Mr. Thiessen discusses international developments and the prospects for the Canadian economy Notes for remarks by the Governor of the Bank of Canada, Mr. Gordon Thiessen, in Saint John, New Brunswick on 5/2/98.

A year ago, in early 1997, prospects for global economic growth were very promising. World economic activity had strengthened and was expected to accelerate further, with the benefit of low inflation, reduced fiscal imbalances, and stable or declining interest rates. In Canada too, output and employment growth had picked up. And the economy was expected to gain momentum in 1997, supported by strong US demand and the lowest domestic interest rates in many years. Low inflation and a dramatic improvement in our fiscal situation had made those low interest rates possible.

Today, the views about the global economy are more mixed. The buildup of events in Asia since last summer has cast a cloud over the economic picture. The International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) have scaled back their projections for world economic growth this year. In early December, they suggested that global output growth could be ¾ to 1 percentage point slower in 1998 than previously expected.

But the news on the external side is certainly not all negative. There have also been some positive surprises recently. For example, the underlying economic momentum in our major trading partners, other than Japan, looks to be stronger than expected a few months ago. And longer-term interest rates have been declining in most industrial countries, which should help underpin global economic expansion.

Today, I would like to give you an update on the Canadian economy and discuss the prospects for the period ahead in light of the latest international developments.

My conclusion and main message is that, even with the current uncertainties on the external horizon, Canada’s economic outlook remains positive. An important basis for this conclusion is that the underlying foundations of the Canadian economy are sounder than they have been for many years. Thus, we are in a better position to weather the impact of unexpected international developments and to make progress in generating higher incomes and employment.

How did we do in 1997?

Let us start with a quick look at our economic performance in 1997. Based on the most recent information available, the Bank of Canada estimates that the Canadian economy expanded at a rate of about 4 per cent from the fourth quarter of 1996 to the fourth quarter of 1997. Exports were the mainstay of the economic recovery until mid-1996; but since then the expansion has become more broadly based. Over the past year and a half, spending by Canadian households on consumer goods and by businesses on investments in technology and new equipment has been the driving force in the economy.

The strong pickup in economic activity has also contributed to a substantial increase in employment. Over 380,000 new jobs were created in the private sector last year, offsetting many times over the 13,000 jobs lost in the public sector because of restructuring. Even more encouraging is the fact that a good part of this increase in employment represented full-time jobs. Moreover, the unemployment rate fell to 8.6 per cent by year-end from 9.8 per cent at the end of 1996.

Inflation has remained low, and within our target range of 1 to 3 per cent for most of 1997, although it did end the year somewhat below target. Some of the factors that contributed to this recent greater-than-expected slowing in the trend of inflation are of a temporary nature and are expected to unwind in coming months. But some of the other dampening influences at work may be more persistent than seemed likely earlier. So, although we see the trend of inflation moving back inside the target range in the near future, on balance it will probably be somewhat lower in 1998 than previously expected.

I would also like to underline the additional progress made during the year in the area of public finances, where government deficits have been further reduced. More importantly, the ratio of public debt relative to the size of our economy is finally falling. This is a major contribution towards the sounder economic foundations that I mentioned earlier.

Altogether then, 1997 turned out to be a good year for the Canadian economy.

Prospects for 1998 and the 'Asian factor'

But what about prospects for the current year? How important are the latest international events when viewed from a Canadian perspective? And what is their likely impact on our economy?

There is no doubt that what started as financial turbulence related to difficulties in Thailand has become a more widespread problem than anyone would have thought likely some months back. An erosion of market confidence led to strong downward pressure on exchange rates and to sharply higher interest rates in the affected South-East Asian countries and, subsequently, in South Korea. These market difficulties in turn uncovered and exacerbated financial and economic weaknesses that had been plaguing these countries for some time.

The international community, including Canada, has taken steps, primarily through the IMF, to help these countries deal with their problems. Some of the initial uncertainties involved in setting up and getting these IMF adjustment programs going have been resolved. And there are now some encouraging signs of improved confidence and financial stability in the region.

Among the industrial countries, Japan is the one most affected by the spillover effects from its Asian trading partners. Not only are its trade links with them important, but this external shock comes at a time when the Japanese domestic economy is much less buoyant than was anticipated earlier. Substantial loan exposure by Japanese banks to the Asian region has also weakened an already ailing financial sector in that country. But it is important to note that Japan has the financial wherewithal to deal with its banking difficulties and that a series of measures to combat these problems and to strengthen the economic recovery have already been taken. Additional financial sector and fiscal measures were announced recently.

At this stage, the situation in Asia is still evolving, and, while prospects have improved, we cannot be sure just how quickly and effectively the South-East Asian, Korean, and Japanese economies will respond to the adjustment measures that have been taken.

What about the potential effects of all this on Canada? Since our trade with Asia, including Japan, makes up less than 10 per cent of our total exports, the direct effects will be relatively modest. But we must also take into account the indirect effects that work through our other major trading partners and through the prices of some of the products we sell abroad.

Indeed, the implications of the Asian crisis for global economic growth and for primary commodity prices on world markets will probably have a more important impact on Canada than the reduction of our exports to Asia.

The fallout from Asia will no doubt have a dampening effect on Canadian output growth for the current year. But there are also other, more positive, developments that could well work to mitigate this effect. As I said before, economic performance in our major trading partners in the West, particularly the United States, has been somewhat stronger than anticipated. And even though our short-term interest rates have risen, Canadian longer-term rates have been falling, along with their counterparts in the United States and Europe, reflecting declining inflation and lower inflation-risk premiums. These longer-term rates are an important element in both business investment decisions and household spending on consumer durables and housing.

The Bank continues to monitor the situation carefully and to appraise the overall effect of these positive and negative influences on our economy. It is clear, however, that economic growth in 1998 will not be as robust as appeared likely last fall. And some Canadian regions and industries, particularly those with heavier reliance on primary commodities and exports to Asia, will no doubt feel the impact more than others. As well, there are the economic effects of the recent ice storm in Eastern Ontario, Quebec, and the Maritimes to consider. But I want to stress that, for the economy as a whole, the outlook is still favourable for continued expansion in output and employment, and for a further gradual reduction in the margin of unused capacity.

Recent developments in international financial markets

Next, I would like to say a few words about recent developments in world financial markets. The key feature of these developments has been the sharp appreciation of the US dollar. Measured against all major currencies, the value of the US dollar has risen by about 4 per cent since late September. Two main factors have combined to push the US dollar up. The first is the remarkable strength of the US economy relative to the economies of its major trading partners. Indeed, the US economy has been expanding more rapidly and operating at higher levels of capacity than were thought to be sustainable in the past. The second factor is the attraction that the large, efficient, and liquid US financial markets hold for nervous investors in search of a safe haven because of the events in Asia.

The dampening effect of the Asian problems on expectations for primary commodity prices has also been a factor behind movements in the currencies of countries, like Canada, that are important producers and exporters of such products.

With all this going on, the Canadian dollar has declined by just under 5 per cent against the US dollar since late September. Because other major currencies have also fallen against the US dollar during this period, the Canadian dollar has declined much less against these currencies. Nonetheless, given the importance of our trade with the United States, the effective value of the Canadian dollar, measured on a trade-weighted basis against all the major G-10 currencies, has declined significantly in recent months.

This decline in the value of our currency led to a further substantial easing of monetary conditions. But, as I said before, even with the effects of the Asian crisis, the Canadian economy is on track to continue expanding and moving towards full use of its potential. In these circumstances, the extent of the recent further monetary easing was not appropriate. That is why we moved last week to re-balance monetary conditions, and to provide support for the Canadian dollar, by raising the Bank Rate by ½ of a percentage point to 5 per cent.

It is probably too early to be drawing conclusions and lessons from this latest episode of world financial turbulence. Still, when it comes to Canada, it is worth noting the different reaction in domestic financial markets this time compared with our experience during the Mexican currency crisis of early 1995. Back then, the international financial turmoil had the effect of focusing market attention on Canada's fiscal problems, causing investors to demand higher risk premiums. And this led to sharply higher longer-term rates in Canada. This time, as I mentioned, domestic longer-term rates have been falling, along with comparable rates in the United States and Europe, to their lowest levels in 30 years.

What this tells me is that it pays to have one's house in order. Now we can see more clearly the importance of the remarkable progress that has been made since 1995 in fiscal deficit reduction. A declining ratio of public debt relative to the size of our economy will help to further reduce our vulnerability to international shocks.

From a monetary policy perspective, the best contribution your central bank can make to helping the economy cope with external shocks is to ensure that inflation remains under control. Nothing is as important to investors, especially during turbulent times, as the assurance that comes from the protection that low and stable inflation provides for the value of money.

Concluding remarks

In closing, let me reiterate that, in view of the uncertainties involved, it is difficult at this time to make precise assessments of the likely effects of the Asian crisis on the Canadian economy. But in making judgments about our economy, we must also consider the positive influences of the economic momentum in many of our major trading partners, as well as the prospects for domestic demand in Canada.

The main factors at play in the outlook for domestic demand suggest that business and household spending should continue to grow. In particular, monetary conditions are very stimulative, providing considerable encouragement for expansion.

All in all, the economic outlook remains positive. And with our low inflation rate and greatly improved fiscal position, the Canadian economy is now in better shape to withstand the impact of the Asian crisis and to continue to make headway in improving the well-being of Canadians.