions that deal with the Bank, as well as the public, that the Bank's ability to meet its responsibilities will not be impaired.

More generally, I am encouraged by the actions that have been taken to date by the financial sector in Canada to deal with the year-2000 challenge. Serious disruptions are unlikely. Nevertheless, it is widely recognized that more work is required, and financial institutions are developing contingency plans so that they can respond quickly to unforeseen problems.

Another issue discussed in the report is the counterfeiting of Canadian currency. While the incidence of counterfeiting has increased, it has not reached levels where it is a serious concern. Nonetheless, with an eye to the future, the Bank has decided to prepare a new series of bank notes that will incorporate some of the anti-counterfeiting devices developed in recent years. Work is underway on a new note design, and we hope to present Canadians with the first of a series of more modern, technologically advanced bank notes within the next two to three years.

At the same time, we are increasing our efforts to educate people who handle currency, and we are co-operating with the RCMP and other police forces to identify false notes and stop counterfeiters as early as possible.

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In the Financial Summary, you will find an accounting of the review and restructuring of operations that the Bank has carried out over the last four years. This review resulted in more emphasis on core central banking functions and improvements in the way we perform them. A sharper focus on strategy, planning, and delegation has improved our ability to anticipate and respond to events. The review has also substantially reduced Bank expenses. The success of this undertaking reflects the quality and the energy of the Bank's staff, and I want to thank them for their exceptional performance.

Finally, I would like to draw your attention to the tribute at the beginning of the report to the distinguished career of Louis Rasminsky, Governor of the Bank from 1961 to 1973. He died in September 1998. I would like to record here the debt that those of us who have succeeded him owe to Lou Rasminsky for the high standards he set in the conduct of monetary policy and the management of the Bank of Canada, as well as for his role in setting out clearly the relationship between the Bank and the government that has been incorporated in the Bank of Canada Act.

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