BANK OF CANADA
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Standing Senate Committee
on Banking, Trade and Commerce
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Good afternoon, Mr. Chairman and Honourable Senators. Thank you for the invitation to appear before this committee to talk about the Canadian dollar.

Since 1991, the Government of Canada and the Bank of Canada have had a formal agreement that says our monetary policy should be directed at controlling inflation. Over time, we have seen that keeping inflation low, stable and predictable is the best way the Bank can fulfill its mandate to promote the economic and financial welfare of Canadians.

We have one main monetary policy tool—our control over the overnight interest rate—and we use this tool to help maintain the rate of inflation at the agreed 2 per cent midpoint of the 1 to 3 per cent control range. This means that Canada must have a floating currency. Since we have a target for inflation that aims to preserve the domestic value of the Canadian dollar, we cannot also have a target for its external value.

At the Bank, we describe the flexible exchange rate system as an "economic shock absorber." By that, we mean that movements in the currency help the economy adjust to shocks, such as swings in both the demand for and prices of the goods and services that Canada produces. These swings cause shifts in our terms of trade—the ratio of the prices Canada receives for its exports to the prices it pays for its imports—and these shifts require economic adjustments in response. The adjustments can be difficult for the individuals and companies that are directly affected. But experience shows that it's less painful for these adjustments to take place through the exchange rate, rather than only through movements in wages and domestic prices.

Since roughly the middle of 2014, we've seen very large declines in the prices of many commodities that Canada produces and exports. Oil is the most obvious example, but it is not the only one. Others, such as copper and aluminum, have also fallen sharply. Resources have always been an important part of our economy, and the Bank of Canada's commodity price index, which tracks the world prices of our most important resources, dropped by more than 50 per cent from mid-2014 to the end of 2015. Over the same period, Canada's currency depreciated from about 94 cents U.S. to about 72 cents U.S., not far from its level today.

Before I talk about the adjustment process, there are two points I want to stress. First, this isn't the first time that Canada's economy has had to deal with sharp movements in resource prices. When former Governor Gordon Thiessen

appeared before this committee in April, 2000, he said, “The downward movement of the Canadian dollar…was largely a response to the sharp decline in world prices of the primary commodities that Canada exports. Our economy had to adjust to this reality; the exchange rate decline facilitated a shift in activity from the primary sector to manufacturing and other export sectors.” The same could be said today.

Further, let’s remember that the dollar appreciated as commodity prices and our terms of trade rose from 2003 until roughly mid-2014, helping to smooth the required adjustments during that period.

The second point is that Canada is not the only country that is adjusting to falling resource prices. Let me draw your attention to Chart 5 of the *Monetary Policy Report* (MPR) that the Bank published in January. This chart illustrates the evolution of the terms of trade and the real effective exchange rates of various countries since the middle of 2014. It shows that commodity-rich open economies, such as Canada, Chile, Australia, New Zealand and Brazil, have all seen both their terms of trade and their currencies weaken. In contrast, net commodity importers such as the United States and the United Kingdom have seen their currencies strengthen.

In the same *Report*, we spell out how we expect the Canadian economy to adjust to this decline in our terms of trade. The first response is a restructuring of our resource sector, and we have already seen cuts in investment and employment among commodity producers. This has happened relatively quickly. We also expect to see a broader impact from the loss of income, which will weigh on household spending and business investment outside the resource sector. This impact is more protracted and is not forecast to peak until next year.

At the same time, the decline in commodity prices is sending a signal to shift productive resources back into the non-resource sector. This will be a long and complex process, but movements in the exchange rate are helping in this regard. Governor Poloz spoke about this adjustment in some detail in a speech in Ottawa last month. Let me recap some key points.

First, the depreciation of the Canadian dollar partly offsets the drop in commodity prices, since commodities are usually priced in U.S. dollars. In other words, resource exporters see their Canadian-dollar revenues fall by less than their U.S.-dollar revenues.

Second, the depreciating dollar helps Canadian exporters outside the resource sector. Those that set their prices in Canadian dollars experience improved competitiveness, while those pricing in U.S. dollars get a boost in revenues.

We are already seeing signs of this effect. Among industries that are sensitive to exchange rate movements, we have identified 21—representing almost 30 per cent of non-energy goods exports—that are showing an upward trend in shipments. Included in this group are industries such as pharmaceuticals, motor vehicle engines and parts, and industrial machinery, which have also seen higher employment since the middle of 2014, according to Statistics Canada’s Survey of Employment, Payrolls and Hours. Statistics Canada’s Labour Force Survey is also showing a more general increase in manufacturing employment since the beginning of 2015.

The final impact of the lower Canadian dollar I'll mention is that it raises the prices of imports. On the one hand, that means all Canadians lose some purchasing power for imports, including goods such as fresh produce that have no simple substitute. It also means price pressures for companies that rely on imported inputs. On the other hand, the depreciation makes Canadian goods and services more attractive relative to imports. Consider tourism, for example. We are seeing more international visitors choose Canada as a destination. Tourism spending has increased for 10 straight quarters in real terms. On balance, the depreciation ultimately leads to increased demand and sales, which means more growth, investment and employment in the non-resource sector.

Finally, let me say a few words about how the currency affects the outlook for inflation. The impact of the resource price shock on inflation is complex. The loss of income from resources means less demand in the economy and, therefore, slower inflation. There is also the direct impact of lower energy costs. At the same time, the depreciation in the currency is raising the prices of imports and therefore boosting inflation. In the January MPR, we estimated that the pass-through from the lower dollar added between 0.9 and 1.1 percentage points to the total rate of consumer price inflation in the fourth quarter of 2015. In addition, because the currency had depreciated further in recent months, we said there is a risk that the pass-through will remain higher.

It's important to note that we expect these forces currently affecting the inflation rate to be transitory; that is, we expect them to drop out of the annual inflation rate so they won't feed into people's expectations of future inflation. However, Governor Poloz and other members of Governing Council have been clear that they will watch closely to ensure that longer-term inflation expectations don't become unanchored from our target. The bottom line is that we are forecasting that total inflation will return to almost 2 per cent by the end of 2017.

To sum up, the depreciation of the Canadian dollar reflects the sharp decline in global resource prices and our terms of trade. As Governor Poloz said, the impact of this shock is complex, and the required structural adjustments will be lengthy and difficult for many Canadians. However, our system of inflation targeting with a floating exchange rate is best for helping these adjustments take place as easily as possible.

Thank you.