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CONTACT: Media Relations
613-782-8782

Expect policy divergence as economies adjust to shocks, Governor Poloz says

OTTAWA, ONTARIO — Diverging monetary policies are the natural consequence of large declines in resource prices and should be expected, Bank of Canada Governor Stephen S. Poloz said in a speech today at the Mayor's Breakfast Series in Ottawa.

Last month's interest rate increase by the U.S. Federal Reserve is the first step in a long process toward normalizing monetary policy in the United States, the Governor said. While this will have implications for Canada and its financial markets, the Bank of Canada is well equipped to respond. "We have a number of tools at our disposal—both conventional and unconventional—to mitigate risks to our inflation target or to our financial system, should they arise," he said.

The drop in resource prices has meant large declines in the terms of trade for resource-producing countries such as Canada, Governor Poloz explained. This shock is reversing trends established in Canada over the past decade, and policy-makers should facilitate the necessary economic adjustments. "The forces that have been set in motion simply must work themselves out," the Governor said.

"This is exactly why countries choose to have flexible exchange rates," Governor Poloz explained. The currency depreciation is operating through three channels. First, it is offsetting part of the drop in commodity prices. Second, it is helping promote growth in non-resource sectors through stronger exports. Third, and less desirably, it is spreading the impact of the loss of income across the entire economy, he said.

Still, "a flexible exchange rate is not a policy panacea," Governor Poloz said. Other policies can also serve as buffers "while still encouraging the necessary longer-term adjustments, including fiscal policies and policies that make labour markets more flexible," he said.

"We've been in this situation before," the Governor concluded. "The Bank of Canada will continue to run an independent monetary policy, anchored by our inflation target, and we will use our tools to manage risks along the way."