Sheryl Kennedy: Canada's monetary policy framework dealing with global economic change

Remarks by Ms Sheryl Kennedy, Deputy Governor of the Bank of Canada, to the International Finance Club of Montréal, Montréal,12 January 2006.

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It's a pleasure to be in Montréal and to be speaking to the International Finance Club.

I'd like to take this opportunity to discuss the Bank of Canada's monetary policy framework—what it is, and how it works to promote strong economic growth and facilitate adjustment to economic change. You are an ideal audience for these remarks. Your expertise in international finance gives you a clear view of how quickly national economies and financial markets around the world are changing. And you know that in a global economy, Canada's economic well-being depends on how effectively it responds to these developments.

The constant economic change that we've been experiencing makes it critical for the central bank to stand on a firm foundation as it works to enhance the country's economic strength. The Bank of Canada's monetary policy framework is such a foundation. In a moment, I'll outline how this framework works to mitigate the effects of shocks, facilitate the adjustment process, and promote sound economic performance. But first, let me discuss some of the major global forces that have been affecting the Canadian economy.

In recent years, a strong global economic expansion has contributed significantly to a sharp rise in the prices of energy and some other commodities. With energy and other commodities accounting for about 45 per cent of our total exports (and some 13 per cent of all value-added economic activity), these relative price movements have led to a substantial improvement in our terms of trade. By this I mean that the prices we receive for our exports have been rising faster than the prices we pay for the goods and services that we import. Together with downward pressure on the U.S. dollar because of that country's very large current account deficit, these improved terms of trade have led to a sharp appreciation of the Canadian dollar. Since the beginning of 2003, our dollar has appreciated by about one third against the U.S. dollar, as well as against a trade-weighted basket of currencies. As a result, the cost of many imported goods, including—importantly—machinery and equipment, has fallen. At the same time, Canada has experienced increased competition from the rapidly growing economies of Asia, especially China. But we have also been presented with new opportunities to expand trade with these countries and to tap lower-cost supplies.

These global developments, while clearly yielding benefits for Canada, have also necessitated adjustments involving significant shifts among economic sectors, and thus shifts in employment, but also new opportunities for growth. Higher prices for energy and other commodities, the appreciation of the Canadian dollar, the opening of new markets, and lower import costs have implications for firms and individuals across Canada. I'll return to this point later. But first, I'd like to talk about what these developments mean for the Bank of Canada and for the conduct of monetary policy.

The monetary policy framework

Under the Bank of Canada Act, the Bank is required to mitigate "fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada." To achieve this goal, we need a clear, effective policy framework, one that gives Canadians confidence in the value of their money and contributes to strong economic performance and a sound financial system.

The two key components of our monetary policy framework are an inflation target and a floating exchange rate. These components work hand in hand, and indeed reinforce each other, to facilitate adjustment to economic developments. Let me elaborate.

To achieve the inflation target of 2 per cent, the Bank aims to maintain a balance between the aggregate demand for and supply of goods and services. When aggregate supply and demand are in balance, the economy can operate at its full potential, and inflation stays low. The Bank aims to achieve this balance by raising interest rates when aggregate demand pushes the economy against

the limits of its capacity and, in a symmetric fashion, by lowering interest rates when demand weakens.

Inflation control facilitates adjustment to economic developments in two ways. First, when inflation stays close to the 2 per cent target, expectations about future inflation become anchored. Firms and individuals can then read price signals more clearly and thus make sound long-term economic decisions, which is especially important during times of rapid change. Second, when aggregate supply and demand are in balance, and inflation is contained, economic resources can be more effectively reallocated from sectors where demand is relatively weak to sectors where demand is relatively strong. This is especially important at times, like the present, when there are large movements in relative prices and changes in the terms of trade.

So far, I have focused on the inflation target. The other key component of Canada's monetary policy framework is a flexible exchange rate. The Bank of Canada does not have a target or a preferred level for the Canadian dollar. But we do monitor the exchange rate closely, and we look for information that can be gleaned from movements in the currency to help us interpret and assess the implications for aggregate demand in Canada.

Together with the inflation target, the flexible exchange rate works to facilitate economic adjustment. How? Put simply, movements in the exchange rate send appropriate signals to businesses, helping them to allocate capital and labour to the most efficient uses.

Now, in formulating monetary policy, we at the Bank need to understand the underlying reasons for a currency movement. Understanding these reasons allows us to estimate the net effect of the currency movement on aggregate demand and, in this way, to make appropriate monetary policy decisions. We've discussed this subject in past speeches and, more recently, in the Autumn 2005 *Bank of Canada Review*. So I will be brief today.

In principle, there are two types of exchange rate movement: "Type One," those that stem from changes in the demand for Canadian goods and services, and "Type Two," those that do not. An example of a Type One movement relates to the strengthening global economy, which, as noted, has led to a substantial increase in world commodity prices and to strong foreign demand for Canadian products, especially raw materials. This development represents a direct increase in Canadian aggregate demand. The associated appreciation of the Canadian dollar has dampened the increase in demand and helped to facilitate the adjustment of the Canadian economy by encouraging a shift in activity towards Canada's commodity-exporting sector. To the extent that the dampening effect on demand exactly offsets the direct increase in demand, there would be no need for a policy response.

A Type Two exchange rate movement does *not* reflect a change in the aggregate demand for Canadian goods and services. Instead, it may reflect a rebalancing of portfolios, that is, a change in foreign demand for Canadian financial assets or a change in Canadian demand for foreign financial assets. However, the exchange rate movement itself has an impact on the demand for Canadian goods and services. When this movement persists, other things being equal, there would be a need for an offsetting change in monetary policy.

A good example of a Type Two exchange rate movement was the appreciation of the U.S. dollar in the late 1990s when global investors, influenced by what they saw as robust prospects for the American economy, sought U.S. financial assets. In 2003-04, of course, we saw the reverse flow: investors became concerned about the large U.S. fiscal and current account deficits, foreign demand for U.S. financial assets declined, and the U.S. dollar, on balance, fell against many major currencies, including the Canadian dollar.

It can be very difficult to determine whether, at a given moment, Type One or Type Two forces are driving the exchange rate. More often than not, shocks of different kinds occur at the same time, posing a challenge for the Bank in terms of determining the implications for monetary policy.

It's interesting to compare the exchange rate movements over the past few years, and their effects on Canada, with those during the Asian economic and financial crisis of 1997-98. Because of that crisis, Asian demand, which had accounted for a relatively large share of the growth of world demand for many commodities, weakened considerably. Prices of key commodities produced by Canada fell, and the growth of Canadian aggregate demand was adversely affected. At the same time, and mainly because of the downturn in world commodity prices, the Canadian dollar depreciated against the U.S. dollar. This depreciation, together with a strong U.S. economy, partly offset the negative effects of the Asian crisis on Canadian aggregate demand.

The current situation, which in terms of commodities is the inverse of the one during the Asian crisis, demonstrates the effectiveness and flexibility of the Bank's monetary policy framework. While the particulars of today's situation are different, the monetary policy framework continues to support appropriate adjustments.

Adjusting to economic change in Canada

Adjustment to economic change is never easy, either for businesses or individuals. Over the past three years, changes in relative prices, including the appreciation of the Canadian dollar, have contributed to a reallocation of labour and capital from the production of non-commodity tradable goods to the production of commodities. As I mentioned earlier, given the importance of commodities to our economy, and given the improvement in our terms of trade, there have been real economic benefits for Canada as a whole.

The flexibility and diversity of the Canadian economy are also helping to facilitate adjustment to global economic developments. Over the past three years, we have seen strong growth in capital spending in commodity-producing industries, as well as substantial gains in both capital spending and in employment in sectors with low exposure to international trade. Capital spending has also increased, although at a more moderate pace, in non-commodity manufacturing industries with a high exposure to international trade.

Here in Quebec, and in central Canada more generally, the strong Canadian dollar and increased energy costs have posed a significant challenge to manufacturers and service providers facing international competition. The Bank closely follows developments in all sectors of the economy, partly through its quarterly *Business Outlook Survey* conducted by its regional offices, including the one here in Montréal.

For Canada as a whole, including Quebec, exports have continued to grow, despite the higher Canadian dollar. And investment in machinery and equipment suggests that a good number of firms are taking advantage of the stronger exchange rate to improve their productivity and enhance their competitiveness.

And, of course, healthy final domestic demand, underpinned by rising incomes and relatively low interest rates, has continued to support economic growth in Canada during this period of significant economic adjustment.

But the adjustment process is not over. We continue to experience changes in the prices of commodities relative to other products, in the exchange rate, and in the world demand for Canadian goods and services. Energy prices, in particular, have surged over the past year, and the associated effects are still working their way through our economy. Increased competition from abroad and structural changes in demand are other important economic forces at play that also require adjustment.

Conclusion

I'd like to conclude by summarizing my key messages. Recent years have been marked by significant global economic change. A rise in the prices of commodities relative to those of other goods that we in Canada produce, the appreciation of our currency, increased international competition, and the rapidly growing emerging-market economies of Asia present challenges and opportunities for Canadian businesses and individuals. Adjusting to these developments is difficult but necessary. The adjustments that have already taken place suggest that Canadians are responding effectively to the challenge.

For its part, the Bank of Canada will continue to help facilitate adjustment by conducting monetary policy with a view to keeping the economy operating at its potential and inflation close to the target. We will be closely monitoring economic developments and assessing their impact.

The monetary policy framework—the inflation target working in concert with a floating exchange rate—will continue to be fundamental in facilitating the adjustments that businesses and individuals are making to deal with changes in the global economy. The Bank is constantly working to improve its research and analysis, as well as its conduct of monetary policy. But we remain confident that our monetary policy framework will continue to provide the firm foundation needed as we work to help Canada deal effectively with global economic change.