Mr Thiessen reviews the challenges for Canadian monetary policy in the Year 2000

Remarks by Mr Gordon Thiessen, Governor of the Bank of Canada, to the Greater Charlottetown Area Chamber of Commerce, Charlottetown, Prince Edward Island, on 2 November 1999.

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Monetary policy actions take a relatively long time to affect the economy and inflation - anywhere between 12 to 24 months. Because of this, central banks must always look ahead and must put in place today the monetary conditions that are needed to help keep the economy on a sustainable path down the road. By “sustainable” I mean a situation where economic growth and job creation are not at risk from rising inflation.

It is in this forward-looking context that I would like to talk to you today about the challenges that may face Canadian monetary policy in the Year 2000.

First, of course, is the turn of the century itself. So let me start by saying a few words about Year 2000 readiness in the Canadian financial sector.

Year 2000 preparations

As I said in Regina a little over a month ago, the Canadian financial sector has done its Year 2000 homework - and, I might add, done it very thoroughly. The Bank of Canada and providers of financial services are confident that Canadians can expect “business as usual” in the financial sector as we head into the Year 2000 and beyond.

The critical systems of financial institutions, including those systems that support automated banking machines, credit and debit cards, and telephone banking, have been modified where necessary and tested. Providers of infrastructure services to the financial sector (for example, electricity and telecommunications) have also reported that they are Year 2000 ready. And major Canadian deposit-taking institutions have guaranteed the safety of their clients’ accounts and records from any Year 2000 computer-related disruptions. The Bank of Canada has given the same guarantee to holders of Canada Savings Bonds.

Even so, retesting of systems and contingency planning will continue right up to, and including, the New Year’s weekend.

Right now, the Canadian financial sector is so well prepared that the major issue is no longer one of potential technical problems. Rather, it is a matter of dealing with a possible overreaction to Year 2000 fears that could be more disruptive than the Year 2000 problem itself.

With this in mind, the Bank of Canada has built up a large inventory of banknotes. This is not because we think that Canadians will actually experience widespread problems using means of payment other than cash, such as credit and debit cards, over the New Year’s weekend. Not at all. Rather, this larger-than-normal inventory, together with the preparations made by the Bank and by private sector institutions that are responsible for distributing banknotes, is intended to reassure Canadians that, should some people decide to stock up on cash, the financial sector will be able to respond. By taking these actions, and by publicizing them, we hope to ease any public concerns in this area and so reduce the likelihood that we will actually need to use these extra banknotes.

We have also made contingency arrangements to ease potential liquidity concerns in the business and financial sectors. Of course, the primary responsibility for contingency plans to meet possible liquidity needs rests with financial institutions. In addition to these private sector preparations, the Bank of Canada has set up a special liquidity facility to address any worries financial institutions may have about being hit with extraordinary demands for liquidity from their customers. And we are widening the range of collateral they can use to secure loans from the Bank. We have also announced arrangements to prevent any unusual liquidity demands from putting upward pressures on money market interest rates in Canada around the end of the year. So, there should be no reason for any material Year 2000 risk premium in Canadian interest rates.

In summary, the Canadian financial sector is well-prepared for the century changeover. All participants, including the Bank of Canada, have made contingency arrangements. Should unexpected glitches develop, these arrangements will provide a quick, effective response to minimize any disruptions. More importantly, they should bolster the confidence of Canadians in the financial sector's ability to operate normally. And this should ease Year 2000 fears and reduce the likelihood of an overreaction.

I would like to reiterate what I have said before: when it comes to financial matters, I see no reason why Canadians should prepare for this coming New Year's weekend any differently than for any other long weekend.

I would now like to turn to the economy and monetary policy.

The current economic situation

The Canadian economy has bounced back from the global financial crisis of 1997–1998 and its negative impact on the prices of the key commodities we export. Indeed, when the numbers for the third quarter of 1999 are out, I expect that they will show that output has expanded by over 4% since the third quarter of 1998. And the unemployment rate has continued to fall over the past 12 months - from 8.3% to its current level of 7.5%.

A number of factors have contributed to this economic rebound.

Commodity prices have turned around, responding to the ongoing strength in North American demand and improved economic prospects in Europe as well as in Japan and the other Asian countries most hurt by the financial crisis. While energy prices have shown the sharpest recovery so far, prices for base metals, potatoes, shellfish and forest products, all of which are important in Atlantic Canada, have risen as well. Still, the prices for certain other key commodities, such as grains and oilseeds, remain soft, plagued by large global supplies and weak demand.

Another factor that has been supporting economic activity in Canada is the amazing strength of the US economy, our major export market. That economy has had a remarkable eight-year-long expansion, marked by vigorous growth in production, strong gains in employment, and low inflation. Inflation has been held down by improvements in productivity as well as special factors such as a strong US dollar, low commodity prices and intense global competition.

Stronger domestic demand has also been instrumental in Canada's economic pickup. Indeed, the stimulus from spending by Canadian households and businesses has been growing recently in response to high levels of confidence, rising employment and relatively low interest rates.

Behind all this, of course, has been our environment of low and stable inflation, which has helped our economy perform well despite the global financial difficulties.

But what about the outlook for the Canadian economy over the next year? How does it shape up?

Let me begin with the US economy. We currently expect that growth there will slow to a more sustainable pace next year. This will reduce the risk that US inflation pressures will intensify. Although the US market will no longer provide the same strong stimulus for our exports, we are now beginning to see stronger economic activity in Europe and Japan that should partly offset a slowing in US demand.

As for domestic spending in Canada, the recent momentum is likely to continue.

With respect to inflation, the total consumer price index has risen recently. But that is mainly the result of the recent increases in world energy prices passing through to retail prices for gasoline and natural gas. Those increases now seem to be coming to an end. There has also been upward pressure on prices from the effects of the earlier depreciation of the Canadian dollar. The core rate of inflation (total CPI, excluding food, energy, and the effects of changes in indirect taxes) is currently near the middle of our 1% to 3% target range.

Overall, this is a positive economic picture as we go into 2000. But as I said earlier, monetary policy must be forward-looking. So central bankers are always peering into the future, looking for potential concerns. After all, it is our job to worry! And there are some rather significant risks to this positive economic scenario to worry about.

Potential challenges for Canadian monetary policy

There are a number of challenges that the Canadian economy and monetary policy may have to face in the coming year. Today, I would like to highlight two that are particularly important.

The first challenge concerns the implications for Canada of the ongoing strength of the US economy. The second relates more to our own domestic situation as the Canadian economy begins to operate at what is estimated to be full production capacity.

Let me start with the issue of the prolonged vigorous expansion of the US economy. This extraordinary performance presents the US monetary authorities with the difficult task of ensuring that it does not lead to overheating and rising inflation. The Americans have already raised interest rates twice over the summer. What would be the implications for Canada if the US economy does not start to slow and the US central bank has to raise interest rates further?

In these days of close global integration, developments in the United States - the world's largest economy - are bound to have a major effect on national economies everywhere. This is especially true for Canada. Our proximity and strong economic ties with that country mean that the state of the US economy and any associated monetary policy actions will certainly affect us.

But there is no automatic rule as to how the Bank of Canada should respond if the US Federal Reserve raised interest rates. We would have to examine carefully the strength of the economic expansion in the United States and the associated price pressures behind such a move by the Fed. The challenge for the Bank would be to assess the implications for our economy and for financial markets. If it looked as though these developments would have a significant effect on Canada and lead to upward pressures on prices here, our objective of keeping inflation within the target range might be jeopardized. In that case, the Bank of Canada would certainly respond. Let me be as clear as I can on this - our current healthy economic expansion will continue only if we sustain a low and stable inflation environment.

A more difficult scenario for Canadian monetary policy would be an actual outbreak of inflation in the United States next year. Let me hasten to add that I think this is rather unlikely, given the past success of the US monetary authorities in keeping inflation under control and their resolve to continue to do so. Nonetheless, it is important that we be prepared for all contingencies. The first thing the Bank of Canada would have to do in such a case is to ensure that the US inflation psychology did not cross our borders. That would mean making it absolutely clear that we would strongly resist movements in the underlying rate of inflation in Canada that risked taking it outside our target range.

Once it became evident that the US inflation rate was persistently rising relative to ours, the Canadian dollar should start to rise in value against its US counterpart. Indeed, with such an adjustment in the Canadian dollar, our floating exchange rate would be playing its proper role in providing an important element of insulation for Canada from those rising US prices. And monetary policy should be ready to encourage that process, if necessary, to prevent a spillover of inflation.

You would be right to gather from what I have said so far that the best news we can all hope for is a "Goldilocks" US economy - not too hot, not too cold. This basically means an economy that slows down to a steady, sustainable pace of expansion that keeps it off the boom-and-bust roller-coaster.

The second challenge I want to talk about today is how Canadian monetary policy should operate as our economy gets close to the full use of its production resources. Whether because of persistent US demand for our exports or strong momentum in spending by Canadian households and businesses, we will very soon reach levels of economic activity that, based on typical measures of our production potential, appear to be at full capacity.

Ideally, we want to see the economy operating at a level that is as close as possible to full potential. At this level, the economy can deliver a low and stable rate of inflation - one that is neither rising nor falling persistently. And economic activity is expanding at as rapid a pace as is sustainable over time.

Unfortunately, in practice, it is very difficult to estimate precisely where this ideal operating level is. And this gets to be even trickier after a period of business restructuring, rapid technological change, and strong business investment in plant and equipment. This is what happened in Canada during the 1990s. And it may have raised our economy's production capacity, although we cannot be sure by how much.

Given the current momentum in our economy and the high levels of activity that we are seeing, and because of the uncertainty surrounding the conventional estimates of potential output, monetary policymakers must be on guard. In other words, we are at the point in the economic cycle where the Bank of Canada will have to be very alert to early warning signs of accumulating price and cost pressures. And we will have to respond promptly and firmly if any such signs emerge.

The Bank will deal with this risk by closely monitoring a wide range of indicators that can help it to assess the extent of present and future pressures on capacity and on inflation. These indicators include unanticipated movements in current inflation, changes in expectations of future inflation, the growth of money and credit, and information gathered from the Bank's regular contacts with businesses across Canada.

In conclusion, let me say that you can be assured that the Bank is very sensitive to the increased risks of inflation that are coming from continued buoyant growth in the United States, improved economic prospects in Europe and Japan, and the increased momentum of domestic spending here in Canada.

In facing the various challenges that may arise over the next year, it will be crucial to ensure that the Bank continues to deliver a trend of inflation that is inside our target range of 1% to 3%. It is only when Canadians can count on inflation staying low and stable that our economy performs best.