BANK OF CANADA
BANQUE DU CANADA

CHECK AGAINST DELIVERY

Opening statement by Mark Carney
Adviser to the Governor
to the House of Commons Standing Committee on Finance
5 December 2007

I would like to begin by saying how pleased I am to appear before this committee to discuss my perspectives on the medium-term policy issues facing the Bank of Canada. I am looking forward to many future appearances before both this committee and its counterpart in the Senate, since a critical component of the Bank's accountability to Canadians is having the Governor appear periodically before Parliamentarians to explain the Bank's views on the economy, monetary policy, and the financial system.

I would like, however, to emphasize at the outset that I am not yet the Governor of the Bank of Canada. Under the Bank of Canada Act, the current governor – David Dodge – remains very much responsible for Canada's monetary policy until the end of January. In recent years, the Bank has operated under a convention whereby monetary policy decisions are taken on a consensus basis by the Bank's Governing Council. I am also not yet a member of the Governing Council. And so, in answering your questions today, I shall endeavour to comment neither on the current stance of monetary policy nor on the economic outlook, so as to avoid prejudicing upcoming decisions of the Governing Council. I trust that all those listening will recognize these important caveats.

Reflecting my current position, I would like to focus on the principal medium-term policy challenges facing the Bank. As set out in the preamble to the Bank of Canada Act, the Bank's objective is "generally to promote the economic and financial welfare of Canada." The Bank achieves this objective by:

- conducting monetary policy to maintain a rate of inflation that is low, stable, and predictable;
- promoting the safety and soundness of Canada's financial system;
- acting as the Government of Canada's fiscal agent to provide efficient and effective funds management; and
- supplying quality bank notes that are readily accepted and secure against counterfeiting. This is very important to the Bank, and we have worked closely with crown prosecutors as well as our partners in law enforcement – particularly the RCMP – and the retail sector to deter counterfeiting through bank-note-related education, communication, and compliance. These efforts have yielded important results, and they will continue.

With that introduction, I will concentrate the balance of my remarks on the Bank's work in monetary policy and the financial system.

Monetary Policy

With respect to monetary policy, I am in the fortunate position of inheriting an exceptionally sound and robust policy framework. Over time, it has become clear that the best contribution monetary policy can make to the promotion of the economic and financial welfare of Canada is to keep inflation low, stable, and predictable. Put another way, inflation control is not an end in itself; rather, it is the means whereby monetary policy can best contribute to solid economic performance. Specifically, the Bank aims to keep the annual rate of consumer price inflation at the 2 per cent midpoint of a 1 to 3 per cent control range. By doing so, monetary policy helps to keep the economy as a whole operating at full capacity and promotes sustainable economic growth.

Canada has been served extremely well by its inflation-targeting policy framework, which has been widely emulated. 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 which reduced our output and increased our unemployment. Despite all the shocks that Canada has faced since inflation targets were introduced, Canada's real output since that time has expanded at an average rate of 3 per cent per year and the unemployment rate has fallen to levels not seen in more than three decades. As in countries where inflation targeting has been adopted, inflation and interest rates have generally been lower and less volatile.

An explicit inflation target was first formalized in a joint agreement between the Bank and the Government of Canada in 1991. Given its initial success, this agreement has been extended four times with small modifications; most recently until the end of 2011. This agreement sets out one clear objective – the inflation target – and creates a transparent accountability framework for the Bank of Canada. The Bank supports that framework through frequent and open communication with Canadians. 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. It is important to underline that the Bank approaches inflation control in a symmetric way.

A floating exchange rate is a key element of our monetary policy framework. It allows Canada to pursue an independent monetary policy appropriate to our own economic circumstances. Although there is no target exchange rate for the Canadian dollar, the Bank does care why the exchange rate is moving and what the potential impact will be on output and inflation. The exchange rate is an important relative price in our economy. Movements in the exchange rate influence the levels of imports and exports, which can help to keep total demand and supply in balance. Further, exchange rate movements act as a signal to shift resources into sectors where demand is strongest. A floating exchange rate helps to smooth that process and to minimize the adjustments in other areas of the economy.

The challenge for the Bank is to understand the reasons behind currency movements, incorporate those with our assessments of other data, and set a course for monetary policy that works to keep total demand and supply in balance and inflation on target. This means that the Bank has to make judgments about the causes and likely persistence of exchange rate movements, the speed and degree to which the exchange rate changes "pass through" to domestic prices, and the possible impact of exchange rate movements on confidence and, through confidence, on consumption and investment.

It is true that exchange rate movements can be, and have been, rather volatile. In these circumstances, it is not surprising that some have called for Canada to fix its currency to the U.S. dollar. In my opinion, it would be a mistake to do so. It would mean that, de facto, Canada would adopt U.S. monetary policy, despite the reality that the structures of our economies are very different and, as a consequence, often require different types of adjustments in response to global developments. We cannot avoid adjustment; the question is simply *how* we adjust to global economic forces. With a fixed exchange rate, the adjustments would have to come through movements in overall output and in all wages and prices. History has shown that these adjustments are more protracted and more difficult than exchange rate adjustments. Again, however, I stress that this position does not mean that the Bank is indifferent to movements in the exchange rate.

Another important aspect of our policy framework is the need to be forward looking, given the lags between policy actions and their effects on the economy. Indeed, a forward-looking perspective is essential to the success of inflation targeting. The joint agreement between the Government of Canada and the Bank of Canada on the inflation target has helped concentrate inflation expectations around 2 per cent. More fundamentally, the successful management of monetary policy by my predecessors has created a self-reinforcing process whereby increased policy credibility further anchors inflation expectations, which then contribute to a more stable macroeconomic environment, which, in turn, enhances policy credibility. We should not underestimate the value of these hard-won gains, and I have no intention of forfeiting them. Well-anchored inflation expectations help to reduce swings in interest rates, lower the cost of borrowing for Canadians, contribute to a more stable, competitive cost of capital for our firms, and, ultimately, support more sustainable growth in output and employment.

Despite our successes, the Bank has an obligation to Canadians to continually evaluate possible improvements to its policy framework. As a result, the Bank has launched a concerted research program to examine whether and how the monetary policy framework in Canada might be improved. The program is focusing on the potential costs and benefits of targeting a lower rate of inflation, of pursuing a price-level target instead of an inflation target, and the challenges of communicating these potential changes to Canadians. The Bank will conduct this research and publish its findings in an open manner in order to encourage debate and suggestions. The research would need to uncover compelling evidence in favour of a change before we would want to alter the system that has proven so successful over the past 15 years.

Medium-Term Challenges for Monetary Policy

The conduct of monetary policy over the coming years will be challenged by four underlying trends. Their precise speed is difficult to predict, but their influence will be impossible to ignore.

These trends are:

- First, the globalization of product, capital, and increasingly – given outsourcing and technology – labour markets;
- Second, the resolution of global imbalances. This requires both the need for stronger domestic demand growth in countries with large current account surpluses, and the move to a flexible exchange rate regime in those systemically-important countries that currently actively manage their exchange rates. As the Bank has consistently noted, this process may proceed in an uneven manner;
- Third, the pace and direction of financial innovation and integration. This has important implications for the degree of financial intermediation, the levels of nominal and real interest rates, and the monetary policy transmission mechanism; and,
- Fourth, the evolution of potential growth in Canada, reflecting the balance of profound demographic changes and developments in Canadian productivity.

These underlying economic and financial trends complicate the pursuit of our inflation target, not only because none is likely to proceed at a steady, predictable pace, but also because they are all interrelated. For example, global imbalances, financial integration, and historically low nominal interest rates can all be partially explained by the familiar process of global integration that is currently taking place on an unprecedented scale. The Bank must better understand these forces in order to effectively meet its responsibilities. It should also continue to share its perspectives on these broader trends so that individual Canadians, companies, and governments have the necessary context when making their savings and investment decisions.

The strength of our financial system will help determine the ultimate impact of these trends, since each has the potential to affect asset-price volatility and the stability of growth and employment. Where financial systems are strong and resilient, they cushion shocks, efficiently allocate resources, and help improve the effectiveness of monetary policy. Where they are weak, however, they can amplify the impact of shocks on macroeconomic activity and reduce the effectiveness of monetary policy. As a consequence, the Bank has a fundamental role to play in promoting the safety and stability of Canada's financial system.

The Bank's Role in Financial Stability

The Bank's role in financial stability is at the heart of our legislated mandate to promote the economic and financial welfare of Canada. Before concluding, I would like to make five brief comments in this regard.

First, as Canada's central bank, we have legislative oversight responsibility for the safety and soundness of systemically important clearing and settlement systems.

Second, we play a central role in providing liquidity to facilitate the settlement of financial transactions. The Bank has traditionally undertaken open-market buyback operations only in Government of Canada debt, and offered standing liquidity facilities against high-quality collateral, in order to keep the overnight rate close to the target policy rate. However, recent events have raised questions over the appropriate role for central banks in the provision of liquidity in money markets. As my colleague Pierre Duguay noted last month, the Bank is currently examining whether some market failures might be best addressed if the central bank had a facility that would provide liquidity at terms longer than overnight, possibly secured with a wider range of securities.

Third, the response to the recent turbulence in financial markets should reaffirm that market participants are fundamentally responsible for their actions. For example, investors must understand the price dynamics and liquidity risks of the products they buy, rather than relying solely on credit-rating agencies. The market is beginning to lead many of the necessary changes, as institutions are improving their liquidity management and credit discipline, and originators and distributors of new loans are beginning to adjust their products to standardize terms and align incentives. At the same time, accurate and timely information about underlying risks is essential for the market to differentiate and properly price risk. Thus, as Governor Dodge highlighted in September, enhanced disclosure and transparency are crucial.

Fourth, recent global events have underscored the importance of continued close co-operation among authorities in Canada. The Bank will continue to work collaboratively with its partners, including the Department of Finance, OSFI, the Canada Deposit Insurance Corporation, and provincial securities commissions, to promote the safe and efficient operation of the key elements of our financial system.

Finally, the Bank will continue to use its membership in international bodies, and its extensive research capabilities, to foster the safety, soundness, and efficiency of the international financial system. For example, the Bank and the Government of Canada have actively promoted reform of the International Monetary Fund through a strengthened surveillance function. Strengthened IMF surveillance can play an important role in the resolution of global imbalances and the development of a more robust international financial system. As part of the international response to recent market turbulence, the Bank is also working through the Financial Stability Forum as that body considers possible changes to accounting and regulatory standards and the extent to which enhanced oversight can improve the management of credit and liquidity risk in global financial institutions.

Conclusion

In conclusion, let me say that it is an honour and a privilege to have been chosen to serve Canadians as the eighth Governor of the Bank of Canada. I am particularly looking forward to leading the Bank’s talented and dedicated staff as we face the challenges of the years ahead. I will do my best to live up to the very high standards of those who came before me and am confident that my experience in both the public and private sectors will help me contribute to the Bank’s important work on behalf of all Canadians.