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to the Canadian Association of New York
New York, New York
15 April 2005

How Canada Is Adjusting to Global Economic Forces

The Bank of Canada has been examining the issue of how the Canadian economy adjusts to movements in the exchange rate for a long time. Canada's economy is very open, so we always need to understand how exchange rate movements are affecting real economic activity and, in turn, what the implications are for monetary policy. And with a 25 per cent appreciation of the Canadian dollar over the past couple of years, this has been a major preoccupation.

Of course, there's much more to the story than just the exchange rate. Powerful forces have been shaping the global economy. These include the emergence of the economic powerhouses of China and India, and large and growing financial imbalances in the United States and Asia. As a result, we have seen large movements in relative prices, and not just the realignment of exchange rates. We have seen firming prices for non-energy commodities, rising oil prices, flat or falling prices for many consumer goods, and dramatic reductions in the prices of communications services and computer equipment. Today, I want to talk about the kinds of adjustments that the Canadian economy is making in response to these forces. I will start with a brief review of how our monetary policy operates and how it helps with the adjustment process. I'll spend a few minutes talking about how the Bank takes exchange rate movements into account as it conducts monetary policy. Then, I will discuss the ways in which the real economy is adjusting to movements in the exchange rate and other global forces. Finally, I will recap the projections for the Canadian economy contained in the *Monetary Policy Report.*

How Monetary Policy Helps the Economy Adjust

Let me begin with a few words about our monetary policy framework. The Bank of Canada Act calls on us 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." We do this by trying to foster an environment of low, stable, and predictable inflation. In particular, we aim to keep the annual rate of consumer price inflation at the 2 per cent midpoint of a 1 to 3 per cent target range. This is the best contribution that we can make to achieving high, sustainable growth of output and employment. To be clear, inflation targeting is not an end in itself. Rather, it is the best means of fulfilling our commitment to promote the economic and financial welfare of Canadians.

We pursue this objective by trying to keep the economy operating at full capacity; that is, we aim for a balance between total demand and supply in the economy. When the demand for goods and services pushes the Canadian economy against the limits of its capacity, and inflation is poised to rise above the target, the Bank will raise interest rates to cool off the economy. And when the economy is operating below its production capacity, and inflation is poised to fall below the target, the Bank will lower interest rates to stimulate growth. So, by maintaining low and stable inflation, monetary policy promotes greater stability in economic output.

A flexible exchange rate is an important part of our monetary policy framework. I hasten to add that we do not have a target or preferred level for the Canadian dollar. I'll come back to the topic of the exchange rate in just a moment.

But first let me talk about how our monetary policy helps the economy to adjust to the powerful economic forces we see today. To begin with, low and stable inflation allows businesses and consumers to better read price signals in markets, which helps them to make better long-term decisions in the face of major economic developments.

A second way that monetary policy helps with the adjustment process comes from our strategy of keeping total supply and demand in balance. In these circumstances, economic resources that are released by shrinking sectors, where demand is weak, can be absorbed by expanding sectors, where demand is strong. Of course, adjustment is never simple or without pain, especially at the personal level. But from a macroeconomic point of view, adjustment can take place with less social and economic cost when inflation expectations are well anchored and the economy is operating close to its potential.

Having a floating exchange rate is a third way in which our monetary policy framework helps with the adjustment process. Let me explain how. Changes in global demand for a country's goods and services tend to bring about movements in that country's currency. The resulting exchange rate movements help to keep balance in the economy by offsetting the impact of the change in demand. For example, rising global demand for Canadian goods and services tends to lead to a stronger Canadian dollar. The stronger currency, in turn, tends to restrain exports and to encourage imports. By restraining the demand for Canadian-produced goods and services, the floating exchange rate helps to keep total supply and demand in balance. Similarly, when there is falling global demand for Canadian-produced goods and services, the floating exchange rate will encourage demand for these goods and services, again helping to keep total supply and demand in balance.

Exchange Rate Movements and Monetary Policy

This brings me to my next subject, which is how we at the Bank of Canada view movements in the exchange rate. As I said earlier, we do not have a target or a preferred level for the Canadian dollar. But this does not mean that the value of the

currency is unimportant—far from it. The exchange rate is something that we at the Bank are always watching closely, looking for the valuable information that helps us to better interpret and predict the strength of total demand for Canadian goods and services.

The way that we take the exchange rate into account as we conduct monetary policy is complicated. This is because the exchange rate can move for different reasons. Sometimes, movements in the exchange rate reflect changes in the demand for a country's goods and services. But sometimes, they do not. This distinction is important, because the two types of movements have different implications for demand in the economy and, hence, for monetary policy. Indeed, the reason behind a movement in the Canadian dollar can be just as important for monetary policy as the movement itself.

Let me take a couple of minutes to explain. First, consider the type of currency movement that reflects changes in foreign demand. In 2003 and much of 2004, we saw a strong increase in the value of the Canadian dollar. This reflected, at least in part, the strong demand for Canadian exports and a sharp rise in the global prices of many of these exports, particularly commodities. The stronger Canadian dollar, in turn, encouraged imports and discouraged exports. This is an example of how the appreciation of the Canadian dollar can work to dampen an initial increase in aggregate demand. Were this dampening effect on aggregate demand to exactly offset the initial, direct increase in demand, all other things being equal, there would be no need for a monetary policy response.

Now, consider the other type of exchange rate movement, which does not reflect changes in demand for a country's goods and services. Instead, it can reflect changes in foreign demand for that country's financial assets or changes in domestic demand for foreign financial assets. For example, during the past two years, investors have become more concerned about the large and growing U.S. current account deficit which, according to the Bureau of Economic Analysis, hit a remarkable US$666 billion, or 5.6 per cent of GDP, in 2004. And so we have seen the U.S. dollar depreciate against many major currencies, including the Canadian dollar. In this example, the stronger Canadian dollar leads to a decline in net exports, just as in the previous example. But in the absence of any initial increase in demand to be offset, the overall effect on Canadian aggregate demand would clearly be negative. And this decrease in demand—if it were to persist—would generate downward pressure on Canadian prices and employment that could push inflation below our target. All other things being equal, this would require monetary policy to be more stimulative than it otherwise would have been.

To be clear, I don't want you to think that we at the Bank have a mechanical or formulaic approach to dealing with exchange rate movements. The truth is exactly the opposite. Analyzing foreign exchange movements and determining the appropriate monetary policy response is a complicated business. When we look at the movement of the Canadian dollar against the U.S. dollar over the past couple of years, it is clear that the upward movement during this period has been driven by both stronger demand for Canadian goods and services and by widespread weakness in the U.S. dollar.

But there have been times during this period when the first factor appears to have been the strongest influence, and at other times, it appears that the second factor dominated.

How Businesses Are Adjusting

Now that I have talked about how the Bank of Canada deals with exchange rate movements, let me turn to how the real economy is adjusting to global economic developments and to the large relative price movements associated with them.

It is interesting to compare the experience of the past two years with that in the period from 1997 to 2002. From the beginning of 1997 to the end of 2001, falling commodity prices led to a decline of more than 6 per cent in Canada's terms of trade — the ratio of the prices Canadians receive for their exports to the prices Canadians pay for their imports. At the same time, "irrational exuberance" about the prospects for the U.S. economy led to heavy financial flows into the United States, and this helped to drive up the value of the U.S. dollar relative to other currencies. The Canadian dollar fell from just under 75 cents U.S. in early 1997 to a low of 61.8 cents U.S. in January 2002, before ending that year at about 63.4 cents U.S.

During this time, the cost of labour relative to capital goods declined in Canada, because most capital goods are imported and priced in U.S. dollars, while labour is paid in Canadian dollars. Businesses reacted appropriately to these price signals by increasing their production of services and of those manufactured goods that require relatively more labour and less machinery and equipment.

What we have seen over the past couple of years is, in many ways, a mirror image of the 1997-2002 period. Commodity prices have risen, and our terms of trade improved by more than 16 per cent from the fourth quarter of 2001 to the fourth quarter of 2004. The cost of labour has increased relative to the cost of capital goods. Again, Canadian firms are responding to the price signals. We are currently seeing large increases in investment spending in oil and gas extraction, other mining activity, and wood-product manufacturing. Firms have been motivated both by high prices for their products and by the expectation that these high prices will persist.

We are also seeing rising investment spending in sectors with low exposure to international trade, such as electric power generation, finance and insurance, and information and cultural industries. In these cases, firms are reacting to recent substantial gains in Canadian domestic demand.

For both of these groups, a crucial point to note is that a large part of the planned investment is motivated by the desire to increase production capacity.

But the story is somewhat different for those sectors that are highly exposed to international trade, but where the prices of their products are not rising. Here, I am referring to sectors such as auto parts, textiles, and clothing manufacturing. Firms in

these sectors are feeling the pressure of the higher Canadian dollar and are also facing increased competition from places such as China and India.

The good news is that there is evidence that many of these firms are making adjustments in the face of adversity. Investment spending for these firms is being channelled towards increasing productivity and reducing costs, not increasing capacity. Because much of the productivity-enhancing machinery and equipment is produced abroad and priced in U.S. dollars, the appreciation of the Canadian dollar has lowered the cost of this machinery and equipment relative to that of labour.

Other firms are using different strategies to adjust to the stronger Canadian dollar and to increased competition from abroad A growing number of firms are looking to cut costs by importing more inputs. Others are phasing out production of goods and services with low profit margins and concentrating on those that yield higher returns.

And of course, all of these adjustments have implications for the Canadian labour market. Overall job growth has been strong, but there have been important sectoral differences. We have seen job gains in commodity-producing sectors and in those that have low exposure to foreign competition. However, employment has fallen in a number of manufacturing sectors. This reflects, at least partly, the fact that some firms are now substituting capital for labour in order to reduce costs, which is the opposite of the situation we saw in the late 1990s and at the beginning of this decade.

Canadian Economic Prospects

Before I conclude, let me quickly review the projections for the Canadian economy that we set out in our *Monetary Policy Report* yesterday.

The global economy has been unfolding largely as expected, and the prospects for continued robust growth are quite favourable, especially over the near term. The outlook for the Canadian economy through to the end of 2006 is essentially unchanged from that in our January *Monetary Policy Report Update.*

Our base-case projection calls for annualized growth of about 2 1/2 per cent in the first half of 2005 and 3 per cent in the second half. Growth of about 3 1/2 per cent is expected through the four quarters of 2006, consistent with closing the output gap in the second half of next year. To express it in annual average terms, growth in 2005 is projected to be about 2 1/2 per cent, down slightly from the January *Update*, while the projection for 2006 is little changed at about 3 1/4 per cent.

With the economy expected to return to full production capacity in the second half of 2006, core inflation should move back to 2 per cent around the end of next year. Based on the scenario implied by oil-price futures, total CPI inflation is expected to remain above the 2 per cent target for some time, before moving slightly below 2 per cent in the second half of 2006.

In line with this outlook, a reduction of monetary stimulus will be required over time. However, I want to stress again that the Bank is not committed to any particular interest rate path or timetable.

Conclusion

Let me now conclude. As I noted at the beginning, there are powerful global economic forces at work, and economies everywhere need to make adjustments. In Canada, businesses are, indeed, making adjustments to meet these challenges and to take advantage of emerging opportunities. At the Bank of Canada, we will continue to monitor these global forces closely and to assess their impact. We will continue to conduct monetary policy with the aim of keeping inflation close to target and thus keeping the economy operating at its full potential. In this way, we will do our part to facilitate the adjustments that Canadian businesses are making to changes in the global economy.