House of Commons
CANADA

Standing Committee on Finance

FINA • NUMBER 023 • 2nd SESSION • 40th PARLIAMENT

EVIDENCE

Tuesday, April 28, 2009

Chair

Mr. James Rajotte

Also available on the Parliament of Canada Web Site at the following address:

http://www.parl.gc.ca

Standing Committee on Finance

Tuesday, April 28, 2009

● (1530)

[*English*]

The Chair (Mr. James Rajotte (Edmonton—Leduc, CPC)): We call the 23rd meeting of the Standing Committee on Finance to order.

Per our orders today, we have the Governor of the Bank of Canada with us, Mr. Mark Carney, and the senior deputy governor, Mr. Paul Jenkins. Welcome to both of you, gentlemen. It's an honour to have you here today before the committee.

These are obviously very interesting times. We're certainly interested in hearing your perspective, the updated forecasts, and also about some very serious issues. All members do have a copy, of course, of your *Monetary Policy Report*, released, I believe, on Thursday.

Mr. Carney, welcome. You may give your opening statement, and then we'll go to questions from all members of the committee.

Mr. Mark Carney (Governor, Bank of Canada): Thank you very much, Chair.

Good afternoon, committee members.

Paul and I are very pleased to appear before this committee to discuss the bank's views on the economy and our monetary policy stance.

Before we take your questions, I would like to give you just a few of the highlights in that report the chair just referenced.

These are interesting, but also difficult, economic times, with the Canadian economy being buffeted by an intense and synchronized global recession. In recent months, the global recession has been exacerbated by delays in implementing measures to restore financial stability around the world. G-20 policy-makers are now responding to the global crisis with a renewed commitment to concrete initiatives and comprehensive plans. Our base-case projection is that these policies will be implemented in an effective and timely manner, and their impact will reach full force next year. The discussions in Washington over this past weekend were consistent with that outlook.

As a result of the current global economic and financial situation, the bank now projects that the Canadian recession will be deeper than we had projected in January. Our return to growth will be delayed by one quarter, to the end of 2009, and our recovery will be somewhat more gradual. In short, the broad outlines of the Canadian outlook are the same, but its profile has shifted.

[*Translation*]

Canada's real GDP is projected to decline by 3.0% this year, and growth is expected to resume in the autumn and accelerate to 2.5% in 2010, and 4.7% in 2011.

Our outlook for inflation is broadly consistent with that in our January Update. Total inflation will temporarily fall below zero in 2009, but core and total CPI inflation are expected to return to the Bank's 2% inflation target in the third quarter of 2011.

In that context, on Tuesday, the Bank lowered the policy interest rate by 1/4 of a percentage point to 1/4 per cent, which is judged to be the effective lower bound of the policy rate. Conditional on the outlook for inflation, the Bank has committed to holding this rate at 1/4 per cent until the end of June 2010.

[*English*]

Since December 2007, we have cut interest rates by a total of 425 basis points to their current historic lows—and to the lowest possible levels. It is the bank's judgment that this cumulative easing, together with the conditional commitment to keep rates low for a considerable period, is the appropriate monetary policy stance to move the economy back to full production capacity and to achieve the 2% inflation target.

However, these are uncertain times, and if additional stimulus were to become necessary, the bank retains considerable flexibility in the conduct of monetary policy at low interest rates. Because it is important to outline these alternatives in a principled and transparent fashion, we published a framework last week that describes the bank's approach to the conduct of monetary policy when the overnight interest rate is at its effective lower bound—as it is at this moment. We welcome the opportunity to discuss with this committee the possible application of that framework to achieve the inflation target.

Additional stimulus could be provided through quantitative easing, which involves the creation of central bank reserves to purchase financial assets, and/or credit easing, which includes outright purchases of private sector assets.

If the bank were to deploy either quantitative easing or credit easing, it would act in a deliberate and principled fashion. The focus of these operations would be to improve overall financial conditions in order to support aggregate demand and to achieve the inflation target. Asset purchases would be concentrated in maturity ranges in order to have the maximum impact on the economy. Actions would be taken in as broad and as neutral a manner as possible. And the bank would act prudently, mitigating risk to its balance sheet and managing its ultimate exit from such strategies at an appropriately measured pace.

Allow me to conclude with a few words on the outlook for the Canadian economy.

● (1535)

[*Translation*]

While there remains a high degree of certainty—particularly with the Canadian economy dependent on forces beyond our borders—we remain confident in the prospects of eventual economic recovery in Canada.

This recovery should be supported by the following factors: the gradual rebound in external demand; the end of stock adjustments in Canadian and U.S. residential housing; the strength of Canadian household, business and bank balance sheets; our relatively well functioning financial system and the gradual improvement in financial conditions in Canada; the past depreciation of the Canadian dollar; stimulative fiscal policy measures; the timeliness and scale of the Bank's monetary policy response.

[*English*]

With that, Mr. Chairman and members, Paul and I would now be very pleased to take your questions.

The Chair: Thank you, Mr. Carney, for your opening statement.

We'll start with Mr. McCallum, for seven minutes, please.

Hon. John McCallum (Markham—Unionville, Lib.): Well, thank you, Mr. Chair. Let me start by saying something nice, and that is I thought it was a very good move and a novel one—or at least novel to me—to announce in advance that your interest rate would stay low for a period of a year or so, thereby hopefully influencing market rates. I hadn't seen that before.

My question, however, concerns statements by Mr. Flaherty compared with your own statements today. Earlier this month in London, the Finance Minister said we had a mild recession and that inflation was likely to become a problem. On inflation, I will quote him:

> I'm very conscious of...the danger of inflation. And we're going to watch closely over the next few quarters...and then we'll take the steps we have to take in conjunction with the Bank of Canada....

So he's saying mild recession and you're saying deeper than expected. He's saying there's a big inflation problem. You seem to say there isn't one—or at least that's my interpretation of your report.

So I have a double question. Isn't that quote by Mr. Flaherty a little bit proprietary on inflation, because I thought that was really your job? Second, who's right in this apparent contradiction between your view and that of the minister?

Mr. Mark Carney: What was the nice bit?

Voices: Oh, oh!

Hon. John McCallum: The nice bit was the first bit about the low interest rate for a year.

Mr. Mark Carney: Yes, thank you for mentioning that. Just to re-emphasize that point, we did see an important move in interest rates further out the yield curve as a result of that commitment, which should provide considerable additional stimulus to the economy.

In terms of the inflation outlook, I will speak only to our outlook on inflation. We do see an easing of headline inflation, and in fact we see headline inflation becoming negative in the second and third quarters of this year. Part of that will be driven by the unwinding of commodity prices, or the year-end effect of high energy prices this time last year. But it also reflects an easing of core inflation. We see core inflation coming down towards the bottom of the band over the balance of this year. This reflects the gap opening up in the economy between the potential of the economy and the actual output.

We are taking steps to provide stimulus to bring inflation back to target over the policy horizon, and we do see it coming back to the 2% target, both core and total inflation, by the third quarter of 2011.

● (1540)

Hon. John McCallum: What about the part about the proprietary statement?

Mr. Mark Carney: I think it's the Bank of Canada's mandate to achieve the inflation target and to conduct monetary policy to achieve the inflation target. I will say that in a situation where we are at the effective lower bound, as we are today, there is a need for even heightened communication and at times coordination with the government, depending on what non-conventional steps might be appropriate given the potential credit and market risk implications of those steps—if we were to follow them. So there is an element, as you know, first of communication, which is always the case, and then potentially of coordination in these circumstances.

Thank you.

Hon. John McCallum: Thank you.

Mr. Paul Jenkins (Senior Deputy Governor, Bank of Canada): If I might add a quick comment on your very first observation regarding the statement to keep interest rates low for the period out to June 2010, it is a conditional commitment based on the projection of inflation—and that is important. But you're absolutely right that the objective of that statement is to influence interest rates further out the yield curve to have stimulative impact on the economy.

Hon. John McCallum: That was the nice part of my comment, which I thought was a really good move.

The last time you were here I said you were out on an optimistic limb, but I think I've been fair in saying it was always conditional on the U.S. fixing the banks fairly quickly, and were that not to happen we'd do worse. I think that has happened. I'm not sure of the exact number, but according to the IMF there's $4 trillion, or some unimaginable huge number, in U.S. bank loans. So I contend there's still a risk that the U.S. banking system will not fix itself quickly enough.

Do you agree with that proposition? What is the outlook, or what will they have to do to make it work? What will the evidence be? When and and how will we know whether this central problem in the world—the U.S. and European banking systems—is indeed fixing itself?

Mr. Mark Carney: Your question is absolutely on point.

The IMF estimate, just for the record, is $4.1 trillion on assets spread globally, but a large proportion of those troubled assets, according to the IMF, is in the United Sates. So the problem still exists. For absolute clarity, it is still an underlying assumption of our current projection that there will be steady progress in stabilizing the U.S. banking system and therefore the global financial system.

What does the U.S. need to do? The first step will be taken on Monday, May 4, with the results of the stress tests that have been conducted on the 19 largest banks—three-quarters of U.S. banking assets. We will look for conservative assumptions in both the economic outlook, which we understand, and the application to losses and capital requirements, which is part of the methodology. We have confidence that that will be the case, but it's short enough in the horizon; we need to see the results.

Then the institutions themselves will need to move forward with raising capital, either through the public sector or on their own. That's another leg of it. That will take some time. Very important is the need to separate the troubled assets, toxic assets, and legacy assets from the institutions. As you are no doubt aware, there is a series of mechanisms to do that involving private capital and public leverage. Those transactions also need to happen in a fairly expeditious fashion.

The last thing to be said is we need stabilization, not just in the U. S. but globally. We need different designs but similar effective steps to recap and separate assets, in order to continue to proceed in the United Kingdom and Europe.

The Chair: Thank you.

Thank you, Mr. McCallum.

We'll go to Mr. Laforest.

[*Translation*]

Mr. Jean-Yves Laforest (Saint-Maurice—Champlain, BQ): Thank you, Mr. Chairman.

Good afternoon, Mr. Carney and Mr. Jenkins.

Mr. Carney, in recent months, the Bank of Canada has granted significant credit facilities and fund advances to banks in general so that they can better restructure or organize with regard to credit.

Are there any conditions associated with this assistance such as, for example, ensuring that access to credit is facilitated as well—we understand that it is for the banks—for businesses and individuals in general? Is that part of the process, conditions associated with that?

● (1545)

Mr. Mark Carney: Thank you.

In late fiscal 2008, the Bank of Canada provided a maximum of approximately $40 billion to the Canadian financial system in the form of exceptional liquidity. Now the amount of that liquidity is approximately $26 billion. So there has been a significant drop, but that's nevertheless a large amount. Providing liquidity was and still is very important for the proper operation of Canada's financial system.

The purpose of our efforts is to improve overall financial conditions in Canada. We have provided liquidity and we are now providing liquidity to keep participants in the financial system. That isn't just the banks, but organizations such as the Caisse centrale Desjardins as well. This system includes all members of the LVTS. We are finding the results of these transactions encouraging. Currently, the Canadian financial system as a whole is doing better than those of the other industrialized countries.

Mr. Jean-Yves Laforest: You are providing the means to the banks and to the caisses Desjardins, whether it be for businesses in the various regions or for individuals who take out loans. I would like to know whether you are sure of setting conditions for those institutions. You've granted them $40 billion, but they have to be accountable to you in one way or another.

Mr. Mark Carney: First, in the money and capital markets, the banks and caisses centrales are continuing to provide their liquidity or to transmit that of the Bank of Canada to the markets. That's absolutely crucial in the case of commercial paper, for example, and for other commercial bonds. The fact remains that, in Canada, credit growth, whether it be for households or businesses, is higher than in the other major countries. Our operations are one of the aspects on which this initiative is based. As to whether conditions have been formally set, the answer is no.

Mr. Jean-Yves Laforest: That answers my question. I believe you should have set some, however. It seems to me that the purpose, in a way, is to help citizens and businesses.

I would also like to know whether the banks have used those credit facilities and, if so, to what extent. You mentioned $40 billion. However, we heard that some banks had preferred not to use the funds put at their disposal by the Bank of Canada so as not to have to be accountable to the government. Is that the case?

● (1550)

Mr. Mark Carney: The entire amount was used by the banks and the caisses centrales. I would like to clarify some points. First, those transactions are subject to a guarantee. Moreover, with respect to monetary and capital markets, we closely monitor the banks' transactions. We frequently speak with the bank presidents about this matter.

Mr. Jean-Yves Laforest: How do we know your predictions are correct this time? In September, you hadn't anticipated such a significant recession. In January, you were still very optimistic and now you are less so. How do we know you're on target this time?

Mr. Mark Carney: How much time do I have left?

The Chair: You have 30 seconds.

Mr. Mark Carney: I thought Mr. Mulcair would ask me that question very elegantly.

With your permission, to go more quickly, I'm going to answer in English.

[*English*]

What is different?

The first point is that our projection is similar to our projection in January. The recovery has moved out by a quarter and the profile of that recovery has flattened a bit, but not that much. In January we said we felt there would be a relatively modest recovery into 2010, and it still holds, but it's just flattened a bit more. Why has it flattened more? It's flattened because of the delay we discussed a moment ago on the stabilization of the financial system. It's also flattened because commodity prices, our terms of trade, have fallen off quite dramatically, and that will have a real income effect on Canada. It reflects a more muted outlook, a weaker recovery, and in fact basically no recovery in Europe in 2010.

[*Translation*]

The Chair: Thank you, Mr. Laforest.

Mr. Bernier, go ahead, please.

Hon. Maxime Bernier (Beauce, CPC): Good afternoon, Mr. Carney and Mr. Jenkins, and thank you for being here with us today.

In the annex to your “Monetary Policy Report”, which you tabled last week, you explain how the Bank of Canada will proceed with what the experts call quantitative easing or, in other words, how it will increase the amount of credit in the economy. You traditionally do that by buying treasury bills.

In the context of this exceptional measure, you could also do so by buying financial assets from the private sector, that is to say the shares or bonds of individual private businesses. The bank will buy those assets by creating money out of nothing.

I must first tell you to what extent this practice of creating money out of nothing and artificially inflating credit troubles me. The inflationary theories of Keynes have been discredited for a number of decades. However, you'd think everyone has suddenly become a Keynesian. If creating new money and inflating credit could really stimulate growth, there would never be recessions or economic slowdowns.

In fact, a number of economists believe that excessive money creation caused this crisis. Excessively easy credit during most of this decade purportedly caused bubbles, particularly in the finance and real estate sectors. A recession occurs when those bubbles burst and the economy has to readjust. If it was easy credit that caused the bubbles and the crisis, I would like to understand how we can hope to get out of the crisis by further increasing credit. By doing that, don't we risk further distorting the economy?

Some say that quantitative easing is now the path to take, since it is practised at most other central banks of the major countries. However, if Canada experiences a less severe crisis because its monetary policy is more conservative and more prudent than those of its partners, it seems to me that doing the same thing as the others is not necessarily the best option.

Mr. Carney, in your report, you admit that purchasing private assets will increase their prices and that that will be done in a neutral manner with respect to sectors and assets of a similar nature. How can you remain neutral, when there are thousands of different financial assets in various sectors? Isn't the bank running the risk of putting itself in a position where it will favour certain sectors or businesses over others?

● (1555)

Mr. Mark Carney: Thank you for your question. First, I would like to emphasize a few points. The objective of these transactions would be... I'm using the conditional for a reason. This isn't the Bank of Canada's plan, but it is one card up our sleeve, only in the event it becomes necessary to promote greater monetary easing as a result of a negative shock. We would have options, such as easing credit rules. The purpose of these transactions is to improve financial conditions, credit conditions across Canada as a whole.

As regards neutrality with respect to similar sectors, we can use adjudication, for example. That is one way to be neutral with respect to certain sectors. It's one tool used by the Bank of England to ease credit.

With respect to your reference to Mr. Keynes, I would simply like to emphasize that it is no longer a question of Mr. Friedman versus Mr. Keynes, this idea of the relationship between the money supply and inflation. In that context, even though our situation and our financial conditions in Canada are better than elsewhere—and that's the truth—they are nevertheless difficult and are remaining difficult. The [*Inaudible - Editor*] of money fell, so that relationship, that danger is much less, as a result of the recession and the global financial crisis.

Hon. Maxime Bernier: Thank you.

Mr. Paul Jenkins: There are other techniques that can be used to achieve a neutral impact. For example, we could think of the indices. There are techniques that a central bank can use to achieve a neutral impact.

Mr. Mark Carney: The Bank of Canada has no interest in pursuing an industrial policy.

[*English*]

The Chair: Mr. Bernier, you have one minute.

[*Translation*]

Hon. Maxime Bernier: I'm very pleased to learn that you're talking about quantitative easing in the conditional only and that you won't automatically resort to it. If Canada's economic position requires it, you'll have another option in your tool box. I believe that's very healthy.

With regard to the neutrality issue, if I understand correctly, it's perhaps not so much the direct purchase of securities in the stock or bond markets, but rather the indices in the various sectors that could help achieve a neutral impact.

Thank you.

[*English*]

The Chair: Thank you, Mr. Bernier.

Mr. Mulcair.

[*Translation*]

Mr. Thomas Mulcair (Outremont, NDP): Welcome, Mr. Carney and Mr. Jenkins. It's always a pleasure to see you.

Mr. Carney, you gave a good answer earlier to the question from my colleague Mr. Laforest concerning the difference between your quite optimistic forecasts and those more tempered ones. You indeed drew the necessary distinctions.

I share the opinion of my colleague Mr. McCallum, who congratulated you saying that you are doing a good thing by giving some assurances to people who are perhaps planning to buy a house. That's one way of stabilizing the situation and generating confidence. I think that's somewhat the purpose, even though you refrain from saying that you might at times be cheerleading. You said that you were only giving the figures. I think there's nevertheless a matter of trust that people have to have in the economy. When you provide that guarantee of more than one year on the interest rate, there's something reassuring that ultimately can only help.

The conclusion is that it is much safer to make predictions about things we control than those we do not, which is very good. We have greater chances of not missing our shot.

I want to go back to the topic of inflation, which has come up in the discussions.

You will no doubt remember—because you have a good memory for these things and for many others as well—that I spoke to you about that a few months ago. You reassured me by saying that you had all the necessary tools.

Earlier you said that we were talking about $4.1 trillion at the world level. I always take the trouble to say that "billion" in French corresponds to "trillion" in English, because that may be confusing. The French billion is 1,000 English billion. So we're talking about $4 trillion worth of debts, bad bank debts.

Mr. Obama has already printed billions of dollars, as though he were a creditist. He's channeling Camil Samson. We are happily printing money, and you are nevertheless sure that that money will have an impact on the market and that we won't have the same kind of inflation as we experienced in the wake of the Vietnam War.

Let's remember that the price of the Vietnam War, apart from the price in equipment and human lives, was terrible inflation because the cost of the war had to be paid. We've already spent billions of dollars in Iraq and Afghanistan that will have to be repaid sooner or later by printing money.

Reassure me by telling me that we won't be repaying the billions of dollars in question through Zimbabwean-style inflation.

● (1600)

Mr. Mark Carney: Thank you.

First, you're right. It is absolutely preferable right now to have a certain degree of stability. With our conditional commitment, I believe we have provided that in part. However, it is a conditional commitment, and conditions are inflationary prospects for Canada. That's clear.

Second, with regard to inflationary tendencies in the United States and the world, I would like to emphasize that there are currently disinflationary pressures at work in the world. The major difference between today and the United States in the 1960s—the period of the Vietnam War and so on—is that global growth is very weak. It will probably be negative in 2009 and, in 2010, according to the Bank of Canada, it will be 2.2% internationally. The potential global growth rate is probably about 3.5%. So there is a gap that will continue to increase next year. Disinflationary pressures could persist for some time.

Mr. Thomas Mulcair: Let's assume that those disinflationary pressures last one or two years. Once they are over and things start to stabilize, we nevertheless can't simply print money; we have to repay the debt.

Mr. Mark Carney: Yes.

Mr. Thomas Mulcair: How will we do it, if not through inflation?

A lot of people who have invested in today's markets would like nothing better than a good spike in inflation to change the value of their securities and currencies.

Mr. Mark Carney: You're right once again. It's absolutely necessary to have an exit strategy. It's necessary for the federal reserve and it's one of the principles of the Bank of Canada. If it were necessary to use our framework, it would absolutely be necessary to have an exit strategy.

● (1605)

[*English*]

One would need to design the purchase of any securities, whether they were government or other securities, in a way that had a maturity ladder that had a way to reverse those operations quickly. After all, the goal is to get back to the inflation target, not through the inflation target. And we would be very prudent in the application of what we're responsible for, which is this framework.

The Chair: You have one minute, Mr. Mulcair.

Mr. Thomas Mulcair: I'm going to take this on to another track, because I'm not sure that we're going to get a second round on this team. I'm going to take you onto a slightly different track now that has to do with following money to tax shelters.

[*Translation*]

I'm talking about tax havens.

[*English*]

I mean tax havens.

There are constants in regulatory theory. One is regulatory lag: we're always a little bit behind the people we're trying to regulate. Another one is regulatory capture: we often have people from the same domain, so they tend to look at things the same way. If people are used to having tax havens and they've always been part of their lives, and then they come in to regulate in the public sector, they'll tell you that this is the way things are.

Is that something we should be looking at as part of the solution as we come out of this? We're going to be looking at restructuring things such as pensions. We had good hearings on that today. We have a lot of work to do as parliamentarians to try to put in the structures to make sure that things are more solid next time around as we get away from the Milton Friedmans of this world who have told us that we should stop worrying our little heads about this; we didn't understand it anyway. It looks like nobody understood it, or at least some parts of it.

The Chair: Okay, Mr. Mulcair, what is your question?

Mr. Thomas Mulcair: What can we be looking at in terms of tax havens, specifically?

Mr. Mark Carney: Very briefly, the issue of *paradis fiscaux*, or tax havens, was an issue addressed by G-20 leaders in London. It is on the agenda. It was not a core part of the problem, but as you suggest, it doesn't mean that it shouldn't be looked at, because it could be part of the next problem.

The Chair: Thank you, Mr. Mulcair.

We'll go to Mr. McKay for five minutes.

Hon. John McKay (Scarborough—Guildwood, Lib.): Thank you, Chair.

Thank you, Governor. Thank you Deputy Governor. After Mr. McCallum and Mr. Mulcair's interventions, I feel relieved of the obligation to say something nice about you.

I want to pursue the noises about your taking on a macro-prudential role in the banking system—that you will be shifting from central banker to super-banker—and the potential for conflict between your primary role, which is a monetary role, and this other role by which you would effectively leave the prudential part to OSFI but in all other respects would be supervising the financial system, particularly the federally regulated institutions.

The analogy that springs to mind, which is not original to me, is putting the ministry of the environment and a ministry of energy in the same department. The issues are not always the same and the policy responses are not always the same. In your enthusiasm, for instance, for quantitative easing, which seems to be putting money into the system to buy assets of varying degrees of toxicity, you actually increase the money supply and therefore the potential to increase inflation, when maybe the proper monetary or policy response would be to keep inflation within a band or under control. I appreciate that when you were talking to Mr. Mulcair you had something of a response to that, but you didn't respond to that issue as it relates to your apparent aspiration to take on a macro-prudential role in the financial system.

Mr. Mark Carney: Okay. I take it there's a question mark after that.

The first thing is that I would note that G-20 leaders agreed in London on the importance of a macro-prudential approach to regulation. So that is a declared objective of all the major economic powers of the world.

The question is how to put that into place. As you rightly note, there are different perspectives from different agencies, and I would say further that there would be different ways to put this into place in different countries. It matters what your regulatory history is; it matters what the structure of your financial system is. And in Canada I believe we have extremely effective cooperation among the federal regulatory agencies—I am including in that the Department of Finance in discharging its responsibilities, obviously OSFI, CDIC, and FCAC—and that lends itself to certain solutions that could operate.

The issue is probably, first and foremost, to determine the precise tools, the mechanisms by which one would put this into place.

I would say—and I'm not commenting on your depiction of any aspirations—that what the bank can bring to the table in these discussions is a macro perspective. And when you look at what macro-prudential regulation or macro-prudential surveillance is, the issue is how either regulations or behaviours start and when they get to a point where they feed back on the macro-economic outlook and the economic cycle and exacerbate those cycles.

We are certainly seeing a very negative feedback from ignoring those issues in our partner countries around the world, and we don't want to put ourselves in that situation going forward.

● (1610)

Hon. John McKay: But the interesting point is that the G-20 countries all get together and say we need macro-prudential supervision. For pretty well everyone in the room, that's true. With Canada it's not quite so true.

So it seems that the impetus to go in this direction is based upon the monetary/fiscal banking experience of other countries rather than here. So if it ain't broke, why are we fixing it?

Mr. Mark Carney: It is very difficult to predict the next crisis, and I would encourage this committee to study carefully the lessons of the crises that were born outside our borders to see their potential applicability to the Canadian system. One should never assume that because it hasn't happened, it won't happen.

The Chair: Thank you, Mr. McKay.

Mr. Laforest.

[*Translation*]

Mr. Jean-Yves Laforest: Thank you, Mr. Chairman.

In the same line of thinking, Mr. Carney, a few years earlier, no one had foreseen the present crisis.

Mr. Duguay told the Finance Committee, in response to a question that I asked him, whether the Bank of Canada had issued warnings about the toxic nature of commercial paper, that, yes, that had been done in your financial review in 2005.

Currently, virtually everyone in the financial field is definitely working to get out of this crisis as soon as possible. However, in light of past experience, do you think there is something that you could have or should have done, using the power that the Bank of Canada holds, and that you did not do? If so, will you correct matters and try to prevent a crisis such as the one we are going through right now from reoccurring in future?

[*English*]

Mr. Mark Carney: Let me make two points in that regard.

First, as Monsieur Duguay mentioned, the bank did warn about the problems in Canadian asset-backed commercial paper in both 2005 and I believe 2007, and quite clearly *deux fois*, I believe.

The second thing is what we could have done further to address the issues. First, I would say that from the overall crisis perspective, as Mr. McKay referenced, we did not have a self-generated crisis beyond ABCP, non-bank ABCP in Canada. So that's not there.

But if you look at it going forward—as currently constituted, what's the role of the bank?—the bank can do analysis, can do exhortation, private and public, for others to adjust if we believe there are issues, and we work closely with our partners. But in terms of direct levers beyond our oversight responsibility for the payment system, which is important but very technical, we do not have those direct levers, and our object in the conduct of monetary policy is very clearly the 2% CPI inflation target.

● (1615)

[*Translation*]

Mr. Jean-Yves Laforest: And for the future?

Mr. Mark Carney: For the future, we are now building our expertise on analysis and the search for financial stability. We are working closely with our federal partners on regulation concerning the major issues and we are taking part in the efforts of the G7, G20 and IMF on a global scale.

Mr. Jean-Yves Laforest: Ultimately, you're telling me that you could have done virtually nothing more than issue the warnings that you gave concerning commercial paper because there is no crisis here, but we are experiencing it.

Nevertheless, for the future, are you able to ask yourself whether you could conduct an analysis, make forecasts or establish corrective measures or procedures for us to protect ourselves even more?

Mr. Mark Carney: Yes.

[*English*]

Our direct powers on these issues are limited, which was the question from Mr. McKay. So our influence is through analysis, research, exhortation, but as currently constituted, we have limited direct responsibilities in this area.

The Chair: Okay.

[*Translation*]

Thank you, Mr. Laforest.

[*English*]

We'll go to Mr. Wallace, please.

Mr. Mike Wallace (Burlington, CPC): Thank you, Chair, and thank you, gentlemen, for joining us today.

You're going to give me a little bit of education here. Reading through your report, on pages 12 and 13 we talk about potential output of the economy. I'm just looking at the sentence, “trend labour productivity is related mainly to the amount of capital per worker”—which I think is probably measurable—“and the pace of technological change”, and I don't know how you even measure that. I'm seeing the potential output and some small potential growth slowly coming back in 2009, 2010, and 2011. Then on the next page I have the pressures on the capacity of the economy.

Are we talking about the exact same thing, or are they two different concepts? Am I missing something on the difference between potential output and the economic capacity?

Mr. Paul Jenkins: No, indeed, they are directly linked. The box you referred to is a box that discusses some of the implications for the trend growth of the economy, the potential growth for the economy, as a result of some of the structural changes that are taking place.

The capacity issue you raised links that level of potential relative to the actual level of demand in the economy. So if the level of demand is below what the economy could produce on a sustained basis, that would lead to disinflationary forces. On the other hand, if the level of demand were to go through that level of potential and sustain above that potential, that would lead to inflationary pressure. So you have made the correct link.

Mr. Mike Wallace: Okay. So bringing this back to the real world for us in terms of what's happening from a policy perspective, I notice in the notes you talked about the automotive sector making a relatively significant impact here.

We're going to be discussing in the next few weeks whether we'll be supporting the automotive industry, at least two players, likely, in a significant way. What would be the negative or positive impact if we did not follow through and support those organizations in terms of potential input? And what's the downside for Canada?

Mr. Mark Carney: If I may, just so everyone's following along, you're on to an important point in that we have revised down our outlook for potential output growth, and in part it's because of the expectation of significant restructuring in key sectors such as the automotive sector. Basically, as capacity has idled, we lose production capacity, and as investments are delayed, we don't build new production capacity.

It's an important enough sector, so the relative success of any restructuring efforts will directly impact our potential output growth in Canada, the speed limit of our economy, if you will, and then have an implication as you move over the page for pressures on capacity.

● (1620)

Mr. Mike Wallace: That modelling you have now, in here, is under the assumption that the automotive capacity that exists today in Canada will stay. Or are you already indicating that there may be some shrinkage in that to begin with?

Mr. Mark Carney: I would like to generalize it so as not to prejudice any discussions, but the adjustment to our potential output does reflect an expectation that in the manufacturing sector significant capacity will be reduced.

Mr. Mike Wallace: I have only one minute left. I will just say that I also very much appreciated the part of the framework for the monetary policy on low interest rates, for me to try to understand what's going on.

The Canadian Bankers Association sent out a very good piece. I just want to make sure it's accurate. They talk about how 1% of their borrowing, as they call it, is based on the rate that you put out overnight. For the overnight money, it's about 1%. But the actual fact is that they get the rest of their money from other parts of the marketplace in terms of being able to re-lend that money out to their customers. Considering that, you have here this long-term money that people base their interest rates on. Are they accurate in how the actual banking system works? There's confusion for people in my riding about how—

The Chair: Thank you, Mr. Wallace.

Mr. Mike Wallace: —if the bank's rate is at 0.25%, why isn't everybody else at prime plus 1% or prime plus 2%?

Mr. Mark Carney: I'll answer very quickly. There is a broad range of sources for bank funding, including deposits, the BA market, longer-term bonds, and the IMP program of the government.

What's important to recognize as well is that those costs and those spreads went up quite sharply in the fall with the crisis; they have been coming down quite considerably since the turn of the year, which is part of the implication for it. Monetary policy changes are now being passed on, including to bank funding costs and further out into the economy. I'll just give you one data point, which is, as you probably are aware, that the variable rate for mortgages now is 3%.

The Chair: Thank you, Mr. Wallace.

We'll go to Mr. Pacetti, please.

Mr. Massimo Pacetti (Saint-Léonard—Saint-Michel, Lib.): Thank you, Mr. Chairman.

Thank you, Mr. Carney and Mr. Jenkins.

My question is more on the fact that you've been here over the last couple of years, and every couple of months we talk about something different and your priorities sort of differ. If I recall, probably a year or a year and a half ago, we talked about productivity and what the bank was going to do in terms of increasing productivity.

Mr. Jenkins, I think with Mr. Dodge you were talking about different tools you had available to increase productivity and the different aspects and areas you were going to look at. About a year ago, we talked about growth and whether we were going to be in a deficit position or not, maybe even six or eight months ago.

With the monetary policy you have today, what is your goal? Are we attacking...what are we trying to achieve? Inflation? Deflation? Are we trying to increase growth? What is the primary objective of our monetary policy today? I'm hearing a lot of different things. I know I'm not asking for an easy answer, but you're going to have to try your best.

Mr. Mark Carney: Look, I think the bank—and I will take the liberty of speaking for my predecessor as well—has always been focused on its 2% inflation target. That's the objective. All these factors, whether it's the speed rate of the economy, the influence by productivity, or whether it's the exchange rate, commodity prices, financial conditions, a variety of things, they matter in the conduct of monetary policy for their impact on inflation, and monetary policy is adjusted to achieve that 2% total CPI inflation target.

Mr. Massimo Pacetti: So you'd be willing to give something up as long as inflation would be in line? I'm trying to generalize. At what point does the bank make a decision? Again, I know it's not in your control, but last week, for example, you cut your overnight lending rate, and the dollar and the bond yields went up. The last time you cut rates, I don't think anything moved; I think the dollar went in the other direction.

So can you really tell how you're going to affect the market—if we talk about the market or bond yields—or are you just hoping? I'm looking at what you have left to play with. In terms of interest rates, there's very little. I know you've talked about quantitative easing and credit easing. That's going to be my next question. Are we going to use the next levers that you have at your disposal?

● (1625)

Mr. Mark Carney: I want to clarify that the impact of our decision last week was to improve financial conditions. Corporate bond yields as a whole went down 14 basis points; the curve out to one year went flat to 25 basis points, taking out between 10 and 20 basis points, depending on the maturity. The Government of Canada is again, out to one year, down 17 basis points. In fact, the spread between Canada and the United States shifted by 19 basis points in our favour at the short end.

We had a big impact, as we expected we would, on a broad range of financial conditions, and to anticipate your next question—

Mr. Massimo Pacetti: That's what I'm saying. On the last announcement, you really did affect the bond yields, but with the previous announcement prior to that, when you cut the interest rates by a good half-point or three-quarter-point—I don't have the numbers—barely anything registered.

Mr. Mark Carney: The curve as a whole has, at the short end, come in since the start of the year, since January, which has had an impact, and we've had pass-through both into the prime rate, into bankers' acceptances, which are very important short-term financing for corporations, and into mortgages steadily, as we've gone through this year.

We have been getting this pass-through, as referenced in the earlier question about overall financing costs for banks.

Mr. Massimo Pacetti: Then the next step, if need be, would be this quantitative easing. Is the quantitative easing only when it comes to credit?

Mr. Mark Carney: I didn't catch the last bit.

Mr. Massimo Pacetti: Is it only for credit? In your opening statement you talked about quantitative easing or credit easing, and it's tough to really understand what quantitative easing would be.

Mr. Mark Carney: Just to be clear on the definitions, quantitative easing, first and foremost, involves the purchase of assets, and those assets can be either government bonds or private securities. Those purchases, to make it quantitative, are financed by the creation of new central bank reserve, central bank money. It's purchase of assets.

It very well could be government bonds, if we were to do it. We'd only do it if we needed to do it to achieve the inflation target to be consistent with this discussion. The judgment of the bank at that point in the future would be based on where the biggest bang for the buck for overall financial conditions would be.

So if we sat in front of this committee or businesses or all Canadians, and they said, “Well, this rate went down and that one went up, so what's the net impact?”, we'd look at having the biggest impact on overall financial conditions.

The Chair: Thank you.

Thank you, Mr. Pacetti.

Mr. Kramp, please.

Mr. Daryl Kramp (Prince Edward—Hastings, CPC): Thank you, Chair.

Good afternoon, gentlemen.

I'd like to ferret out just a little bit more information on the one point. Even the venerable Mr. McCallum was surprised at the long-term commitment of the low interest rate. I'm wondering where this came from within your department. What do you use for comparables? Have other nations been successful with this, or have they not? What are the potential negative aspects to the Canadian economy that we could ever potentially expect if something went wrong? What are the pitfalls of it?

Mr. Mark Carney: Thank you, Mr. Kramp.

In terms of the comparables, I will give you two. One, there is a small set of central banks—the Riksbank in Sweden and the Norges Bank in Norway are two examples—that provide a path every time they make a decision for their overnight interest rate, all the way out, if you will.

There are examples of central banks that do that. Their view is that to have the overall impact each time they make a decision, it is where that path as a whole goes in the market. It's, if you will, the ultimate in transparency.

Now the other relevant data point, to answer your question, is what happened earlier this decade when there was concern about potential deflationary pressures in the United States. The Federal Reserve gave verbal guidance that rates would be low for a considerable period. There was a range of verbal phrases that gave guidance to the market in terms of where rates would be, if you still had ambiguity or you had some ambiguity in terms of the exit strategy, some would suggest.

The judgment of the bank and the decision came from the governing council—the six of us, Mr. Jenkins, me, and the four deputy governors—that to provide this clarity was the best thing for markets, given that we were at the zero lower bound, given that we had gone to as low as we could go.

To answer the last bit of your question, on what the risks are, I would say the biggest issue here is that people start to confuse a conditional commitment with a guarantee. It's not a guarantee; it is conditional on the outlook for inflation. Our judgment is that keeping rates at this rate through June 2010 is consistent with achieving our inflation target. I would draw your attention to our outlook for inflation on page 24, where we have probability bands around that outlook for inflation.

So if you want to judge, if you're bullish on inflation or on the outlook, you can see what the relative probability is that we would get there sooner and that we would have to change that commitment.

● (1630)

Mr. Daryl Kramp: Thank you very much.

Do I have another minute?

The Chair: You have two minutes.

Mr. Daryl Kramp: Thank you.

What I would like to discuss, then, just for second, are toxic assets. I'm curious as to how you would define what a toxic asset is. What are the benchmarks? What are the parameters?

Obviously this isn't something we can put a universal definition to, but we have to have some means and mechanisms—if we're going to have any intervention at all from governments, whether or not they're going to take equity ownerships into something—as to what we've considered to be a toxic asset. How do you see the definition coming to fruition so that you, or we, as parliamentarians, can make a decision as to whether or not we wish to take that on as a toxic asset?

Mr. Mark Carney: Very quickly, the term “toxic assets”, at least in this round of financial crises, originated and was applied to a range of structured products. They included those based on subprime mortgages, but much more broadly, they were effectively related to broken markets, structured securitization markets that no longer functioned well. The term has been broadened considerably, and you sometimes see the term “legacy assets” or “troubled assets”. The broadening now includes basically non-performing assets, including non-performing loans, that are affected by the recession in the downturn.

Let me make a general point, because you asked about your role here, that there is not a toxic asset problem in Canada. We don't have these concentrations, nor is there a concentrated pool of troubled assets that reflect difficult economic circumstances. The general point is that when you get into a banking crisis—so it's relevant for the U.S., it's relevant for the U.K., it was relevant for Sweden in the 1990s—you look for concentrations of troubled assets, using the broad definition. It could be real estate lending. And then in order to relaunch the banks, there are different alternatives, but there's a decision to be taken to separate those assets, in a fair way for taxpayers, from those institutions and relaunch those institutions.

The Chair: Thank you.

Thank you, Mr. Kramp.

We'll go to Mr. McCallum again.

Hon. John McCallum: Thank you.

I think you've seen an all-party consensus in favour of your one-year-plus interest rate drop. Rare.

I'd like to pursue the question of inflation. You know the old metaphor of the punch bowl, that the job of the central bank is to take the punch bowl away before the party gets going. I think in a crisis the job is to force-feed the world with this punch bowl, and then when inflation possibly rears its head, you have to quickly take it away.

I'm with you, with your view, and not with Mr. Flaherty's view. As long as we have output below potential and high unemployment, I don't believe you're going to have an inflation problem, which is what you're essentially saying. But I also think it's kind of an unprecedented and delicate operation, and quite critical in terms of timing, to take this monetary ammunition away just at the right time —not too much, not too little, not too late, not too soon. So you're kind of into uncharted territory, in a way—or at least not chartered for a long time, if ever.

My question is, how do you figure out an operation of such delicacy?

● (1635)

Mr. Mark Carney: Thank you for the question.

We really do look to apply our inflation-targeting framework. We look at the lags on monetary policy, which tend to run from four to six quarters out. We look at the scale of the difference between the potential of the economy and where the economy is operating. I think in that regard it's very important, Mr. McCallum, that we are disciplined in our judgment about the potential of the economy, because one of the mistakes one can make in these situations is to overestimate the speed limit of the economy in a severe recession.

The reality is, and it's an unfortunate reality, but in this adjustment process, capacity is lost, investment is delayed, productivity is slower than it otherwise would be, and so those inflationary pressures could come back sooner than otherwise. We've made an important revision to our potential output in this forecast, as Mr. Wallace was referencing.

I should say as well that we've made the commitment that given the relative importance of this forward-looking fan chart on inflation and the link to the conditional commitment, we will revisit that in our October monetary policy report as well.

Hon. John McCallum: Thank you very much.

The Chair: Thank you, Mr. McCallum.

Mr. Dechert.

Mr. Bob Dechert (Mississauga—Erindale, CPC): Thank you, Mr. Chair. Thank you, Mr. Carney and Mr. Jenkins.

Mr. Carney, in your report earlier today you mentioned that as the Canadian economy begins to improve, hopefully later this year and early next year, we should see the end of the stock adjustments in Canadian and U.S. residential housing. I think we've seen some good news in the U.S. recently in that regard. I spent some time yesterday with representatives of the Mississauga Real Estate Board, which is in the city I represent. They tell me that real estate prices are stabilizing in Mississauga and sales are improving.

Are you seeing anything similar across Canada? Maybe you could comment on the U.S. as well.

Mr. Mark Carney: I'll start briefly. We are expecting a relatively significant price adjustment in houses in Canada this year, in the high single-digit order of magnitude. It's under way, and it's concentrated largely in western Canada. A lot of progress has been made there. What we've seen is a slowdown in starts in Canada such that they're running below.... Currently the demographic rate of household formation would be around $170,000 to $175,000. So you're getting that stock adjustment happening in Canada.

What you've seen in the United States, as everyone is painfully aware, is that housing starts, after running above trend, have dropped to a level significantly below trend, below 600,000 units. When you think about that gap that started to open up, even with the overhang of foreclosures and the difficult financing conditions.... Now that U. S. authorities are starting to make real progress on lowering mortgage rates there—I referenced 3% earlier, and they're trying to get things down below 5%—they are having some success. In our opinion, that's going to start to impact increasingly house purchase activity in the United States as the year goes on and into 2010, and it will provide a measure of stabilization there.

I would make a basic point about the United States that is sometimes easy to ignore. The first thing is for housing starts in the U.S. to stop falling. It's been subtracting a percentage point from growth for some time in the United States. We're now getting down to extraordinarily low levels, and we'll start to see that adjustment. We also expect to see some adjustment in the auto sector.

If I could draw committee members' attention to page 21 of the report, in chart 17 there the blue line shows U.S. GDP outlook; once it gets into the dots, it's our forecast. The green line, which is trade-weighted activity in the U.S., is important. For the sectors of the U.S. economy that are important for Canada, you see the big gap that opens up, 2007 into 2008, and then you see our view as you start to get some of these stock adjustments. The U.S. growth doesn't get up too much, but U.S. activity in housing, autos, while not sky-rocketing, starts to come back towards equilibrium and outside impact on Canada. That's one of the reasons we see 2.5% growth in Canada next year as opposed to a lower level.

● (1640)

Mr. Bob Dechert: I have another question on forecasting. Obviously, we've seen the forecast change dramatically month to month, even week to week. Would you suggest that the government change its fiscal and monetary policy with those forecasts as they change week to week or month to month, or would you suggest they stick with the plan, implement the plan, and then adjust it at an appropriate time down the road?

Mr. Mark Carney: I'll speak for us. When the outlook changes, we can change policy. We do that in a transparent way. Since we last met in January, as it became apparent the situation had deteriorated, we adjusted policy in March. Fiscal policy is not as nimble as monetary policy is, so the timeline of adjustment of forecasts is necessarily different.

As the Bank of Canada, we do not look to adjust our forecast on a weekly basis in real-time updating. But the senior deputy governor and I can assure the committee that we will adjust policy if the outlook has changed, consistent with achieving our inflation target.

The Chair: Thank you, Mr. Dechert.

We'll go to Mr. Mulcair.

[*Translation*]

Mr. Thomas Mulcair: We're going to continue on the theme addressed in your last sentence because that's the subject I wanted to raise following the conversation we had earlier, Mr. Chairman: adjusting policy.

[*English*]

You control a lot of policy. And you've been very generous with us today, talking about everything from the appropriateness of government intervention in the automobile field to your own experience. As we come to grips with some of the policy changes that we have to come up with over the next couple of years to avoid the problems of the past, what role do you see for the Bank of Canada?

I'll share with you an observation. It seems, as we've gone through this, that always there's somebody who was seeing the right thing. Whether it was the people who made their presentations on what Madoff was up to in New York...and there were people who saw right through Madoff, but there was nobody to talk to.

We had this absolutely Kafkaesque conversation with the people from the Dominion Bond Rating Service about how they were able to give the evaluations they did of non-bank ABCPs. It was an extraordinary experience. So there are people out there who are seeing things.

Now, you're very crucial, for us, in this whole process, because you have this point of view that allows you to see much further than most people, and much deeper. What role is the Bank of Canada going to play as we come to grips with this?

I gave a couple of examples before of what we're going to be looking at over the next couple of weeks, everything from credit cards to pensions. The subject here, of course, is the liquidity or the availability of credit. How do we make sure, with the structures we put in place, that we don't go the other way and wind up needlessly hamstringing things?

I will allow myself an opinion: that in the wake of Enron and a couple of other debacles, some of the accounting rules that were invented in the United States as sort of the wall of protection actually wound up being far worse than the malady they were put in place to remedy.

How do we avoid some of those traps? What are some of the courses that we should be on? And how can the Bank of Canada help us in that?

Mr. Mark Carney: It's an extremely important question.

I'll give you, in a moment, a couple of examples of issues to consider, but let me start by saying, in response to an earlier question, that we can analyze and do research, and then it's our responsibility to make public that analysis in a constructive way so that those who are responsible for either regulating or for legislating these issues can make informed judgments.

In that regard, I think it's our responsibility, through our financial stability report, through speeches, and through other mechanisms and appearances, to raise with you the issues that, in our judgment, rise to a macro level; they'll have an impact on the economy.

What are some of those issues right now? One of them is the procyclicality of capital standards. We saw it on the way up. We're seeing some of the issues on the way down, now, in that institutions have capital buffers that they can't necessarily use. In other words, they can't necessarily expand lending to the extent to which they might otherwise, because the floor is not the minimum; it's a higher level.

There are a variety of aspects that are technical—but important in terms of treatment of markets and measurement of risk in markets—that add to that procyclicality. Firms will hold more capital in a recession, or strive to hold more capital in a recession, than they might necessarily have to do, which will make the recession worse. That's one example.

The second thing that's extremely important, and you referenced it obliquely, is the securitization market. It is extremely important globally that securitization gets relaunched properly. Given the challenges with the credibility of public ratings—the agencies are trying to address it, but there are still challenges—careful thought needs to be given to potential credit enhancements or other mechanisms, including transparency, to relaunch securitization as a matter of urgency; less so in Canada, more so globally, but there's no reason why Canada shouldn't lead on an issue such as this, which would be net helpful for our system.

The third issue, which we're looking at in great detail, is core funding markets, repo markets. As one example, how do you ensure...? One part of it is what's our role as a liquidity provider in those markets? But there are also regulatory tax and other accounting issues around it. You have to make sure that those markets stay open, because that's how you avoid a crash on that.

On pension issues, accounting, Mr. Jenkins can talk at length and in a very informed manner. There are clear issues.

The last thing, and I'll end with this, is that with regard to our role, as I said, it's our job to do some analysis and highlight what we see as the most important issues. We're happy to share that analysis. We'd be more than pleased to. It's also our job to work effectively with the other agencies, both federal and provincial, to ensure that changes are taken.

● (1645)

The Chair: Thank you.

Thank you, Mr. Mulcair.

I'll go to Mr. McKay.

Hon. John McKay: Thank you, Chair.

At this G-20 meeting there was a commitment to increase regulation and oversight over financial institutions, instruments and markets, including the hedge funds, and to focus regulators on macro-prudential risk. I think it's generally agreed that the biggest hole in our financial architecture is the absence of a securities regulator, and to the government's credit, they've actually moved some distance on that issue.

If in fact no securities regulator gets produced, does this macro-prudential role effectively become a back-door way of achieving some control over these hedge funds and financial institutions, instruments, markets, and things of that nature?

Mr. Mark Carney: There's no question that the issue of the perimeter of regulation, if I may, catching those institutions that have potentially systemic implications, such as hedge funds in some jurisdictions and such as, as it turned out in Canada, arguably the institutions that created the vehicles of non-bank asset-backed commercial paper, which ended up being quasi-systemic in Canada... that the ability, from time to time, of the financial industry to innovate around the regulatory net has to be addressed.

That is a decision for the G-20 leaders, and it has to be put into practice. It requires coordination. As the bank, we work with the system we have, so we do sit down—well, at least on a quarterly basis, and in fact more frequently, given the nature of the times—with the provincial securities commissions in tandem with the Superintendent of Financial Institutions and the federal Department of Finance to discuss these types of issues to see how we can address them in the current framework. That doesn't mean the framework might not be better if it were to be changed, but we're working within the current framework.

● (1650)

Hon. John McKay: But your conversation with those various regulators can only be as strong as those regulators. If, say, in the case of non-bank asset-backed commercial paper, there appears to have been virtually no regulation whatsoever, that it fell between a whole bunch of cracks, how is macro supervision going to address that?

Mr. Mark Carney: One of the issues that we've advocated—and it was adopted, again in that same communiqué of G-20 leaders—is that regulators have a responsibility as well for the financial system's stability. Therefore, in their actions they must take into account the implications of their actions or regulations for the system as a whole. The first thing you do is to ensure that in the objects of regulation there is that other object, as opposed to simply, for example, a strict micro potential or investor protection responsibility. So it's very important that it's there.

To operationalize that, the question then becomes, how do you as a regulator form that judgment about the macro implications of your actions or regulations? Quite frankly, from a Canadian perspective, I would say that's a conversation about how formal that conversation is with entities that have a macro perspective. How formal that conversation is and how directive it is...different countries will take different views. The Europeans are taking a directive approach that would not...well, it's a European approach, not a Canadian approach.

The Chair: Very briefly.

Hon. John McKay: Obviously, there's been a lot of conversation about the DBRS, the Dominion Bond Rating Service, and things of that nature. The very nature of what they do is essentially to provide opinion on the quality of the security. Is your proposal going to mine down to that level of, in effect, being a super opinion on the quality of the security?

Mr. Mark Carney: First, you reference a proposal that we do not have, so by definition you can't read that into it. But if you're talking about a macro-prudential approach, no, one wouldn't focus in on a specific security unless that security itself were a major part of the capital markets, such as, for example, the GSE bonds in the United States. They turned out to be systemically important, in part because of the ambiguity of the guarantees around that and the knock-on effect that had as little as nine months ago. It seems like years ago, but it was less than a year ago. So that would be an example. Macro prudential is really the forest rather than the trees, and individual securities are trees. One wants rating agencies to do their job properly.

The Chair: Thank you, Mr. McKay.

Mr. Carney, I want to follow up on your response to Monsieur Laforest's question about the difference in the forecast for economic growth between this time and the last time you were here. You talked about the recovery moving out and flattening, and then you referenced commodity prices. If I recall in your last presentation, you had commodity prices increasing over the long term as one of the factors of recovery. You referred us to page 27, in terms of U.S. demand for Canadian exports. I'm wondering to what extent commodity prices are included in those exports.

On the second reason for the recovery being delayed or the recession being worse, you talk about the more severe synchronized nature of the global downturn. You also reference less ambitious policy actions in other industrial economies, including the U.S. and Europe. I know it's probably a touchy subject to comment on—actions in other countries and other central banks—but I wonder if you could comment on the commodity price aspect and actions in other countries.

I don't know to what extent the bank forecasts commodity prices and what detail they get into, but natural gas is moving forward, for example. It may interest people to know that for Alberta, the price of natural gas is more important than the price of oil.

So perhaps you could comment on commodity prices, and then on actions in other countries, specifically at the monetary policy level.

● (1655)

Mr. Mark Carney: Thank you for the question.

We do two things with commodities. We differentiate between energy commodities and non-energy commodities. For energy commodities, our forecast is the futures curve for natural gas and oil. You're absolutely right that natural gas is far more important to Canadian growth and activity in Alberta, at least at the current time, than the price of oil. As you well know, natural gas prices are off sharply since January by almost 17% or 18%. That is part of the deterioration in our terms of trade.

The second thing we do, based on our global outlook, is forecast on non-energy commodities. That global outlook has come down in this report versus the last one. As a result, there's a softening in the global commodity outlook.

If you want a very simple shorthand on this, look at table 3, page 19, real gross domestic income, which is a way of aggregating this, plus other factors. There is a sharp reduction in the outlook for 2009 and 2010. So there's an income effect there that has implications.

The sharp downturn in Q1—the 7.3% annualized contraction in Canada—and the slightly sharper downturn in Q4 than we previously forecasted have an implication, in that firms have a lot more inventories than they wanted. That provides some of the drag to growth in Q2 and Q3, as they don't produce us much and need to work those inventories off. That has short-term implications. So those factors are important.

On the U.S. activity variable you referenced, commodities play a role, but given the weight of manufacturing exports to the U.S., the response to the earlier question stands.

The Chair: What about the less ambitious policy actions in other countries, as noted on page 7 of your report?

Mr. Mark Carney: Ah, the less ambitious. There are two aspects to that. Global fiscal policy moved less rapidly and was less ambitious than the 2% target of the G-20. We will now probably get there in other countries—at least there's an announced intent. But implementation is important, and it's getting pushed out into 2010, as opposed to earlier.

The most important issue is that efforts to stabilize banking systems have taken longer. There has been less implementation than expected in the United States. The last time we were here was the day of the announcement of a component of the plan, as opposed to the entirety of the plan in the United States. That has had some implications.

We have had considerable discussions with our colleagues in the U.S. and Europe, most recently in some detail over the weekend. We take some comfort from those discussions, in that the will is certainly there and the plans are in place. There are real implementation challenges, but they're seized with the importance of the situation.

The Chair: Okay, we appreciate that.

We'll go to Mr. Pacetti, please. I'm sorry, Ms. Hall Findlay, first.

Ms. Martha Hall Findlay (Willowdale, Lib.): We are going to do our best to share this time. Thank you, Mr. Chair.

Mr. Governor, you've talked about the possibilities of quantitative easing and/or credit easing. There are two parts to my question. Can you give us some real world examples of what might happen economically over the next months to cause you to do that, understanding that your goal is 2% inflation? Within that, what is your preference for quantitative versus credit easing, and when might either one of those be your preference?

● (1700)

Mr. Mark Carney: The easiest shorthand for the real world examples is to look at the risks to our projection. These include a deeper global recession than envisioned, so that the famous second derivative is not as positive as we'd like and the bottoming out—to some extent the slowing of the decline—that is expected in the second quarter and into the third quarter and then up does not materialize. Clearly there are delays in progress on the stabilization of the financial system. There is a lot that needs to be done. Nobody is going to wave a flag and say it's over, but I think we'll know when we see major hiccups. The lack of progress will be clearer than the presence of progress. It will be slowly built up, in that regard.

I would say those are the two fundamental issues. While we see at this point some choppiness in the data, for example, in the U.S., where there is some positive and some negative and the negative still outweighs the positive, we see some stabilization in upticks in some of the softer data—the survey data, consumer confidence, business confidence, purchasing managerial indices around the world—but I would caution that they are coming from very low bases and this is a very recent improvement. So there is a lot still to be done in order to establish that return from what is a deep recession.

Ms. Martha Hall Findlay: In which circumstances is quantitative versus credit preferred?

Mr. Mark Carney: In which circumstances? I think the important thing is that we get some sort of shock that pushes the outlook for inflation down in a persistent fashion so that we need to provide additional stimulus. At that point, the bank would need to make a judgment about which of these—and within these strategies there are various ways to put them into effect—would have the biggest impact on overall financial conditions. It's a judgment at that point in time.

If I may, I would point out that, for example, in the credit markets, markets that were constrained or not very active in January have considerably improved to this point. So the strategy that might have been necessary in January might well be different from the strategy now. It's hard to predict where things would be at a point in time. Particularly, on my last point, if the reason for the revision and the outlook was—I hesitate to talk in conditionalities. In fact, I probably should just end this answer here, so I will.

Ms. Martha Hall Findlay: Thank you.

Mr. Mark Carney: You sucked me in.

Voices: Oh, oh!

The Chair: Thank you.

We'll go to Mr. Menzies, please.

Mr. Ted Menzies (Macleod, CPC): Thank you, Mr. Chair, and thank you to our two witnesses, Mr. Carney and Mr. Jenkins.

I would like to go back to something that we haven't spent a lot of time on here, and it may not be in your field of expertise, but I think both of you understand it better than many of us. What do we do with these impaired assets or toxic assets that got a lot of institutions into a lot of trouble? You talk about $4.1 trillion worldwide. Where does it go? Is it simply discounted and sold off? How do we make sure that we don't see those toxic assets finding their way back in to create the same problem all over again?

Mr. Mark Carney: Thank you, Mr. Menzies.

There are a couple of things. One is that, just to be absolutely clear, the $4.1 trillion is the estimate of the IMF—we're not necessarily endorsing it. But I'd make two comments, and I'm not trying to be cute. Part of the reason they're called “toxic” assets is that their presence affects or poisons existing management of the institutions that hold them. So you end up having a situation where management is spending a disproportionate amount of its time on the work-out of these assets, as opposed to running the institution on a go-forward basis, thinking about new loans and new activities they could do.

That's why in general in banking crises—and there have been a hundred-odd banking crises over the course of the last 30 years, unfortunately, around the world—the preferred strategy ultimately becomes to separate those assets from those institutions that are going to move on, going forward, because you really do need to have banks that are thinking about the extension of credit on a go-forward basis, as opposed to spending the vast majority of their time working out distressed credits.

So where will they go? There are a variety of strategies. Different countries will take different strategies, and there is the option of either purchasing them or transferring them to a vehicle so that the upside and the downside from those assets accrues to the taxpayer. In some countries that is what will be done and is being done. That can be done through nationalization and separation. It can be done through the sale of assets or the appropriation of those assets in exchange for new capital. It can be done through an insurance scheme. It can be done in a variety of ways, and different countries will do different things.

The United States' plan is that institutions would be able to sell those assets to market participants, who themselves have received financing from the public authorities in the United States in a way to jump-start the asset sale process, both for securities, toxic assets, and for impaired loans under a couple of extremely important programs. That's an element of this stabilization we will watch quite closely.

● (1705)

Mr. Ted Menzies: Thank you.

Mr. Wallace, I believe, has—

The Chair: There's another round, if we want.

Thank you, Mr. Menzies.

We'll go to Mr. Pacetti.

Mr. Massimo Pacetti: Thank you, Mr. Chair.

Just quickly from where I left off last time, from what I understand, part of the quantitative easing part is the printing of money. What happens when we start printing money? Does it really matter what we purchase with that money we print, or is it just going to cause inflation? I don't want to cause panic. I'm just wondering what happens with the next tool you have at your availability.

Mr. Mark Carney: It's an extremely important question.

The first point is to re-emphasize that we'll only use it if we have to use it.

The second point is that the important step is the purchase of the assets and the implications of those purchases on overall financial conditions, whether it's government bonds or some other securities, to improve, ultimately, the cost of credit and the availability of credit to businesses and households in the country.

Now, at the same time...I'm getting to your point.

Mr. Massimo Pacetti: It will be to buy inventory from somebody's...it won't be to buy cars.

Mr. Mark Carney: No, and we also wouldn't buy.... I should have corrected that. There was a question earlier with reference to equities. That would not be the intent.

Part and parcel of that, though, as you say, is the creation of new central bank money. So the first channel is to purchase the securities, improve overall financial conditions, improve activity output, and reach the inflation target. The other channel, though, is that this is financed by the creation of new central bank money. And that has an impact on output and inflation that is less strong, in our judgment. One just looks to the experience of Japan in the 1990s as the classic example of this. The whole focus, or the preponderant focus of policy, was the creation of money—the liability side of the central bank balance sheet—as opposed to the purchase of assets, which is the asset side of the balance sheet.

We need to be prudent, deliberate, and careful about that second channel, though, because when confidence starts to return, when growth starts to return.... There is always a relationship between reserve money, very narrow money, and broad monetary aggregates, nominal demand, in an economy. When you're in a situation at the zero lower bound, the experience has been that the relationship is very, very weak. But as you start to recover, that relationship will reassert. So you need an exit strategy. You need a way to unwind it, and you need to be disciplined in the amount you pursue this strategy.

● (1710)

Mr. Massimo Pacetti: If you were to choose the latter, meaning increasing the liability side when you did print the money, wouldn't that make more sense? Then you would let the market forces determine where the money is best needed. Or would you already know just by buying the assets, by the Bank of Canada buying the assets itself?

Mr. Mark Carney: We have to do something with the liabilities. You have to do both. It's not either/or. Both of them happen at the same time. You create a liability. The question is what you do with the assets. Do you do it on a very short-term basis, or do you...?

Mr. Massimo Pacetti: The question is whether the bank determines that or whether you should let market forces in. The market forces could even be the banks or your customers, whoever it would be.

Mr. Mark Carney: There are two issues here. One is that if you look at the government curve, the government bond curve, the bank would have to make a decision about what maturity on that curve would have the biggest implication for overall financial conditions and activity in the economy. As we've adjusted the overnight rate, and as we've put a conditional commitment on that overnight rate now, we've affected that curve. The question is whether we try to affect other aspects of that curve, not just to affect the level there but also to improve overall conditions. That's the first point.

The second point, and we try to be quite clear in the annex to the framework, is that if it were desirable—that's a big if—to purchase private assets, it would be limited to situations in which it would have a big macroeconomic impact, again, but also in which there was evidence of clear market failure. So the idea of letting the market solve the market failure is not there.

Mr. Massimo Pacetti: It's not black and white.

Just quickly, has anybody printed money? The United States has, right?

Mr. Mark Carney: Yes, the central banks that are pursuing both quantitative and credit easing at present are the Federal Reserve, the Bank of England, the Swiss National Bank, and the Bank of Japan. They are all pursuing both strategies at the current time.

Mr. Massimo Pacetti: Has Europe done it?

Mr. Mark Carney: Europe has.... It depends on your definition. I think, strictly, in terms of the definition of the European Central Bank, that it has not yet pursued that.

Mr. Massimo Pacetti: Thank you.

The Chair: Thank you, Mr. Pacetti.

We'll go to Mr. Wallace, please.

Mr. Mike Wallace: Thank you, Mr. Chair.

I really appreciate the time you've put in here today, Mr. Carney and Mr. Jenkins. It's not often that we get you for two hours after a five-minute speech from you, which is great. It gives us lots of time to ask questions.

To follow up on where I was on the estimated pressures on capacity of the economy, in your statement you talk about the labour issues, so I'm going to focus on the labour part. You're saying, if I understand you correctly, that the labour shortages that had been appearing before, that you had been looking at in your surveys, have now disappeared. I don't know if it says that they've disappeared or that the labour shortages are smaller. Are there still labour shortages? Are you still hearing that? That's my first question.

Then, what's the issue for us, from a capacity perspective, coming out of this?

Mr. Paul Jenkins: Certainly from our business outlook surveys across the country, it's fairly clear that the companies we've surveyed have moved from a position of looking for labour, i.e. a shortage of skilled labour, to a situation where there is an excess. From that point of view, coming back to your very first observation, we talk about it in terms of the overall size of what we call the “output gap”. So the economy is working below its potential.

Mr. Mike Wallace: Then, in your next sentence, you say, “In contrast, the 12-month change in the average hourly earnings of permanent workers, reported by Statistics Canada”...showed strength. When you say it showed strength, does that mean it stayed steady, went up? What are the implications to that being the way it is?

Mr. Paul Jenkins: In general terms, the numbers, in terms of average hourly wage increases you get from Statistics Canada, are still growing at a rate of around 3% or 3.5%. Given the increase in unemployment, one would have thought you might have seen some of those wage increases coming down from where they had been. That was something we felt was worth noting in the report.

● (1715)

Mr. Mike Wallace: Does that affect our potential in terms of getting back to where the economy is working at full speed?

Mr. Paul Jenkins: No. In the context of the overall framework for monetary policy, one of the real advantages of our inflation-targeting framework is that we are forward looking. Therefore, when you see an output gap of the size we're currently facing in Canada, it is for that reason that we've eased monetary policy, the cumulative easing of 425 basis points since December 2007, and the conditional statement, providing quite a bit of stimulus to get the economy moving forward again.

Mr. Mike Wallace: Do I have a minute left, or no?

The Chair: You have two minutes.

Mr. Mike Wallace: Oh, good.

I need you to explain something in layman's terms. In your annex, you do a nice job on....

We're at, what, 25 basis points right now, or whatever the overnight interest rate is?

Mr. Paul Jenkins: It's 0.25%.

Mr. Mike Wallace: Okay.

You say there's a danger of going to zero. Can you explain what the actual danger of going to zero is? What would that do to the economy?

Mr. Mark Carney: The issue, if I may, with the effective lower bound is that there are a variety of shorter-term money markets or financial markets, and it would be very difficult for them to function at that level, because there are transaction costs associated with operating those markets, and the actual net return from those transactions.... As soon as the transaction costs are positive, and if the net yield is close enough to zero, then those markets will cease to function. One way to think about it is that there are certain fees associated with money market funds, so what is the yield they're getting on the underlying securities and do they cover the operating costs of those fees?

We thought long and hard about where the effective lower bound was in Canada. Our judgment—and it's been validated, I think—was that we could bring rates down to 25 basis points and we could hold that so Canadians would get all the stimulus they deserve, if you will, given the situation, and that markets would continue to function well. And that has been the case in Canada.

This level is different in different financial systems. In the U.K., the judgment is that the effective lower bound is 0.5%. In the U.S., they are oscillating between zero and 0.25%. In Japan, they've pushed it all the way down to 0.10%.

So it varies by economy or by system, but we look at a host of those financial markets, and that's why we stopped where we did.

The Chair: Okay. Thank you, Mr. Wallace.

We have time, I believe, for three short rounds, if we can make them brief.

We'll have Mr. Mulcair, Monsieur Carrier, and Mr. Kramp.

Mr. Mulcair.

[*Translation*]

Mr. Thomas Mulcair: I have about four minutes? All right.

[*English*]

First of all, I'm going to take the opportunity to say thank you. You've been very helpful today.

I want to spend a little bit more time with you on the question of *paradis fiscaux*, tax havens. You mentioned that at the G-20 meeting, the most recent one, it was an issue that came up. I know that President Sarkozy is the only one who's been pushing hard on this issue. At a conference I attended in Paris in January, he was very strong on this, as was Angela Merkel. It was a fascinating experience.

I have to share an anecdote with you. The head of the Dutch Socialist Party told a very funny anecdote about when he came in, very recently. He decided he was going to modernize his party and get rid of some really old-hat things in his party's constitution. The first thing he insisted on tearing out two years ago when he came in was this antiquated part where everybody, way back then, was talking about nationalizing banks. And of course two years later it was all the rage. So there you go. Sometimes history catches up with you.

On the question of tax havens, there is a grave concern that a lot of the money that can be there to do productive things has disappeared into these sinkholes and is being held. It has never been properly taxed and it has never been properly accounted for.

I mentioned Madoff before, in passing, and that there had been people who had seen it. I think one of the surprise aspects of Madoff is this. It's going to be like when the safety deposit boxes at Lloyds Bank in London were robbed a couple of decades ago. Not too many people said what was in them. I have a feeling it might be a little bit that way with Madoff, too. Not too many people will remember how that money got there, where it was from, and where it was supposed to go.

More seriously, there is an issue that I think legislators, regulators, and law enforcement agencies have to look at. If we're supposed to have a system that's closed, where we can account for money and we can tax it, and it can be made productive, and lots of it can be siphoned off and held in a dead box, then we have to have a way to go after it. Is that idealistic? Is that realistic? Or do you think it is something that should be on the table at more G-20 meetings and something that committees like ours should be looking at?

● (1720)

Mr. Mark Carney: I think there are a couple of aspects there.

One aspect is this issue of opacity or lack of transparency, of money being held outside the net, if you will, of taxation. Related to that is aggressive tax planning that utilizes these environments. I believe the government has taken a look at the international taxation regime for Canada, which includes the appropriate use of third countries for tax planning. I refer you to the report by Peter Godsoe that is relevant to this issue, but maybe not comprehensive for the issues you're raising.

Mr. Thomas Mulcair: We were a little bit concerned about the Godsoe report, though, because it actually brought us back a little bit in terms of what was allowed to be cycled through outside countries by Canadian companies, something that we thought had been shut down, that Godsoe recommended be opened up. Minister Flaherty, whom I know a little bit, especially his body language, didn't seem to be completely convinced he was doing the right thing. It seemed to be *contre nature* for him to be doing that, but he did it anyway. I don't want to drag you into our turf. That's too partisan; that wouldn't be fair.

But keep going on the Godsoe report, if you could—in ending.

The Chair: Very briefly, Mr. Carney.

Mr. Mark Carney: Very briefly, the point I was trying to make in the reference was that there is a tax planning element to this and a competitiveness element to this that has to be considered. Then there's the fundamental issue, which you're raising, in terms of tax evasion, effectively—which is very on point for continental Europe—through the use of banking secrecy and other mechanisms and various tax havens, which is being addressed through this.

The Chair: Thank you.

Mr. Thomas Mulcair: I just want to end on one last thing. It's all in one sentence. There is a difference between aggressive tax planning, which can be tax avoidance, which is legal, and tax evasion, which is of course illegal.

The Chair: Okay. Thank you, Mr. Mulcair.

We'll go to Monsieur Carrier.

[*Translation*]

Mr. Robert Carrier (Alfred-Pellan, BQ): Thank you, Mr. Chairman.

Good afternoon, Mr. Carney and Mr. Jenkins. I missed your presentation because I was stuck in the House. However, I had time to read it.

At the end of your presentation, you talk about various factors on which the recovery depends and over which you don't have a lot of influence. Do you have a preference as to the various economic recovery measures that could be introduced by the government? You say that if additional impetus proved to be necessary, you would have other ways of influencing interest rates.

Would you prefer that the economic recovery be brought about by those various factors? Can you make any recommendations to the government on various budget recovery measures, bearing in mind that it is no doubt more productive to create economic activity among the population than to have to act on monetary policy, which I think is a last resort for a government that has not managed to stimulate the economy adequately?

Mr. Mark Carney: First, I have to be careful with that question because it is not within our mandate to offer the government official advice on the budget.

Second, the budgetary measures that Canada and the United States have taken are one of the factors in the Canadian recovery. Those measures will have increasing impact on our economy by the end of the year, especially in 2010 and especially in the United States.

As a result of the deep recession in Canada and internationally, it is important to consider measures that could enhance the productivity of our economy, as we've just discussed with Mr. Wallace. I'm talking about measures such as those contained in the last federal budget and a number of federal budgets that will be able to improve our economy's infrastructure and have a major impact on the global economy and productivity, as well as on commodities prices.

● (1725)

[*English*]

The Chair: Okay.

[*Translation*]

Mr. Paul Jenkins: I'd like to make a brief comment. Our forecasts are based on the fiscal policies that governments have clearly announced.

[*English*]

The Chair: *Merci*.

We'll go to Mr. Kramp for a final question.

Mr. Daryl Kramp: Thank you, Mr. Chair.

Obviously, the one thing that's always constant is change. In this world today, I don't think any of us have ever seen the changes taking place, either in markets, or economic policy, or the actual disastrous happenings on a global scale—at least certainly not in my time. But how do we react, and in what timeframe do we react?

Of course, many people call for major budgetary initiatives weekly and monthly. Quite honestly, I think we all recognize that's not feasible and doable. However, governments do have to react, and they can't always wait until after the fact. We can't now do a once-a-year budget when we're into situations that are so dramatically changing.

Should your information and monetary policy reports be done weekly, monthly, or quarterly? Consequently, for major budget initiatives and/or larger fiscal policy statements, what framework would you suggest for the government?

Mr. Mark Carney: Wow.

An hon. member: Oh, oh!

Mr. Mark Carney: Are you sure that clock's right? The—

The Chair: The question is how often do you want to see us, I guess?

Some hon. members: Oh, oh!

Mr. Mark Carney: I think on the *Monetary Policy Report*, or our projections, my personal feeling is that we probably have it about right. I take your perspective if you want to see this more frequently, but there's a lot of work that goes into this. Having the projection updated four times a year, you get a better-quality projection, if you will.

In doing this, it's our responsibility, though, in the intervening period to be pretty clear about whether we're starting to get off course on that projection. It's obviously our responsibility to be pretty clear about the assumptions underlying that projection.

With respect to government measures, I'll leave it to this committee to advise the government. We will take the actions of the government and adjust monetary policy accordingly. These are times of great uncertainty, and the assurance we'll give you is that we will do whatever is necessary—but no more—to achieve the inflation target.

The Chair: Thank you, Mr. Kramp.

Mr. Carney and Mr. Jenkins, thank you very much for being with us here today. We sincerely appreciate your time and your responses to all of our questions.

Thank you, colleagues.

This meeting is adjourned.

Published under the authority of the Speaker of the House of Commons

Publié en conformité de l'autorité du Président de la Chambre des communes

Also available on the Parliament of Canada Web Site at the following address:
Aussi disponible sur le site Web du Parlement du Canada à l’adresse suivante :
http://www.parl.gc.ca