**Opening Statement by Stephen S. Poloz**
**Governor of the Bank of Canada**
**Appearance before the House of Commons**
**Standing Committee on Finance**
**4 November 2014**
**Ottawa, Ontario**

Good morning, Mr. Chairman and committee members. I am pleased to introduce you to Carolyn Wilkins, who assumed the post of Senior Deputy Governor of the Bank of Canada on 2 May of this year.

Before we take your questions, let me give you some of the highlights of the economic outlook. I'll draw mainly on the October *Monetary Policy Report* (MPR), which the Bank published recently, but I'll also reflect back a bit further since it has been some time since we last met. I'll touch on some new advances in our thinking, and talk about how the environment is driving an evolution in the way central bankers conduct monetary policy.

Our outlook for the global economy continues to show stronger momentum in 2015 and 2016, but the forecast profile has been downgraded since July. In the two weeks since we published the MPR, new data on retail sales and monthly GDP have given us a stark reminder that data don't follow a straight line. The good news for Canada is that the U.S. economy is gaining traction, particularly in sectors that are beneficial to Canada's exports.

And our exports do appear to be responding, with some additional help from a lower Canadian dollar. Our conversations with exporters indicate that they are seeing a better export outlook from the ground.

However, it is clear that our export sector is less robust than in previous cycles. Last spring, as you may recall, we identified which non-energy subsectors could be expected to lead the recovery in exports, and which would not.

We have since investigated in more detail the subsectors that have been underperforming. After sifting through more than 2,000 product categories, we have found that the value of exports from about a quarter of them has fallen by more than 75 per cent since the year 2000. Had the exports of these products instead risen in line with foreign demand, they would have contributed about $30 billion in additional exports last year.

By correlating these findings with media reports, we could see that many were affected by factory closures or other restructurings. In other words, capacity in these subsectors has simply disappeared. This analysis helps us understand a significant portion of the gap in export performance.

Our research also tells us that most of the sectors expected to lead the recovery in non-energy exports still have some excess capacity. Our *Business Outlook Survey* interviews indicate that while companies plan to invest in new machinery and equipment, few are planning to expand their capacity, at least so far. This helps explain why business investment might be delayed relative to what would be expected in a normal cycle.

This research has important implications for Canada's employment picture. We know that when companies restructure or close their doors, the associated job losses are usually permanent. If companies can meet increased export demand with existing capacity, the associated employment gains can be fairly modest, with most of the increase in output coming in the form of higher productivity. The bigger employment gains will come when we enter the rebuilding phase of the cycle—when companies are sufficiently confident about future export demand that they begin to invest in new capacity and create new jobs.

These considerations enter into our estimation of the output gap—the difference between GDP and potential GDP—which is the key macroeconomic determinant of the outlook for underlying inflation. When the economy moves into a position of excess supply, inflation declines, and when it moves into a position of excess demand, inflation rises.

There is no single preferred measure of capacity in the economy. Traditionally, we have put the most weight on measures based on output, or GDP. Each October, we do a full analysis of the determinants of potential output, and its future trend. We have done so in this MPR, but in future we will update this analysis in every MPR. This time, we also offer a special technical box that considers the dynamics of excess capacity in longer business cycles like this one.

The reason this is important is that in such longer business cycles, the restructuring or closure of firms reduces potential output while creating permanent job losses. This means that the output gap can appear smaller than the labour market gap, which is our current situation. This is why we pay additional attention to measures of slack in the labour market. For example, our composite labour market indicator (LMI), which was first presented in last spring's *Bank of Canada Review,* provides a measure of slack based on several underlying labour market data series.

The difference between the output gap and the labour market gap persists until after the rebuilding phase of the recovery I discussed earlier, when the excess capacity measures eventually converge.

Our judgment is that we have considerable excess capacity and that continued monetary stimulus is needed to close the gap and bring inflation sustainably to target. But we take account of our uncertainty around the degree of slack by considering a range of possible slack estimates in our deliberations.

Another important building block of our policy framework is the neutral rate of interest, which is the rate that should emerge once all the dust has settled—inflation is on target, the economy is operating at its full capacity, and all shocks have been worked out. There is uncertainty around this rate, too, and we estimate that it now lies between 3 and 4 per cent, which is well below pre-crisis levels. But since the difference between current rates and the neutral rate is our best estimate of monetary stimulus, understanding the risks around this is also important.

After weighing these considerations, it is our judgment at this time that the risks around achieving our inflation objective over a reasonable time frame are roughly balanced. Accordingly, we believe that the current level of monetary stimulus remains appropriate.

Some observers have commented that the considerable monetary policy stimulus around the world may be sowing the seeds for the next financial crisis. Certainly financial stability risks, especially those related to household imbalances, remain a concern to us here in Canada. But our economy faces significant headwinds and continued monetary policy stimulus is needed to offset them in order to achieve our inflation objective. It is our judgment that our policy of aiming to close the output gap and ensuring inflation remains on target will be consistent with an eventual easing of household imbalances.

Just as our analysis of the economic forces has been evolving with events as they transpire, so is the way we conduct monetary policy adapting in real time to the changing environment. There is now particular emphasis on the incorporation of uncertainty into policy decision making. We published a discussion paper on the subject earlier this month.

We have begun putting our growth and inflation forecasts in the form of ranges rather than points, and have given even more prominence to uncertainty and risks in the MPR. We've refined our analysis of financial stability risks and raised the profile of our *Financial System Review*. And, we have begun to offer a more fulsome description of how those risks are entering our policy deliberations, particularly in the opening statement that precedes our press conferences. These changes have brought more transparency to our decision making, and our policy narrative has shifted from one traditionally seen almost as "mechanical engineering" to one now characterized as "risk management."

One powerful risk management tool that policy-makers have in their tool kit is forward guidance—the ability to provide to markets more certainty about the future path of interest rates. This effectively takes uncertainty out of the market and places it firmly on the shoulders of the central bank. There are costs as well as benefits to using this tool, and so we have decided that forward guidance will be reserved for times when we believe the benefits to its use are clear—periods of market stress, periods when traditional monetary policy tools are constrained, and so on. Otherwise, we will let markets do their job, which is to deal with the daily flow of new information and grind out new pricing, without specific interest rate guidance from the Bank, but supported by the increased transparency around our outlook for inflation and the risks we are managing.

And with that, Carolyn and I would be pleased to answer your questions.