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Canada's Monetary Policy Approach: It Works for Canadians

I welcome this opportunity to talk to you today. In recent months, the debate over Canada's exchange rate system has heated up and calls for the adoption of a common currency with the United States have attracted a lot of attention.

Today, I would like to revisit the issue of the appropriate exchange rate regime for Canada and to set out as clearly as possible the Bank's position. I propose to frame my discussion in terms of Canada's approach to monetary policy. I will conclude with some comments on the current economic situation.

The goal of monetary policy and how to achieve it

The Bank of Canada's commitment is to contribute to the economic well-being of Canadians. This means conducting monetary policy so that it fosters sustained economic growth—by creating conditions that favour rising output, employment, and incomes, and a stable macroeconomic environment.

Low, stable, and predictable inflation

Experience over time and across countries has taught us that the best contribution monetary policy can make to a sound economy is to preserve confidence in the value of money. Fundamentally, this means that Canadians should be able to count on their central bank to keep future inflation low, stable, and predictable. In this way, they can go confidently about their affairs, making sound economic decisions. This, in turn, should lead to better economic performance nationally.

Seen in this light, the focus on low inflation is not an end in itself, but rather a means to an end—the end being the advancement of the economic well-being of Canadians.

Of course, a low-inflation policy by itself is not sufficient to guarantee the best economic outcome for Canada. Fiscal prudence and other policies that aim to improve the structure and flexibility of the economy are also essential. But low inflation provides a crucial underpinning to a well-functioning economy.

If the goal of monetary policy is to achieve and preserve low inflation, how would the central bank go about it?

Anchors for monetary policy

When a central bank raises or lowers its key policy interest rate, it sets in motion a series of events that starts with the financial markets, works through changes in spending, output, and employment, and ends with an effect on the rate of inflation. This series of events is known as the transmission mechanism of monetary policy.

The problem is that the transmission process is lengthy. So it takes time for monetary policy actions to affect output and inflation. Some effects are felt relatively quickly. But the full effects are not felt for some time—3 to 6 quarters in the case of output and 6 to 8 quarters in the case of inflation. This means that, as central bankers go about their day-to-day business of implementing monetary policy, they must look ahead and anticipate what is likely to happen down the road. They have to work with assumptions and make judgment calls about future economic developments and about the timing and final outcome of any monetary policy action they take. All of this involves considerable uncertainty.

This being said, as we look around the world, there have been different ways to focus the conduct of monetary policy and to give people greater comfort that things are on track, thus helping to tie down or "anchor" inflation expectations.

Most countries have now adopted some kind of explicit target or anchor for monetary policy. The major exception is the United States, where a statement of general intentions with respect to inflation has, in recent years, proven sufficient to anchor monetary policy, in light of the U.S. Federal Reserve's strong credibility.

In terms of explicit anchors, there have been targets for monetary aggregates, fixed exchange rates, and inflation targets.

. . . targeting monetary aggregates

Most industrialized countries, including Canada, have in the past tried to target the rate of money growth.

However, in both Canada and the United States, targets for money growth have not proven to be an effective monetary anchor. Deregulation and financial innovation have weakened the reliability of money measures, and the relationship between money growth and the rate of inflation has proven unstable. But we still look at money for its information content about current and future developments in output and inflation.

For all practical purposes, then, there are only two options today in terms of explicit anchors for monetary policy: fixing the exchange rate or targeting inflation.

. . . fixing the exchange rate

For many countries, especially smaller ones, tying their currency to that of a larger neighbour or major trading partner with a history of low inflation is one way to achieve a low rate of inflation.

There are, of course, different forms of fixed exchange rates. They can range from 'softer' systems—such as a peg—to 'harder' fixes that lie at the opposite extreme from a free floating currency. These harder fixes can be a currency board, the outright use of another country's currency ("dollarization"), or a full monetary union.

Pegged exchange rates that can be adjusted (that is, revalued or devalued) have been the most widely used anchor since the Second World War. They were the prevailing order under the Bretton Woods system, which was established after the war and lasted until the early 1970s, when it finally collapsed in the face of increasingly open financial markets, large capital flows, and U.S. expansionary policies.

The problem with a fixed, but adjustable, exchange rate is that it does not guarantee that the value of the currency relative to other currencies, and thus its purchasing power, will not rise or fall. For example, the currency could come under downward pressure if it is pegged at a level that is out of line with the country's economic situation (say, because of large and growing fiscal deficits and debts). Should the markets then begin to question the authorities' commitment to the peg, domestic and foreign investors would scramble to get out, triggering a currency crisis. There is no shortage of such examples in recent history: repeated episodes in Latin America since the 1980s, crises in Europe in 1992 and 1993, and in Southeast Asia and Russia in 1997–98.

Because pegs have proven problematic, a more realistic approach would involve adopting one of the more rigid fixes. I will have more to say about this later. But let me move on now to the third option for an explicit monetary policy anchor—inflation targets.

. . . targeting inflation

Among a number of industrialized countries that, like Canada, are operating a floating currency, there has been a tendency over the past decade to adopt explicit inflation targets as the anchor for monetary policy. The same tendency is now evident among a growing number of emerging-market economies that have recently moved to flexible exchange rates following the collapse of their pegged rates. The objective is to consistently maintain low and stable inflation, while the flexible exchange rate helps the economy to adjust to shocks.

Why inflation targets and how do they work to guide monetary policy?

In such a framework, the central bank targets the rate of inflation—say, 2 per cent—several quarters ahead. Then, based on its judgment of the current and projected strength of demand relative to the economy's production capacity, as well as the implications for future inflation relative to the target, it will take action now—because of the long lags involved—to ensure that the target is achieved down the road.

The value of the inflation target as an anchor: the Canadian experience

In Canada, explicit inflation targets were jointly introduced by the Government of Canada and the Bank of Canada in 1991. Since 1995, the goal has been to keep the trend of inflation inside a target range of 1 to 3 per cent.

In adopting the targets, the Bank expected that they would provide a useful framework within which to assure Canadians that inflation would remain low and stable, thus leading to less fluctuation in output and employment. We also expected that the targets would provide a precise goal against which to measure the conduct of monetary policy, thus helping to increase the Bank's public accountability.

After a decade of experience, it is clear that inflation targeting has proven to be an effective way of keeping inflation low, and that an inflation target provides an anchor for inflation expectations.

Moreover, that target has supplied the Bank with a mechanism for assessing, and dealing with, demand pressures on future inflation in a way that helps to keep the economy on a more even keel. Indeed, there is already some evidence that the pronounced ups and downs in economic activity, so typical of the past, have diminished.

Here's how the target helps the Bank to 'stabilize' the economy. When demand pushes against the economy's capacity to produce and seems likely to put upward pressure on future inflation relative to the target, the Bank will raise interest rates. This will help to moderate demand and reduce inflation pressures. Equally importantly, when demand is weak and seems likely to put downward pressure on future inflation relative to the target, the Bank will lower interest rates, thus providing more room for the economy to expand.

In short, the emphasis on inflation control allows the Bank to support growth when the economy is weak and to prevent overheating when the economy is strong and is pushing against capacity constraints. Now, this goes back to what I was saying at the beginning—that monetary policy contributes to sound economic performance by means of its focus on low inflation.

With a low-inflation climate encouraging further initiatives by Canadian businesses to improve cost control, efficiency, and productivity, and with marked fiscal progress by all levels of government, our economy has performed well over the past several years. And it has generated solid gains in employment and incomes.

In light of the important economic and social benefits that low inflation and inflation targets have delivered, the federal government and the Bank of Canada recently agreed to retain the current target of 1 to 3 per cent. To increase the chances that inflation stays inside that range, the Bank will now be aiming expressly at the 2 per cent midpoint. Moreover, the new agreement runs for five years, instead of three, to the end of 2006. Both of these changes should help to increase predictability and to reassure Canadians that low inflation will be a continuing feature of the domestic economic scene.

Now, let us see how the exchange rate fits in all this and why Canada needs a floating currency.

Why do we need a floating exchange rate?

If we want to set our own goal for inflation or, what's more relevant (since today all industrial countries pursue a similar low-inflation objective), if we want to run a monetary policy suited to our own distinct economic circumstances, we need monetary independence. Monetary independence can exist only within a flexible exchange rate system.

The real value of a floating currency for Canada lies in helping our economy to absorb some of the impact of external shocks. A classic example would be a sharp movement in the value of our exports relative to our imports, such as occurred in 1997–98, when world commodity prices plummeted in the wake of the Asian crisis. In that instance, a downward movement in the value of the Canadian dollar helped offset some of the losses suffered by our commodity producers. More importantly, it strengthened the competitiveness of Canadian manufacturers. They, in turn, were able to expand production and offset some of the downward pressure on output and incomes from the decline in the commodity sector. In this way, our national economy was able to adjust more quickly, and with less overall fluctuation in output and employment, than if the exchange rate did not move.

Consider what would have happened under a fixed exchange rate. With the exchange rate not allowed to move, domestic wages and prices would have had to decline to restore external competitiveness. And since neither wages nor prices are flexible enough to adjust quickly, much of that adjustment would have had to come through declines in output and employment.

In a world where capital is free to move across national borders, a floating exchange rate can also help to absorb some of the pressures stemming from large capital flows and to facilitate any necessary economic adjustments. Indeed, I would remind you that the decision to float the Canadian dollar in 1950, and again in 1970, was taken in the context of large capital inflows (and rising commodity prices) that were causing concerns about their inflationary effects on our economy and were putting strong upward pressure on our currency.

The key point in all this is that Canada cannot insulate itself from external shocks. Whether we are on a flexible or a fixed exchange rate, the reality is that those shocks require a domestic adjustment. And, in the end, that adjustment *will* be made—one way or another. But, without the flexibility a floating currency can provide, it will take longer, be more difficult, and cost more overall in terms of lost output and jobs.

Now, when the exchange rate moves up or down, there has to be some way to anchor expectations about its value. Otherwise, the freedom of the currency to float could, in the context of a downward movement, undermine confidence in its value on world markets and at home. Under our approach to monetary policy, the domestic inflation target serves as that all-important anchor for the exchange rate.

The inflation target and a floating currency work well together—indeed, they reinforce each other. And they both have very significant economic benefits for Canada.

These days, the advantages of a monetary policy approach based on inflation targets and supported by a flexible exchange rate regime are being increasingly recognized by others around the world. And Canada is often held up as a model. Why then the calls in this country to go back to pegging our currency to the U.S. dollar or to enter into a currency union with the United States?

Pegging would mean losing the macroeconomic benefits of a flexible exchange rate, without gaining the assurance that the exchange rate will not move in the future. So what people are talking about now is a currency union with the United States.

On the face of it, the prospective gains from such an arrangement would seem to be attractive. After all, Canada is one of the most open economies in the world, exporting over 40 per cent of its output and importing about as much. Moreover, 80 per cent of this trade is with the United States. So, yes, by adopting the U.S. dollar, Canadians could save on the transactions costs of converting national currencies and hedging against currency movements. There could also be some other advantages linked to the improved efficiency that can result from reduced exchange rate uncertainty.

The crucial question, however, is whether the savings from such an arrangement would compensate for the loss of monetary policy independence and for the loss of the buffer that a flexible exchange rate provides against economic shocks.

Research by the Bank of Canada and by many outside analysts confirms that Canada benefits significantly from having a separate currency and a floating exchange rate. It is true that Canada and the United States share many characteristics. But when it comes to economic structure, there are many important differences. Not only is our economy far more open than that of the United States, but Canada is also more dependent on raw materials. Moreover, while we are net exporters of primary commodities, the Americans are net importers. Sharp swings in world commodity prices have a much greater impact on economic activity in Canada and, more importantly, they affect us differently than our neighbours. It is very clear that the structure of our economy is sufficiently distinct from that of the United States that a flexible exchange rate can play a key role in facilitating the domestic economic adjustment to such shocks.

From a strictly economic perspective, it is always possible that, at some future time, the structures of our two economies could converge to a point that the benefits of a common currency could outweigh the macroeconomic costs of abandoning our flexible exchange rate. But it is also possible that those structures could diverge further (if more trade led to greater specialization). We simply do not know. I would emphasize, however, that the crucial factor here is not the extent of the integration between Canada and the United States, but rather how close or how far apart our economic structures are, or will be.

Former Bank of Canada Governor Thiessen put it well last December when he said that "as long as we remain a major producer of primary commodities, and as long as we want to pursue separate economic policies that are suited to our own circumstances and that require differing monetary conditions, the shock-absorber element of a floating currency will serve us well."

I fully associated myself with this view during my appearance last month before the House of Commons Standing Committee on Finance. I said: "it's quite clear that at this stage in our evolution, a floating currency for Canada vis-à-vis the United States . . . is a great advantage because the structures of our economies differ."

Thus, one may not argue that, for all time and under all circumstances, a floating currency will be the right solution for Canada. But, what I can say is that, given the structure of our economy, for now and for as far into the future as I can see, the advantages of a flexible exchange rate, anchored by a domestic inflation target, clearly outweigh the benefits of a currency union. And they will certainly always outweigh those of a peg.

I hope that I have made it clear today that Canada's monetary policy approach of a flexible exchange rate, anchored by an inflation target, works. There is no need to fix it.

Let me now conclude my presentation by giving you our latest reading of the economy.

Recent Economic Developments

Since late last year, the pace of economic expansion in Canada has slowed substantially, mainly because U.S. demand for our products has been much weaker than anticipated. Canadian manufacturers, particularly of motor vehicles, electronic products, and telecommunications equipment, have had to make very significant adjustments. At the same time, final domestic demand in Canada has remained firm, buttressed by underlying strength in the energy sector, retail sales, housing, non-residential construction, and most service industries. National accounts data to the end of March and more recent indicators show that our economy has been expanding at a moderate pace since the last quarter of 2000.

As we look ahead, we see domestic demand in Canada continuing to grow, supported by the easing that has taken place in monetary conditions, the recent tax cuts that are boosting disposable incomes, gains in employment, and the projected completion of the current inventory adjustment.

We also continue to see U.S. demand growth picking up in the second half of 2001, given substantial reductions in interest rates, relatively high levels of consumer spending, the expected end of the inventory correction, and recently announced tax cuts (which include rebates beginning in July). But because of the ongoing weakness in U.S. capital investment, there is still uncertainty about the exact timing and strength of the projected pickup in U.S. growth in the second half of the year.

While that uncertainty poses some risks for Canada, we continue to expect that the pace of economic expansion here will pick up in the second half of the year and strengthen somewhat further in the course of 2002.

Total CPI inflation has recently been above the top of the Bank's 1 to 3 per cent target range because of rising energy prices, including higher electricity rates. Total CPI inflation will probably remain volatile over the next couple of months, before moving down to about 2 per cent by the end of the year, if world prices for crude oil and natural gas stabilize around current levels.

The main risk to the Canadian economic outlook continues to be the possibility that the projected pickup in U.S. growth may be delayed. At the same time, even though the prices of crude oil and natural gas have eased from their recent peaks, the Bank will need to stay alert to any signs of energy costs spilling over into other consumer prices, and thus putting upward pressure on the trend of inflation. In light of these risks, the Bank will have to continue to monitor the situation very carefully.

In sum, the Bank remains positive about Canada's economic prospects. We continue to expect that the economy will grow by between 2 and 3 per cent this year and return to a somewhat higher growth path in 2002. This judgment is based on recent evidence that is broadly in line with the Bank's expectations. And it is supported by the marked improvement in our economic fundamentals, which gives Canada a very good chance to weather the current economic difficulties.