BANK OF CANADA

Opening Statement by
Gordon Thiessen
Governor of the Bank of Canada
before the Standing Senate Committee on
Banking, Trade and Commerce
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Mr. Chairman, my colleagues and I always welcome our appearances before your committee. We released our latest *Monetary Policy Report* this past Monday. It covers a broad range of economic and monetary issues and provides an account of our policy actions and their results.

The ultimate objective of Canadian monetary policy is to help create and maintain conditions that are conducive to improved overall economic performance over time. The best way for the Bank to make that contribution is through low and stable inflation. As jointly agreed with the government of Canada, the Bank aims to keep the rate of inflation within a target range of 1 to 3 per cent.

In our previous report last May, we highlighted the uncertainties that clouded the global economic outlook. During the past six months, these uncertainties intensified. While some stability returned to Asia, other parts of the world came under pressure through the late summer and early fall, following Russia's unilateral declaration of a debt moratorium and Japan's apparent inability to deal with its problems. Many emerging-market economies suffered large capital outflows and widening interest rate spreads, as investors looked for safe havens and greater risk protection. Spreads between private sector and government bonds also increased more broadly, and market liquidity tightened.

These international developments have had a significant influence on the conduct of monetary policy in Canada over the past six months. Problems in Asia and Russia have led to a decline in the prices of key primary commodities we export. And the difficulties that this has caused in our resource industries continued to put downward pressure on the Canadian dollar through the summer. With global markets becoming extremely nervous after the Russian crisis in August, and tending to exaggerate the importance of commodities for Canada, pressure on our currency intensified. And our medium- and long-term interest rates began to rise sharply at a time when comparable U.S. rates were falling. To forestall a loss of confidence in our currency, the Bank of Canada raised the Bank Rate by one percentage point in late August. This helped the Canadian dollar to stabilize and medium- and long-term rates came back down.

When the U.S. Federal Reserve lowered its target rate three times between September and November, by a total of 75 basis points, in response to concerns about a credit crunch and a slowing in the U.S. economy, the Bank of Canada followed suit. Similar reductions in our Bank Rate were appropriate, given the importance of the U.S. economy to Canada, our continued low inflation rate, and the improving climate in international financial markets as a result of the U.S. actions.

Let me now turn to the prospects for the Canadian economy.

The international economic and financial turmoil has resulted in downward revisions to the estimates for global economic growth this year and next. Still, with the exception of Japan, economic activity in the major industrial countries is expected to remain reasonably well sustained through to the end of 1999, especially in North America and Europe.

With sustained U.S. demand, and with employment gains and accommodative monetary conditions at home, we expect that the Canadian economy will continue to expand over the next year. I must stress, however, that the outlook is more conditional than usual because of lingering international uncertainty.

I should also note that the extent to which growth in the economy will take up slack over the next year will depend on how quickly international and domestic financial markets stabilize. Because financial stability is particularly important to household and business confidence, helping to preserve confidence among investors in Canadian financial markets will be an important consideration for the Bank in the near term. But, over the medium term, the fundamental focus of monetary policy remains on keeping the trend of inflation inside the target range of 1 to 3 per cent. We expect inflation to stay in the lower half of that range over the next year.

The main point I would like to underscore is that, even though Canada has been affected by the global situation, we are weathering the storm better than in the past. I believe that this is because of the remarkable progress we have made in getting our fiscal house in order, achieving a low and more stable rate of inflation, and restructuring our private sector to become more productive and internationally competitive.

Mr. Chairman, I would also like to provide your committee with some comments on the implications of this past year's global upheavals for the Canadian dollar, and explain the Bank's response to all this.

To understand what is going on, we need to correctly identify cause and effect in the decline of the Canadian dollar. Exchange rates will typically reflect developments at home and abroad. Thus, the downward movement in our currency is the ***consequence*** of developments since the summer of 1997. It is not the ***cause*** of the economic difficulties we are currently facing, as some commentators seem to suggest.

The worldwide capital flight to the safe haven of U.S. assets and the 15 per cent decline over the past year in the prices of the primary commodities we export have been the main factors behind the marked depreciation of our currency against the U.S. dollar.

In particular, the drop in commodity prices has meant lower incomes and wealth for Canadians -- a harsh reality that we must adjust to. Because we are on a floating exchange rate, this adjustment has taken place through a decline in the external value of the Canadian dollar. Had we been on a fixed exchange rate system, the adjustment would have been slower and more costly, as it would have to come entirely through lower output, employment, and wages.

What can, and should, the Bank of Canada do about the exchange rate in times of international financial turbulence and major external shocks?

First of all, let me repeat that the objective of monetary policy is domestic price stability -- that is, keeping inflation low and stable. In this policy approach, the exchange rate and interest rates are the channels through which monetary policy operates; and they must be allowed to adjust to help achieve the inflation targets.

But when the momentum of currency movements pushes the exchange rate too far, beyond what is justified on economic grounds, the Bank needs to remind market participants of the positive trends in our economy.

The Bank may do that by intervening in the foreign exchange market to buy Canadian dollars, as we did through the first half of last August. But, we can also respond with Bank Rate changes. This would be appropriate in the following two cases. First, when the magnitude of the decline in the currency leads to excessive monetary easing. Remember that a falling currency is a source of stimulus to the economy because it encourages exports and domestic production of import substitutes. Second, when there are signs that confidence in the currency is eroding. A loss of confidence can prove very costly for the economy if it leads to persistently higher medium- and long-term interest rates on loans for house purchases, construction, and business investment.

It was because of such concerns that the Bank responded strongly to the decline in our currency during the Mexican crisis in early 1995. And, as I discussed earlier, it was again to head off a loss of market confidence that we raised the Bank Rate last August.

I hope that this helps to clarify questions about the exchange rate and some of our recent related actions.