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Global uncertainties and the Canadian economy

I am delighted to have been invited to speak to the Board of Trade on this occasion when the Bank of Canada's Board of Directors is meeting here in St. John's.

This past year, we have had to deal with the implications for our economy and our currency of increased global uncertainty and pressures arising from the problems that originated in Southeast Asia. I am sure that the effects of these developments, especially on primary commodities, such as oil and nickel, are already very familiar to Newfoundlanders.

To understand what is going on, we need to look at the nature of the forces that are currently affecting our economy. We also need to correctly identify cause and effect when it comes to the decline in the external value of our currency over the past 12 months. The commentary on this subject has not always been helpful.

I would like to start my presentation with a quick review of international developments, focusing on the extent to which the problems in Southeast Asia have persisted and spread. Next, I will discuss the implications of these developments for the Canadian economy and give you the Bank's latest assessment of the outlook. I can tell you now that I believe that the key trends in our economy remain positive. Lastly, I will talk about the decline in the external value of the Canadian dollar and about the response of monetary policy to that decline.

The world around us

For over a year now, volatility and uncertainty have been the main traits of the international environment in which Canada operates.

The financial crisis started in Southeast Asia in the summer of 1997, then spread to South Korea, and in turn exacerbated the domestic economic difficulties that Japan was already facing. Recently, Russia has been added to the list of afflicted countries, and now some countries in Latin America are under pressure.

As with the crisis in Asia, the financial problems in Russia have reverberated around the world through foreign exchange, stock, and bond markets, touching off concerns of still further contagion.

It is certainly easier now, with the benefit of hindsight, to see the extent to which many investors from industrial countries were attracted to higher-yield investments in emerging-market countries, without fully appreciating the risks involved. When investors suffered substantial losses in certain markets, they sought to reduce their exposure to emerging markets more generally. But this rapid withdrawal of funds brought to the surface areas of weakness in some of these economies, making investors still more nervous. The recent events in Russia are a prime example of this process.

The apparently contagious nature of these developments has led to some pessimistic predictions of recession in the world economy. How concerned should we be about this?

While the international environment has turned out to be more difficult than most people had thought earlier, let me reassure you that it is certainly not all negative.

To be sure, the situation in Japan is worrisome -- not only because of that country's economic importance but also because of its strong trade and financial links with other troubled Asian economies. But, and this is an important but, Japan has the capacity and the financial wherewithal to turn its situation around. With resolute action to speed up the implementation of measures to deal with its ailing banking sector and to kickstart its domestic economy, the present concerns would dissipate.

More importantly, economic activity in the United States has been very robust and is expected to remain healthy. In Canada, too, and in Europe the situation is positive. This is certainly not insignificant, for North America and Europe together account for more than half of world output. And recent declines in medium- and long-term interest rates to record low levels are helping to sustain domestic spending in all industrial countries.

With this as background, I would now like to turn to the impact of these international developments, and of the associated uncertainties and pressures in financial markets, on Canada.

How is our economy faring?

The international developments of the past year have affected our economy more than previously anticipated. And there is no doubt that those Canadian industries and regions that depend on the production of primary commodities are facing considerable difficulties.

To appreciate this particular link between recent international developments and the Canadian economy, let me point out that Asia, including Japan, absorbs between 30 and 35 per cent of the world output of certain key primary materials. So it is not surprising that world commodity prices have been hit hard by the Asian crisis. The recent events in Russia, which is a major commodity producer, have added to the uncertainty about the outlook for the world supply and prices of primary commodities.

Because of all this, the U.S. dollar prices of commodities that are important to Canada have fallen by about 15 per cent over the past 12 months. While commodities are less important to us than they used to be, they still make up about 30 to 35 per cent of our merchandise exports.

Although Canadians have to deal with these difficulties coming from abroad, it is important to remember that, overall, our economy is still in good shape. This is, first and foremost, because some basic aspects of our economic situation have improved markedly in the last few years. We now have a low rate of inflation, a fiscal surplus, and a declining (though still high) public debt-to-GDP ratio. As well, Canadian businesses have undertaken major restructuring and investment initiatives to increase their productivity. Because of these fundamental strengths, we are now better positioned to weather sudden shocks.

As for the near-term outlook, there are also a number of positive elements in the picture. Economic activity in the United States, our main customer, remains high. And here in Canada, the latest indicators suggest continued expansion in consumer spending and business investment, supported by higher employment and low medium- and long-term interest rates.

This year, the Canadian economy will not repeat the 4 per cent growth experienced through 1997. But it may still expand by 2 1/2 to 3 per cent (fourth quarter over fourth quarter). Clearly, a good deal of uncertainty surrounds any estimate at this juncture, given the international situation. For one thing, it is difficult to judge how quickly and effectively Japan will deal with its problems, and what this will mean for the rest of Asia. The extent of the impact from the recent spreading of the crisis to Russia and the pressures in parts of Latin America is also uncertain. But, at the same time, most forecasters have consistently underestimated the resilience of the U.S. economy, and may still be doing so.

Implications for the Canadian dollar

One of the most talked-about economic events in Canada over the past year has been the decline in the external value of our currency. At its lowest point, in late August 1998, the Canadian dollar had depreciated by about 13 per cent against the U.S. dollar and by more than 7 per cent against the German mark from its average value in the first half of 1997, before the Asian crisis erupted. Since that low point in late August, the Canadian dollar has recovered somewhat against the U.S. dollar.

What has caused these movements?

Exchange rates will typically ***reflect*** developments in Canada and abroad. Thus, it is important to keep in mind that the recent movements in the Canadian dollar are the ***consequence*** of developments that have occurred over the past year. They are not the ***cause*** of the difficulties we are now facing, as some of the recent commentary seems to suggest.

It is also important to note that our exchange rate is the price of the Canadian dollar expressed in terms of the currency of another country, usually the U.S. dollar. So, the exchange rate will be influenced by events affecting both countries. If we are to correctly interpret movements in the Canada/U.S. exchange rate, we must also look at what has been happening to the United States, not just to Canada. And that makes any interpretation more complex.

Until very recently, the U.S. dollar has been exceptionally strong against ***all*** currencies. In part, this reflected the buoyancy of the U.S. economy. But in the difficult and uncertain global environment of the past year, the strength of the U.S. dollar also came from its role as the major international currency. After the Asian crisis, and with renewed vigour in the days following the events in Russia, international investors sought shelter in U.S. dollar assets. Indeed, the turmoil in financial markets in late August seemed to be the result of a worldwide reassessment of risks by investors following the announcement of the Russian debt moratorium.

Thus, to the extent that the depreciation of our currency reflected the appreciation of the U.S. dollar against all currencies, the cause was the global flight of funds into U.S. assets.

But that is not the whole story. The downward pressure on our currency over the past year was also related to events that were seen as affecting Canada more specifically. As I explained earlier, one important event was the marked decline in the prices of the key primary commodities we export.

The drop in these prices has meant lower incomes and wealth for Canadians. The profit outlook for many of our resource industries has deteriorated and production and employment in those industries are likely to be affected. And the market value of companies in those sectors has reflected these developments. Moreover, lower net export earnings from our primary commodities imply, all else being equal, a larger deficit in our balance of international payments and a greater need for foreign borrowing than would otherwise be required.

All these commodity-related developments have led to downward pressure on our exchange rate. And the lower dollar spreads the wealth and income effects of falling commodity prices across the economy.

In effect, a lower Canadian dollar means higher domestic prices for all those goods that are imported and for many of the import substitutes we produce here. For a given level of income, these higher prices imply a decline in living standards for Canadian consumers. Retailers who feel unable to pass on these price increases to consumers will have to absorb them in lower profits which, in turn, will mean lower returns for their shareholders.

The bottom line is that the decline in commodity prices has made us less well off than we were before. And we have to adjust to this reality.

These effects are unavoidable, even if we were able to prevent the Canadian dollar from falling. In fact, if the currency were not allowed to move at all, the adjustment would be slower and more costly, taking place through reductions in wages which usually involve sharper fluctuations in output and employment. Under a floating exchange rate, the process is facilitated by some downward movement in the dollar which spreads the burden of adjustment. Over the years, this has been an important justification for a flexible exchange rate in Canada -- that adjusting through exchange rate movements to the shocks that periodically hit our economy makes for a generally smoother and fairer process than adjusting through reductions in output, employment, and wages.

But I do not want to leave you with the impression that foreign exchange markets always know the appropriate value for a currency. They sometimes push too far once a trend is established in one direction or another. Indeed, I believe that during this latest episode of global financial turbulence, markets exaggerated the commodity connection of the Canadian dollar. For example, our exports of highly manufactured goods, apart from the important motor vehicle sector, have grown by nearly 20 per cent over the past 12 months, and now represent about 30 per cent of our merchandise trade. This development seems to have been largely overlooked.

Monetary policy response

So, what can and should the Bank of Canada do about the exchange rate in times of international financial turbulence and major external shocks?

First of all, let me remind you that the objective of Canadian monetary policy is to hold the rate of inflation within a range of 1 to 3 per cent. This target, jointly agreed upon by the government and the Bank of Canada, reflects the conclusion that low inflation will contribute to a stronger, more stable economic performance over time.

If we are to fulfill our commitment to keep inflation low and stable, monetary policy must remain focused on that objective. The exchange rate and interest rates are the channels through which monetary policy operates and they must be allowed to adjust to help achieve the inflation targets.

But what if the momentum of currency movements pushes the Canadian dollar beyond any level that is justified on economic grounds? Judgments as to what is, or is not, justified are very difficult to make, but there are times when the good economic news gets lost in the face of a persistent currency decline.

On those occasions, Canadian authorities need to remind investors of the positive trends in our economy. And to reinforce the message, the Bank may intervene, on behalf of the Minister of Finance, to support the currency by buying Canadian dollars in the foreign exchange market. But we do know that this kind of intervention will be effective only if a good number of investors share our belief that the currency movement has been overdone.

The Bank can also respond to currency declines with Bank Rate changes. There are two sets of circumstances in which this would be appropriate. The first is when the magnitude of the currency decline threatens to push the economy off a sustainable, non-inflationary growth path. Remember that a declining currency is a source of stimulus to the economy, because it encourages exporters and producers of import substitutes to expand their activities. That is why the Bank always puts the exchange rate and interest rates together in order to measure the amount of monetary stimulus in the economy. If a declining currency leads to monetary conditions that are persistently too easy and inconsistent with the inflation targets, the Bank will offset that with higher short-term interest rates.

The second situation that would prompt a Bank Rate increase is when there is a potential loss of confidence in the Canadian dollar. If confidence is undermined, both Canadian and foreign investors will move out of investments denominated in Canadian dollars unless they are compensated with substantial premiums in interest rates. Higher premiums, which translate into higher medium- and long-term interest rates, are very costly for the economy. It was because of such concerns that the Bank responded strongly to the decline in our currency during the Mexican crisis in early 1995.

The recent Bank Rate increase at the end of August was also designed to counter a potential loss of market confidence. In this case, investor nervousness was exacerbated by the financial crisis in Russia and was reflected in a sharp decline in our currency and rising medium- and long-term interest rates. Since the Bank Rate increase, the Canadian dollar has recovered and medium- and longer-term interest rates have come down.

Concluding comments

I have placed a great deal of emphasis on recent international developments in my remarks today because the implications of these developments for the Canadian economy and the exchange rate are important and complex.

Let me summarize my main points.

For the past year, our economy has had to cope with the fallout from the Asian crisis, which has turned out to be more widespread and prolonged than most of us had predicted. Although we are having to deal with these difficulties and with the ongoing global uncertainty and pressures, it is important to remember that there is still a significant positive element in Canada's external environment coming mainly from a resilient U.S. economy. And there is still considerable underlying buoyancy in our domestic economy. What's more, the improvement in our basic economic foundations puts us in a better position than before to withstand the present adversity.

In addition to pressure from the worldwide strength of the U.S. dollar, some of the downward movement in the Canadian dollar over the past year was a reflection of the impact of lower commodity prices on our economic well-being. However, by early August, it appeared that investors were exaggerating the importance of these effects and losing sight of the overall positive fundamentals in our economy. The Bank intervened, buying Canadian dollars, to encourage market participants to pause and reassess their views of the Canadian economy. When that pause was overwhelmed by a new wave of nervousness precipitated by the events in Russia in mid-August, the Bank raised the Bank Rate to forestall a loss of confidence in the currency and thus reverse a costly increase that was taking place in medium- and long-term interest rates. Since then, these interest rates have come down.

Let me conclude by pointing out that, despite all the recent attention on the Canadian dollar because of exceptional external developments, the fundamental focus of monetary policy remains on keeping the trend of inflation in Canada inside a target range of 1 to 3 per cent. Low inflation is the best contribution the Bank of Canada can make towards improved overall economic performance over time. It also provides the best underpinning for a sound Canadian dollar in the long run.