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Remarks by Mark Carney
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CHECK AGAINST DELIVERY

Inflation Targeting in a Global Recession

It's always a pleasure to be in Halifax, a city steeped in history and rich in spirit – a spirit that this Chamber has embodied for centuries, with roots dating back to 1750.

Indeed, I am always struck when I come here by how successfully this city celebrates its past, even as it prepares for the future. This dynamism is recognized in the nominees for this year's Halifax Business Awards in the current issue of "Business Voice."

I am honoured to be part of your "Distinguished Speakers Series," although my colleagues tell me that "distinguished" is just something people call you when you reach a certain age. I have certainly aged since I became Governor, but I will gratefully accept anything that could be interpreted as a compliment. In these challenging times, you take what you can get.

These are challenging times, indeed. We are facing a financial crisis without comparison for generations. Most financial markets have experienced historic declines in prices and unprecedented spikes in volatility. Storied financial institutions have fallen. The global capital market is under great strain. Issues of financial stability that were once the obsession of a pessimistic few are now the daily concern of many.

In response, governments and central bankers have taken bold measures. More initiatives are likely in the coming weeks. These measures will work, although it will take time for confidence to return and for capital to flow once again. In the interim, the sudden, synchronized slowdown across the globe will mean lost jobs and foregone output. This global recession has lessened concerns about rising inflation – concerns that seemed all too real just a few months ago, with soaring prices of fuel, food, and other commodities. In some countries, though, these have given way to concerns that the opposite problem – deflation – might materialize.

In challenging times such as these, people, rightly, look to a few constants: to institutions they can rely upon and to certain expectations that will be met. My message today is that Canadians can rely on the Bank of Canada to fulfill its mandate; they can expect inflation to be low, stable and predictable. The relentless focus of monetary policy on inflation control is essential in this time of financial crisis and global recession and remains the best contribution that monetary policy can make to the economic and financial welfare of Canada.

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Inflation, Disinflation, and Deflation

Inflation is, of course, defined as a persistent increase in the average price of goods and services; in other words, a rising trend in the cost of living. In the broadest terms, this is measured by the total, or headline, consumer price index (CPI), which tracks the retail prices of a representative "shopping basket" of goods and services over time. It is also the rate that the Bank of Canada targets for its monetary policy.

Disinflation occurs when there is a decline in the rate of increase in prices, while deflation refers to a sustained fall in prices; where the annual change in the CPI actually turns negative year after year.

Those of you "distinguished" enough to remember the inflation of the 1970s and 1980s may wonder why anyone – particularly a central banker – might be concerned with too low a level of inflation or even a fall in the general price level. The answer is that we are not concerned if these periods are transitory. In fact, as I will discuss in a moment, the Bank expects total CPI inflation to be below zero in the second and third quarters of this year before returning to the two per cent target by 2011.

While such transitory movements in prices are generally harmless over the long term, greater risks arise from a sustained fall in prices. Such deflation, if left unchecked, can weigh on economic activity in two main ways. First, it increases the real burden of debt, making it more difficult for indebted households to consume and leveraged firms to invest. Second, if deflationary expectations take hold, purchases and investments may be postponed in the expectation that they can be executed at a lower price at a later date. After all, if prices are falling, why buy that new car or refrigerator – or invest in technology or equipment – when they could be cheaper in six or nine month's time?

A mild deflation took hold in Japan in the 1990s and was associated with a lost decade of missed economic opportunity. Today in the United States, the economy is in the midst of a serious recession and, with the recent dip in U.S. total CPI inflation to below zero, concerns about the possibility of deflation there have increased. Recognizing the risks, the Federal Reserve is responding proactively and presciently – cutting interest rates effectively to zero and committing to using "all available tools" to maintain price stability.

With this backdrop, the question is being asked whether sustained deflation could happen here in Canada. The possibility is actually remote for three reasons.

First is the resilience of our economy. The Canadian economy has a number of advantages: labour, product, and capital markets that are flexible and open; one of the soundest banking systems in the world; and households, corporations, and a public sector that have considerable financial flexibility. So while our economy will be tested by the current global crisis, it is well positioned to respond.

Second, a floating currency means that we have an independent monetary policy. Quite simply, we are in control of our own monetary destiny.

Third, we have used that monetary independence to great advantage. As one of the pioneers of inflation targeting, Canada has deep experience with the clearest, most powerful monetary policy framework. The advantages of that framework have been demonstrated, with inflation brought down and kept low and stable since the early 1990s, and they are equally relevant in times of disinflationary pressures. To underscore this point, and before turning to the outlook for growth and inflation, let me review the Bank's monetary policy framework.

Inflation Targeting

In its simplest terms, monetary policy is concerned with how much money circulates in the economy, and what that money is worth. The single, most direct contribution that monetary policy can make to sound economic performance is to provide Canadians with confidence that their money will retain its purchasing power. That means keeping inflation low, stable and predictable. Monetary policy makers have learned over decades that it pays to be precise about this objective.

The cornerstone of the Bank's monetary policy framework, therefore, is its inflation target which since 1991 has been set jointly with the Government of Canada. The target aims to keep the annual rate of inflation, as measured by the CPI, close to 2 per cent – the midpoint in a range of between 1 and 3 per cent.

The agreement sets out one clear objective – the inflation target – and the Bank is accountable to Canadians through its open and transparent communication of success in achieving that objective. If inflation deviates from the target, the Bank will explain the reasons why, what it will do to return it to target, and how long the process is expected to take. Our *Monetary Policy Report Update*, released last Thursday, is an example of that communication.

Canada has been served extremely well by its inflation-targeting policy framework, which has been widely emulated. Since the targets were initiated, the rate of inflation, as measured by the CPI, has averaged very close to 2 per cent. The Bank's exemplary record of inflation control has meant that we have avoided the destructive effects of high inflation prevalent in earlier decades – effects that were disproportionately felt by poorer Canadians, and that reduced our living standards and increased our unemployment. As in other countries where inflation targeting has been adopted, inflation and interest rates have generally been lower and less volatile.

It is important to underline that the Bank approaches inflation control in a symmetric way. This means that we care as much about inflation below the target as about inflation above the target. Just as inflation targeting has proven its ability to prevent the entrenchment of high and volatile inflation, it also has the power to prevent the onset of persistent deflation.

Expectations and the 2 per cent Target

When a shock threatens to push inflation either above or below the target range, the Bank of Canada will act to bring inflation back to the 2 per cent target. This certainty – that the Bank will act – helps to keep expectations of future inflation close to the inflation target.

Economists call this “anchoring inflation expectations,” and it brings a number of benefits: it helps to reduce swings in interest rates, lowers the cost of borrowing for Canadians, contributes to a more stable, competitive cost of capital for our companies and, ultimately, supports more sustainable growth in output and employment.

What matters most for economic decisions is the real interest rate, which is the nominal rate less the expected inflation rate over the relevant time horizon. Importantly, provided medium term inflation expectations remain well-anchored around the 2 per cent target, the Bank can keep real interest rates low even in the face of temporarily falling prices.

One of the realities of monetary policy is that it takes time to take effect. For this reason, it must be forward looking. To do that, we use a number of indicators to determine how serious and long-lasting inflation (and disinflationary) pressures might be.

Much as we aim for low, stable, and predictable inflation, there will always be sharp movements in total or headline inflation. These are generally driven by volatile price changes in a small number of goods and services. In Canada, for example, fully 90 per cent of the monthly variations in the CPI are linked to price changes in just 8 of the 54 major goods and services categories included in the index. Further, these price changes are often quickly reversed and can add considerable “noise” to total CPI, making it difficult to discern genuine movements in trend inflation.

For this reason, the Bank uses core inflation as an operational guide. By focusing on the more stable components, the Bank can get a better fix on the underlying trend in inflation. This is important because monetary policy operates with long and variable lags, and any attempt to control short-term movements in inflation is likely to prove counterproductive, destabilizing both inflation and real economic activity.

Our experience in Canada has shown that core inflation is a better tool for discerning inflation trends than is total CPI. Indeed, when the two deviate, total CPI inflation tends to converge on core inflation rather than the reverse. When total inflation temporarily moves higher or lower than the target, households and businesses know that it will probably return to target within a relatively short time.

The present situation offers a compelling example. When there is a sudden and persistent shock, as we have seen in the past few months from outside our borders, the immediate effects may be felt before the full effect of the monetary policy response kicks in. However, these monetary actions will have an impact on economic output and will bring inflation back to the target.

Current Outlook

With this background, let me turn now to the current economic climate and its implications for inflation.

The outlook for the world economy has deteriorated significantly in recent months. The financial crisis intensified last autumn and spilled over into an already weak global economy. This, in turn, put further strains on the global financial system, increased

uncertainty and sharply reduced the confidence of businesses. The major advanced economies, including Canada, are now in recession, and emerging-market countries are increasingly affected. In response to the sudden downturn in global demand, energy prices have fallen further, and global inflationary pressures have abated rapidly.

Stabilization of the global financial system is a precondition for economic recovery. To that end, governments and central banks are taking bold and concerted actions. There are signs that these extraordinary measures are starting to gain traction, although more will be required and it will take some time for financial conditions to return to normal. In addition, considerable monetary and fiscal policy stimulus is being provided worldwide.

As a result of these global developments, Canada's economic growth is expected to decline through mid-2009. Canadian exports are already falling sharply because of the downturn in external demand, especially from the United States. Here at home, demand is also declining as Canadians households experience a reduction in their net worth. This reflects lower commodity prices, as well as steep declines in consumer and business confidence.

That said, the Canadian economy is expected to begin recovering later this year and to accelerate to above-potential growth in 2010 as policy actions begin to take hold and with support from the past depreciation of the Canadian dollar. On an annual average basis, then, real GDP is projected to decline by 1.2 per cent in 2009 and to rebound by 3.8 per cent in 2010.

What does this mean for inflation? It means that we should expect a temporary divergence between headline and core inflation in the coming quarters. Reflecting the sharp year-on-year falls in energy prices (and assuming that energy prices follow recent prices in the oil futures markets), total CPI inflation should fall relatively abruptly, dipping below zero in the second and third quarters of 2009.

I want to emphasize that this projected brief period of falling prices does not signal the onset of deflation for four reasons. First, most prices will not, in fact, be falling. At present, the prices of more than half the goods in the CPI basket are actually rising at more than the 2 per cent target.

Second, while core CPI inflation in Canada should ease through 2009, its anticipated low should be 1.1 per cent in the fourth quarter of this year – still within the target range for total CPI.

Third, consistent with the past experience that I referred to earlier, and reflecting the accommodative stance of monetary policy, we expect total CPI inflation to begin to converge towards core, starting at the end of this year, reaching 2 per cent by mid 2011.

Fourth, we should again see the benefit of well-anchored inflation expectations in helping to return actual inflation to the target. While measures of near-term inflation expectations have been volatile recently, reflecting the sharp swings in energy prices, over the longer term, they remain well anchored at 2 per cent. Indeed, the Consensus Economics'

forecast for total CPI inflation in 2009 fell to 0.7 per cent in January, but moves back up to 1.9 per cent for 2010. Consensus expectations farther out remain at 2 per cent.

This pattern in near- and medium-term inflation expectations is very similar to what we saw during the sharp commodity-price spike last spring. At that time, short-term expectations moved up sharply while medium term expectations remained anchored at 2 per cent. These expectations proved to be well justified as total inflation fell back into line with core inflation.

The Ongoing Effectiveness of Monetary Policy

The Bank's projection of an economic recovery reflects, in part, the monetary easing that we have already put in place – cutting the policy rate by 350 basis points since December 2007. Guided by its forward-looking framework, the Bank began cutting interest rates sooner – and has cut deeper – than most other central banks. With the usual lag, these moves will have a powerful impact on economic activity and inflation.

Nonetheless, some are questioning, with rates already so low and global credit markets strained, whether the Bank's moves can still have an effect.

We know from experience that inflation control works much more predictably when there are well-functioning financial markets operating within a sound and stable financial system. The Canadian system has been under some strain since the onset of global difficulties, but it is important to keep those strains in perspective.

It bears repeating that the Canadian banking system does not face the same challenges as those in other major economies. Canadian banks had modest exposures to the U.S. subprime market and other complex structured products. More importantly, our banks are better capitalized and substantially less leveraged than their international peers. In contrast to many international banks, which face enormous pressures to scale back their assets and liabilities to bring them into line with their capital, Canadian banks have actually been raising private capital to grow their businesses. Indeed, over the past year, they have raised over $15 billion in Tier 1 capital from the private capital markets.

Consequently, Canadian banks continue to lend. This is significant, because banks are a more important part of our financial system than in many other countries, and their relative strength means that total credit is continuing to grow in Canada. That said, we expect this credit growth to slow in the coming months as result of declining demand during the recession.

It is worth noting that our lower overnight rates have largely been passed through at shorter maturities. Since the easing cycle began in December 2007, we have lowered the overnight rate by 350 basis points. The prime rate has fallen by 325 basis points, Bankers Acceptance rates (key short-term financing instruments for corporations) have fallen by about 380 basis points, and variable rate mortgages by about 185 basis points.

At longer maturities, the declines have been more modest. In part, this reflects the typical pattern, as long-term rates tend to be less volatile than short-term rates over the business cycle. For example, five-year fixed-rate mortgages have fallen by just over one and a half percentage points. Corporate bond yields have been virtually flat, as a substantial increase in the risk premium charged by investors has offset the decline in government bond yields. While the widening of spreads at longer maturities is larger than usual, this partly reflects the fact that these spreads were unusually narrow to begin with.

The Bank has taken into consideration the higher risk premiums demanded in today's markets in setting its overnight rate. As well, it has taken into account the effect on future Canadian inflation of the lower level of foreign demand that has resulted, in part, from financial difficulties in other countries. The policy rate is lower than it otherwise would be in the absence of these difficulties.

Finally, the role of the exchange rate in monetary policy should not be overlooked. The substantial past depreciation of the Canadian dollar provides an important offset to weaker global demand and lower commodity prices.

Conclusion

To conclude, let me say that the inflation target that has served Canada so well when inflation was above the 1 to 3 per cent control range, will also serve it well when inflation falls temporarily below that range. So let me leave no doubt, no uncertainty about the Bank's commitment. Our focus is clear, our actions consistent, and our objective explicit: 2 per cent CPI inflation.

Guided by Canada's inflation-targeting framework, the Bank will continue to monitor carefully economic and financial developments in judging to what extent further monetary stimulus will be required to achieve the 2 per cent target over the medium term. The Bank retains considerable policy flexibility, which we will use as required.

While the current financial crisis presents challenges for policy-makers and citizens alike, Canada faces those challenges from a position of strength. In time, the global financial crisis will end, and the global economy will recover, although the speed with which this will happen is subject to a high degree of uncertainty.

As we work through this difficult period, you can be assured that the Bank of Canada remains relentless in its focus on keeping inflation low, stable, and predictable – the most important contribution we can make to the economic and financial welfare of Canada.