BANK OF CANADA
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Remarks by Mark Carney
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to the Greater Victoria Chamber of Commerce
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CHECK AGAINST DELIVERY

The Three Rs: Review, Reflect, and Reaffirm

September is a time to review the past, reflect on the present, and reaffirm goals for the future. Like students who returned to school this month, I will follow this annual discipline today by (i) reviewing the extraordinary events of the past year; (ii) reflecting on the policy response and the current economic outlook; and (iii) reaffirming the Bank of Canada's commitment to price stability. While this September brings signs of renewed growth around the globe, the recovery is in its earliest stages and almost entirely driven by public policy. Over the medium term, a difficult hand-off from public- to private-led growth must occur. Over the longer term, the economic environment will be challenging as the global economy undergoes a fundamental restructuring.

Review

A year ago, we were in the midst of the most severe economic crisis since the Great Depression. Major institutions had collapsed, and the very functioning of the global financial system was threatened. Virtually every financial asset in the world was being repriced: equity markets plunged, credit spreads soared, and currency volatility spiked. The financial crisis in the United States, the United Kingdom, and continental Europe spread rapidly through financial, trade, and confidence channels, triggering a synchronous and deep global recession.

Major central banks reacted immediately by providing hundreds of billions of dollars in extraordinary liquidity to keep the system functioning. On October 8, G-10 central banks, including the Bank of Canada, conducted an exceptional, coordinated interest rate cut of 50 basis points, the first since the September 11 terrorist attacks. A few days later, the G-7 took decisive action. In a historic meeting on October 10, 2008, G-7 countries, including Canada, committed to:

- Use all available tools to support systemically important financial institutions and prevent their failure.
- Take all necessary steps to ensure that banks and other financial institutions have broad access to liquidity and funding.
- Ensure that our banks can raise capital from public as well as private sources, in sufficient amounts to re-establish confidence and permit them to continue lending to households and businesses.

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The ambition and clarity of these commitments were unprecedented. In those countries at the heart of the crisis, governments re-capitalized banks and guaranteed their borrowings, while central banks further expanded liquidity provision. In some cases, total government commitments to the financial sector reached a remarkable 25 per cent of GDP. In effect, there was wartime spending on a peacetime calamity.

At the beginning of this year, even though the financial system had retreated from the edge of the abyss, the economic outlook appeared exceptionally uncertain. The paradox of thrift—where individually rational actions are collectively damaging—was in full force. The shock and severity of the crisis had deeply shaken business and household confidence. Businesses were delaying investments and building cash reserves. Similarly, households were postponing major purchases and building up precautionary savings. And banks around the world were curtailing lending and conserving capital. As a result, industrial production and world trade were plummeting.

Nonetheless, in a decidedly minority view at the time, the Bank judged that the necessary policy responses to secure recovery were being put in place and that economic growth would resume later in the year. The scale and timeliness of monetary policy support were already significant. By April, most major central banks had reduced interest rates to their lowest levels in history, and some went even further by instituting unconventional credit and quantitative easing strategies. Over the same period, fiscal policies around the world were eased substantially to support demand. Finally, through the G-20 process, bold reforms were launched to establish a more stable, more efficient global financial system.

The Bank’s message over the past year has been relatively straightforward: “There is a plan to restore confidence and growth, we are implementing it, and it will work.” The Bank has long expected that the combined impact of policy measures would build over time and reach full force in 2010. And we have consistently expected that the impact would be particularly pronounced in Canada, owing to the combination of the timeliness and scale of monetary policy stimulus, fiscal stimulus, the strength of our financial system, and the relative health of Canadian corporate and household balance sheets. It now appears that those expectations are beginning to be fulfilled.

Reflect

Indeed, there are increasing signs that activity has begun to expand in many countries. Growth is probable in all major economies this quarter, and the pace of global growth next year is likely to be even higher than the Bank had projected in our last *Monetary Policy Report*. While this recovery is still nascent and sluggish, its appearance nonetheless makes some ask, what was all the fuss about? Was that truly the Great Recession?

Initial success should not give way to complacency. Only the unprecedented and decisive actions across G-20 nations arrested the economic free fall and have begun to boost global demand. Reflecting the scale of fundamental adjustments still going on, the global recovery is likely to be protracted. In other words, we may be on the right track, but there is a long road ahead.

As we go forward, it will be important to distinguish between policy-induced growth in the near term, private-demand momentum in the medium term, and the global economy's ability to respond to the longer-term challenges that this crisis has exposed.

The Near-Term Outlook: Policy-Induced Growth

The nascent global recovery is largely the product of extraordinary policy measures taken over the past year. In the United States, social security payments, tax credits, and temporary incentive programs, such as the "cash for clunkers," are having major impacts on demand. Similarly, in Japan, government transfers to individuals have provided an important, temporary boost to consumption. Chinese domestic demand has also been stronger than originally expected, but here too, the impact of policy should not be underestimated. Crucial measures include a fiscal stimulus package estimated at 5.5 per cent of GDP and a 34 per cent increase in bank lending, underwritten by banks that are predominantly state owned.

Global financial conditions have improved markedly, albeit from distressed levels. Spreads have fallen, corporate bond issuance has been very strong, and equity markets have rebounded to levels near those prior to the failure of Lehman Brothers. Nonetheless, in most major economies, bank lending is subdued and non-price terms are tight. Overall, the global financial system remains strained and many markets, including interbank lending and securitization markets in the United States, still benefit from public support.

On the business side, the sharp fall in activity around the globe earlier this year has meant that firms were stuck with much higher inventories than desired. A brutal de-stocking followed as firms slashed production. Now, with prospective sales recovering, the inventory cycle has begun to turn. This will provide a significant, but temporary, boost to growth.

Against this backdrop, growth has resumed in Canada. Our recovery will be supported by the relative health of Canadian balance sheets, our well-functioning financial system, the timeliness of monetary policy action, and the recent firming of commodity prices. As we signalled in our interest rate decision earlier this month, GDP growth in Canada in the second half of this year will likely be stronger than projected in our July MPR.

It is important to recognize, however, the importance of temporary factors. For example, the strength in existing home sales partially reflects pent-up demand from the consumer paralysis at the height of the crisis. In addition, affordability has improved, largely as a result of very low interest rates. Another example is Canadian auto production, which looks on track to more than double (on a seasonally adjusted annualized basis) in the third quarter. That bounce primarily reflects the restarting of capacity that had been shuttered when major auto companies restructured earlier this year, as well as the need to rebuild inventories that have been drawn down as a result of the U.S. cash-for-clunkers program.

These dynamics may begin to reduce the amount of slack in our economy. It should be recalled, however, that currently there is a very large gap between the potential of our economy, or aggregate supply, and aggregate demand for our output. The evidence for this is widespread. Manufacturing capacity utilization rates are at their lowest level in at least a quarter century, the unemployment rate has increased by 2.9 percentage points to its highest level in 11 and a half years, and, according to our July *Business Outlook Survey*, only 28 per cent of firms would have difficulty meeting an unexpected increase in demand, which is the lowest level since the aftermath of September 11, 2001. In our July MPR, the Bank estimated that our conventional measure of the output gap, which is a broad measure of the gap between aggregate supply and demand in the economy, reached -4.3 per cent. This is the widest gap, positive or negative, seen since the recession of the early 1980s.

This large output gap will moderate inflationary pressures during the initial phase of the recovery. And it will take sustained private demand growth to return our economy to its productive potential.

The Medium-Term Outlook: The Hand-Off to the Private Sector

G-20 policy-makers have committed to maintain stimulus “until the recovery is assured.” So what are the drivers of this recovery? What will be required to not only remain on track but also on schedule?

Externally, it is important that private demand consistently grow in the countries that were at the epicentre of the crisis, particularly the United States. Unfortunately, this recovery may be both difficult and uneven. The sharp rise in unemployment will weigh on consumer confidence and the growth of disposable income. In addition, the repair of household balance sheets will take some time.

Similarly, the repair of major foreign financial systems remains a work in progress. The disappearance of the shadow banking sector and the ongoing strains of the recession will mean that it will take further restructuring and considerably more capital for financial conditions to return fully to normal. In the meantime, the financial sector will continue to restrain growth in many industrialized economies.

There are some offsets to these external headwinds. First, the composition of U.S. activity will likely become more favourable to Canadian growth. The recent pattern of U.S. activity, with its severe weakness in the housing and auto sectors, meant that the U.S. recession proved particularly challenging for our businesses. As these sectors stabilize and begin to grow modestly, this effect will be reversed and will be important for Canada.

In addition, while the overall pace of global growth will likely be subdued, the Canadian economy will rely more on emerging-market growth for external demand. This would provide an important support for commodity prices and, therefore, the Canadian economy over the medium term. However, the ability of emerging markets to sustain more vigorous growth in domestic demand remains an open question. For example, rapid expansion of domestic lending is challenging in any environment, particularly in those countries, such as China, with developing banking systems.

On balance, the external sector may not be reliable as the sole engine of the Canadian recovery. In this context, domestic factors could prove decisive. As noted earlier, contributions from inventories will be temporary. Housing should provide some near-term strength, but the degree of pent-up demand appears limited. With the fiscal stimulus largely finished by next year, consumer and business spending will need to drive economic growth.

Sustained growth in consumer spending will require household decisions that are based on confidence rather than relief, and that are funded by income rather than debt. A rebound in disposable income growth will require improved labour market conditions, starting with hours worked, followed by stabilization, and then by increases in employment. Given the slack in the economy, this could take some time.

Firms will need to act with confidence as well. Replenishing inventories and restarting idled capacity will not be sufficient. Hiring and investment intentions, and eventually capital spending and employment decisions, must recover as well. Given the openness of our economy, these prospects will turn importantly on perceptions of external conditions.

In assessing the progress of the recovery, the Bank will not rely on a single data point. Survey indicators will likely be the first to show the turn, but we will need to see follow-through in the harder statistics. Ultimately, we will be looking for an accumulation of evidence across a range of indicators.

Considerable risks to the outlook for inflation remain. Upside risks include a faster-than-expected recovery in consumer and business confidence and further improvements in our terms of trade. Downside risks are largely external and include setbacks in the ongoing repair of the global financial system and more persistent weakness in foreign private demand. In addition, the possibility of persistent strength in the Canadian dollar would work against the positive factors just mentioned. The recent rise in the dollar is, in part, a reflection of the same factors that are leading to a recovery in Canada, notably the rebound in commodity prices. It is also a result of a more generalized weakening of the U.S. dollar, as global financial conditions normalize. Other things being equal, a persistently strong Canadian dollar would 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. Even though we are at the effective lower bound for our policy rate, the Bank retains considerable flexibility in the conduct of monetary policy.

The Longer-Term Outlook: A More Challenging Global Environment

Over the longer term, the pattern and pace of global growth will be significantly altered. This *was* the Great Recession, and it will have far-reaching repercussions. The rate of potential growth in the global economy has likely fallen in the aftermath of the crisis and will take some time to rebuild. The fiscal cost of arresting the downfall will need to be first contained and then repaid over many years. Most fundamentally, the sources of demand will need to rebalance, both within and across economies.

Addressing these challenges will require difficult and extensive measures in all economies. Once the recovery is assured, concerted efforts will be necessary in most economies to restore fiscal sustainability. This need is particularly sharp in those countries with looming demographic pressures and unsustainable entitlement programs. Fiscal pressures could also become more acute if the rebalancing of global growth is not successful. As the recent G-20 meetings attest, major reforms are necessary to create a more resilient and efficient global financial system. In addition, given the sharp rise in unemployment and the likely important changes to global growth, structural reforms to improve labour market flexibility and to retrain workers will be important. Finally, surplus countries that need to boost domestic demand, such as China, will require a comprehensive program of structural reforms. The necessary reforms to social safety nets and to liberalize the domestic financial sector are complex and will take years to bear fruit. They must also be complemented by material adjustments to the real exchange rates of deficit and surplus countries.

Reaffirm

In the face of these challenges and uncertainties, the credibility of macroeconomic policy is essential. One constant is the Bank's 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. That means keeping inflation low, stable, and predictable. 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.

The Bank's sole monetary policy objective is to achieve its 2 per cent inflation target. Having a simple, credible price stability objective proved enormously helpful during the crisis and should continue to be so during the eventual exit. The Bank approaches inflation control in a symmetric way, meaning that we care as much about inflation dropping below the target as about inflation rising above the target. Inflation targeting is equally able to prevent the entrenchment of high and volatile inflation or the onset of persistent deflation. As a consequence, inflation expectations have remained well anchored at the Bank's 2 per cent target.

The ability to maintain inflation expectations has helped to keep real interest rates low and to provide the necessary monetary stimulus. The inflation anchor remains essential, even when providing extraordinary guidance. This is why the Bank's current commitment—that our target rate is projected to remain at its effective lower bound through the end of the second quarter of 2010—is explicitly conditional on the outlook for inflation.

It is important to recognize this statement for what it is—the Bank's judgment that our policy rate should remain at 1/4 per cent at least through the end of June of next year in order to achieve our 2 per cent inflation target. This conditional commitment does not indicate what will happen following the end of the second quarter of 2010. Nor is it a guarantee that rates will absolutely remain at the current level. In short, it is an expectation, not a promise. If circumstances affecting the outlook for inflation change materially, the conditional commitment would change. The only constant is that the Bank will consistently set monetary policy appropriately in order to achieve the inflation target.

Conclusion

To conclude, one lesson should be clear: policy matters. Aggressive policies arrested the economic free fall triggered by the financial crisis. Policy action is driving the initial recovery. Policy-makers will have to act deftly to maintain stimulus long enough for private demand to take up the burden of growth, but not too long to undermine confidence in and the sustainability of that growth. Even once that feat is accomplished, the aftermath of the crisis will make considerable demands on structural policies in all countries, including Canada.

Recent events were a watershed. A powerful and sustained restructuring of the global economy has begun. Canada is entering this period with many strengths, but the efforts required of us will be historic. Our businesses will need to develop new markets as the traditional advantage of relatively open access to U.S. markets becomes less valuable. The Bank of Canada will continue to review, reflect, and report on the broader global forces I have outlined today. As I have reaffirmed, our principal contribution will be to consistently achieve our inflation target, so Canadians can plan and invest with confidence.