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The Canadian economy and monetary policy in unsettled times

When the Asian crisis erupted in the summer of 1997, few observers anticipated that international financial markets would still be under its influence more than a year later. Most expected that the crisis would be contained and resolved relatively quickly. But then who could have foreseen a year ago that the Japanese situation would deteriorate as much as it has; or that Russia would declare a debt moratorium, jolting markets everywhere, and increasing financial pressure on parts of Latin America?

All these unexpected developments have slowed world economic activity. Canada's very open economy has not been immune to these forces. The sharp decline over the past year in the demand for, and the prices of, the key primary commodities we produce has taken its toll. British Columbia has been particularly hard hit because it produces and exports a larger share of such goods than other Canadian provinces. These developments have been reflected in the value of our currency, which has declined substantially against the U.S. dollar.

All this seems to have provided fertile ground for some pessimistic scenarios. Indeed, some commentaries have raised the spectre of global recession and deflation, implying a consequent downturn for Canada. Are such concerns justified, or are they an overreaction to events?

I believe that the pessimistic commentary has been overdone. Given the global uncertainty and financial market volatility of the past year, Canada has been coping relatively well. It is normal for people to feel queasy and to fear the worst when caught in the kind of stormy seas we have encountered in the past year. But the important thing to remember is that these days Canada is better positioned to ride out the storm. And we will feel much better if we can keep our eyes on the horizon -- for there are signs that the sky is clearing.

What I would like to do this morning is to put the recent changes in the global economic and financial environment in perspective. Next, I will look at the implications for the world economy and for Canada in particular. I will finish with a discussion of the Bank of Canada’s response to the international turbulence.

Global financial problems in perspective

I will spare you the detailed chronology of the past year's events. You are probably already too familiar with it. Rather, I intend to focus on what has made this latest episode of global financial turbulence more troublesome than others in recent history. This should help us see recent developments in the Canadian economy and in monetary policy in a clearer light. It should also provide some insight on what needs fixing in the international financial system and what mistakes to avoid in the future.

So, why has the 1997-98 financial turmoil been more widespread and long-lasting? The way I see it, there were two main reasons. First, with the benefit of hindsight, it is clear that too many incautious international portfolio investments were made in the wake of the growing globalization of capital markets. Second, it has taken Japan much longer than expected to deal with its serious economic and financial problems, problems that long predated the Asian crisis.

Let me explain why I think these factors have had such an impact this time around.

First, the matter of *incautious international investment practices* -- what was the problem here? With the opening up of financial markets and with the decline in interest rates in industrial countries, a growing number of investors were attracted to higher returns abroad. "Abroad" often meant the so-called emerging-market countries, particularly those in Asia. With their rapid rates of economic growth year after year, these countries seemed to have great investment potential.

But foreign investments, especially in emerging markets, are far more complex than domestic ones. And assessing these investments can be very tricky. For one thing, investors are dealing with companies operating far away, in a very different economic and political environment. For another, financial regulatory and supervisory practices in some of these countries are less well-developed and transparent. In addition, investors may have felt rather well “protected” from risks -- for a couple of reasons. First, past assistance packages by the International Monetary Fund (IMF) and other international agencies may have led them to believe that the international community would always come to the rescue if worst came to worst. Second, many investment advisers evidently were not terribly fussed about the exchange rate risk because most Asian currencies were fixed to the U.S. dollar. It is all too easy to forget that having a fixed exchange rate is not in and of itself a guarantee that a currency will not decline in value -- which in fact is what many of these currencies have done.

In the end, huge amounts were placed in emerging markets in the 1990s by mutual funds, pension funds, financial institutions, and their clients, evidently without full appreciation of the risks involved. Moreover, many banks in these emerging markets were also taking large risks. They were borrowing short term from foreign banks, in U.S. dollars, at relatively low rates, and lending out long term, in domestic currency, at high rates -- often to domestic real estate developers.

When pegged exchange rate systems in Asia broke down under pressure, because they were fixed at levels that had become incompatible with changing economic fundamentals, both local and foreign investors rushed for the exits. And as exchange rates tumbled and interest rates soared, a host of other long-standing problems, especially related to weak banking systems, were unearthed. Investors that got burned in Southeast Asia tried to reduce their exposure to all emerging markets.

Initially, emerging countries outside Asia managed to withstand the pressure -- until the outbreak of the Russian crisis. That Russia was running into serious fiscal difficulties had been well known for some time. But its decision to declare a unilateral moratorium on its debt last August shook markets everywhere, and even the most sophisticated investors became very agitated. The resulting global reassessment of risk, and the greater weight placed by investors on security, led to a movement of funds out of emerging-market bonds and corporate bonds into more secure U.S. Treasury bonds. Interest rates rose in the markets for riskier securities, and liquidity tightened -- hence, the concerns through the autumn about a global "credit crunch" and recession.

The second factor that has exacerbated the global financial turbulence this time is *the surprising severity and intractability of Japan's long-standing economic and financial problems*. Remember, Japan is the second largest economy in the world. Most of us expected that, once the Japanese recognized the seriousness of their problems, they would move quickly and decisively to fix them. A stronger Japanese economy would have made a significant difference to the outlook for the world economy. And it would have helped to speed up the turnaround in Southeast Asia -- much as a strong U.S. economy facilitated the adjustment in Mexico, following the 1994-95 crisis in that country. The deterioration of the Japanese economic and political climate in the spring and early summer of 1998 was an important factor in the intensified market pressures that precipitated the Russian crisis last August.

What to do about the global turmoil?

So what are we to conclude from all this?

The last thing we should do is retreat behind national borders and start placing restrictions on the free flow of international capital. That would be very unfortunate. Even though capital flows may sometimes prove difficult to handle, especially for small countries, there is much to be gained from access to world savings -- provided those savings are used prudently and productively. What we must do is find ways to minimize the costs, without giving up the benefits.

The Bank of Canada believes that a flexible exchange rate is very useful in this context. Under such a system, borrowers and lenders are constantly aware of the exchange rate risk, and the kind of pressures that built up behind the fixed exchange rates in Asia last year are much less likely to emerge.

I should also note that a good deal of work has already been done by the international community to strengthen the global financial system and reduce the risk that these recent problems will recur. In their October communiqué, the Finance Ministers and Central Bank Governors of the G-7 countries outlined a series of initiatives. These are designed to: increase the transparency of the international financial system; promote international standards of good practice; strengthen incentives to meet such standards; provide assistance to developing countries to reform and reinforce their economic and financial systems; and put in place a process for crisis management that envisages the involvement of private lenders at an early stage.

But all this, you may say, is to improve the international navigation and radar systems in the future. Meanwhile, we are still in difficult seas, wondering what's up ahead and worrying what may hit us next.

How worried should we be about the world economy and the outlook for Canada?

Keeping our eyes on the horizon

I can tell you that there are positive factors in the picture as we look ahead. Let me elaborate, starting with the global environment. Perhaps the most reassuring element is that the economic expansion in the main industrialized countries, except Japan, is still well sustained. Remember that these countries account for more than half of world output. The U.S. economy, in particular, remains strong, growing much faster than anticipated in the third quarter. So even if it slows, that economy -- Canada's main export market -- will still be operating at relatively high levels. The major European economies, as a group, are also expanding moderately. And a number of industrial countries, including the United States, the United Kingdom, and many countries in continental Europe, have lowered their interest rates to help sustain domestic spending.

Japan is still the main uncertainty at this point. But the recent legislation to rehabilitate its banking sector, which is at the core of Japan's problems, and other measures proposed to stimulate the economy are grounds for cautious optimism. If these are implemented in a sensible, systematic fashion, the world economic outlook will brighten considerably.

Another factor that added to the pessimism through the early autumn was the concern about a “credit crunch” in the United States that could spread elsewhere, including here in Canada. However, the recent interest rate reductions by the U.S. Federal Reserve have eliminated the worst scenarios envisaged at the time. Some of the rise in interest rates on “less-than-prime” debt, which occurred during the autumn because of concerns in global markets about risk and liquidity, has reversed. And the availability of credit is slowly improving.

This is not to say that we are completely out of trouble yet; or that there is no longer considerable uncertainty out there. But, for the reasons I have discussed, I certainly do not believe that the scenarios of worldwide recession and deflation are very likely as we look ahead.

As for Canada, it is true that we have been hit hard by the more than 15 per cent decline in commodity prices over the past year. It is also true that those lower prices, together with the slowing world economy, are affecting our export industries -- a fact that this audience probably knows only too well. It is also evident that the nervousness and volatility in financial markets have made some Canadian consumers and businesses less confident, affecting domestic spending plans. As a result, the Canadian economy has expanded much more moderately this year than in 1997, when it grew by more than 4 per cent (fourth quarter over fourth quarter).

As we look ahead to 1999, the considerable degree of global uncertainty that is still lingering makes all economic forecasts more tentative than usual. Because financial stability is so important for household and business confidence, the expansion of our economy will be influenced by how quickly global financial markets stabilize. Still, with accommodative monetary conditions and recent solid employment gains, spending by Canadian households and businesses, while slowing, should continue to contribute to an expanding economy. And, based on the Bank's current assessment of the world economic outlook and Canada’s improved competitiveness, our exports should continue to grow.

The monetary policy response to the international turbulence

Let me now turn to monetary policy. You will not be surprised to hear that throughout this period, the conduct of policy has been influenced by these exceptional international developments.

The sharp drop in commodity prices has inevitably meant lower incomes and wealth for Canadians. And we have had no choice but to adjust. Because we are on a floating exchange rate, much of the adjustment has taken place through a decline in the external value of the Canadian dollar. Had we been on a fixed exchange rate, we would still have had to adjust.

But the adjustment would have been more difficult, since it would have had to come mainly through downward pressure on output, employment, and wages.

The depreciation of the Canadian dollar since the fall of 1997, while distressing, had for the most part been relatively orderly before the Russian crisis in August. At that point, pressure on our currency intensified because of a frantic worldwide capital flight to more secure U.S. assets and an exaggerated sense internationally of the importance of commodities for Canada. The move out of "commodity currencies" was intensified by fears that Russia would start dumping commodities on world markets.

As the decline in the Canadian dollar accelerated through August, medium- and long-term interest rates, including mortgage rates, began to rise sharply at a time when comparable U.S. rates were falling. We took this as a signal of potential loss of confidence in Canadian-dollar investments that could prove very costly for the economy. To head that off, we raised the Bank Rate by one percentage point in late August.

Our action, and the subsequent return of some stability to markets in the United States and elsewhere, helped to restore confidence in Canadian-dollar assets. And medium- and longer-term interest rates came back down.

When the U.S. Federal Reserve lowered its target interest rate three times between September and November, because of concerns about a possible “credit crunch” and an expected slowing in their economy, we followed with similar reductions in our Bank Rate. These cuts were appropriate, given the importance of the U.S. economy to Canada, our continued low inflation rate, and the improving international financial climate.

I know that the depreciation of the Canadian dollar has been a source of concern and dismay to many people. One concern is that a weak currency blunts the incentives to improve productivity in the export sector. I must say that this is more likely to be a problem if the weakness of the currency reflects an inflationary environment. But such is not the case in Canada today. Inflation is low and stable, and the Bank of Canada is formally committed to keeping it that way.

At the same time, I most certainly agree that we should always be looking at our economic policies from the perspective of their likely impact on the growth of productivity. After all, productivity is what matters for a sound economic performance and for rising standards of living over time. Currently, the low Canadian dollar provides an opportunity for Canadian businesses to expand their presence in foreign markets. But they must also continue to work hard to increase productivity and to ensure that they stay competitive as our currency regains strength.

What about monetary policy -- what is it doing to further productivity? The focus of Canadian monetary policy is on domestic price stability. This means keeping inflation low and stable over time -- currently within a target range of 1 to 3 per cent. The Bank aims to avoid both inflation and deflation. And if we are successful, we will have provided Canadians with greater predictability, fewer cyclical fluctuations, and sustained low interest rates. I believe that a monetary policy that seeks to provide this kind of environment is the most conducive to productivity growth over time.

Concluding remarks

To conclude, let me just say that Canada cannot escape the uncertainties that have clouded the global economic outlook. The pace of economic expansion in Canada is not as robust as it was a year ago. But our economy should continue to grow over the next year, supported by accommodative monetary conditions and sustained U.S. demand.

Although it may be difficult to see while we are still battling the waves of global instability, the fact is that we are coping better this time around because our economy is in sounder shape. And this gives me reason to remain rather positive about our economic future.