Remarks by Mark Carney
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CHECK AGAINST DELIVERY

Fortune Favours the Bold

It is my pleasure to be here in St. John's.

Each time I visit Newfoundland and Labrador I am struck by the landscape – the clash of rock and ocean. This is a place that invites superlatives.

We are all products of our environment and the people of Newfoundland and Labrador reflect the bold drama of this province's geography and its history.

At this point in time, Canada and the world need to call upon such boldness.

To explain why, I would like to touch upon the recent past, the present outlook, and our challenging future.

The Recent Past: The Recession in Context

From the end of 2008 to the middle of last year, Canada experienced a short, sharp recession. With the exception of government spending, all major components of aggregate demand declined, and industrial production dropped 15 per cent. Canadian exporters suffered particularly, owing to the sharp fall in the components of U.S. economic activity that matter most for Canada. For example, U.S. demand for motor vehicles fell by more than half and housing starts by two-thirds. Partly as a result, several major Canadian industries are now undergoing deep restructurings.

The recession had a considerable impact on employment. Some 400,000 Canadians lost their jobs, and our unemployment rate spiked by almost 3 percentage points to its highest level in more than a decade. Although the labour market is clearly improving, with three-quarters of the jobs lost now recovered, too many Canadians who want to work are still out of a job, and many of those still employed are working fewer hours than they would like (see Appendix, Chart 1).

As painful as our recession was, Canada suffered less than most other advanced economies. Consumption, housing, and employment in Canada all held up substantially better than in the United States. The cumulative fall in Canadian real GDP of 3.3 per cent compares with declines of 3.6 in the United States, about 5 per cent in the euro area, and more than 8 per cent in Japan.

Canada's better performance can be explained by two factors. First, with a highly credible monetary policy and the strongest fiscal position in the G-7, Canadian policy-makers were able to respond swiftly and effectively with extraordinarily accommodative

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measures. The Bank of Canada began cutting interest rates in December 2007 and pursued an aggressive series of reductions until our policy rate reached one-quarter of one per cent in April of last year, the lowest it can effectively go. The Bank then provided exceptional guidance on the likely path of interest rates necessary to achieve the inflation target in order to maximize the monetary stimulus from its actions.

Second, Canada entered the recession with notable advantages, including a well-functioning financial system, strong corporate balance sheets, and relatively healthy household finances.

We will have to draw on these advantages during the recovery. While the global downturn was synchronous, economic performance across markets and sectors is likely to be increasingly uneven. For some Canadian businesses, the recovery may prove as challenging as the downturn.

Do not be misled. This was the Great Recession. To claim otherwise with simplistic comparisons to prior downturns is to ignore both the rapidity and the scale of the policy response, as well as the likelihood that the aftershocks from the crisis will persist for years. [1] In particular, the Bank expects that:

- the pace, composition, and variability of global growth will be substantially different across economies;
- the level and volatility of commodity prices will be higher;
- the nature of the global financial system will be radically altered; and
- the openness of global markets for goods and capital can no longer be assured.

Canada is not a bystander in this global upheaval. We can influence policies and focus reforms. Our businesses can anticipate and take advantage of emerging trends. But the efforts required of all of us will be heroic, and hesitation will be costly.

For both policy-makers and businesses at this juncture, Virgil's adage applies: *fortune favours the bold.*

The Present

The current economic outlook is neither as robust as recent data indicate nor as dire as current headlines scream.

The global economic recovery is proceeding, but it is increasingly uneven across countries. There is strong momentum in emerging-market economies; some consolidation of the recoveries in the United States, Japan, and other industrialized economies; and the possibility of renewed weakness in Europe.

Global growth is now projected to average slightly above 4 per cent a year through 2012. Few, apart from the Bank of Canada, thought that possible at this time last year. The Bank continues to hold the view that, led by domestic demand, Canadian growth will likely be the strongest among the G-7 nations over the next two years.

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[1] P. Cross, "Year-end review of 2009." *Canadian Economic Observer*, Statistics Canada Catalogue No. 11-010-X, 23, No. 4, April 2010.

Recent activity in Canada is unfolding largely as expected. The economy grew by a robust 6.1 per cent in the first quarter, led by housing and consumer spending. Employment growth has resumed. Household spending is expected to decelerate to a pace more consistent with income growth. The anticipated pickup in business investment will be important for a more balanced recovery.

This outlook is subject to considerable uncertainties. In most advanced economies, the recovery remains heavily dependent on monetary and fiscal stimulus. The required rebalancing of global growth has not yet materialized. In general, broad forces of household, bank, and sovereign deleveraging have barely begun and will add to the variability, and temper the pace, of global growth as they proceed.

Recent tensions in Europe are likely to result in higher borrowing costs and more rapid tightening of fiscal policy in advanced economies. As I will discuss shortly, without countervailing policies, this could lead to a more protracted recovery.

Nothing Is Easy

The reality of a policy-led, multi-speed recovery is that the global economy is now bumping up against three limits.

The first is the supply response in commodities. With emerging-market economies' share of global growth now two-thirds, rather than the one-half it was at the start of the millennium, global growth is more commodity-intensive. In our April forecast, the Bank projected an additional 30 per cent increase in the prices of non-energy commodities over the next few years.

The second limit relates to the challenges of derivative monetary policy. Owing to managed exchange rates, many emerging-market economies are acting as if U.S. monetary policy were appropriate to their circumstances. Despite strong capital inflows, these countries are resorting to a series of measures of unproven effectiveness to address overheating pressures. Capital controls, restrictions on loan-to-value ratios on mortgages, and higher reserve requirements are all stop-gap measures in the face of broader forces.

While these measures will have some impact, ultimately, there are only two possibilities in emerging-market economies: either higher interest rates or higher inflation.

The third limit is fiscal stimulus. Reflecting the massive fiscal response and the recession, the International Monetary Fund projects that advanced economy debt will rise from about 80 per cent of GDP in 2008 to 110 per cent by 2015.

Major efforts will be required to stabilize the situation. The canary in the coal mine, Greece, faces one of the largest primary adjustments ever undertaken. Moreover, as with other European countries, Greece cannot expect to benefit from lower interest rates, depreciation, or export growth to facilitate adjustment. It will require significant wage reductions and productivity enhancements to restore competitiveness and growth.

The possible responses of other countries to the situation are denial or conviction. In the former case, growing public debt will push up global interest rates, crowding out private investment and lowering potential growth. [2]

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[2] In a simulation that assumes that advanced countries do not make any fiscal adjustments to stabilize their debt dynamics, the Bank found an increase of 175 to 300 basis points in advanced-economy yields, given

Given the scale of the fiscal challenge, it is perhaps not surprising that some eminent economists are looking for an "easier" way out. This form of denial is to allow temporarily higher inflation in order to inflate away public debt.

To the Bank, this is a siren call.

Those most in need of fiscal consolidation are often those with debt portfolios of the shortest duration. The "surprise" would have to be very sudden and very large to have a material impact. Of course, if temporary inflation becomes built into expectations, real rates may well increase, rather than fall, thereby exacerbating debt dynamics. Moreover, in the past, it has proven devilishly hard to keep inflation high temporarily. Would it be credible to have a one-off increase in the inflation target?

Central banks have worked for decades to get inflation down to levels consistent with price stability. We should not risk these hard-won gains.

The second, more positive, and more likely, response to the fiscal challenge is conviction.

We have seen that conviction in recent weeks. The European financial stabilization plan, announced in May, is a bold step towards accelerated fiscal consolidation. The plan has been followed by a series of concrete actions. Spain announced measures totalling 1.5 per cent of GDP in additional fiscal consolidation, while Portugal introduced consolidation measures amounting to 1 per cent of GDP for 2010. Greece has passed the key elements of its austerity package, and the United Kingdom is planning for an early and tough budget. Similar measures are likely in other countries in the coming weeks.

However, the coming "Age of Austerity" carries its own risks. Fiscal policy that is tighter, sooner for all could create deficient demand in the global economy. The Bank of Canada estimates that, in the absence of real exchange rate adjustment and higher domestic demand elsewhere, the shortfall in global GDP could reach $7 trillion by 2015.[3]

To recoup this enormous sum, both the public and private sectors must be bold.

Public Boldness: The G-20 Agenda

At the Pittsburgh summit last September, the G-20 claimed that "It worked." Well, it isn't over. The G-20's agenda is comprehensive and radical, but we need to implement, as well as propose.

As a consequence, Canada's priorities for the upcoming G-20 Leaders Summit are:

- To make concrete the G-20 framework for "strong, sustainable, and balanced growth." This stresses the shared responsibility of countries to make up that $7 trillion shortfall I just highlighted.

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the scale of the debt burden. See K. Beaton, C. de Resende, R. Lalonde, and S. Snudden, "Prospects for Global Current Account Rebalancing," Bank of Canada Discussion Paper No. 2010-4. April 2010, available at: <http://www.bankofcanada.ca/en/res/dp/2010/dp10-4.pdf>.

[3] See M. Carney, "The Virtue of Productivity in a Wicked World," Speech delivered to the Ottawa Economics Association, 24 March 2010, available at: <http://www.bankofcanada.ca/en/speeches/2010/sp240310.html>, and Beaton, de Resende, Lalonde, and Snudden (2010).

- This will require changes in behaviour and policy adjustments on several fronts, including:
    - sustained and credible fiscal consolidation in the advanced countries;
    - structural and financial reforms that will increase domestic demand in major emerging-market economies;
    - increased real exchange rate flexibility in emerging-market economies to facilitate the adjustment from external demand to domestic demand; and
    - structural reforms to enhance productivity and potential growth in advanced economies.
- To move forward on the core G-20 financial reform agenda. There are two main approaches to reform: to protect the banks from the cycle and to protect the cycle from the banks. Both are necessary.
    - Protecting the banks from the economic cycle means making each bank, individually, more resilient. This will require more capital, higher liquidity, and better risk management, complemented by stronger supervision. While there is still much to be done, in general, these types of measures will make global financial institutions look more like their Canadian peers.
    - Protecting the cycle from the banks means making the system as a whole more resilient. This requires building a system that can withstand the failure of any single financial institution. These measures (including contingent capital, better infrastructure for key markets, and new resolution authorities) are new and will change how our financial system operates.[4]
- Finally, to ensure that business can operate, as much as possible, in an open and stable trade and regulatory environment. We must live up to the G-20 commitment to resist trade and financial protectionism.

Private Boldness: Thriving in a Multi-Polar Economy

And what of private boldness? With so much uncertainty, isn't now the time for corporate caution?

Waiting on the sidelines ignores both the scale of the challenge and the opportunities presented by both our historic underperformance and the transformation of the global economy.

We should recognise that Canada is not as productive as it could be. Our productivity ranking has dropped from third of the 20 countries in the Organisation for Economic Co-

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[4] See M. Carney, "The G-20's Core Agenda to Reduce Systemic Risk," Speech delivered to the International Organization of Securities Commissions (IOSCO), 10 June 2010, available at: <http://www.bankofcanada.ca/en/speeches/2010/sp100610.html>.

operation and Development (OECD) in 1960 to 15th of the current 30 members.[5] After some promising signs in the late 1990s, average labour productivity growth has since slowed dramatically.

A small part of this could be due to measurement errors (which will be corrected over time) and a bit more reflects lags associated with the economy's adjustment process, but most of this yawning gap between us and our peers reflects fundamental shortcomings. Addressing these will require more concerted efforts on the part of business and government since:

- Canada underinvests in machinery and equipment (M&E), training, and innovation—in fact, *all* of the underlying drivers of productivity.
- Canadian workers have about half the amount of information and communications technology of their American counterparts.
- Canada is 16th among the member countries of the OECD in the intensity of business research and development.
- Even when we do invest, we are mediocre. Our poor multifactor productivity growth indicates that Canadian firms do not effectively use the capital that they purchase.

In general, while there is more to do, governments have put in place many of the conditions for a productivity revival. Our tax competitiveness has improved dramatically. Comparatively, Canada invests the largest proportion of GDP in primary research. Tariffs on machinery-and-equipment investment are being eliminated, and we have sound macro policies and generally effective regulation. Governments will need to maintain the reform momentum, but they cannot be expected to *will* individuals and companies to take risks.

Business will need to step up. Productivity growth fell in the latest recession, the first time this has happened in three decades. Despite the availability of capital, relatively strong balance sheets, and improving economic conditions, business investment has been subdued compared with past downturns and the scale of the challenge (see Chart 2). Investment intentions for 2010 remain modest and largely driven by the public sector.

This needs to change for a balanced recovery and a more competitive economy.

This is not just a challenge for our largest corporations. Our small- and medium-sized enterprises are, in many respects, the engines of our economy. The rapidly changing global economy will mean that more, too, will be asked of them.

The imperatives for Canadian businesses appear clear. New suppliers need to be sourced; new markets opened; a new approach to managing for a more volatile environment developed.

The relatively slow recovery expected in our most important trading partner, along with ongoing sectoral adjustments, means that Canadian firms have to find new markets. The global economy is increasingly multi-polar. Emerging-market economies currently account for about two-thirds of global growth. They represent almost one-half of the

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[5] Organisation for Economic Co-operation and Development, *Compendium of Productivity Indicators*, 2006 and 2008.

growth in imports over the past decade, particularly of capital goods. They are the main drivers of commodity prices and are therefore important determinants of our terms of trade. More fundamentally, they are increasingly thought to be leaders and innovators in public policy and business.[6] Canada needs to become fully engaged with these emerging centres of economic power.

Monetary Policy Going Forward

In the wake of the shock of the global financial crisis, the Bank of Canada was aggressive. We engaged in a series of innovative, coordinated actions with G-10 central banks; we slashed interest rates to their lowest possible levels; and we then provided unprecedented transparency on their likely future path through our conditional commitment.

All of these actions were necessary for the Bank to fulfill its mandate to achieve its inflation target of 2 per cent CPI inflation.

A more subtle approach is now warranted. The Bank must balance the competing influences on Canadian activity and inflation of momentum in domestic demand and the increasingly uneven global recovery.

In recent months, as the need for emergency settings of monetary policy was passing, the Bank gradually reduced the degree of monetary stimulus. In April, we ended our conditional commitment, which in itself represented a tightening of monetary conditions.[7] At the start of this month, the Bank raised its target overnight rate to 50 basis points and re-established the normal functioning of the overnight market.

These decisions leave considerable monetary stimulus still in place, consistent with the large degree of excess supply in Canada, the strength of Canadian spending, and the uneven global recovery.

Given the ongoing uncertainty surrounding the outlook, any further reduction of monetary stimulus would have to be weighed carefully against domestic and global developments.

In light of the scale and volatility of these conflicting forces, it should be evident that no particular path for monetary policy is preordained.

Conclusion

In conclusion, now is not the time to rest on our laurels. Public and private boldness, both at home and abroad, will be required to secure the recovery. This means G-20 action to reform the global financial system and to secure a sustainable recovery. This means investments by our businesses to improve productivity and to gain new markets. This means Canadians should fully engage the new multi-polar global economy.

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[6] R. B. Zoellick, President The World Bank Group "The End of the Third World? Modernizing Multilateralism for a Multipolar World," a speech delivered to the Woodrow Wilson Center for International Scholars, April 14, 2010, available at: <http://web.worldbank.org >.

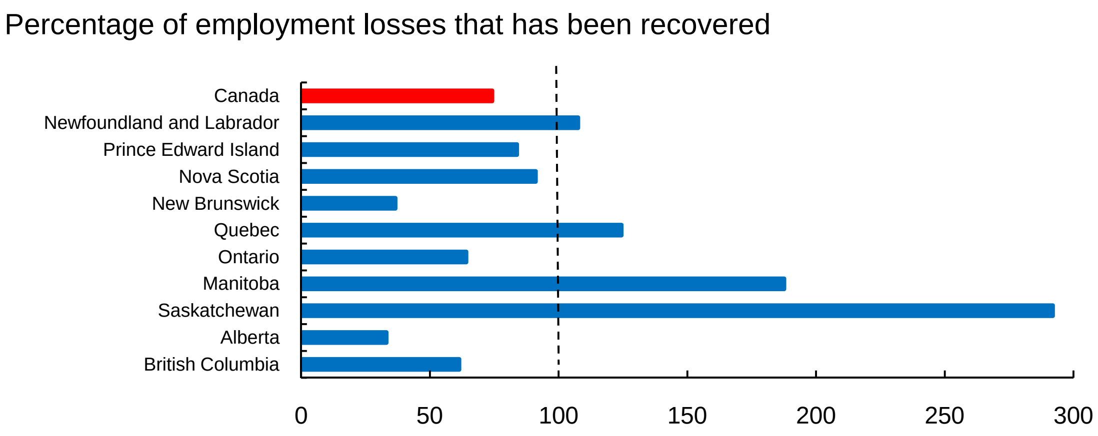
[7] See Bank of Canada, "Framework for Conducting Monetary Policy at Low Interest Rates," *Monetary Policy Report*, April 2009, available at: < http://www.bankofcanada.ca/en/mpr/pdf/2009/mpr230409.pdf>.

These are all big decisions. How quickly and how effectively they are taken will influence activity and inflation in Canada and, therefore, the stance of monetary policy. The Bank will need to be agile.

The Bank will maintain its unwavering commitment to price stability. 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. Price stability lowers uncertainty, minimizes the costs of inflation, reduces the cost of capital, and creates an environment in which households and firms can invest and plan for the future.

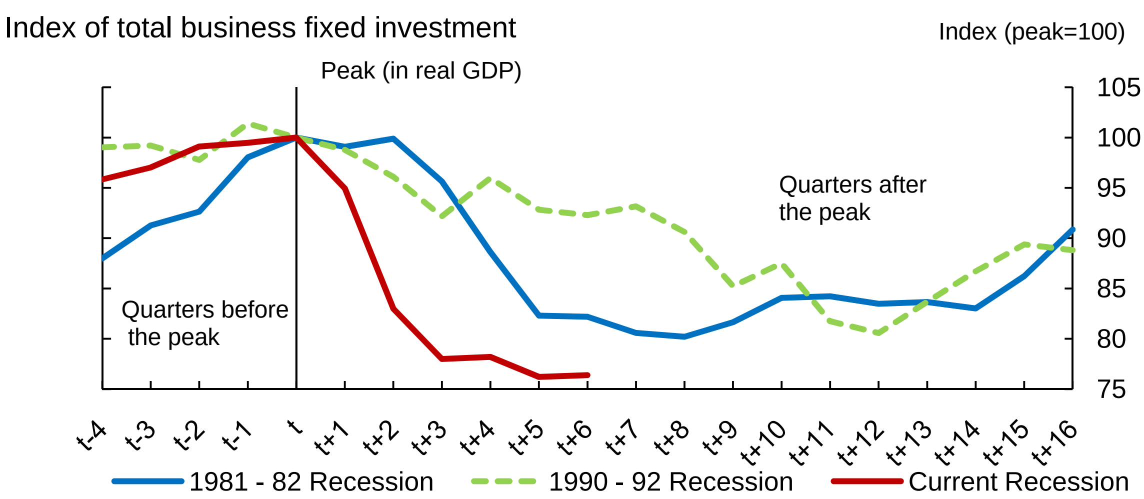
Appendix

Chart 1: Recovery in employment



Sources: Statistics Canada and Bank of Canada calculations

Chart 2: Business fixed investment is relatively weak



Sources: Statistics Canada and Bank of Canada calculations