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Promoting Canada's Economic and Financial Well-being in an Uncertain World

Remarks to the St. John's Board of Trade
St. John's, Newfoundland and Labrador
15 September 2010

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Deputy Governor
Bank of Canada

www.bank-banque-canada.ca

Mandate

The Bank of Canada's mandate, as set out in the Bank of Canada Act, is:

- "to regulate credit and currency in the best interests of the economic life of the nation . . ."
- ". . . so far as may be possible within the scope of monetary action,"
- "and generally to promote the economic and financial welfare of Canada . . . ."

Mandate

We do this by:

- aiming to keep inflation low, stable, and predictable
- promoting a stable and efficient financial system
- supplying secure, quality bank notes
- providing efficient banking services to the government and to financial institutions

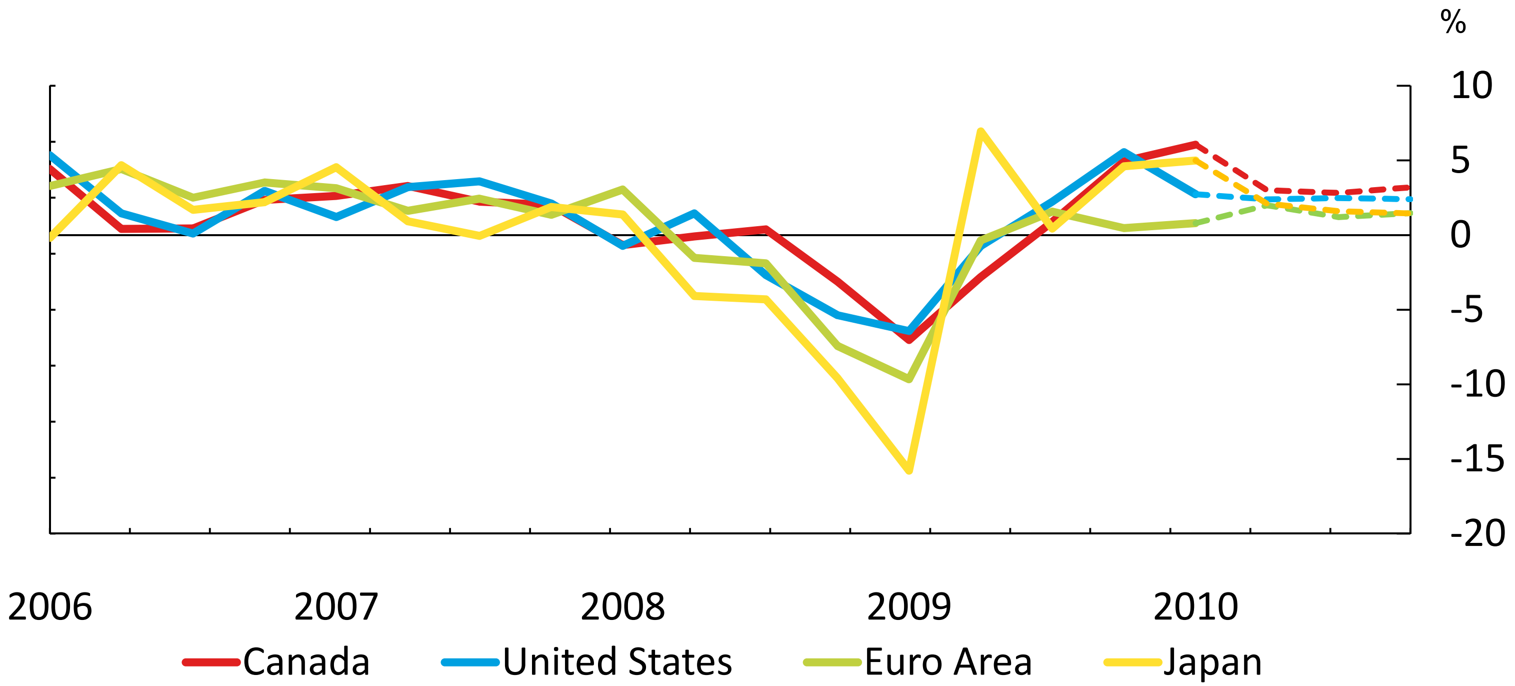
Contents

- What is the outlook for the Canadian economy?
- What is the outlook for the economy of Newfoundland and Labrador?
- How are the Bank of Canada’s key responsibilities being met in the current economic context?

Economic Outlook

The world economy is recovering from the most severe crisis since the Great Depression

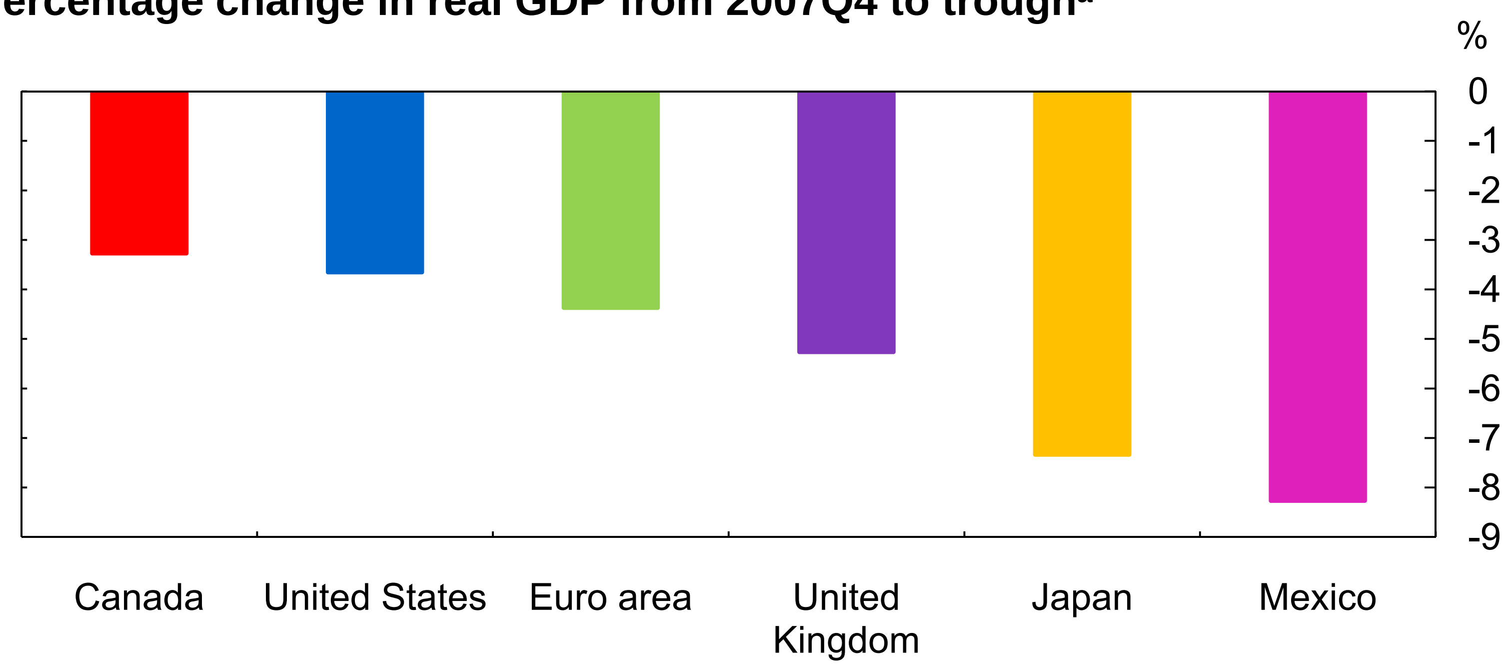
Quarterly real GDP growth at annual rates



Sources: Statistics Canada, U.S. Bureau of Economic Analysis, Eurostat, and Japan Statistics Bureau

Economic downturn less severe in Canada thanks to a sound banking system, strong household and business balance sheets, and timely policy response

Percentage change in real GDP from 2007Q4 to trough[a]



a. 2007Q4 corresponds to the start of the recession in the United States (based on NBER).
Sources: OECD, Bank of Canada calculations

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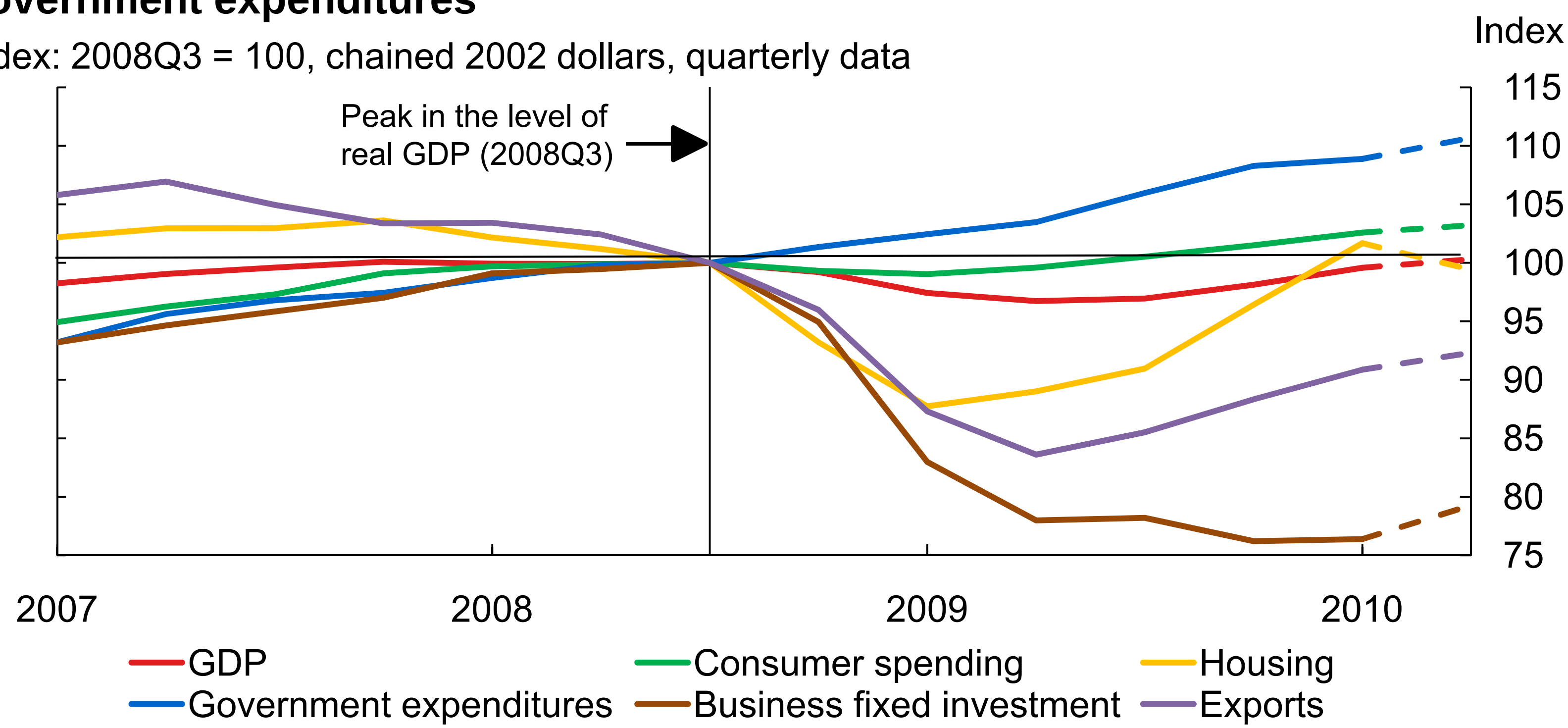
Recovery in Canada is continuing

Real GDP is close to its pre-recession level, supported by household and government expenditures

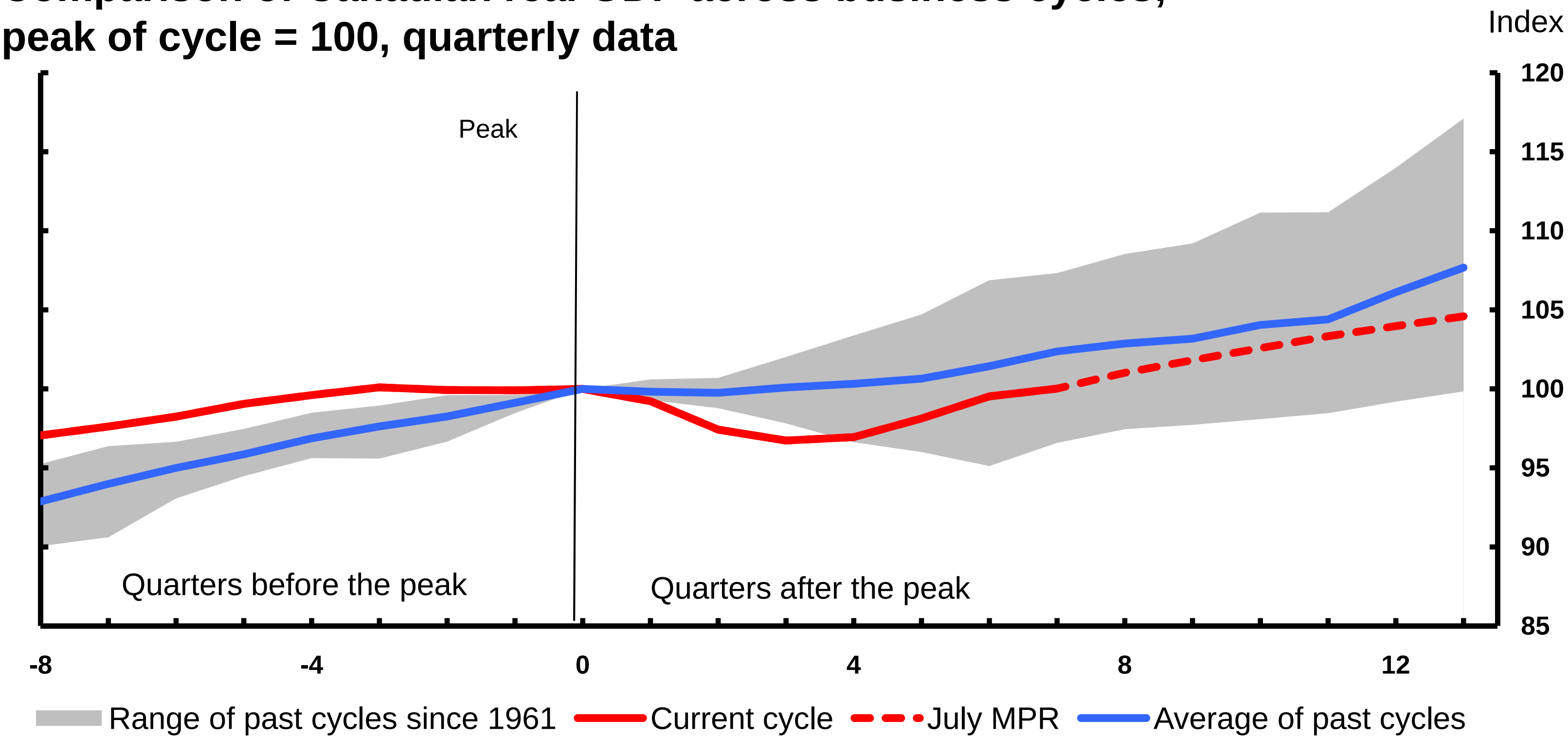
Index: 2008Q3 = 100, chained 2002 dollars, quarterly data



Note: Numbers for 2010Q2 are Bank of Canada estimates.
Source: Statistics Canada and Bank of Canada calculations

The recovery in Canada should be more modest than in previous cycles

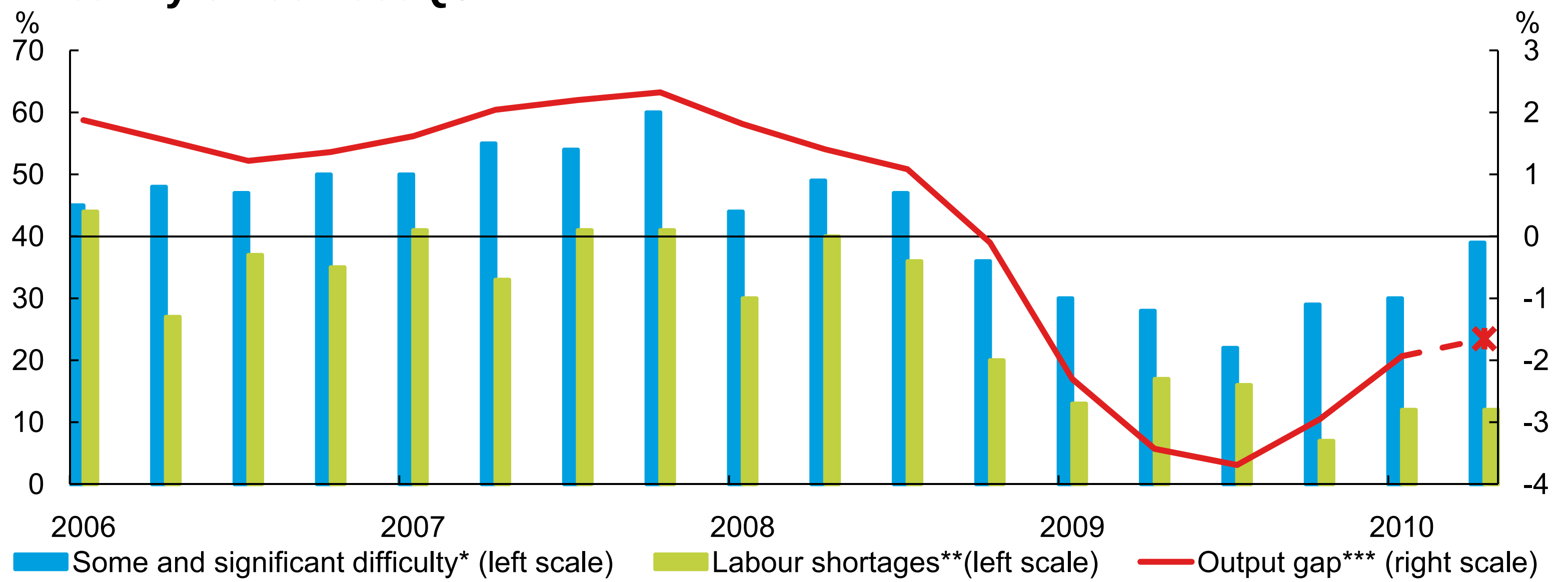
Comparison of Canadian real GDP across business cycles; peak of cycle = 100, quarterly data



Sources: Statistics Canada and Bank of Canada calculations

There remains considerable excess supply in the Canadian economy, but the gap is narrowing

Excess supply in the Canadian economy has narrowed significantly since 2009Q3



* Response to *Business Outlook Survey* question on capacity pressures. Percentage of firms indicating that they would have either some or significant difficulty meeting an unanticipated increase in demand/sales.

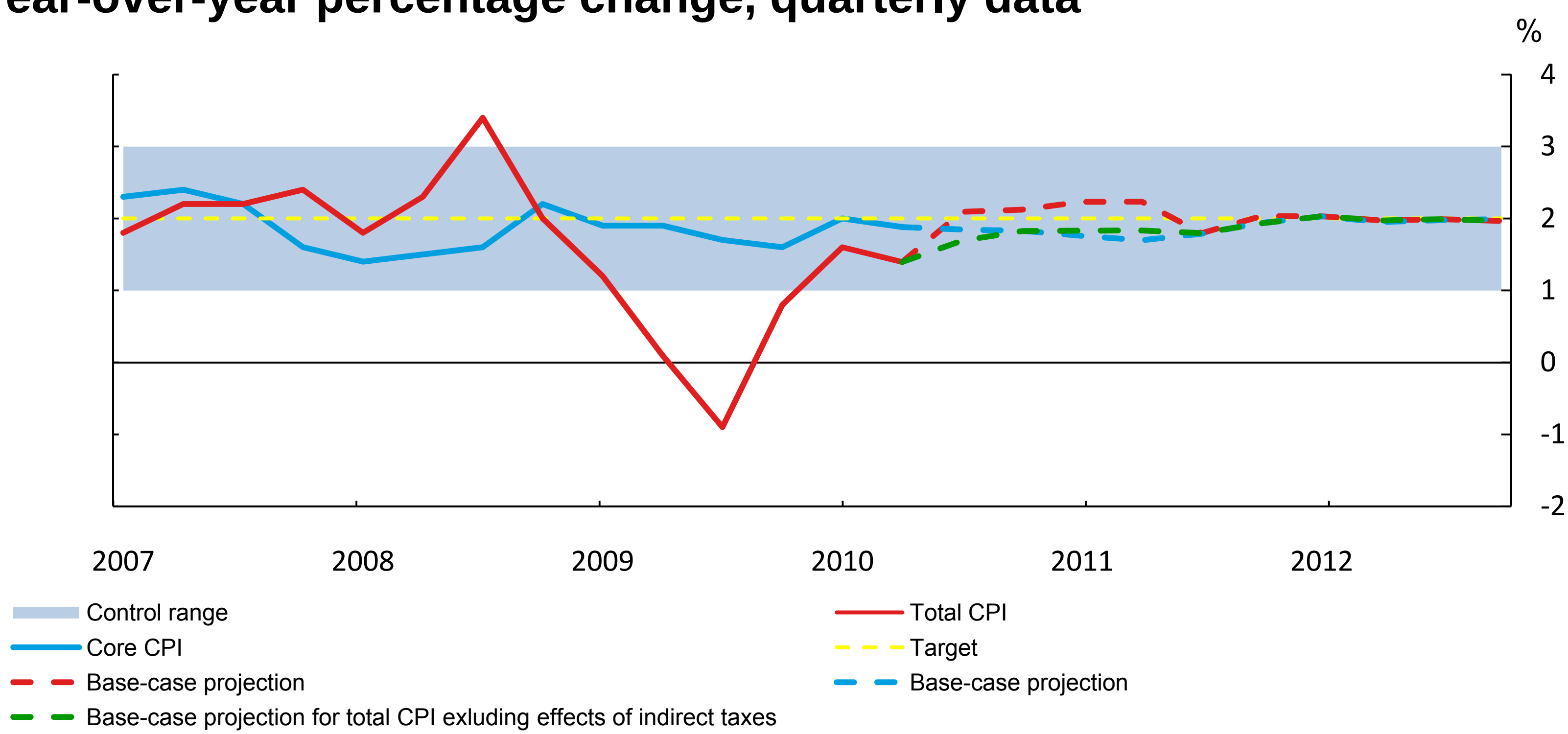
**Response to *Business Outlook Survey* question on labour shortages. Percentage of firms reporting labour shortages that restrict their ability to meet demand.

*** Difference between actual output and estimated potential output. The estimate for the second quarter of 2010 (indicated by *) is based on a projected increase in output of 3.0 per cent (at annual rates) for the quarter.

Source: Bank of Canada

Total and core CPI inflation are projected to return to 2 per cent in the third quarter of 2011, as the Canadian economy returns to full capacity

Year-over-year percentage change, quarterly data



•CPI excluding eight of the most volatile components and the effect of changes in indirect taxes on the remaining components.
•Sources: Statistics Canada and Bank of Canada projections

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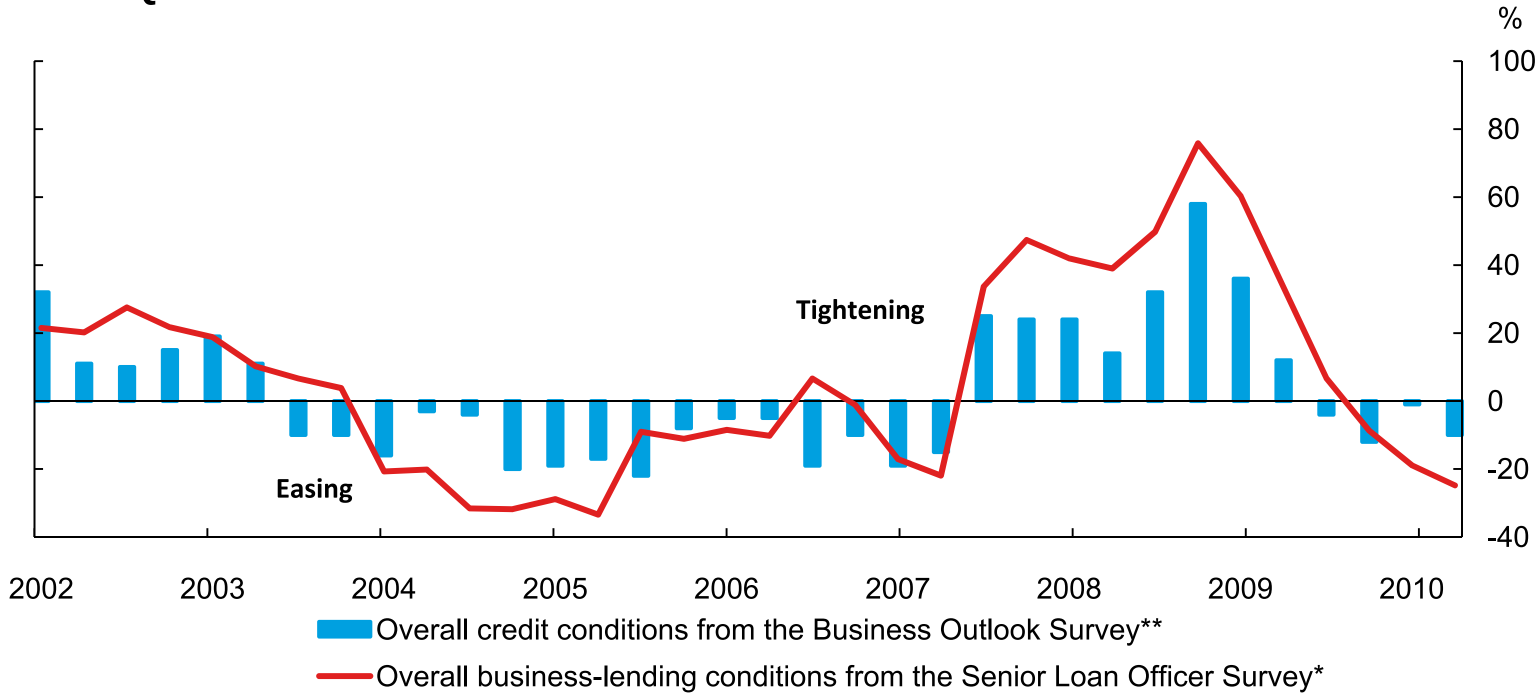
Lending conditions for non-financial firms have started to improve . . . although small businesses are still experiencing some modest further tightening

Survey results suggest that credit conditions for Canadian non-financial firms eased in 2010Q2



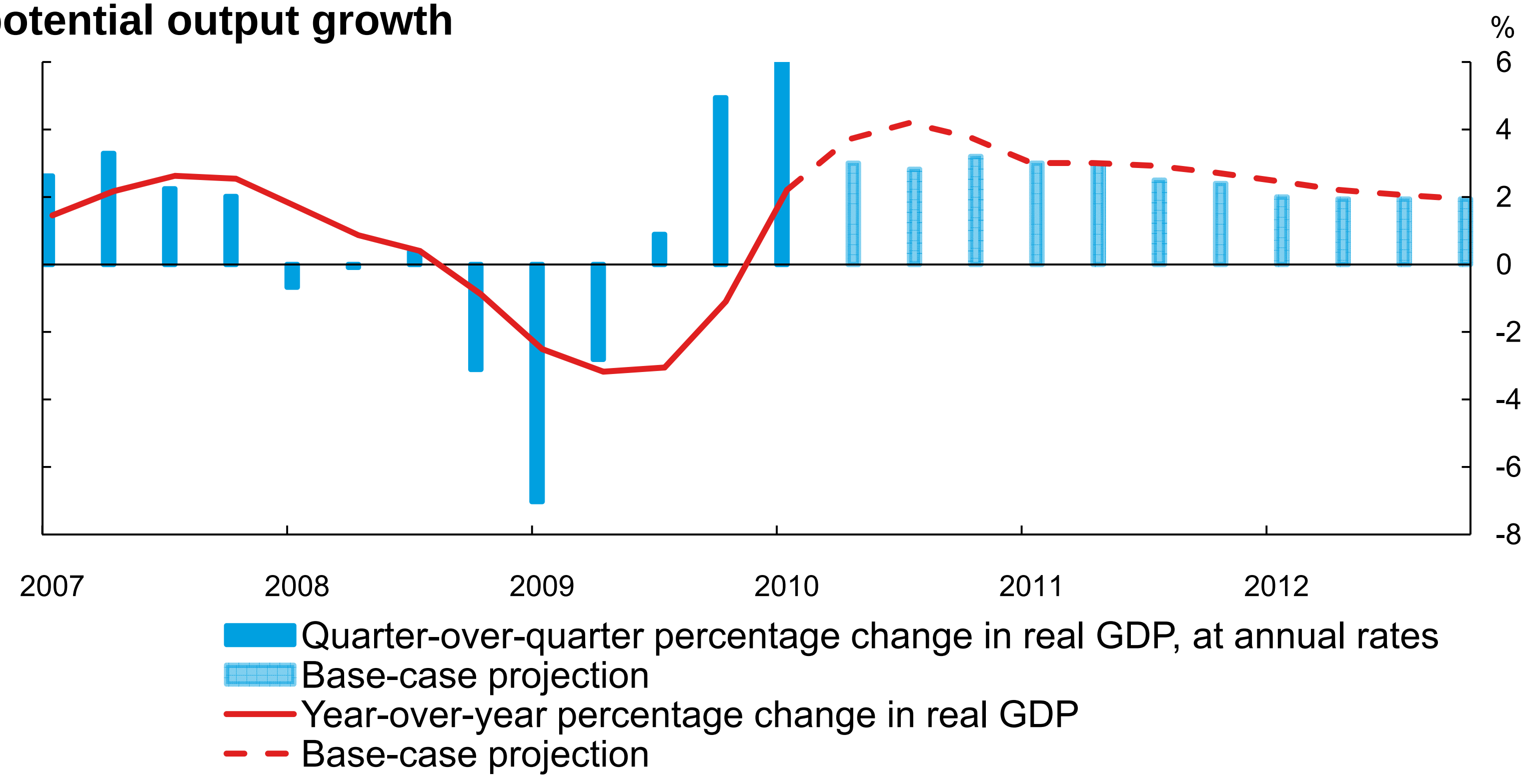
* Weighted percentage of surveyed financial institutions reporting tightened credit conditions minus the weighted percentage reporting eased credit conditions.

**Percentage of firms reporting tightened credit conditions minus percentage reporting eased credit conditions.

Source: Bank of Canada

The Canadian economy is projected to grow by 3.5 per cent in 2010 and 2.9 per cent in 2011, after having contracted by 2.5 per cent in 2009

Real GDP growth is expected to moderate to the rate of potential output growth



Sources: Statistics Canada and Bank of Canada projections

Prospects for long-term growth in Canada

- Coming out of recession, expect to converge to long-term growth rate around 2 per cent—compared with 3 per cent average of decade before crisis
- Reflects aging work force, together with weak productivity growth
  - Labour productivity has grown by only 1 per cent a year (half the rate in U.S.)
  - Canadian workers have less high-tech, high-efficiency equipment to work with
  - Small and medium-size enterprises not as innovative as they could be

Where are we now?

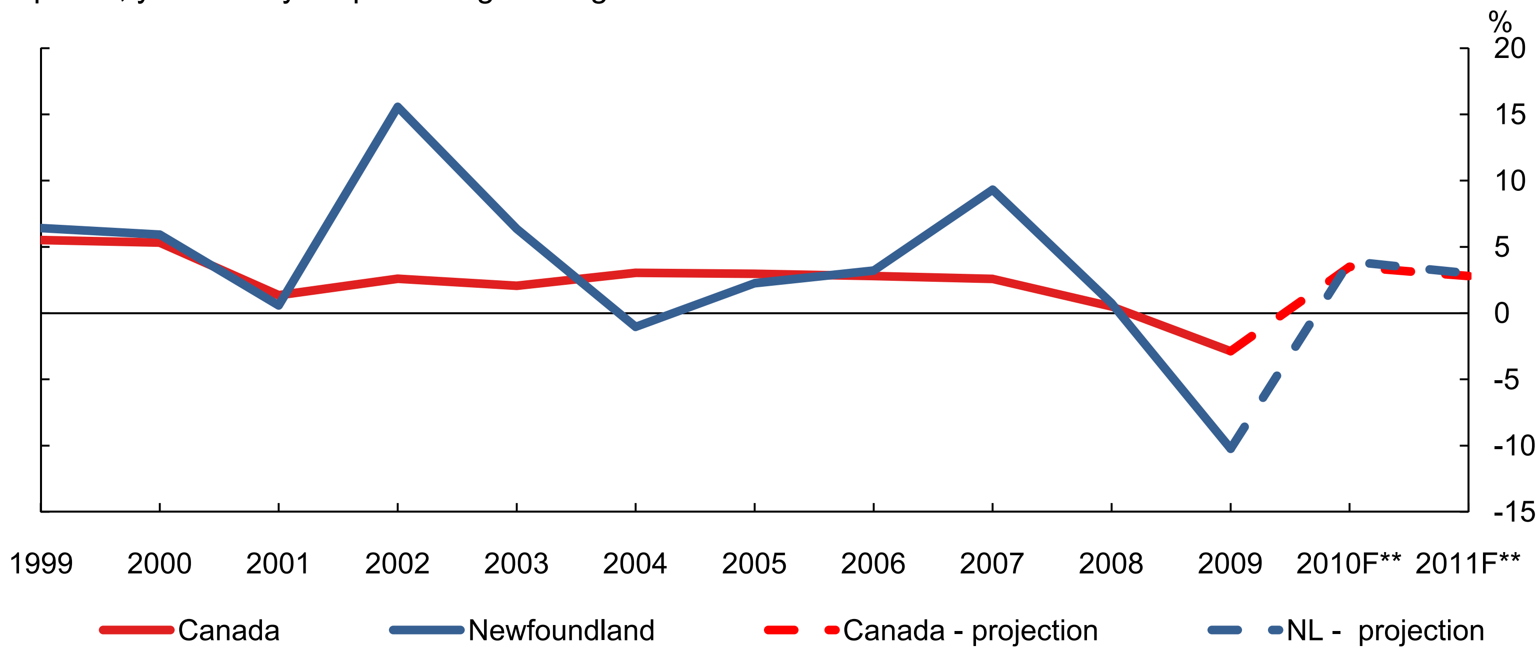
- Global recovery proceeding but remains uneven
  - In United States, private demand held back by high unemployment and ongoing deleveraging
- Economic activity in Canada softer than expected—and significant excess supply remains
- Financial conditions exceptionally stimulative
- Inflation expected to remain near 2 percent target
- Unusual uncertainty surrounding outlook

Economic Outlook: Newfoundland and Labrador

Economic Outlook: Newfoundland and Labrador

Newfoundland growth in real GDP

At basic prices, year-over-year percentage change



**Mean of private sector forecasts

Source: Statistics Canada

Economic outlook: Newfoundland and Labrador

- From 2000 to 2008, Newfoundland and Labrador experienced the strongest rate of economic growth among the ten provincial economies.
- In recent years, housing starts, retail sales, and car sales have generally outpaced the national trend.
- Economic activity is now recovering in 2010 after having fallen sharply in 2009 due to a reduction in oil production and, to a lesser extent, the global recession.
- Major projects in the oil and mineral sector play an important role in this recovery.
- Recent data confirm that labour markets have rebounded strongly in 2010 from the declines seen in 2009.

Economic outlook: Newfoundland and Labrador

- Due to its recent strength, the Newfoundland and Labrador economy is probably operating with much less slack in capacity than the rest of Canada.
- Prices, particularly here in St. John’s, reflect this situation. Wages, housing prices, and consumer price inflation have also outpaced the national trend.
- Unlike the rest of Canada, Newfoundland and Labrador’s recovery is less dependent on a global recovery in the short-term. Investment spending at major projects will all but guarantee a few years of strong growth.
- An improved global outlook would lead to higher commodity prices and even better growth prospects over the long-term.

Key Responsibilities: The Bank’s Approach

Four core areas of responsibility

The Bank of Canada has four core areas of responsibility:

- Monetary policy
- Financial system
- Currency
- Funds management

In each of those areas, we apply the same approach, which consists of:

- A clear objective
- Accountability and transparency
- A longer-term perspective

Monetary Policy

Our objective: Keep inflation low, stable, and predictable

- Reduces uncertainty and helps businesses, consumers make decisions with greater confidence
- Implies that we ease in the downturn and tighten in the upturn – acting to dampen the business cycle
- Inflation target set under an agreement with the federal government, reviewed every five years – next renewal is in 2011

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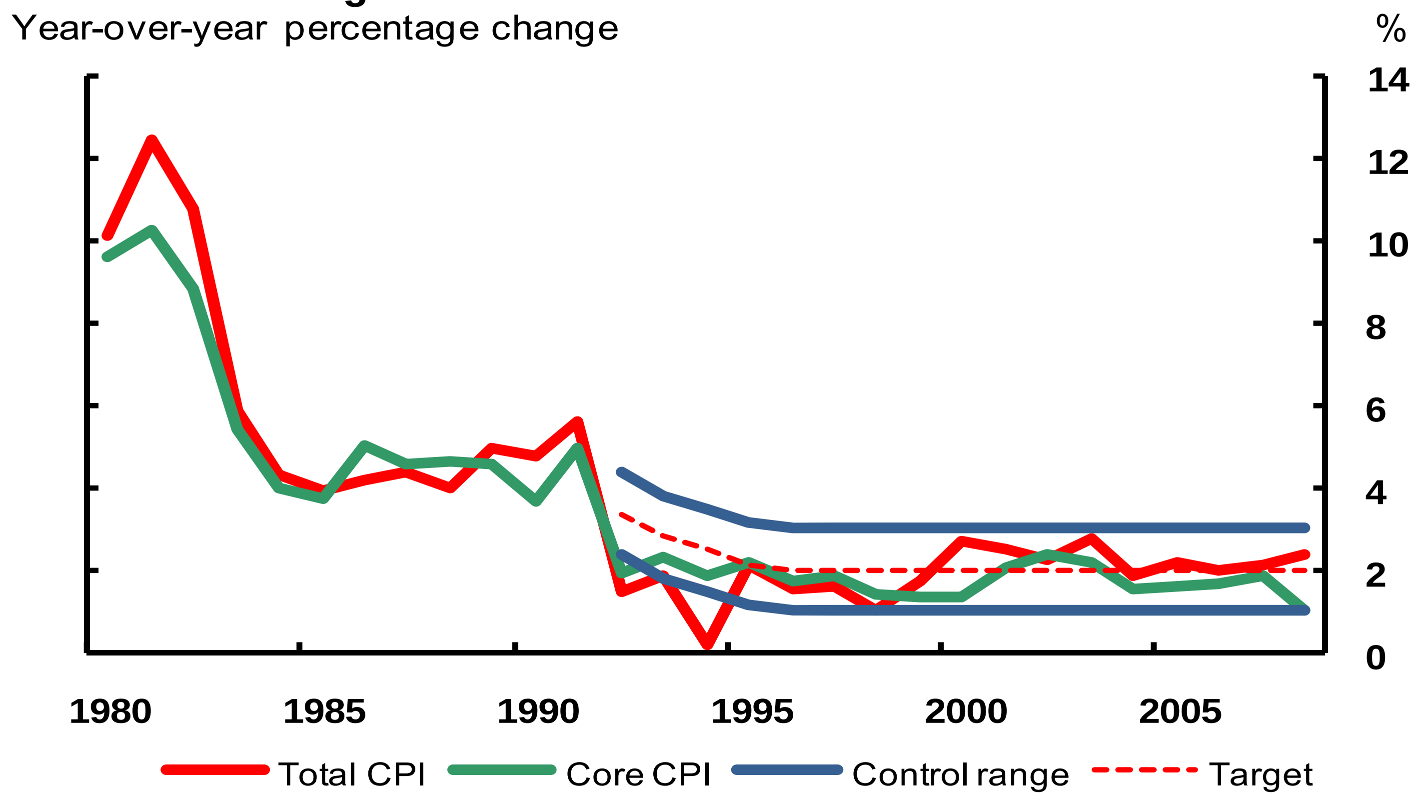
Monetary Policy: Low and stable inflation

CPI annual averages



Source: Statistics Canada

Monetary Policy

The Bank achieves the 2 per cent inflation target by adjusting its target for the overnight interest rate

- That, in turn, influences other interest rates, exchange rate, and, ultimately, overall demand for Canadian goods and services
- Policy actions can take up to two years to have their full effect on inflation
- Therefore, the Bank always looks ahead to future inflation

Monetary Policy

Monetary policy is more effective when Canadians understand what the Bank is doing and act accordingly.

- To foster understanding:
  - policy rate decisions announced eight times a year on a fixed schedule,
  - accompanied by supporting analysis of economic developments and projections of inflation
  - analysis elaborated on in quarterly *Monetary Policy Report*
- Communications focus on medium-term perspective of monetary policy

Monetary Policy

Global financial crisis:

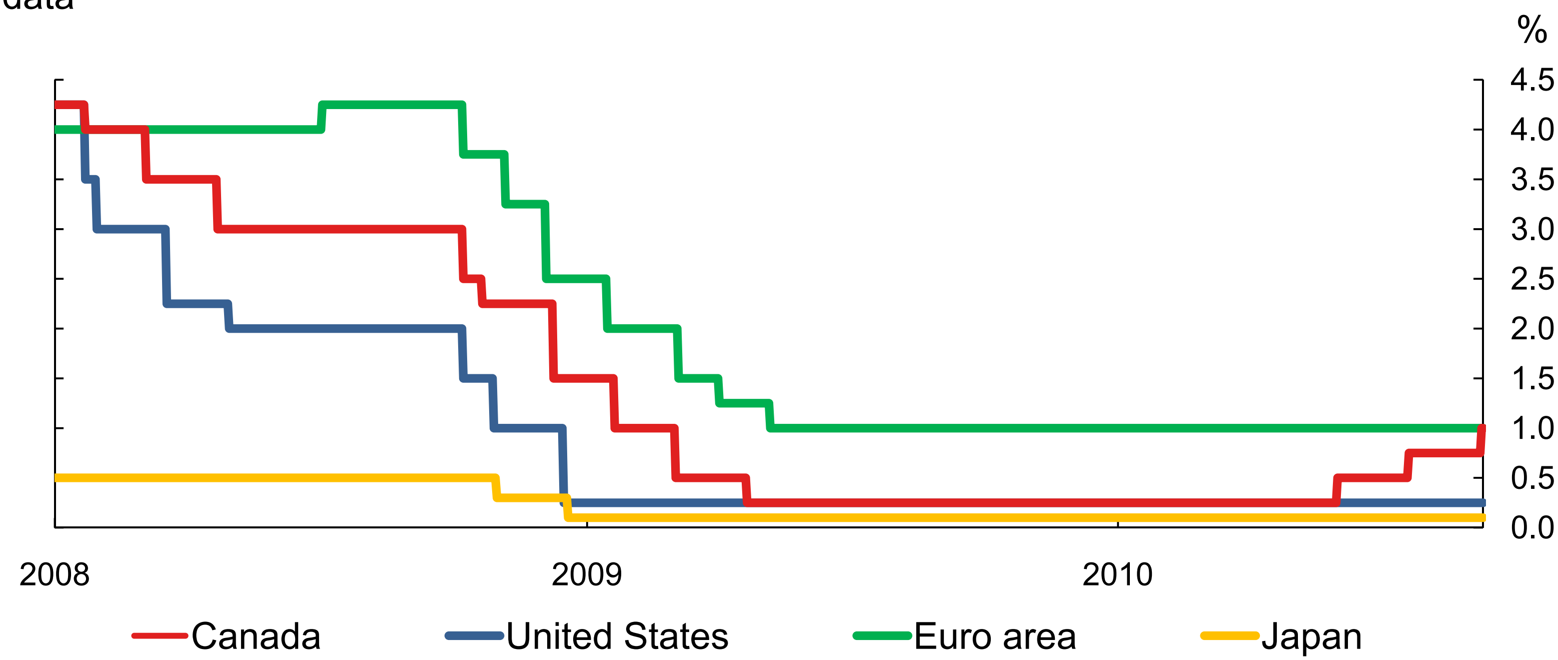
In reaction to the crisis and consequent recession, the Bank of Canada:

- reduced the target for the Bank's overnight rate to one-quarter of one per cent − as low as effectively possible
- committed to leave the rate there until mid-June 2010, conditional on the outlook for inflation
- articulated a strategy to provide further monetary stimulus through quantitative easing and credit easing **if needed**

Monetary Policy: Interest rates, global

Policy rates have remained at historic lows in most countries

Daily data

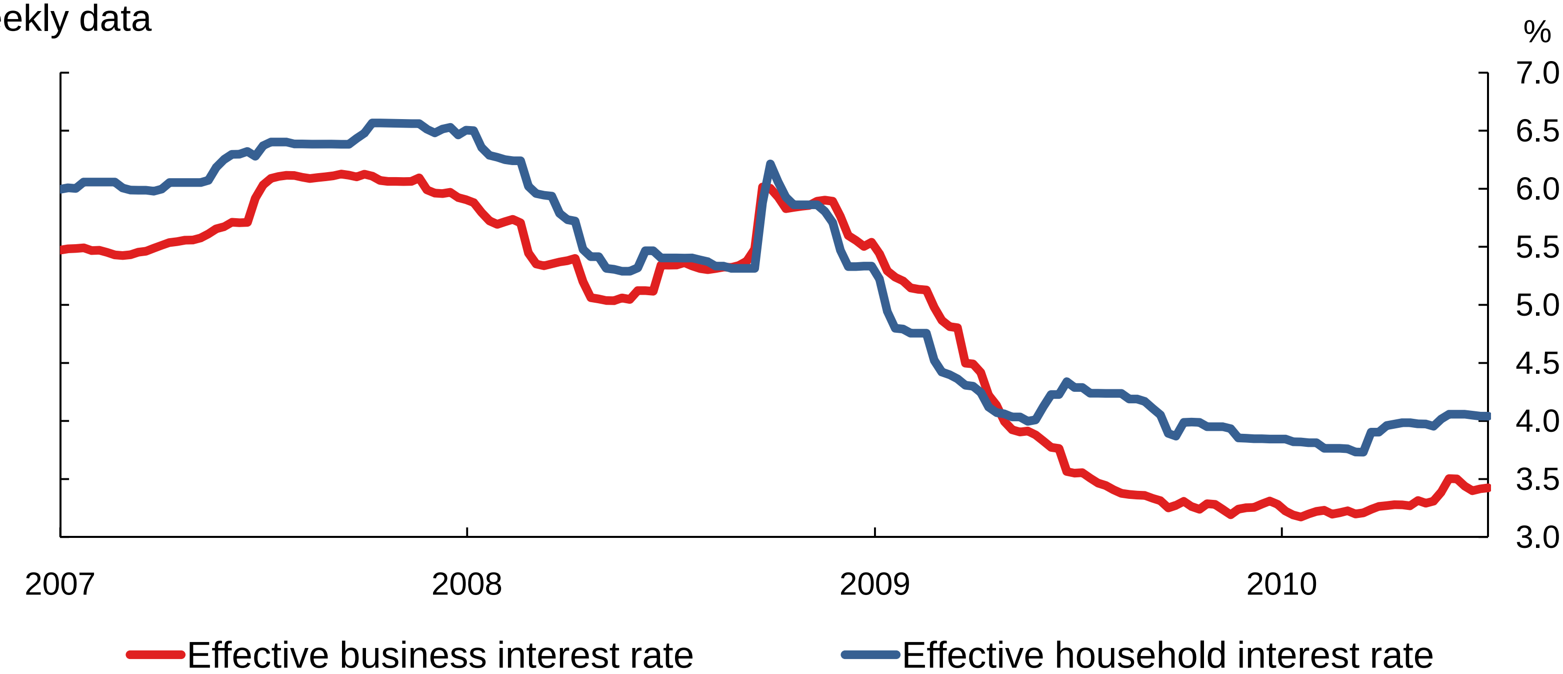


Sources: Bank of Canada, Federal Reserve, European Central Bank, and Bank of Japan

Monetary Policy: Interest rates in Canada

Borrowing costs for households and businesses remain at exceptionally low levels

Weekly data



Note: For more information on these series, see <http://credit.bankofcanada.ca/financialconditions>.
Source: Bank of Canada calculations

Monetary Policy

With signs of economic recovery, the Bank of Canada began to withdraw stimulus:

- In April 2010, removed conditional commitment
- June to September 2010, raised the overnight rate three times by one-quarter of one percentage point to 1.0 per cent

Financial System

Our objective: To promote the stability and efficiency of the financial system, in Canada and globally

Canada's financial system consists of:

- financial institutions, such as banks, caisses populaires, insurance companies
- financial markets, including securities and foreign exchange markets
- clearing and settlement arrangements

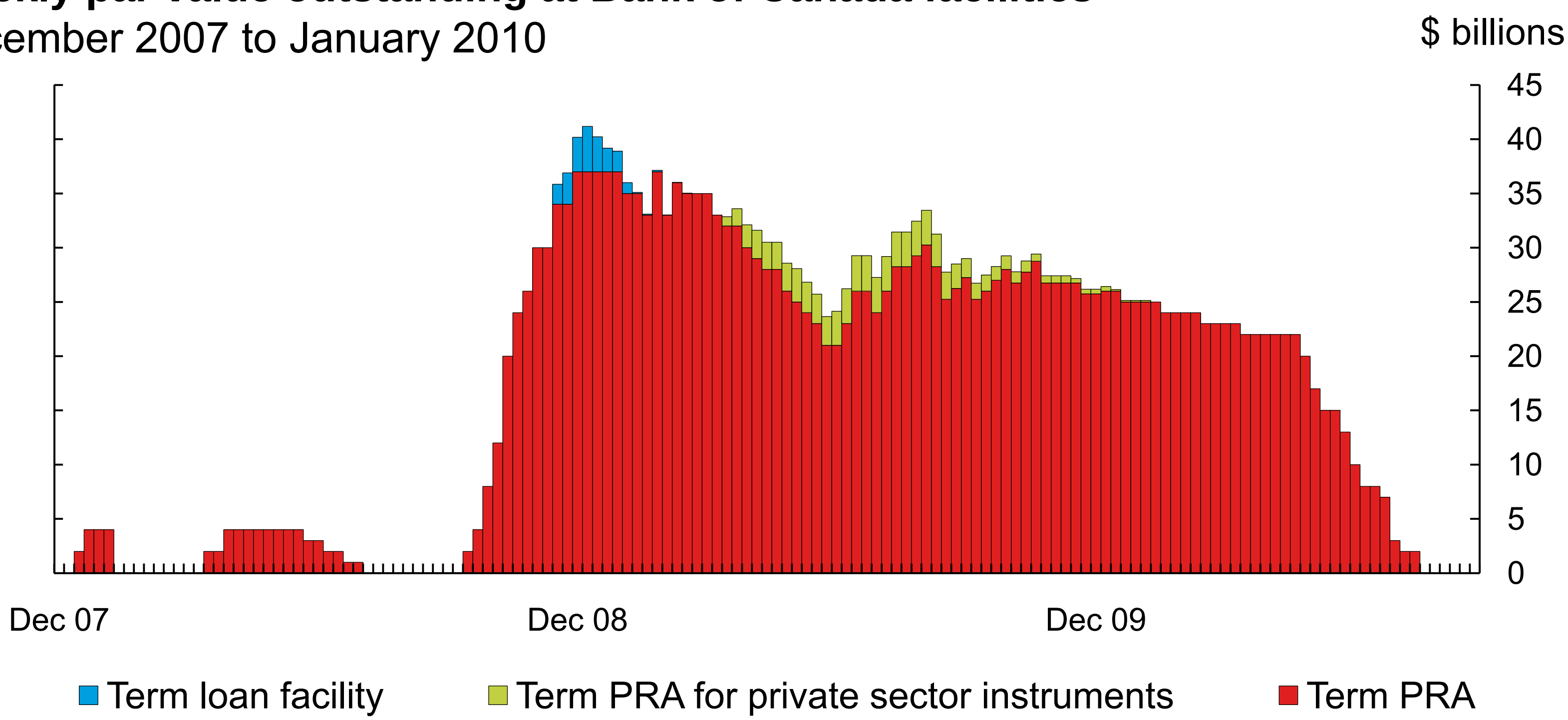
Financial System

The Bank achieves its objective by:

- providing adequate liquidity to support the stable functioning of the financial system
- overseeing clearing and settlement systems to prevent risk contagion
- encouraging the development of key financial markets
- assessing risk and vulnerabilities in the financial system
- publishing informative research and analyses in the Bank's *Financial System Review*
- working with other domestic and international policy makers (e.g. FISC, HoA, FSB)

The Bank massively expanded its liquidity provisions to support the functioning of the financial system when markets froze

Weekly par value outstanding at Bank of Canada facilities
December 2007 to January 2010



Source: Bank of Canada

Financial System

The global financial crisis has brought increased attention on the system as a whole

- Interdependencies among institutions and markets
- Need for key funding markets to remain open
- System-wide approach to regulation
- Shared responsibility of Department of Finance and federal financial regulatory authorities (including Bank of Canada)
- Ultimate responsibility rests with Minister of Finance
- G-20 leaders have announced plans for major reforms of global financial system

Currency

Our objective: Meet the needs of Canadians for reliable bank notes – readily accepted, secure from counterfeiting

- Bank’s anti-counterfeiting goal: fewer than 50 counterfeits detected annually per million notes in circulation
- Currency is distributed through financial institutions
- The Bank’s regional offices oversee distribution system and deliver currency education programs to law enforcement, financial institutions, and retailers
- Rising demand for bank notes, a source of rising revenues to the Bank (and the government)

Currency

Bank's strategy to maintain confidence in bank notes:

- Develop bank notes that are increasingly more difficult to counterfeit
- Increase the routine verification of bank notes by retailers
- Maintain the high quality of bank notes in circulation
- Promote counterfeit deterrence by law-enforcement officers and prosecutors

Currently developing Canada's next bank note series, expected to be introduced in late 2011 (latest design, using state-of-the-art anti-counterfeiting technology launched in 2004)

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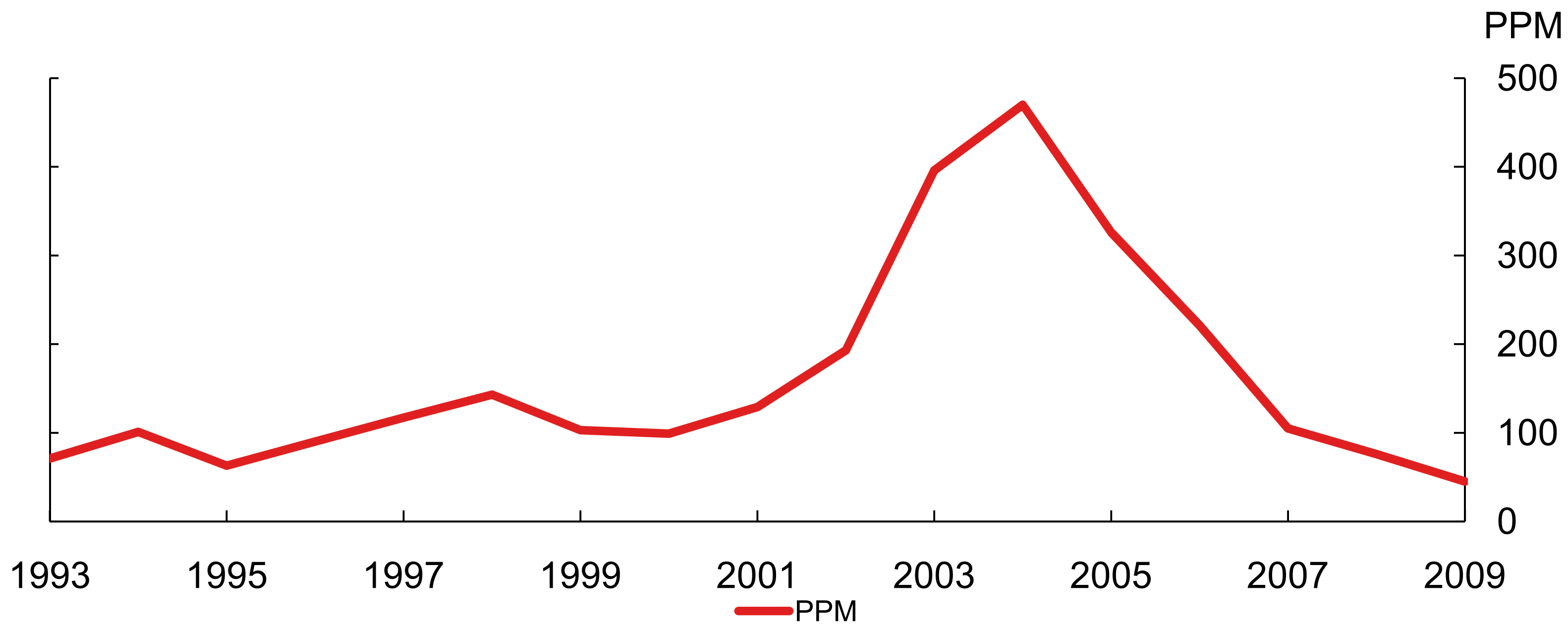
The Bank's strategy has been effective in reversing a surge in counterfeiting from 2001 to 2004

Counterfeit Canadian bank notes detected for each one million genuine notes in circulation

Annual data



Funds Management

Our objective: To provide effective banking services to the federal government and key financial system players. This involves:

- managing Canada's foreign exchange reserves and federal government's cash balance
- managing the public debt in collaboration with the Department of Finance
- administering the Canada Savings Bonds program
- providing the means of final settlement of daily flows of payment among financial institutions

Conclusion

Through turbulent and tranquil times the Bank of Canada remains committed to price stability:

- Reduces uncertainty
- Minimizes the costs of inflation
- Reduces the cost of capital
- Creates an environment in which households and businesses can invest and plan for the future

For further questions, please contact:

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- Brian Henley, Director, Board of Directors, Bank of Canada
  or
- David Amirault, Senior Representative, Economics (Atlantic Region) Bank of Canada