Mr Thiessen gives an update on the Canadian economy and on the state of Year 2000 readiness in the Canadian financial sector

Speech by Mr Gordon Thiessen, Governor of the Bank of Canada, to the Chamber of Commerce Regina, Saskatchewan on 23 September 1999.

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It is always a pleasure to return and speak to people in my home province. This time, we are here for a meeting of the Bank of Canada's Board of Directors. Once a year, our Board meets outside Ottawa, in a different part of the country. This year, we are delighted to be in Regina.

Today, I would like to give you an update on the Canadian economy – its recent performance and its prospects. I would also like to brief you on the state of Year 2000 readiness in the Canadian financial sector.

The recent performance of the Canadian economy

Here in Saskatchewan, you know only too well that the last couple of years have been difficult for the Canadian economy, especially for producers of primary commodities. But there is reason for optimism as we look ahead. To fully appreciate why, we need to understand the international shocks that have buffeted our economy since mid-1997 and how we have dealt with them.

The global financial crisis, which started in Southeast Asia in mid-1997 and spread to other countries during 1998, led to a sharp decline in the world prices of primary commodities. By this time last year, the average price (in US dollars) of key commodities produced in Canada had fallen by about 20% over the course of the previous 18 months.

And when Russia declared a standstill on the servicing of its debt in August 1998, the effects were felt far and wide. Conditions tightened in financial markets everywhere. Many highly rated corporate borrowers in the industrial countries were faced with a reduction in the availability of credit and with higher borrowing costs – the same conditions that faced governments from emerging-market economies.

Nevertheless, the Canadian economy has fared surprisingly well over the past year. Of course, we have not experienced booming conditions. Indeed, some of our primary sectors, such as farming, continue to struggle with low prices. Grain prices, in particular, have been plagued by ample global supplies and weak demand. But, on the whole, the economy has performed well. I expect that when the numbers for the third quarter of this year are out, they will show that output has grown by about 4% since the third quarter of 1998. This compares with growth of only 2½% over the same period the year before.

To be sure, the economic impact of the Asian crisis on Canada has been moderated by the strength of the US economy and by the prompt response of major central banks, particularly the US Federal Reserve, to the global financial difficulties. And the efforts made by emerging-market economies in Asia to deal with their problems have helped to gradually repair confidence and improve world economic conditions.

Although these positive developments are certainly important, it is also true that we have coped better with this crisis than in the past because our economy is now operating from a firmer base than it has for some time. This reflects a number of fundamental improvements in our economic structure. I would highlight three in particular:

- first, our low-inflation record and the Bank of Canada's commitment to keeping inflation low;

- second, the virtual elimination of government deficits and the beginning of a downward trend in the high level of public debt to the size of our economy (as measured by the ratio of public debt to GDP);
- third, the major restructuring of Canadian businesses during the 1990s in response to stronger global competition and to technological change.

It has not, of course, all been smooth sailing. You will recall that throughout the summer of 1998 our currency kept losing ground in reaction to the sharp fall in commodity prices, which was made worse by the fallout from events in Russia. And with signs of a potential loss of confidence in Canadian dollar assets, the Bank of Canada moved to raise short-term interest rates significantly in August 1998.

But once we got through that period of unusual global turmoil, we were able to reverse that increase rather quickly. Consequently, Canadian interest rates for all maturities fell back to levels below those in the United States, consistent with Canada's lower inflation rate.

The downward movement in the Canadian dollar, besides softening the impact on our resource sector, encouraged a rather prompt increase in exports of manufactured goods. This helped to compensate for the reduction in receipts from commodity exports. With this shift of economic activity out of the resource sector and into manufacturing, conditions in the labour market did not deteriorate as one might have expected. In fact, the unemployment rate has continued to decline over the past 12 months – from 8.3% to its current level of 7.8%. And despite the loss of jobs in the resource sector, close to 350,000 net new jobs have been created across the economy over this period.

The three factors I mentioned earlier – low inflation, reduced budget deficits and debts, and business restructuring – have provided a sound base for the Canadian economy during this turbulent time. They have also helped smooth the process of exchange rate and economic adjustment that I have been describing.

Because of our good inflation record in recent years, achieved through the Bank's commitment to inflation targets, inflation remained subdued, even as our currency was falling and causing prices of imported goods to rise. Low inflation and a much improved fiscal position have helped to keep interest rates down. At the same time, because of restructuring, many more Canadian firms have been in a strong position to take advantage of the low Canadian dollar and increase their sales abroad. Low interest rates have also made it easier for businesses to finance investments so that they can expand production capacity and increase their foreign sales.

The outlook for the Canadian economy

The fundamental improvements in our economic foundation and the way that Canada has coped with these recent external financial difficulties give us good reason to be optimistic about the future.

The export sector has been an important source of strength for the Canadian economy for some time now. Recently, the stimulus from spending by Canadian households and businesses has also been growing. Indeed, with the waning of last autumn's global strains, consumers have regained the confidence to go out and buy a new car, a house, or furnishings. And businesses have revived their plans for investment in machinery and equipment (including continued buoyant spending on computer upgrades, partly related to Year 2000 readiness). With improved confidence, relatively low interest rates, and gains in employment, these trends should continue.

Clearly, conditions outside Canada remain crucial to our economic outlook. In Europe, prospects for stronger growth now look better than they did a few months back. Even for the troubled Japanese economy, next year should be brighter. Forecasts for a number of emerging-market economies, particularly in Asia, have also been revised up. And with these improved global prospects, the prices of a number of our key commodities – especially energy, base metals, and minerals – have risen.

Of course, for Canada the external influence that matters the most is the US economy. That economy has turned in an amazing performance in the past seven years – robust output growth, low unemployment, and low inflation. But with US consumers and businesses continuing to spend strongly, and labour markets tightening further, some signs of cost pressures have emerged recently. This has rekindled concerns about a pickup of inflation down the road. And it has prompted the US Federal Reserve to reverse part of last autumn's easing, by raising interest rates twice this summer, in an effort to return the economy to a more sustainable, non-inflationary pace.

The Fed's success in preventing the US economy from overheating and bringing it down to a "soft landing" is critical for the world economy and especially for Canada. The worst case for us would have been for the Fed to have delayed action and risked another inflationary boom. Not only would this require more drastic tightening by the Fed down the road, but it could well lead to a recession – another episode of boom and bust.

The Bank of Canada did not follow the two interest rate increases made by the Fed this summer. While there is no reason that changes in US interest rates should automatically trigger similar movements here, neither is it the case that such developments are irrelevant for us. Canada is closely integrated into the world economy and international financial markets. Developments in the United States, the world's largest economy, will always have a major global impact. When it comes to Canada, the central bank must carefully assess the economic and financial circumstances in the United States that are behind any move by the Fed and their likely implications for our economy. Sometimes this will mean that the Bank of Canada will respond to a Fed move and sometimes it won't.

The interest rate actions taken by the Fed this summer improve the odds of continued, non-inflationary economic expansion in the United States. This is good news for all concerned. But it also means that we cannot count on the US economy to provide the same strong stimulus for Canadian exports in the future as it has in the recent past. Thus, the improved outlook for Europe and the firmer markets for primary commodities are particularly welcome developments for Canada. These external factors, along with the relatively low domestic interest rates and improved employment conditions that I mentioned, bode well for sustained economic expansion in Canada. Altogether, our economy should continue to grow at a healthy pace and take up slack in production capacity.

Core inflation is expected to stay low over the next year, in the bottom half of the Bank's 1% to 3% target range. But as the economy begins to produce at full capacity, monetary policy will have to be mindful of the potential for price pressures.

However, there is a lot of uncertainty and imprecision in our estimates of the economy's capacity to produce. For example, we do not know to what extent large investments in new technology and in machinery and equipment during the 1990s may have raised production capacity. Consequently, the Bank will be putting more emphasis on, and carefully watching, a range of indicators to assess the degree of pressure on capacity and on inflation. The interpretation of developments on this front will be an important challenge for monetary policy in the period ahead, one that will require a great deal of careful analysis.

The Year 2000 changeover in the financial sector

With the end of the millennium approaching, any review of near-term economic developments would be incomplete without a word on the efforts by financial sector participants and public sector agencies, including the Bank of Canada, to deal with the implications of the Year 2000 date change.

As part of its commitment to Canadians, the Bank seeks to promote the safety and soundness of our financial system. With this in mind, we have for some time now been working closely with various Canadian and international organizations to minimize any effects on our financial sector as we head into the year 2000.

Today, I can tell you that the Canadian financial sector has done its homework. It has been passing its Year 2000 tests. And contingency plans have been made. So, at the dawn of the new year, the Bank expects that it will be "business as usual," but we will also be ready if anything unusual happens.

Efforts to identify and fix potential Year 2000 problems in the Canadian financial sector started early. And they have been exhaustive, with expenditures in the billions of dollars.

Operators of systems shared by the financial sector have made the necessary changes and fully tested them. For example, last June, the Canadian Payments Association and its members participated in a Global Payments Systems test to verify the ability of financial institutions around the world to send and receive international payments. Domestic clearing and settlement systems have also been tested, as have all systems used by the markets for transactions involving Canadian debt and other securities. They are ready to operate in a Year 2000 environment.

At the same time, virtually all individual financial institutions have completed and tested changes to their critical systems, including those that support automated banking machines, credit and debit cards, and telephone banking. 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 for Canada Savings Bonds records.

Of course, the Bank of Canada's own critical computer systems have also been reviewed, upgraded as necessary, and tested. And they are Year 2000 ready.

An important issue for the financial sector is the state of preparedness of providers of infrastructure services (e.g. electricity, telecommunications). These, too, are reporting that they are Year 2000 ready.

With all the effort, time, and resources devoted to the task, it is not surprising that a number of knowledgeable Year 2000 commentators have singled out the Canadian financial sector, especially the banking sector, as one of the world leaders in Year 2000 preparedness. That is a strong vote of confidence, which should help reassure Canadians.

Still, we cannot afford to be complacent and relax our efforts. Computer systems will continue to be monitored and retested right up to the end of the year. There is also a need for ongoing clear, responsible communication to keep the public well-informed and confident in a smooth Year 2000 transition. At the same time, increasing attention is rightly being paid to contingency plans.

In this connection, the Bank of Canada has recently announced a number of arrangements to provide an additional measure of confidence to financial institutions and the general public. We are putting in place a special line of credit to assure these institutions and the users of financial services that if there is any unusual demand for liquidity around the turn of the year, it will be met. And the Bank is prepared to accept a wider-than-normal range of collateral to support any liquidity loans it provides. We have also made arrangements to counter any unusual pressures on money market interest rates during this period.

All this should be enough to reassure the vast majority of Canadians that the safest place to keep their money is with their financial institutions. In fact, they should prepare for the century-changeover weekend much as they would for any other long weekend.

Nevertheless, there will be some who still feel that they need to take further precautions. Those who prefer a little extra reassurance in the form of additional cash can rest easy – it will be readily available. The Bank has increased considerably its inventory of bank notes. And it has been working with financial institutions to ensure that the system can meet an increase in demand for cash across Canada. But let me reiterate that there is no reason for Canadians to feel that cash is the only way they can pay for goods and services over the New Year's weekend.

Overall, the Bank of Canada and other financial sector participants have every confidence that Canadians can plan on it being "business as usual" in the financial sector heading into the year 2000.