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CHECK AGAINST DELIVERY

Central Banking in Canada: Meeting Today's and Tomorrow's Challenges

Good afternoon, it's a pleasure to be with you again. When I last spoke to the Board of Trade three years ago, my topic, "Weathering Economic Shocks," was not dissimilar to today's—although our perspective in 2006 was certainly different. Indeed, the global financial crisis of the past two years has presented unique, stressful challenges that have forced us all to assess what has worked well and what needs to change. Today, I would like to review some of the critical thinking around these issues, primarily from the perspective of our work at the Bank of Canada. I will also offer some thoughts on Canadian public policy more broadly, as well as on the economies of Canada and British Columbia.

A Look Back

All of us, collectively and as individuals, have been immersed in the fallout from the global financial crisis that began to unfold in August 2007. Its impact has been profound and widespread, across national economies and financial markets. Heightened uncertainty in global financial markets associated with the collapse of the subprime-mortgage market in the United States, the opaqueness of structured securitized financial products, an overreliance by banks on wholesale funding, and generally lax regulation resulted in key markets seizing up. Credit spreads widened dramatically, and a forced deleveraging process made credit expensive and unavailable to many households and businesses.

As the process unfolded, it was evident that many financial institutions were insolvent. Firms such as Bear Stearns, AIG, and Lehman Brothers suddenly became household names. The intensity of the stress in financial markets quickly led to a deep, synchronous global economic recession, which some have dubbed the "Great Recession."

Policy-makers reacted swiftly to the onset of the recession. Last autumn, on our Thanksgiving weekend, G-7 finance ministers and central bank governors put in place a plan of action acknowledging the need for a global solution. This was followed by a series of G-20 summits—starting last November in Washington, D.C., and most recently, in Pittsburgh two weeks ago—which quickly broadened the reach of countries involved in turning the situation around and preventing a recurrence. While the resulting coordinated set of plans to stabilize global financial markets and provide macroeconomic stimulus is beginning to bear fruit, the recovery is going to be protracted, given the extent of repair required in financial markets and system infrastructures around the world.

The gravity and global reach of what we endured during the past two years have been unprecedented in the past half-century. While acknowledging this, we should not forget the valuable lessons learned from other serious economic and financial challenges of previous decades. Let me mention a few.

A major challenge was the struggle to reduce the high, variable inflation rates of the 1970s and 1980s and to establish a low, stable, and predictable inflation environment. Another was the effort made in the mid–1990s to put Canada's fiscal house in order, with a medium-term focus on reducing public debt levels relative to the size of our economy.

We have had to respond to major external shocks: the Asian, Russian, and Latin American financial crises of the late 1990s and start of this decade; the worldwide collapse of the high-tech bubble in 2000–01; and the 9/11 terrorist attacks. And, familiar to this audience, we have witnessed the emergence of China and India, along with technological advances and the increasing globalization of trade and finances.

As diverse as these challenges were, two themes are common to them all. The first is the importance of sound policy frameworks to guide our thinking and our actions. The second is the importance of economic flexibility, by which I mean our ability to adjust to changing circumstances and return to full production potential as quickly as possible. Most of my remarks today relate to the first of these two themes; I will pick up on the second towards the end.

Canada's Response to the Global Financial Crisis

As you know, the Bank's monetary policy objective is to achieve its 2 per cent inflation target for the consumer price index (CPI). It is through inflation control, by providing Canadians with confidence in the future value of their money, that we contribute to good economic performance in Canada—a means to an end. Throughout the global financial crisis and recession, our monetary policy decisions have been anchored by our inflation-targeting framework, and we have calibrated our actions to achieve the 2 per cent target.

In a series of rate cuts between December 2007 and April 2009, we reduced our target overnight rate of interest by a total of 425 basis points. This includes an exceptional, coordinated cut of 50 basis points, taken by the G-10 countries one year ago today. Since April, the target rate in Canada has remained at 0.25 per cent, which we regard as the effective lower bound. Also in April, we stated that, conditional on the projection for inflation, we will keep the policy rate at that level until the end of the second quarter of 2010. These actions have resulted in interest rates dropping, for many borrowers, to record post-World War II lows. In addition, inflation expectations—given the credibility of policy—have remained firmly anchored to the 2 per cent target.

Clearly, these have been unusual times—so much so that they have demanded consideration of unconventional instruments in our conduct of monetary policy. In an

Annex to our April *Monetary Policy Report* (MPR), we set out a framework for conducting monetary policy at low interest rates.

This framework includes three instruments**.** The first is a conditional statement about our target policy rate, which is the one unconventional instrument we have employed thus far. The second is quantitative easing, which refers to outright purchases of financial assets through the creation of excess settlement balances on the books of the Bank; and the third, credit easing, refers to purchases of private sector assets in key, temporarily impaired credit markets. The use of any of these instruments would clearly be cast in terms of what is needed to achieve our inflation target.

Canadians have also benefited through the crisis from other policies. A sound fiscal framework, aimed at reducing the national debt-to-GDP ratio over the medium term, has provided an important degree of flexibility in this time of need. A system-wide focus on financial stability, including the provision of liquidity to key markets by the Bank of Canada and risk assessments in our *Financial System Review,* has provided further support. Canadians have also benefited from a risk-based approach to financial system regulation.

The combined effect of the decisions and actions taken in each of these policy areas is a primary reason why Canada has avoided the worst of the global financial crisis. Although our economy has suffered a deep recession, due to the impact of the U.S. recession and the collapse of commodity prices, Canada has avoided a boom-bust cycle in housing, and our financial system, especially our banking system, has continued to function relatively well.[1] Indeed, some attributes of Canada's regulatory system for financial institutions are being advanced globally through the G-20 process.[2]

Overall, the Canadian experience shows that sound policy frameworks, working in tandem, help address difficult circumstances—even situations as extreme as those we have recently faced.

Looking Ahead

Still, our experience of the past two years makes it clear that the status quo is no longer sufficient. At the Bank of Canada, we must strengthen our frameworks, in terms of both monetary policy and financial stability, to increase the country's capacity to avoid crises to the extent possible and to address shocks when they do occur.

In terms of *monetary policy*, there are two critical streams to our work plan. The first relates to our inflation-targeting regime. In November 2006, when we renewed the

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[1] One exception was in a very specific segment of the Canadian market for non-bank-sponsored, asset-backed commercial paper (ABCP), which had transparency problems and which led to the standstill under the Montreal Accord.

[2] For a more detailed review of these attributes, see P. Jenkins, "Canada's Financial Sector: Responses to the Global Crisis" (presentation to the Colombian Banking Association, Cartagena, Colombia, 10 July 2009).

current five-year inflation-target agreement with the federal government, we also launched a research program to examine ways to strengthen our monetary policy framework.[3] Two questions were posed: What are the costs and benefits of a lower inflation target? What are the costs and benefits of a price-level target?[4]

Considerable study on these two questions has already been undertaken, involving not only researchers at the Bank, but also academics and colleagues at other central banks. I won't review this work today. However, more information can be found on our research website, http://www.inflationtargeting.ca/, and in summary articles in the *Bank of Canada Review*.[5] We will take a hard, objective look at what the research finds, and you can expect to hear more from us on this subject in the coming year.

The second stream relates to the transmission mechanism—that is, how our monetary policy actions work their way through financial markets and the economy. The crisis has made it abundantly clear that central banks must have a better understanding of the links between the real economy (that is, output, inflation, and employment) and the financial sector. For example, time-varying term, liquidity, and risk spreads have been shown to be empirically relevant for explaining real activity, as have non-price terms for credit. Another important insight from the financial crisis is that broader procyclical dynamics—that is, forces that amplify cyclical fluctuations—in money, asset, and credit markets also have implications for the real economy and hence, monetary policy. A critical part of the Bank's research agenda is on these real-financial linkages, to better understand them and incorporate them into our models and policy analysis.

In terms of *financial stability*, what we have witnessed over the past two years has been an increasingly complex set of interrelationships among credit, market, and funding risks. These interrelationships, involving key segments of the global financial system, have had significant consequences for economies worldwide—consequences that have brought to the fore the critical importance of effectively managing liquidity, credit, and market risks, as well as the importance of ensuring adequate levels of capital.

In several of these areas, Canada—as I noted earlier—has stood out for the sound management, regulation, and supervision of its financial institutions. However, the focus at this micro level is not enough. Indeed, another key lesson of the global financial crisis has been a recognition of the need for oversight of the system as a whole, including both systemically important institutions and markets. Such an approach is critical, because systemic risks can arise from the collective actions of institutions and market participants

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3 See "Renewal of the Inflation Control Target, Background Information" (Ottawa: Bank of Canada, November 2006).

4 In the price-level-target approach to inflation control, bygones are not bygones, unlike the current policy. Under price-level targeting, if inflation has been below trend, causing the price level to fall below target, monetary policy would need to generate above-trend inflation for a while to return the price level to target. Or, if inflation has been above trend, lifting the price level above its target, the central bank would need to temporarily induce below-trend inflation to return the price level to its target path over time.

5 See various articles, *Bank of Canada Review* (Ottawa: Bank of Canada, Spring 2009).

that, at the individual level, may appear to mitigate risk, but that collectively—because of interconnectness and common exposure—contribute to the instability of the system overall. The off-loading of assets in illiquid markets is just one example.

A system-wide, or macroprudential, approach is the shared responsibility of the Department of Finance and all of the federal financial regulatory authorities, including of course the Bank of Canada, the Office of the Superintendent of Financial Institutions, and the Canada Deposit Insurance Corporation. Ultimately, it is the Minister of Finance who is responsible for the sound stewardship of the financial system.

A macroprudential approach involves two main elements. The first is macroprudential surveillance to identify the buildup of risks to the financial system. The Bank is well placed to contribute to macroprudential surveillance, given our mandate to take an economy-wide perspective, our research on, and knowledge of, the economy and financial system (including the clearing and payments system), and our connections with key international organizations.

The second element is macroprudential regulation, or regulation designed to strengthen the resilience of the financial system as a whole, which is the responsibility of the Minister, with advice from the Bank, OSFI, CDIC, and others. Progress here will need to take into account those interdependencies among institutions and markets that have implications for the overall stability of the financial system. Issues to be addressed include sound market infrastructure, product standardization and transparency, counterparty relationships, and countercyclical macroprudential tools such as countercyclical capital buffers. Work on these issues represents a multi-year investment at home and abroad. The Bank is undertaking research and analysis in a number of areas, including how to mitigate procyclical behaviour in the financial system, what is required to keep core funding markets continuously open, and models to stress test the Canadian financial system and gain insights into its functioning.

Advancement of this work will be aided by research and analysis in international committees and working groups, as well as in academia and at central banks. A particularly challenging aspect of this work will be the development of macroprudential tools and their use in promoting financial stability.[6]

But what do the lessons of the past two years tell us about the interactions and overlap between monetary policy and financial stability? It’s clear that monetary authorities need to be concerned about financial instability which, as the past two years have taught us, can threaten price stability due to the recessionary consequences for the real economy. It was in response to such disinflationary forces—even a concern about deflation on the part of some—that we aggressively cut interest rates to support the economy and thus, achieve our 2 per cent inflation target.

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[6] These tools could include minimum risk-weighted capital ratios; minimum capital held against a bank's trading book; maximum leverage ratios; maximum loan-to-value ratios for mortgages; and minimum margin requirements and haircuts.

Financial instability can also affect the monetary policy transmission mechanism. As I noted earlier, heightened uncertainty and instability in financial markets raise spreads and non-price terms in credit markets in ways that are unpredictable, and with consequences that are uncertain. This puts weight on monetary policy to take aggressive actions—including the potential use of unconventional instruments—to offset these consequences.

Financial instability is primarily about market failures and distortions that need to be addressed directly. The experiences of the past two years demonstrate that the best way to do this is through effective financial regulation, which includes macroprudential regulation to address systemic risks.[7] Interest rates are a blunt policy tool. Their use to address financial instability could create uncertainty for pricing financial assets and result in a misallocation of capital, with consequences for the whole economy. There could also be a risk of a loss of credibility for the monetary authorities, as they pursue their mandate of price stability.

This all adds up to the fact that there are important issues to be addressed and considerable work to be done in updating and designing new tools to meet the challenges of central banking going forward. In using our conventional monetary policy tool, the target overnight rate, we need to better understand real-financial linkages, and how changes in the target rate are transmitted to the economy. We need to further develop our thinking about, and assess the effectiveness of, unconventional monetary policy tools when the target policy rate is at the effective lower bound. And, in order to promote financial stability, we need to contribute to the development and use of macroprudential tools, especially countercyclical tools, to address periods of both financial exuberance and pessimism.

There remains, however, the issue of how central banks should react to developments in asset prices because of their consequences for both inflation and financial stability. Experience shows that increases and collapses in house prices affect aggregate demand, and have played a particularly important role as a driving force behind bouts of financial instability. In Canada, house prices enter directly into the calculation of the CPI. The Bank of Canada follows developments in house prices closely and factors them into our decision-making process regarding the level for the target overnight rate, consistent with achieving our inflation target.

In our 2006 background document, we indicated that the central bank should focus on the inflation and output consequences of any economic disturbance, including asset-price shocks, and should continue to respond in a manner consistent with meeting our inflation objective. We also said, "some flexibility might be required, however, with regard to the time horizon over which this is realized."[8] That might involve extending the usual horizon for achieving the inflation target in response to an asset-price shock, in return for greater financial, economic, and inflation stability over a somewhat longer horizon. The

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[7] M. Carney, “Some Considerations on Using Monetary Policy to Stabilize Economic Activity” (presentation to a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 22 August 2009): p. 3.

[8] See “Renewal of the Inflation Control Target, Background Information,” op. cit., p. 9.

challenge would lie in making such judgment calls, calls that become even more difficult for an open economy such as ours when the asset-price shock comes from abroad. Here, our flexible exchange rate would be helpful, by performing its usual role as an important shock absorber.

How central banks should respond to asset prices is receiving considerable attention in light of the experience of the past two years.[9] More discussion and debate are called for, drawing on those experiences and on what research can tell us.[10]

Issues of Broader Public Policy and the Economy

Let me now turn to public policy more broadly, and to the economy. There are two elements relating to public policy that I wish to touch on briefly, since both have taken on heightened importance as a result of the global financial crisis. The first is the importance of policies that promote flexibility and an innovative business environment. As we have often seen, most recently during the global financial crisis, many adverse shocks to the Canadian economy come from abroad. We must be able to adapt and adjust in response to these developments. Sound macroeconomic and financial policies are very important, but we also need policies that enable the efficient shifting of resources from one sector to another and that provide incentives for businesses to be nimble in developing new products and markets as trends change in global demand.

The second element relates to the importance of a rotation of global demand to address global current account imbalances. Fundamentally, this means that, over the coming years, more U.S. economic growth must come from net exports, and more Chinese growth must come from domestic demand within China. The United States will remain Canada's major trading partner, but we increasingly need to consider other markets outside North America as destinations for Canadian products. Here, I'm referring not only to China, and not only to commodities. Canada has a comparative advantage in many other areas—for example, communications, transportation (ground and air), education, and financial services, to name only a few—and we must exploit these.

In terms of the economy, there are increasing signs that activity has begun to expand in many countries in response to the substantial stimulus that has been provided. However, as I noted earlier in my remarks, we should expect a protracted recovery, given the financial repair that needs to take place.

In Canada, growth has resumed, supported by stimulative monetary and fiscal policies, a well-functioning financial system, the relative health of Canadian balance sheets, firmer commodity prices, and a rebound in business and consumer confidence. As we signalled in our September interest rate decision, GDP growth in the second half of 2009 will likely be stronger than projected in our July *Monetary Policy Report*. It would appear, however,

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[9] W. R. White, "Should Monetary Policy 'Lean or Clean'?" (Working Paper No. 34, Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute, August 2009).

[10] For example, under certain conditions, price-level targeting could possibly provide a better framework for addressing financial stability issues without jeopardizing the price stability credibility of the monetary authorities. See Carney, op. cit., pp. 5-6.

that some of this stronger growth reflects the effects of temporary factors**,** such as the impact of the U.S. “cash-for-clunkers” program on Canadian automotive production. In our September press release, we also reiterated that, conditional on the outlook for inflation, the target overnight rate can be expected to remain at its current level until the end of the second quarter of 2010 in order to achieve the inflation target.

Broadly, the factors at play nationally are also evident in the recent developments of the B.C. economy. As elsewhere, activity in British Columbia appears to be picking up after a very difficult year for virtually all areas of the B.C. economy. Residential construction and demand for existing housing are improving, with a dramatic upswing in the resale market that is attributed to the stimulative effects of lower mortgage rates, lower selling prices, and improving consumer confidence. Despite the completion of projects related to the 2010 Winter Olympics, it’s expected that major public sector spending on transportation and other infrastructure projects will contribute to growth this year and in 2010. Firmer commodity prices are also a positive. However, export markets remain weak, especially the U.S. market, and are only expected to strengthen gradually.

Overall, in line with our July projection, we see positive economic growth in British Columbia next year. There will be the boost from the Olympic and Paralympic Winter Games; the results of the Bank's *Business Outlook Survey* are also consistent with this view. More generally, in looking ahead, further progress in raising business and consumer confidence levels, and growth that is private-sector driven will be increasingly important in spurring full recovery here in British Columbia.

Turning to the outlook for inflation, we see inflation returning to our 2 per cent target in the second quarter of 2011, with both upside and downside risks around this projection. Upside risks include a faster-than-expected recovery in consumer and business confidence, and further improvements in Canada’s terms of trade. Downside risks are largely external, such as a risk of setbacks in the ongoing repair of the global financial system, and more persistent weakness in foreign private demand. All else being equal, a persistently strong Canadian dollar would also reduce real growth and delay the return of inflation to target.

The Bank will assess the balance of risks to inflation in its upcoming MPR, which we will release two weeks from today. Even though we are at the effective lower bound for our policy rate, the Bank retains considerable flexibility in the conduct of monetary policy.

Conclusion

The Great Recession has taught us many lessons, and has re-affirmed the importance of international co-operation, where Canada has much to contribute. We have also seen, through the turmoil of the past two years, that our policy frameworks have served us well. However, we must improve our capacity to address future challenges. This includes strengthening the Bank's policy frameworks for promoting both price stability and financial stability. This work is well under way at the Bank and internationally.

The Great Recession has also drawn attention to the importance of policies that promote economic flexibility and an innovative business environment. It has shown us, once again, how adverse shocks to the Canadian economy often come from outside and thus, why it is essential to continue to develop policies that encourage ready adaptation and adjustment to external developments. As a nation, we have taken major steps in this direction. This is particularly true for the economy of British Columbia, which has seen considerable restructuring in recent years. We cannot now lag in these efforts.

Finally, the experiences of the past two years have brought into sharp focus the reshaping of the global landscape that began more than a decade ago. Given our comparative advantages, this phenomenon offers us many opportunities, ones we cannot afford to waste.

Thank you for your attention and I would be pleased to answer any questions.