House of Commons
CANADA

Standing Committee on Finance

FINA • NUMBER 056 • 2nd SESSION • 40th PARLIAMENT

EVIDENCE

Tuesday, October 27, 2009

Chair

Mr. James Rajotte

Standing Committee on Finance

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● (1100)

[*English*]

The Chair (Mr. James Rajotte (Edmonton—Leduc, CPC)): Good morning, ladies and gentlemen. Welcome to the 56th meeting of the Standing Committee on Finance.

The order of the day, pursuant to Standing Order 108(2), is a study on the report of the Bank of Canada on monetary policy.

We are very pleased to have with us this morning two witnesses from the Bank of Canada. We have the governor, Mark Carney—welcome, Mr. Carney, to the committee again—and we have the senior deputy governor, Mr. Paul Jenkins.

Mr. Carney, I understand you have an opening statement. Then you will have questions from all members. We look forward to your statement here at the committee. Thank you for coming.

Mr. Mark Carney (Governor of the Bank of Canada): Thank you, Chair. Thanks for having us.

[*Translation*]

Good morning, Mr. Chair and distinguished committee members.

Mr. Jenkins and I are pleased to appear before this committee today to discuss the Bank of Canada's views on the economy and our monetary policy stance. While conditions in the Canadian economy have improved since we met here in February and April, many of the basic challenges remain. I would like to give you some of the highlights from our Monetary Policy Report, released last week.

Recent indicators point to the start of a global recovery. Economic and financial developments have been somewhat more favourable than the Bank had expected in July, although significant fragilities remain.

In Canada, as expected, a recovery in economic activity is also underway, following three consecutive quarters of sharp contraction. This resumption of growth is supported by monetary and fiscal stimulus, increased household wealth, improving financial conditions, higher commodity prices, and stronger business and consumer confidence.

However, heightened volatility and persistent strength in the Canadian dollar are working to slow growth and subdue inflation pressures. The Bank expects the current strength in the dollar, over time, to more than fully offset the favourable developments since July.

Given all these factors, the Bank now projects that, relative to our July Monetary Policy Report, the composition of aggregate demand will shift further towards final domestic demand and away from net exports.

[*English*]

The bank now expects growth to average slightly lower over the balance of the projection period. The bank projects that the Canadian economy will contract by 2.4% this year and then grow by 3% in 2010 and 3.3% in 2011. This projected recovery will be somewhat more modest than the average of previous cycles.

Total CPI inflation declined to a trough of minus 0.9% in the third quarter, reflecting large year-on-year drops in energy prices.

Total CPI inflation should rise to 1% this quarter, while the core rate of inflation is projected to reach its trough of 1.4% during the same period.

Owing to the substantial excess supply that has emerged in the economy, the bank expects both core and total inflation to return to the 2% target in the third quarter of 2011, one quarter later than we projected in July.

The main upside risks to inflation relate to the possibility of a stronger-than-anticipated recovery in the global economy and more robust Canadian domestic demand.

On the downside, the global recovery could be even more protracted than projected. In addition, a stronger-than-assumed Canadian dollar, driven by global portfolio movements out of U.S.-dollar assets, could act as a significant further drag on growth and put additional downward pressure on inflation.

Last Tuesday, the bank reaffirmed its conditional commitment to maintain its target for the overnight rate at the effective lower bound of one-quarter of 1% until the end of June 2010, in order to achieve the inflation target.

The bank retains considerable flexibility in the conduct of monetary policy at low interest rates, consistent with the framework that we outlined in the April MPR.

Our focus in the conduct of monetary policy is on achieving the 2% inflation target. The exchange rate should be seen in this context. It is an important relative price, which the bank monitors closely. But what ultimately matters is the exchange rate's impact in conjunction with all other domestic and foreign factors on aggregate demand and inflation in Canada. To put it simply, the bank looks at everything through the prism of achieving our inflation target.

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

● (1105)

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

We'll start with Mr. McCallum. You have seven minutes.

Hon. John McCallum (Markham—Unionville, Lib.): Thank you, Mr. Chair, and welcome to both our witnesses.

Let me begin by saying, Mr. Carney, that I think you are doing a great job. I know I'm not alone in appreciating the frankness and directness of your language—at least in terms of the language of central bankers.

I would like to begin with the question of the high dollar. I remember from my academic times that there was a lot of discussion as to whether unsterilized intervention or sterilized intervention were terribly effective over the medium term, especially in a world where the whole world seems to think the U.S. dollar should go lower. If that is the world in which we live, I certainly support your efforts to keep the Canadian dollar from going too high, because of the damaging impact, as you say, on jobs and manufacturing, but I question whether, if it's the Bank of Canada against global tendencies, you have sufficient instruments.

That is my question.

Mr. Mark Carney: Thank you.

The first thing I would say, as I mentioned in my opening statement, is that what is important ultimately is that we have sufficient instruments to achieve our inflation target, and I would remind you—I know that you know this—that the objective of the Bank of Canada is to conduct, across the suite of policy options that we have, all those policies in order to achieve the 2% CPI inflation target. In that context, the exchange rate is an important factor.

To answer your question directly, history has shown that intervention in and of itself, without backing policy moves or policy moves that are consistent with the direction of that intervention, seldom is effective over the longer term. What we have underscored with the current situation with the Canadian dollar is that in the context of all other factors that are affecting aggregate demand and inflation in Canada, it is a downside risk. Recent movements have caused a shifting out by one quarter in the profile of when we will return to our inflation target, and within that context, the bank retains considerable options to provide additional stimulus, if it's required, in order to achieve that target.

Hon. John McCallum: Maybe you don't want to reveal your arsenal publicly, but in addition to intervention, what other instruments would you consider for influencing the dollar if you perceive that it's going too high?

Mr. Mark Carney: Again, the instruments that we have are to achieve the inflation target. When we last met at this committee, in April, we had published a similar report, and the annex of that report detailed a strategy, our principles and our policy for unconventional monetary policy—policy of very low interest rates, which included options of credit easing or quantitative easing—and the conditional commitment that we have put into force.

So we have those options to provide additional stimulus, if it's required. And I'll remind you of the obvious, which is that at this stage we think the policies that we put forth, including the conditional commitment through June 2010, are consistent with achieving that inflation target over the reasonable horizon.

● (1110)

Hon. John McCallum: Thank you.

My second question has to do with the concept of prudential macro-management, which I think you've spoken of quite frequently. My understanding is that at certain times in the past you've suggested that the Bank of Canada's mandate might go beyond inflation per se to include some kind of prudential macro-management of the economy, which would involve more direct activity vis-à-vis banks.

My question is double-barrelled.

Perhaps “power struggle” is not the right term, but how would you describe the current division of labour between OSFI, the Bank of Canada, and the Department of Finance, including the minister?

Second, there was an interesting editorial in *The Globe and Mail* this morning that said that maybe the Bank of Canada should have an expanded mandate—perhaps what you might call prudential macro-management—but should the Bank of Canada have an expanded mandate, there should be an opportunity for parliamentary debate because it might require some change in the Bank of Canada Act.

The double question: one, what is the current division of labour; and two, what do you think of parliamentary debate on the possibility of an expanded role for the Bank of Canada?

Mr. Mark Carney: With respect to the first part, the division of labour, I'll underscore what I said yesterday and what Paul Jenkins said earlier in another public speech about a month ago, consistent with the words of the Minister of Finance: the Minister of Finance has overall responsibility for the financial system. So overall responsibility rests with the Minister of Finance and, through the Minister of Finance, Parliament. So that's absolutely clear.

The second thing is that the current structure of regulation in Canada has a prudential regulator, bank regulator, insurance regulator, with OSFI, the Bank of Canada—which has a loosely defined or an imperfectly defined financial stability responsibility—and other agencies. And we work with provincial securities regulators, CDIC, OSFI, and the federal Department of Finance to ensure there aren't gaps. I think that level of cooperation and interaction, which has been somewhat ad hoc, has been very effective, because we do work very effectively together.

The crisis in other countries has thrown up the issue of how to best organize across various agencies these micro-responsibilities and these macro-responsibilities. Undoubtedly, different countries will have different solutions that will respect their regulatory histories, their successes, and their failures. Canada, obviously, has had successes. It is ultimately the decision of the minister and through Parliament, as appropriate, how to best organize the Canadian system, given our strengths, given our history. The bank will participate as appropriate in those discussions, in those decisions. I would underscore that the system in practice has worked very effectively during the course of this crisis and coming out of this crisis.

The last point is that we are working very closely with OSFI, with federal finance, and as appropriate, with provincial regulators on the redesign of regulations across the whole suite that's coming out of the G-20 process. Most of those decisions or those consensuses are being formed at an international level. So it is important that we work closely together, and we are doing that.

Hon. John McCallum: Thank you very much.

The Chair: Thank you, Mr. McCallum.

Monsieur Laforest, *s'il vous plaît*.

[*Translation*]

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

Good morning, Mr. Carney and Mr. Jenkins.

Mr. Carney, yesterday, you delivered a speech to the Autorité des marchés financiers in Montreal.

The newspapers are carrying a summary of your speech. First, you said that you were a little skeptical of financial institutions. You said that they have to change their attitude. Second, you say: “Financial institutions need to demonstrate an awareness of their broader responsibilities.”

When I read that sentence, I was a little surprised. I was particularly struck by the word “broader”.

In your view, how have the responsibilities of financial institutions become broader than those they had before the crisis? What are you looking for from financial institutions in this context?

● (1115)

Mr. Mark Carney: Thank you for your question.

First, I would like to make it clear that my speech in Montreal yesterday was more for consumption outside our borders than inside Canada. To repeat, during the crisis, our financial institutions worked together in a spirit of close cooperation. They did so very effectively and in a way that served Canada well. That is my first point.

The second point is that, as with all financial institutions, in whatever country, the key, in my view and the view of the Bank of Canada, is that they must think in terms of the system and not merely of themselves. For example, a financial institution must consider the effect of its actions on financial stability. This is necessary because it is possible to change the institution's way of doing things.

Mr. Jean-Yves Laforest: That is summarized well in *La Presse*.

You say that financial institutions have broader responsibilities as if you mean new responsibilities. What responsibilities do they have now that they did not have before?

Mr. Mark Carney: It is not a matter of new responsibilities; the responsibilities are the same as they were before the crisis. If it is part of a system, a financial institution has a responsibility to that system.

I will finish my answer in English.

[*English*]

What was clear, internationally, was that a number of institutions did not behave in that fashion. They took advantage of the safety nets and conducted business on the presumption that support would come. This increased the risk.

Part of what is being done at the G-20 is to bring about changes in these attitudes through processes such as living wills and changes to markets that will make institutions think more of the system and act in accordance with it.

[*Translation*]

Mr. Jean-Yves Laforest: Fine.

Turning to the economic recovery, you are forecasting a 3% growth next year and a little more the following year. Just now, you said that the rapid rise in the Canadian dollar was putting economic growth at risk.

Do you feel that Quebec is more at risk than other Canadian provinces? Which provinces would be most affected if the Canadian dollar was more or less at par with the American dollar?

Mr. Mark Carney: We provide national projections, Canadian projections, but we do not provide projections for specific provinces. I can tell you that some sectors will be more affected. The manufacturing sector, for example, undergoes difficulties when the dollar is consistently strong or increasingly volatile.

Mr. Jean-Yves Laforest: Do you have ways to counter something like that? What steps you will you be taking if parity materializes?

Mr. Mark Carney: If parity...?

Mr. Jean-Yves Laforest: If we reach parity quickly.

● (1120)

Mr. Paul Jenkins (Senior Deputy Governor, Bank of Canada): Perhaps I can add something.

First, we can see that the Canadian economy has a number of things going for it. Commodity prices are a little higher in all regions. The level of business and household confidence is also higher than a year ago. With the gains in and the changes to financial conditions, wealth... There are positive things going on in all regions.

In our forecast, we noted that, if the dollar continues to be high, the effect will be to offset these positive elements. As the governor mentioned, monetary policy deals with the economy as a whole. We are focusing our objectives on inflation.

Mr. Jean-Yves Laforest: Is the present value of the dollar its actual value or is it affected by speculation to any extent? What do you currently see as the real value of the dollar?

Mr. Mark Carney: We never express an official opinion on the value of the dollar.

Mr. Paul Jenkins: It is only an assumption.

Mr. Jean-Yves Laforest: Thank you.

[*English*]

The Chair: Merci, Monsieur Laforest.

Mr. Menzies.

Mr. Ted Menzies (Macleod, CPC): Thank you, Mr. Chair.

Thank you to our two witnesses here today.

I am listening to your comments and thinking back to about a year ago. A lot of things have changed in a year. We had no idea where we were headed, but I would like to go to the role our finance minister certainly played. There was a reason he was named finance minister of the year. I think people don't realize the role you play. You go to these meetings too, Governor, and interact with your counterparts. I'd just like you to reflect on that, and we'll follow up with some of your comments yesterday that I think follow along that theme of Canada's role in trying to make sure we stay the course.

I'd like some comments from you on Canada's role in that. I sense it's larger, perhaps, than most Canadians recognize. We were a major part of the recovery because we were the ones who were pushing and continued to push on staying the course with this stimulus money—it was the right decision, and it's turning out to be proven that way.

You talk about our conditions having improved but only minimally, so if you could, just explain to us the role you play and your interaction with central bank governors from other countries—G-8 and G-20, for example.

Mr. Mark Carney: Thank you.

First, I'll say for the committee's benefit that there are frequent communications between the governors of the G-7, G-10, and G-20 central banks now, but very frequent direct meetings, monthly meetings, face-to-face, more frequent telephone conversations. Unfortunately, there were very frequent conversations around this time last year, because there was a lot to talk about, and through into the year.

I would assure you that because of that, a level of trust and openness has been built up with the core central banks over the years. It persisted in the crisis, and we benefited from that. We knew about every bad thing that was going to happen before it was public, directly from a governor of the affected central bank. That was enormously helpful for some contingency planning on our part, but also to have a sense of the dimension of the problems.

The second thing with the global central banks—and I won't go into all the details—is the coordinated liquidity provision: a series of facilities put in place, emergency facilities unfortunately, that had to be put in place to keep the system functioning. About this time last year, we participated in and helped initiate a coordinated interest rate cut of the major central banks because we could see the very rapid deterioration in the economy. It was helpful; it comes with a lag, but it was helpful on margin.

I think where you start to see Canada's broader role—and I very much broaden this to the role of the Minister of Finance and the Department of Finance and the regulators—was when you shifted into fiscal policy and then saving the system. In the meeting in October of the G-7, when it was unfortunately necessary for some fairly bold, unprecedented moves to be taken, Canada had credibility at that table to make that case: that now was the time for everybody to step in and support their institution so the system as a whole would continue to function. That was not an enjoyable decision for anybody to take, but it did help to have somebody at least at the table for whom it wasn't immediately necessary, and I think on margin that helped build that consensus. Major decisions were taken there.

The forward-looking issue since then has been how to rebuild the system. The crisis lingered for a long time after that, but it was arrested then. The tail was going to be taken out then, I think, once the decisions of October last year were taken. But how do you rebuild the system? That's the G-20 regulatory agenda that has been built up over time. I think Canada has played an important role, in part because there are some lessons to take from why our system did not have the problem, and we've taken lessons from that. What's been important as well is to be constructive around the table is to be honest and recognize that there are lessons for us to learn from what's happened elsewhere and there are things we can improve about our system and participate in those discussions that way.

● (1125)

Mr. Ted Menzies: Okay, thank you.

That's very valuable, because I think most people don't understand all of the roles the Bank of Canada plays.

If I can get way off topic here, I do want to recognize Paul Jenkins for all of the advice he has helped me with on pensions. I don't think many people realize the involvement the Bank of Canada has had in pensions, the studies you have done. I appreciate, Paul, all of your advice on this process.

Very quickly, I read a quote from Christian Noyer, if I'm pronouncing it properly, the central bank governor of France. He's suggesting that there are signs of resumed risk-taking practices reminiscent of those that led to the crisis. To your comments, I hope we've learned from this about how difficult it has been to deal with this. I hope we've learned and don't go back into the risk-taking we had before. I'm sure that's the role you've been playing.

Mr. Mark Carney: Very briefly, I would associate myself with Governor Noyer's comments. There are concerns globally about the resumption of some of the practices previously.

The Chair: Thank you, Mr. Menzies.

We'll go to Mr. Mulcair, please.

[*Translation*]

Mr. Thomas Mulcair (Outremont, NDP): Welcome, Mr. Carney and Mr. Jenkins.

In a time of crisis, clear answers help people understand issues that are actually quite complicated. The last time we had the pleasure of meeting, Mr. Carney, our topic was tax havens. You were telling us about what you called “aggressive tax planning”.

I wonder if you could give us more details about that because, since we last met, the OECD has published quite an alarming figure. It seems that $6 trillion are now in tax havens. In French, I would say “*billion*”, which means the same as “trillion” in English: 1,000 billion. That makes it a little difficult to follow, but we are talking about 6,000 billion dollars.

An expert committee that studied the matter in England made a comment that is interesting in a societal context. The experts said that money is often earned through stable institutions like central banks, courts, police services and government institutions. But once it is earned, the money is taken out of the economy when people send it offshore.

Let me come back to your expression, which I suppose would be “*planification fiscale aggressive*” in French. It has always been the case that tax evasion is not allowed. On the other hand, we are not required to arrange our affairs in order to pay the most possible. I would like to ask you where you see the dividing line to be.

● (1130)

[*English*]

Tax avoidance is legal. No one is requiring you to organize your affairs in such a way as to pay the maximum tax possible. But tax evasion is illegal.

I'd like to know if the bank has taken a look at that rather alarming figure of $6 trillion that the OECD put up with regard to tax havens. Is that part of your thinking with regard to the overall money supply?

[*Translation*]

Mr. Mark Carney: Thank you. That is a very important question. The matter of tax havens is one of the G20's highest priorities. I should point out that the G20 presently has a priority process chaired by the senior associate deputy minister, Mr. Macklem, and the head of this committee. So, working with France, a process was put in place last month that is due to wrap up in January, I believe. Its goal is to...

[*English*]

investigate the consistency of implementation of the new principles that were agreed on in Pittsburgh for tax havens and to identify those that are inconsistent, that would allow crossing that line that you rightly made between avoidance and evasion, and do not provide sufficient information for appropriate remedial action.

That is a priority that's being addressed, and Canada is involved through the Department of Finance. It goes back to Mr. McCallum's question earlier in terms of division of labour. There are resources in the department that are on that. We're aware of the issue, but that's their responsibility and they're active on it.

Mr. Thomas Mulcair: Thank you for that clear answer.

Since these rounds go so quickly, I'm going to start on another issue I would like to discuss with you. It might seem a bit far from the immediate subject of the economy, but I think you might be convinced that it has something to do with the value of the Canadian dollar. There's a basic principle of sustainable development that's called “the internalization of costs”. When you want people to understand it, you tell them that the extra $3 they pay on a tire is fair if the cost of recycling that tire is about $3 and that the people who drive cars should pay that $3 rather than have it come out of general tax revenues. That's a basic principle of sustainable development.

With regard to the tar sands—or to please our friends from Alberta, the oil sands—there's an argument that could be made that we're not internalizing the entire cost in what is being sold, both environmentally and to future generations. That influx of dollars that has not been pared down by the internalization of cost is one of the drivers for the increased value of our loonie, which of course is having the side effect of making our exports even more difficult, and hurting the manufacturing and forestry sectors even further.

Is it part of your job, under the division of labour you described to us earlier, to look at these issues? I think it is. Even though the subject of the oil sands might seem a bit far from your normal day-to-day preoccupations, I honestly believe that if we're going to take a sustainable development approach—in other words, every time the government has a decision to make, to look at the environmental, social, and of course economic aspects to determine what course of action is best to take....

Right now we're spending $60 billion extra this year on the backs of future generations, but we're not leaving them anything in terms of a sustainable green renewable energy future, as we could have done with that money, and as the Americans are doing. We're leaving them an inheritance, a succession that will require them to spend even more to clean it up.

I would like you to talk bit about that notion of sustainable development, internalization of costs, and the oil sands as one of the drivers of the higher Canadian dollar, and whether under your division of labour it's part of your reflection.

Mr. Mark Carney: I'm tempted to say no, it's not under the division of labour. But no, the energy sector is clearly a very important sector in the Canadian economy. We need to understand the short-, medium-, and long-term drivers for investment in those sectors. In fact in the report this last week we highlighted recent developments and structural developments in natural gas markets, which are important for the outlook investment in natural gas in Canada. That's something we've taken into account, which is a potential structural break in investment in natural gas because of developments in U.S. shale gas, an important point for Canada. So we do look at the various sectors and those forces.

I would note that cross-border investment decisions in energy are partially influenced by expectations for the pricing of carbon over time in various jurisdictions. The timeframe for that and the scale of that are also influenced by the prospects for agreements through the various UNCC processes, including what is leading to Copenhagen, and related to that. They are separate tracks, discussions that happened through the G-20.

Now, as a central bank, we obviously take those decisions as they are made and look at the implications for investment and activity in Canada.

● (1135)

The Chair: We'll have to continue this discussion on the second round.

Thank you.

We'll go now to Mr. McKay, please.

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

Thank you, Mr. Carney and Mr. Jenkins, for your appearance.

I always appreciate your candour. I see in this morning's paper that you are weighing in against hubris among central bankers. All I can say is good luck with that. Possibly next week it will be original sin.

In the category of tilting at windmills, as exemplified in your recent conversation about the Canadian dollar, I commend you in every effort you make to talk the dollar down. But it seems that we have a permanent case of Dutch disease and that our commodities drive our dollar. We have not chosen the Norwegian solution, which is to isolate commodities from their economic impact. By default, or otherwise, we've chosen the Dutch model. We have permanently impoverished some regions of the country that don't have commodities while helping to enrich those that do.

Our non-policy decisions will ultimately make us permanent hewers of wood and drawers of water, with little prospect, in spite of the best efforts of the Bank of Canada, of seeing the Canadian dollar come back to a level that would allow a real manufacturing sector to succeed in this country.

Mr. Mark Carney: Just for the record, I spoke of the hubris of bankers, not central bankers. There is no hubris in central bankers, or any original sin.

As to your question, it's an important issue. There are many factors that drive markets in our currency and all others. The Canadian economy, as you correctly imply, is much more than primary industries. The other areas of the Canadian economy—the manufacturing sector, the service sector, other primary industries aside from energy—are important components of our economy and influence pressures on inflation, which is ultimately our mandate. The point we have tried to make is that our suite of policy tools will be used to ensure the maximum likelihood of achieving our inflation target over a reasonable horizon. The question of the dollar needs to be seen in that context.

Hon. John McKay: In effect, and I put this a little stronger than I might care to, you're saying that your inflation policy is the only policy instrument you have to deal with the unwarranted rise in the Canadian dollar. Am I misinterpreting what you're saying?

● (1140)

Mr. Mark Carney: The clear mandate of the bank in the conduct of monetary policy is to achieve the 2% CPI inflation target. That is the clear mandate, that's how we're judged, and that's how we're held accountable. Related to that, but not always overlapping it, we have an intervention policy agreed to by the Government of Canada. It provides for intervention in the foreign exchange markets under two scenarios: gapping in the foreign exchange market, which is a relatively rare occurrence, given the liquidity of those markets; and market volatility sufficient to create the prospect of serious impact on economic growth. These are conditions not to be taken lightly.

Mr. Paul Jenkins: In response to your question, Mr. McKay, it's worthwhile to go back to the governor's opening statement about how we currently see things. We have a flexible exchange rate regime that is part of our inflation control framework, and we look at the exchange rate through that prism. What we have said in our press release and in our monetary policy report is that notwithstanding the positive factors currently in play in the Canadian economy, the rise in the Canadian dollar, if it were to persist, could have counter-balancing effects. So we're looking closely at the impact of the dollar on the Canadian economy and the inflationary consequences of that impact. It's through this prism that we think about these things.

The Chair: Thank you, Mr. McKay.

We'll go to Mr. Roy for five minutes, please.

[*Translation*]

Mr. Jean-Yves Roy (Haute-Gaspésie—La Mitis—Matane—Matapédia, BQ): Thank you, Mr. Chair.

Good morning, Mr. Carney and Mr. Jenkins.

Earlier, when you were answering my colleague Mr. Laforest's question, you said that financial institutions need to show good financial citizenship because they have broader responsibilities. That was the gist of your comment. Most observers today are saying that as soon as the economy started to rebound, American financial institutions, in particular, went back to behaving the same way they had before.

Is it too much to hope that financial institutions might show good corporate citizenship with respect to their activities? The current economic crisis was caused by the fact that financial institutions, particularly American ones, took enormous risks without the reserves they needed to deal with those risks.

The same can be said for big companies. GM and Chrysler are just two examples of many large companies that were not able to handle the crisis because they did not have enough in the way of reserves and were not reasonable in their planning. Ford, on the other hand, had the reserves it needed and was able to deal with the crisis.

Right now, observers are telling us that the system has not changed, not one bit. In Europe, they are considering imposing a capital tax on financial institutions. The same could apply to companies, in order to create some sort of insurance so that governments are not obligated to invest hundreds of billions of dollars—as was the case in the US—because of a crisis brought on by the irresponsible behaviour of the heads of corporations and financial institutions. I think we should establish some sort of insurance.

Mr. Carney, I would like to know if you are currently talking to the Department of Finance about the possibility of imposing a sort of capital tax that would ensure that we have a fund to deal with the irresponsible behaviour of some in the financial sector?

Mr. Mark Carney: I will start with the last part of your question.

No, we are not in talks with the Department of Finance regarding a new tax on transactions or capital. In Canada, about five years ago in certain provinces, and some ten years ago at the federal level, there was such a capital tax. In my view, a capital tax is a very bad idea. But the idea of regulating capital is very important.

The Bank of Canada, the Office of the Superintendent of Financial Institutions, our regulator, and the Department of Finance work together very closely at the international level to enhance rules about capital for all financial institutions, but as for European and American institutions—

● (1145)

Mr. Jean-Yves Roy: But not for large companies.

Mr. Mark Carney: We are not doing it for large companies.

Mr. Jean-Yves Roy: But the problem is similar to that of the banks.

Mr. Mark Carney: At one point, the large auto companies had a lot of capital, but they suffered losses year after year.

[*English*]

No one is talking about regulating the capital of enterprises; we're talking about financial institutions, because of their central role and the spillovers,

[*Translation*]

the ripple effects on other sectors of the economy.

[*English*]

That's where one needs to buttress things.

We are working to bring global capital standards toward Canadian levels. We are very confident that will happen, but there's more work to be done in those discussions.

The Chair: Thank you.

Just briefly, Mr. Jenkins?

Mr. Paul Jenkins: No, it's okay.

The Chair: Thank you.

We'll go to Mr. Dechert, please.

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

Good morning, Governor Carney, and thank you for your presentation and report.

I note with interest page 15 of your report, where you take us through an analysis of the recovery of our economy in the second and third quarters. You state here that the economy began to recover in the second quarter, due in part to a number of factors, including new purchases of consumer durables and renewed residential investment. You also mention that fiscal incentives also helped to fuel renovation.

Are you referring to the home renovation tax credit there?

Mr. Mark Carney: Yes, we are.

Mr. Bob Dechert: Okay.

What kind of stimulus do you think that contributed, in dollar terms, to the improvement in the second quarter?

Mr. Mark Carney: Well, the one thing that needs to be recognized is that while the housing market is something that's near and dear to all our hearts, and something that's very prominent, housing is a relatively small proportion of the economy. We do see a strong housing market going forward. We saw part of this recovery in the second quarter. But we're talking tenths of a percentage point in the contributions from the housing market as a whole.

We will say, though, that in our view, although it's tough to quantify these things, the combination of the clear ending of the crisis—the free fall, if you will—the monetary stimulus and the fiscal stimulus, and the coordination that was seen globally should have had, and likely did have, a knock-on effect on the confidence of households.

Mr. Bob Dechert: Right. So it had some impact on kick-starting the economy.

On page 15, again, you say this about the second quarter:

> Government expenditures were another important source of demand, contributing 1.2 percentage points to growth (at annual rates) in the quarter.
>
> Available indicators, including the recent pickup in employment, suggest that real GDP growth resumed in the third quarter. Household spending continued to recover, and the contribution of government expenditures increased.

What types of government expenditures are you specifically referring to here?

Mr. Mark Carney: The paragraphs refer to, in broad-brush terms, the beginning of the infrastructure spending from the government's economic action plan.

We see—I think it's important to guide the committee—that this impact will build into 2010. And as to a growth in 2010, very importantly, it will be a relatively unusual recovery compared to history. It will be a little weaker than historically, but the key components will be consumption, more so than usual; housing a bit more than usual, but it's small; and government. It will be less from net exports than what we'd normally see because of how weak the United States is.

● (1150)

Mr. Bob Dechert: It's fair to say, though, that you are seeing the impact of government spending.

Mr. Mark Carney: We are starting to see the impact, yes.

Mr. Bob Dechert: Very good. Thank you.

Mr. Chair, I would like to share my time with Mr. Bernier.

The Chair: Mr. Bernier.

[*Translation*]

Hon. Maxime Bernier (Beauce, CPC): Good morning, Mr. Carney. Thank you for being here.

Last week, there were many newspapers reporting that you would not hesitate to intervene if the loonie rose too high against the American dollar. From the comments in *La Presse*, we get the sense that a strong currency has absolutely no positive impact on export industries or Canada's short-term economic growth.

However, a strong currency does have positive effects. It allows consumers to take advantage of lower prices, because of imports. It allows those travelling to the U.S. to benefit from a favourable exchange rate. It also benefits companies that import equipment, as you know, from the United States or elsewhere in the world. Lastly, it allows Canadian investors who invest abroad to receive a better return on their investment.

Therefore, if you were to intervene, it would also have a negative impact. It would mean creating Canadian dollars to devalue the loonie at the same rate as the U.S. Federal Reserve is devaluing the American dollar. In addition, it is a known fact that, during the Great Depression, competitive devaluation made the crisis worse.

So I want to ask you whether you think a strong dollar has both a positive and a negative side. If so, how will you make a balanced decision that takes all of those effects into account?

Mr. Mark Carney: Thank you for your question. That is very important, of course....

[*English*]

The Chair: Mr. Carney, I'm sorry. Members have a habit of asking questions that take up all the time, so you'll have five minutes to think about that. We'll go to the Liberal round, come back to the Conservative round, and then you can answer that question.

Mr. Pacetti, please.

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

Thank you for coming, Mr. Carney and Mr. Jenkins. I'm not sure you'll need five minutes to answer that question.

I also have some questions on currencies, but I think we've talked about them.

I'd like to get your opinion on the recent announcement on Friday that the U.S. government closed another seven regional banks. That hasn't really been discussed, and I think it will affect the way our banks approach things.

Mr. Mark Carney: Without commenting on the specific institutions that were affected by that, as you and committee members are aware, there are difficulties in the commercial real estate sector in the United States, in addition to the residential real estate sector. A number of smaller regional banks are particularly affected, and a series of these closures were the product of commercial real estate losses.

In most cases, links between these institutions and Canadian institutions are non-existent.

Mr. Massimo Pacetti: That was going to be my follow-up question, because our banking institutions are heavily invested in the U.S. We're already seeing lending constraints here in Canada. There's less money available, even though the banks say there is more money available. Is that going to affect Canadian banks in terms of their liquidity or overall strength?

Mr. Mark Carney: Canadian institutions do have varying exposure to the United States market. I think that exposure is well documented.

Mr. Massimo Pacetti: Does that affect their lending capacity here in Canada?

Mr. Mark Carney: Canadian banks on the whole are very well capitalized, and they have been lending. Household credit, largely from bank-based credit, grew north of 7% on an annualized basis through September. Business credit has now turned positive again. It was briefly negative in September. That lending capacity is there and is being deployed.

● (1155)

Mr. Massimo Pacetti: Thank you.

I'd like to challenge you a little on what you just said. I'm not sure what you were referring to. You said the Bank of Canada knew what was going to happen and you were well prepared. I'm just looking at the different projections from the bank and other experts. The one thing we did know was that we didn't know. That's my feeling.

As early as April we said that the economy was going to decrease by 3%, and then it was revised to 2.3% in July. I'm not sure where we are now. It's continuously changing. The economy is evolving.

Mr. Mark Carney: I'll answer very quickly so you can have another question.

We knew beforehand about specific institutions having problems—that's what I was referring to. But on your projection point, the revision from 3% to 2.3% is almost fully explained by Statistics Canada revising the Q1 numbers. That's arithmetic, as opposed to a change in projection.

Mr. Massimo Pacetti: When you were here the last time it was almost unexplainable. Every time we have economists come forward they give us different amounts and say they're expecting different numbers in terms of recovery. We're getting different numbers from different areas. I understand that it comes with the job, but people are looking for direction. What should we know now about what will happen in the next six months?

Mr. Mark Carney: The first thing I would say—and maybe I'm biased on this—is that the broad brush of our projection has been proven correct. We came here in January this year and said we expected a recovery to begin in the second half of this year, driven largely by the stimulus that has been put in place. And that's what has happened. Whether it was going to be in the third or fourth quarter, and the exact magnitude of that recovery...but we said that and were appropriately questioned by this committee on the reasons behind it. That has largely come to pass.

What are we saying going forward? We're saying that the recovery is going to be more modest than usual, so it will feel less like recovery than solid growth, if you will.

Mr. Massimo Pacetti: The reason I'm asking is that we're seeing, for lack of a better word, a jobless recovery. Is there reason to be worried about the fact that the banks—again, not the Canadian banks, but internationally—don't seem to be recovering as quickly? Some have and some haven't, if we look to the south. Is there a risk that we're going to have one of these ups and downs in terms of recovery?

Mr. Mark Carney: There are risks on both sides for this recovery, absolutely. Certainly there are significant risks that come from abroad, on both sides, and risks in the United States. So there are upside and downside risks.

What we have said about the labour market, and it's very early days, is that there were some early signs of stabilization in the Canadian labour market. That said, unemployment, as everyone knows, has gone up quite sharply, and hours worked are very low. Average hours worked are very low. I hate to use an economic term, but there's a lot of slack in the labour market at present in Canada. If I may make a general point, that slack and the slack in capacity utilization and business activity means that there is quite a large output gap, which affects the ultimate pressures on inflation. It is part of the reason we have policy where it is, because it's going to take some time to use up that slack.

Mr. Massimo Pacetti: Thank you.

The Chair: Thank you, Mr. Pacetti.

Mr. Carney, we'll go back, if we can, to the question posed by Mr. Bernier, please.

Do you want to restate it?

[*Translation*]

Mr. Mark Carney: No, that's fine.

Mr. Bernier is right, of course. There are both positive and negative consequences when you have a strong dollar. What matters is how the exchange rate, combined with all the other internal and external factors, impacts overall demand and inflation in Canada. That is what determines the Bank of Canada's monetary policy.

[*English*]

The Chair: Merci.

We have about four minutes in this spot.

I just wanted to follow up, Mr. Carney. You talked about the redesign of regulations internationally. In your speech in Montreal, you spoke about the G-20 reform agenda, and in the section “Protecting the Cycle from the Banks” there were three interesting statements.

You talked about “building a system that can withstand the failure of any single financial institution”. Lehman Brothers obviously comes to mind.

You talked about the “conviction among policy-makers that losses endured in future crises must be borne by the institutions themselves”. AIG comes to mind when you state that.

Then you talked about creating “a system in which individual financial institutions are less important and markets more important”. That's quite an interesting statement.

You sort of discuss four measures there. I want you to go into that.

It was obviously a challenge. Lehman Brothers, on September 15 of last year, was the hot spot, the point of the financial crisis. Then there was, I think most would argue, an overreaction with respect to AIG. There was such a fear of any other institution failing that there was an overreaction.

When you talk about creating a system in which individual financial institutions are less important and markets more important, what exactly do you mean, and how would you go about doing that?

● (1200)

Mr. Mark Carney: Thank you for the question, Chair.

Very briefly, one of the issues in the crisis was that a series of institutions had to be saved. The judgment of the relative authorities was that it had to be saved because their failure would have seized up further broken-down markets and brought down other institutions because they were so interconnected.

Quite frankly, that's an unacceptable situation, that markets are dependent on individual institutions surviving. Certainly what's unacceptable is after that has been revealed, to continue to manage the system in that way, because that changes behaviour if you know that institutions will be “saved” for that reason.

What does one do about it? Our very strong opinion is that one has to change in a variety of jurisdictions, including our own, some of the infrastructure of markets, so that the markets can continue to function if an institution stops working. In other words, we have looked at—and it's detailed in those remarks, as you know—the funding markets in Canada. These would be the repo markets and the interbank markets. We're working with industry players to see whether it makes sense—still to be determined—to move those on to a centrally cleared platform. There's lots of jargon there. The point of that is that transactions go through a clearing house, which is a utility-type structure that is very well capitalized and robust to all states of the world. If one of those institutions that's trading through that clearing house for whatever reason has to fail, the clearing house is protected. It's not lost, and the system as a whole is protected.

If you go back—and I'm sorry to take up so much time on this, but it's important—one of the issues with Bear Stearns was that it was in this very short-term market. It was a key player in the repo market, and the entire market, as judged by the Fed, and I think rightly, would have stopped functioning. That would have seized up the bond market and other markets if Bear Stearns hadn't opened for business the following Monday. That's the type of situation we're trying to get away from. It's going to take some fairly substantial changes to market infrastructure.

The Chair: How would that, in a practical way, prevent a future Lehman Brothers failure from occurring?

Mr. Mark Carney: It would—

The Chair: It's not the failure but the effects to the entire system of the failure.

Mr. Mark Carney: One of the issues with Lehman Brothers, Bear Stearns, and other major institutions when they fail was that institutions didn't know which other institutions that were trading with Lehman Brothers had just lost a lot of money because Lehman failed. That made everybody suspect and that made everybody pull back.

The point would be that if the trading in a given market is done through a central counterparty, the only thing that matters is whether that central counterparty fails. The institution can fail, and that's bad news for them, but in terms of the repo market, which is my example, because the central counterparty is still there nobody has lost any money, including the central counterparty, because it's on a collateralized basis. Now, somebody has to oversee the counterparty and make sure that this is robust. But it is doable. It's done in other markets and it should be applied.

The big question mark, which is the subject of active discussion—more relevant outside of Canada than in Canada—is what happens in the credit derivative market, which by some estimates is tens of trillions of dollars in size and is entirely dependent on bilateral relationships.

● (1205)

The Chair: I would like to continue that, but I am out of time. Perhaps we'll come back to it later.

We'll go to Mr. McCallum again, please.

Hon. John McCallum: Thank you.

I'd assume you'd agree, because it is a fact, that Germany, France, and Japan experienced positive GDP growth in the second quarter of this year.

Mr. Mark Carney: We agree with that, in fact. Yes, they did.

Hon. John McCallum: I assume you would agree, since it is also a fact, that therefore by definition those three countries emerged from recession in the second quarter of this year.

Mr. Mark Carney: I would hedge my answer on that. As you well know, definitions of recession and recovery based simply on GDP are a little unrepresentative. There are broader factors, like industrial production, unemployment, etc.

Hon. John McCallum: Okay. But at least if one takes the simple definition of recession, if we have consecutive quarters of negative growth and then positive growth, by that simple measure are you out of recession?

Mr. Mark Carney: For the purposes of this exercise I will agree with that.

Hon. John McCallum: You may figure out where I'm going. There is this myth propagated by the government that Canada is leading the G-7 out of recession. Now the governor has just agreed that three of the G-7 countries, in the second quarter of this year, actually experienced positive growth and by one measure were out of recession, whereas Canada experienced not only negative growth but the most negative growth of all the remaining four G-7 countries.

Maybe this is a little political—

Voices: Oh, oh!

Mr. John McCallum: —but how can one say that Canada is leading the way out of recession among G-7 countries when three of the four had emerged by Q2 and Canada had not?

Mr. Mark Carney: Could we get a ruling on that?

I think in the fullness of this experience of the recession and the recoveries, and the amount of time it takes for economies to return to their previous path of potential growth, it is likely that Canada will return to its path of potential more quickly than the other crisis-affected economies, including the two European countries you mentioned. But that's something one sees over the fullness of time, and that's what ultimately will matter.

Hon. John McCallum: Thank you.

If I may turn to a less political question, I'm sure you won't want to tell us how high the dollar has to go before you're worried, but let me ask you two questions related to that.

I would assume that if the dollar appreciates because of higher oil or commodity prices, you would be less concerned than if the dollar appreciated because of...speculation, shall we call it? And second, I would assume that you're concerned partly about the level but also about the speed. Are those two assumptions I'm making true, that you're less concerned if the dollar appreciates because of commodity prices, and you're particularly concerned if the appreciation is very rapid?

Mr. Mark Carney: I would say simply that what matters for the bank is where the currency is and where all other domestic and external factors are and the totality of their impact on aggregate demand and therefore inflation in Canada. And obviously our terms of trade, prices of commodities, are one of the external factors that matter. But just to take the exchange rate and just to take the terms of trade, and to ignore everything else—U.S. activity, domestic activity, housing market, etc.—would be a partial analysis and would be inconsistent with our mandate to meet our inflation target.

Hon. John McCallum: What about the issue of speed?

Mr. Mark Carney: Again, partially there is a question of speed and impact through confidence, as a channel, but that needs to be brought into the broader analysis.

Hon. John McCallum: Thank you very much.

The Chair: Thank you, Mr. McCallum.

We'll go to Mr. Kramp, please.

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

Welcome to all of you.

I was pleased to see that the Bank of Canada, in your earlier comments, doesn't speculate but deals with facts. But I'm going to ask you to maybe do just that, only in a little different situation and with regard to the U.S. situation rather than Canada. The reason I would ask that, of course, is that the relationship is well cemented; there are the references to one sneezing and the other catching the cold, and the mouse and the elephant. But in the assessment of the current financial health of the U.S. institutions, certainly that has serious and severe implications for the general direction of the Bank of Canada and/or Canada as a whole. Would you be in a position to just speculate on the current assessment of the U.S. financial services sector, and also the future prospects of the U.S., both in long-term and short-term growth?

● (1210)

Mr. Mark Carney: In terms of the U.S. financial institutions, as I think you may be aware, the Federal Reserve, in conjunction with the regulators, conducted a thorough stress test of the 19 largest institutions in the United States earlier this year, and that revealed capital requirements consistent with a further severe recession between now and the end of 2010. Those institutions have all now been recapitalized, and in many cases more than recapitalized, so that they have more capital than was required under SCAP, the supervisory capital assessment program. These institutions represent more than 80% of the banking assets in the United States. So to Mr. Pacetti's question earlier, we will see a series of smaller institutions with difficulties, but this is the core of the U.S. system.

That said, it is the view of G-7 governors and regulators that there is an opportunity now for global institutions outside Canada, where profitability is returned to the sector, to further build capital buffers in order to provide the necessary credit for the economy, and there is a view that institutions should take that into account when considering returns to shareholders and setting compensation, given the global outlook. That applies equally to the United States, as it does elsewhere.

In terms of the short- and longer-term prospects for the United States, history has shown—and generally we make reference to this in the report—that countries that have been affected by financial crises often see a reduction in their potential growth and it takes a long time to bring themselves back. So the absolute level of the economy, the capacity of the economy, is reduced, and then in terms of the speed with which they can return, it takes some time to get back. There are certainly elements of that in the United States, and that is one of many reasons we see what is for the United States a substandard recovery. We detail that in a chart, actually, on page 10 of the report, which shows all the historic recoveries since the Great Depression in the United States, and this will be weaker.

Longer-term potential of the United States is still in the hands of the inventiveness and resources of the American people. It's down to decisions of government, the central bank to a lesser extent, because these are longer-term decisions, and of individuals there, but it's something we're all going to have to watch.

The final point I would make is that it is our view that this crisis is a watershed in many respects, in that there will be an adjustment of demand in the United States, less consumption, and more outwardly focused net exports, and more of global growth will come from major emerging markets than our historic markets. So from a medium-term perspective, Canadian businesses are well advised to seek out those markets and develop those ties.

Mr. Daryl Kramp: I have a brief question.

The Chair: You have ten seconds.

Mr. Daryl Kramp: Regarding the Chinese renminbi potentially replacing the dollar at some particular point, that's recognized, but what are your thoughts on that?

Mr. Mark Carney: The U.S. dollar is the reserve currency of choice. That is not a right, it is a reality. Of choice, the United States dollar is the reserve currency, and we expect that to continue to be the case for the foreseeable future.

● (1215)

The Chair: Thank you, Mr. Kramp.

We'll go again to Mr. Mulcair.

Mr. Thomas Mulcair: Mr. Carney, in your remarks with regard to the United States situation, you walked us through some of the lessons of the past year, some of the things we've learned and some of the things that are being corrected, one would hope, toward the future.

You referred to the insistence of the governor of the French bank that we have to get away from some of the risk-taking practices of the past, which he sees as creeping back in. It can fairly be said that President Sarkozy of France, both on the issue of tax havens and on the issue of these past practices, is taking a leading role. He was very happy after his first G-20 meeting with President Obama, because the issue of tax havens, which you talked about correctly before, was dealt with.

One of the things that we find here in government, if this whole exercise is to have a purpose.... You correctly refer also to the difference between what you have to do as the governor of our central bank and what the minister and his department have to do and what we all have to do as parliamentarians, who are supposed to give form to all these nice thoughts in legislation. What other things should we also be looking at?

Mr. Menzies referred to the work Mr. Jenkins is doing on pensions. I think there is something that cuts across party lines that we can be doing better to protect pensions, and that long term has a lot to do with the stability of our economy and the quality of life of our society. But what are some of the other things that we can and should be looking at?

For example, is it possible to look at the simple objective fact that many executive pay packages are now 250 to 300 times the wage per year of the average salaried employee? Should there be a fiduciary responsibility placed on members of the governing boards of corporate entities to make sure that when they are determining remuneration, global pay packages, it should be based on value added to the company, not pure speculation on the future? Is there something that we can be doing, as legislators, to bring that sort of legislation forward and better protect future generations with regard to the institutions that have shown to be, in many cases, quite fragile?

Mr. Mark Carney: That's an important question.

Do I take it you don't want a comment on pensions?

Mr. Thomas Mulcair: I think we all agree that on pensions we're on the right track, and we're getting an important report in December.

Mr. Mark Carney: Right.

With respect to compensation, there have been very carefully developed, thoroughly developed—with the endorsement of President Sarcozy directly—compensation principles that have been agreed on at the G-20, were agreed to in Pittsburg. They are consistent with many of the points you made and go beyond compensation tied to longer-term performance, compensation that vests over time, so you can find out whether that longer-term performance actually happens; an ability to claw back compensation if it proves to be ephemeral; corporate governance reforms that allow shareholders, through the boards, to have a say on pay; and disclosure principles that would allow people to make informed decisions about those. And those principles have been agreed to. The spirit of those is to be put into effect very quickly, over the next several months. The regulators are going to monitor the extent to which actual practices are consistent with those principles. And this is going to be a test of how well the process works, because then, at the G-20 level, through something called the Financial Stability Board—which brings together regulators, central banks and treasuries—there is going to be a review of the various packages in the various jurisdictions and whether they are consistent. So there will be a peer review process that will be able to challenge other countries, if their practices are not consistent with these principles, which is relevant in a—

[*Translation*]

Mr. Thomas Mulcair: It is easy to see how someone might perceive that as the fox guarding the chicken coop, if we are not pursuing legislation that would set out the authority to rigorously enforce those principles, with a view to public scrutiny. Is it sufficient, or will we need to adopt more stringent measures, do you think?

Mr. Mark Carney: In my view, it is better to have principles and procedures to assure lawmakers that those principles are being implemented in Canada and internationally. The procedure set out by the G20 includes regulators and the Financial Stability Board. After the first run-through of the....

● (1220)

[*English*]

The first time of this process, which will be within....

[*Translation*]

the time to ask questions will be in five or six months.

Mr. Thomas Mulcair: All the parties have agreed to wait until December to discuss the pension issue. In six months' time, we will have a first version of what you have just described, and we will be in a better position to determine whether we need to intervene or not.

Mr. Mark Carney: It will be February or March, I believe.

[*English*]

The Chair: Merci.

We'll go now to Mr. McKay, please.

Hon. John McKay: Thank you, Chair.

Thank you again, Mr. Carney.

I want to go back to this issue of this recovery that doesn't feel like a recovery. Some have described it as a jobless recovery. I look at chart 14 in your report, which shows that there's excess supply that remains in the Canadian economy. It's consistent with my own family's experience, where I have a nephew who's a recent graduate of an engineering school, had a job, and got laid off. Another one was a graduate of a business school, had a job, and got laid off. Both of them are struggling to find work. It's consistent with my own constituency's difficulties with people having work.

Then we read in this morning's paper that the stats on EI are actually kind of stale-dated information. You look at the U.S., and their unemployment rates are twice normal rates, around 9% or 10%. Ours are up there as well.

So I'm wondering whether we're actually looking at, if you will, structural unemployment going forward within the near term to medium term, that both from your own information and from observations abroad, it would appear the new normal will be unemployment rates of 8% to 10% in Canada, which will be largely parallelled by the U.S. I would be interested in your observations on that.

Mr. Paul Jenkins: Perhaps I can lead off in response to the question.

I think one of the very impressive attributes of the Canadian economy that we've seen over the last five to ten years has been the flexibility in the Canadian economy, including in the labour market, where we've actually been able to respond to shocks. That's not to say it's been easy, but we have been able to do it.

Perhaps a little bit to Monsieur Mulcair's question, I think that as a nation we need to continue to pursue policies that actually continue to help us increase what I would call the economic efficiency of Canada, our ability to adapt. Most of the shocks that we've had to deal with over the last 15 or 20 years have come from outside Canada. I have been very impressed with the flexibility of the Canadian labour market, so I would not subscribe to the view that you've just put forward in terms of structural adjustment, structural unemployment.

What we will have, without doubt, going forward will be a need to continue to focus on some restructuring of the Canadian economy in response to what we have gone through. I'm absolutely confident we will make that adjustment, but it will take continued persistent effort to bring that restructuring about.

Hon. John McKay: I'm very impressed by the ability of Canadians to adjust to changing labour conditions. I don't disagree with you on that point. I'm somewhat less impressed by government's response to changing conditions, and the apparent unwillingness to actually engage in the new economies, to encourage the new economies, and things of that nature.

So it appears to me that in some respects Canadians are on their own, that they are going to have to adjust, that they are going to have to look at reduced work hours for quite a while. They're going to be looking at other forms of employment, where you pick up a little bit of a job here, and a little bit of a job there, and put it all together to pay your bills.

Can you give a suggestion as to a policy response that you think would be most efficacious, given this potential of protracted unemployment?

● (1225)

Mr. Paul Jenkins: The governor has talked about initiatives on the financial side. On the real side of the economy, an area that we need to continue to put focus on is the removal of interprovincial trade barriers. I really do think that is an issue that—although we've made some progress on it—continues to be important, and it very much is in the context of having an economic union that can operate effectively in response to changes in the world that are going to continue to affect us. That would certainly be one very important aspect.

The other element the governor touched on is that when you look forward, this changing composition of demand globally is going to be critical. We've talked about the fact that U.S. savings rates have to go up. That means the U.S. consumer is going to be buying less through that adjustment period, and there will be more reliance on growth in Asia. So these are going to be the markets that are going to be growing very rapidly. We have comparative advantage in a number of industries that we can sell into these markets, I believe.

The Chair: Mr. Laforest.

[*Translation*]

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

Mr. Carney, I want to come back to the speech you gave yesterday. You said that in order to prevent another financial crisis, the Bank of Canada wants to rely more heavily on principles-based regulation and the judgment of people.

From a practical perspective, we have just come through a financial crisis that may not be completely over. The Caisse de dépôt et placement du Québec suffered $40 billion in losses, and a large chunk of that was the result of investing heavily in commercial paper. The answers we have been hearing have a lot to do with the fact that we were relying on the judgment of certain people, and I get the feeling that their judgment was not very good.

It really makes me wonder when you say that you want to prevent another financial crisis by relying more heavily on people's judgment.

Mr. Mark Carney: I understand your concern, but I never said that.

Mr. Jean-Yves Laforest: So, it is a translation error?

Mr. Mark Carney: No, it is not the translation.

The Bank of Canada has a strong preference for principles-based regulation and reliance on the judgment of people rather than blind faith in the security blanket of excess capital, but against the backdrop of a new regulatory framework for institutions, an increase in tier 1 capital and the creation of a macroprudential buffer for banks.

The creation of a new macroprudential or countercyclical buffer will be key in preventing future crises and reducing bubbles. That is a critical part of OSFI's work. A number of factors are at play, but against the backdrop of a new regulatory framework, the G20 framework, we must rely on the judgment of individuals, regulators and companies.

Mr. Jean-Yves Laforest: What I understand from your answer is that you agree with me that a lot of people showed a lack of judgment.

● (1230)

Mr. Mark Carney: Before the crisis and during the crisis, yes, absolutely.

Mr. Jean-Yves Laforest: Surely, you have reserve funds. Is there still a lot of money in the foreign exchange account, which is one, if not the main, reserve of the Bank of Canada? When was the last time you used the account? Do you expect to use it to bring down the value of the loonie, if it gets too close to the American dollar?

[*English*]

Mr. Mark Carney: The exchange fund account is the reserves of the Government of Canada. The bank acts as an agent for the Government of Canada in the management of those reserves. Those reserves have built up gradually in recent years. Part of the increase in reserves has been a result of some recent reforms to the IMF, the International Monetary Fund. Just for clarity in answering the question, I refer the committee to previous answers on the issue of the exchange.

For clarity in answering the question, in the case of intervention to slow the appreciation of the currency, it is not an issue of using reserves; it is an issue of adding to reserves. Intervention in that form would add to the reserves of the country, as opposed to using them. They're not bound by the level of those reserves.

That is no more than a direct factual response to the question.

[*Translation*]

Mr. Jean-Yves Laforest: Thank you.

[*English*]

The Chair: Merci, Monsieur Laforest.

We'll go to Mr. Wallace, please.

Mr. Mike Wallace (Burlington, CPC): I'd like to thank the governor and the deputy governor for coming and joining us. This is your semi-annual visit to be held with us. I appreciate the answers you've been giving over the last hour and half.

I only have a couple of issues, and there are hopefully no politics involved in them.

On your estimate, for example, of the 3% growth for next year, and I think 3.3% or something like that for the year after, is that strictly based on your modelling? We heard—as a member of the finance committee—from another organization this week that talked about the fact that there's a variety of opinions out there. Some organizations look at what they're doing and we take an average.

Is it strictly your modelling, and you're not paying much attention to what everybody else is doing?

Mr. Mark Carney: It is much more than just economic modelling. We discussed in the past that we have a series of economic models, over twenty economic models, that we use to form our judgments about the outlook for growth in Canada. Those judgments, though, are informed by meetings with all the major sectors in our economy, from energy, through manufacturing, through the retail sectors, etc. It's the work our regional offices do on the field—a lot of work—the formal surveys that we do, and we have published our most recent one. Then it's the responsibility of the governing council, very much informed by the institution. From all this information, all this technical modelling, it is the responsibility of the senior deputy governor, myself, and the four deputy governors on the governing council to form the judgment of the projection for the global and Canadian economy. We are responsible for that projection, and it is a mixture, Mr. Wallace, of technical, of survey, face-to-face meetings, and judgment.

Mr. Mike Wallace: I appreciate that. I'm understanding that.

On page 24 there's a chart that says the recovery in Canada should be more modest than in previous cycles. It's an interesting chart. Is it really fair to compare this recovery, this cycle, to other cycles? I think it goes all the way back to 1961. The economics of the day, the variables, the conditions are so vastly different from what was happening in 1961, from what was happening in the seventies, eighties, or nineties. What's the use of that chart, to be perfectly honest with you?

Mr. Mark Carney: I think there are a couple of uses of it. The reason we put it in is to compare it to page 10, which is the American outlook, which is the slowest recovery in the United States since the Great Depression. If you could see, for example, their build-up for this, it's not in the report.... For example, consumption in the United States is very weak relative to previous recoveries. The reason we go back to the 1930s for the U.S. and only back to 1961 for Canada is a question of data. Statistics Canada didn't start to have the quarterly data, so you can't reconstruct this chart.

I think it's because we thought that it was important, first for comparison, but then secondly, to give some context to what is a recovery. We get as many people telling us that they think the recovery is going to be too fast as people who tell us that they think it's going to be too slow. Certainly the recovery over our horizon, in the next two years, will not be as strong relative to previous ones. It's an important element relative to the amount of excess capacity slack we have in the economy, and therefore how much time it takes to use that up, and therefore what the pressures are on inflation and where our policy is.

● (1235)

Mr. Mike Wallace: Wouldn't it be better for us to have a chart showing the recovery of let's say the G-7 and how we compare against our competitors, in the current timeframe, based on the relatively similar conditions they're facing at the time? Does that chart actually exist?

Mr. Mark Carney: We can construct that chart. It won't be perfect on a quarterly basis for the other comparatives, but we are happy to construct that chart and circulate it to the committee.

The Chair: Thank you, Mr. Wallace.

We'll go to Mr. Pacetti.

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

The committee was in Washington in the month of June. We met with senators, congressmen, and regulators. There was a consensus that regulatory reform was needed, but there didn't seem to be a consensus on how that was going to be conducted. There's been a lot of speculation. There have been a lot of things written. I'm just wondering what is going on in the international scene, and how is that going to affect Canada?

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

This is quite important. It is imperative that the various reforms we've talked about this morning be consistent with the G-20 agreement, that they are agreed to at an international level. The crisis came from abroad and had a severe impact on Canada. So we need others to get their houses in order. That's the first point.

A related point is that we don't want to disadvantage our system by putting in place rules that others haven't put in place. Let's put it this way. That's a discrete decision that needs to be taken by the relevant Canadian authorities, but it would be far better if these were agreed to and implemented at an international level.

There is a long list of reforms. A key issue, just to give you a feel, is the work that's being done on bank capital—what's the new minimum going to be? What will this countercyclical buffer look like? Is there going to be a leverage ratio as an agreement by leaders and by the relevant committee in Basel? What will it look like?

Canada has higher minimums. Canada has a leverage ratio. We are starting from the right position on this, but we need to get others to agree to reduce the risk.

Mr. Massimo Pacetti: What's the holdup?

Mr. Mark Carney: These are major decisions. Part of the issue is that a number of other economies are short of capital, and these regulations will accelerate the need to increase capital. So we have to calibrate the new impact studies.

Mr. Massimo Pacetti: Can't you ask that it be ramped up progressively or for a number of years?

Mr. Mark Carney: Yes. We have to get the transition right. We have to agree on that. We're on an accelerated basis. We've agreed to main principles. We're going to do the right impact studies over the course of the next six or nine months of 2010. The target, explicitly, and this was agreed to and publicly announced, is to have the pin put in—the actual numbers for these levels—and the formulae by the end of 2010. So it's coming soon.

The second thing, if I may, which is very important internationally and is difficult to implement, is moving standardized over-the-counter derivatives onto public platforms, such as clearing houses or exchanges. I talked earlier about repo, which is short-term funding, but these are credit derivatives and interest rate swaps. It is tens and trillions of dollars

[*Translation*]

—billions of dollars, in French.

● (1240)

[*English*]

Mr. Massimo Pacetti: That's what I was going to get to as well. Is there a holdup in North American countries or European countries, or is there just a general fall behind—I'm looking for the proper word—in countries across the G-20?

Mr. Mark Carney: We are working hard to ensure....

Mr. Massimo Pacetti: Can we name somebody?

Mr. Mark Carney: We're working hard to ensure that there is no holdup, and I would say that in the last week a number of central bank governors have commented on the urgency of these reforms and their implementation.

Mr. Massimo Pacetti: Okay. Getting back to the repo, how does that work in Canada? It's the first time I've heard that term. Is that the Bank of Canada's role?

Mr. Mark Carney: Repo is basically short-term lending that is collateralized against a bond. The simplest is against a government bond. You have a government bond and you give it to me for two days. I give you cash. You pay me interest, but you are protected.

Mr. Mark Carney: It should be a private market. When we lend, when we provide liquidity to the system, we do it on what is very effectively a repo-type transaction when we provide exceptional liquidity. But we're not talking about a central bank market; we're talking about a private market that is much deeper and broader elsewhere than in Canada, and our position is to the detriment, we think, of our system. This crisis presents an opportunity to redesign that market, and we are working with industry to help them redesign—

Mr. Massimo Pacetti: But it has to be done quite quickly, because I'm seeing that short sales are coming back in vogue.

The Chair: Just very briefly.

Mr. Mark Carney: The repo would not address the short-selling issue, but the broader regulatory reform. The broader agenda is moving quickly, but this implementation, even on track, will be with us collectively through 2010, just to guide expectations.

The Chair: Thank you.

Thank you, Mr. Pacetti.

We'll go to Mr. Dechert, please.

Mr. Bob Dechert: Thank you, Mr. Chair.

Governor Carney, we talked earlier about the value of the Canadian dollar, and you rightly point out it's a source of concern. We're not out of the woods yet by any means, given what that might do to manufacturing in this country. But isn't the value of the Canadian dollar really an international vote of confidence in the Canadian economy and the management of the Canadian economy in comparison with other industrialized nations?

Mr. Mark Carney: Currency levels, whether it's the Canadian currency or other currencies, are the product of a variety of fundamental factors: movements in terms of trade, current account positions, fiscal positions, relative interest rate positions, expectations on interest rates and capital inflows, etc. So it is difficult to isolate one particular factor for any particular currency.

Mr. Bob Dechert: Certainly people wouldn't be buying Canadian dollars if they thought the economy was doing worse than our major competitors, one would expect.

If the Canadian dollar remains relatively high compared to the value of the U.S. dollar, for example, how important are Canadian corporate and business tax rates to maintaining the competitiveness of our Canadian economy? If the Canadian dollar is taking us in one direction, what would you say about tax rates and where they should go over the next little while?

Mr. Mark Carney: I believe you'll have the opportunity to meet with the Minister of Finance later today, so I would suggest.... I would prefer not to comment directly on fiscal matters.

I would say again, though, we take those decisions that are ultimately taken by parliamentarians as given and then we take those into account in our outlook for the economy in conjunction with the exchange rate. Other external factors determine the outlook for inflation, and we set policy appropriately in that context.

Mr. Bob Dechert: Thank you for that.

Can you comment on Canada's debt-to-GDP ratio versus those of other G-7 countries—where we are now, and where you see that going over the next few years?

Mr. Mark Carney: Canada entered this crisis with a net debt-to-GDP ratio that was lower than its G-7 peers. On current estimates—OECD estimates or IMF estimates—everybody's net debt-to-GDP ratios are going to go up because of the fiscal stimulus that's been put in place, but Canada is not expected, on the basis of those external analyses, to lose that lowest position in the shorter-term forecast horizon.

● (1245)

Mr. Bob Dechert: Do I have any more time?

The Chair: You have two minutes.

Mr. Bob Dechert: Ms. Block was going to ask a question, and then I think Daryl Kramp may want to.

The Chair: Mr. Carney, I want to follow up on the discussion we were having. I have just one quick question then.

Under protecting the cycle from the banks, this will mean that parties will have to put more capital into the exchange, as I understand it, and more reserves. It's a more stable system, but my understanding is the total amount of credit will be less. Is that a correct understanding, and if so, does that present us with another policy challenge? Because this committee has also been looking at access to credit issues. So if you just want to address that briefly, I'd appreciate that.

Mr. Mark Carney: The general equilibrium result does not necessarily mean that credit available to households and businesses will be reduced as a result of these reforms, and that is part of the job of the impact study that is performed through this Basel committee, the international committee. It's partly what it means for the banks, but also what all these changes mean collectively—what are they likely to mean for economies and for availability of credit?

The other issue, Mr. Chair, is how attractive, in relative terms, is lending from a capital perspective versus trading in capital markets activities. One of the things the crisis has revealed is that the amount of capital that was set aside under Basel II regulations was very low relative to the activity in trading books and capital markets activities. Now, that has been very quickly rectified with an adjustment for trading-book capital. I would defer to the Superintendent of Financial Institutions, but I believe that is coming into force in the first quarter. It is agreed, but it's effectively coming into force now.

The Chair: I appreciate that clarification.

I will go to Mr. McCallum, please.

Hon. John McCallum: I appreciate having a third opportunity.

This might be a lob-ball question, in a sense. I think over the years there's a certain cyclical reappearance of this idea that we should abandon flexible exchange rates and inflation targeting and move to some common North American currency or dollarization or fixed exchange rate. This idea was put about when the currency was very low. I just saw last week an argument to this effect put forward in *The Globe and Mail*. As I think you know, I've always favoured the status quo, and I wonder if you could explain why you believe that the flexible exchange rate and inflation targeting is better for Canada on economic grounds than some sort of North American common currency.

Mr. Mark Carney: Thank you. It's a very important question. I recognize that you've done some of the important research on the issue.

The first time I came before this committee was in the fall, about two years ago, and we had a brief discussion of this issue at that time, but there's certainly nothing that we've seen through the intervening years, through the course of the crisis, that has lessened our view that Canada is well served by having the policy combination of a floating exchange rate and inflation targeting. If anything, that view has been reinforced.

Let me talk briefly about some of the advantages of a floating exchange rate. First, I think we have to recognize that there are going to be shocks on the real side of the economy—domestically, internationally, commodity prices, etc.—and our economy is going to have to adjust to those shocks in some way. The exchange rate acts first as a shock absorber that adjusts in real time quickly to those shocks, which helps our economy to move in the right direction. The alternative to those adjustments is wholesale adjustments of wages and prices that are much more painful and much more protracted than the adjustments, as you know, that can come from the exchange rate.

We saw that in the Asian crisis, the weakness that came from the Asian crisis. Our dollar moved during that in anticipation, as it turns out, of the weakness that ultimately was going to come in commodity prices, importantly, which helped our economy through it. The dollar has moved in the recent past in anticipation of commodities' strengths, in terms of trade strength and relative advantages, which again has helped our economy adjust.

With a fixed exchange rate you still need that adjustment, and you're going to get it in a more painful fashion. One sees that in regional effects in the United States and in Europe as a result of this crisis, where there are needs for real adjustment, but with a fixed exchange rate they are much more painful adjustments. One is better served having a flexible exchange rate or having effectively the same industrial composition, the same composition of the economy, across the countries in the common currency area.

The other thing we would emphasize is that the advantages of fixed exchange rates are largely micro-economic—the move to the fixed exchange rate, lower transaction costs, lower uncertainty, and in some cases lower borrowing costs and enhanced policy credibility. Well, the Government of Canada has—and it has just been reinforced by the U.S. dollar issue the government did within the past three months—one of the lowest borrowing rates in the world; it is one of the best credits in the world. We would be hard-pressed to improve our borrowing costs, as many European countries did, and from a policy credibility perspective I think we feel that both on the monetary and fiscal side we do have that.

So it's hard to see the upside. It's easy to see the downside.

● (1250)

Hon. John McCallum: Thank you.

I have one last quick question. I agree with what you said, but what do you say to the manufacturer who longs for certainty and would like nothing more than a dollar fixed at, say, 92¢ forever?

Mr. Mark Carney: We say, first, that we will conduct our policy to provide the maximum certainty on inflation. That policy consistency reduces overall uncertainty for that manufacturer. It reduces borrowing costs, cost of capital in this country, which helps.

Secondly, we would say that movements in exchange rate do provide important information about where economic forces are going and provide important signals. They also provide, as Mr. Bernier referred to earlier, some advantages in terms of capital investment and otherwise.

All things taken together for the economy as a whole, and that's our job and yours as well to think about, it is our clear view that the advantages of a floating exchange rate, combined with a credible monetary policy framework—that's crucial—far outweigh the perceived advantages of a fixed exchange rate.

The Chair: Thank you.

We'll go to Mr. Kramp.

Mr. Daryl Kramp: Thank you.

In winding this session down, let me take this opportunity, both independently and on behalf of the Government of Canada and I would assume the vast majority of people assembled here today and certainly a great number of Canadians, to thank you and tell you that we appreciate your diligence in dealing with this as an unseen, unpredicted by many, circumstance. We're thankful, but if I might just suggest, there are also concerns. I'd like to know, just how close to empty were we in the tank?

In other words, Mr. McCallum and others mentioned that there have been various instruments at your disposal to deal with the problems and difficulties we had, whether those are interest rates or the condition of quantitative easing that you discussed. As a good poker player, did you still have an ace up your sleeve, per se? Did you have cards left to play, so that had we been in a more dire situation or should we return to a dire situation, we'd have a means by which to deal with it?

Mr. Mark Carney: Thank you for the question.

Yes. We have consistently emphasized that the Bank of Canada retains considerable flexibility in the conduct of monetary policy. We were at pains, as you recall, to outline the principles behind policy at very low interest rates—so-called unconventional policy. We have not had to deploy those instruments beyond the conditional commitment, with which you're familiar, but we certainly retain all those other options. I would underscore our determination to use those options if the situation required it in order to achieve the inflation target, but we would only use them to the extent that they were required to achieve the inflation target.

So to go back to your analogy, no, the tank is full. It's like the pickup trucks that used to have two tanks: the interest rate tank had been used up, but we switched over to a full tank of unconventional. We haven't had to use it.

In our expectation, just to underscore for members of the committee, we think policy is set appropriately in order to achieve that target, staying at 0.25%. We expect to stay there through the end of June 2010 on current outlook for the global and Canadian economies in order to achieve that inflation target.

● (1255)

Mr. Daryl Kramp: Fine. Thank you.

What I'd just ask you as well, then, as Parliament proceeds into the future, is that if you have any thoughts or deliberations as to other regulatory measures we might consider to help prepare us to keep an additional level of fuel capacity, we would be most appreciative.

The Chair: Did you want to respond to that, Governor?

Mr. Mark Carney: I think it deserves a more fulsome response at the appropriate time. We defer to the proposals of the government in due course.

The Chair: Thank you.

We'll go to Mr. Mulcair for the final round.

[*Translation*]

Mr. Thomas Mulcair: Thank you, Mr. Chair.

I am sure that the minister appreciates your concern, but one of the reasons for these meetings is precisely so we can benefit from your unique expertise. As other members have already said—and I am very sincere in agreeing with them—we have confidence in you, in your ability to analyze the facts and to give us recommendations, when necessary, not only in response to what we have already done, but also as potential guidance for the future.

I want to come back to the first question I asked you the first time we met, a question that is a lingering concern for me. Even if you look through the lens of 2% inflation, are you concerned about whether we will be able to generate inflation ourselves by changing oil reserves and printing more money? With the money coming in, Canada has become an oil powerhouse. Will we experience the same kind of instability as the Netherlands did in the 1950s, when it generated incredible oil wealth but wiped out whole sectors of its economy, namely the manufacturing sector?

Are there issues that cause you to lose sleep at night and that we should be studying?

Mr. Mark Carney: Thank you.

The Bank of Canada's biggest concern in the medium term is the extensive restructuring of the global economy. We have just come out of a major global recession. For Canada, that means that demand sources will be changing. We need to make significant changes to our trade strategies and our markets, both now and in the future, which will have legislative consequences.

The Bank of Canada seeks to control inflation, but we also work very closely with the Office of the Superintendent of Financial Institutions, the Department of Finance and our international counterparts. We absolutely have to address all of these issues surrounding the financial system. That is key.

[*English*]

Mr. Thomas Mulcair: It's a pleasure to meet with you, as usual, Governor Carney.

In the two minutes left I'd like you to elaborate a little on that for us. You've given us some indication of what has to be done. Do you have any great fear that we might have missed something; that this deep recession you've just described might be the first of two or three if we haven't got everything right? Is there a real danger that there might be another trough waiting for us once we walk out of this one?

● (1300)

Mr. Mark Carney: There is a danger that the recovery outside our borders has limited momentum that will further deepen the restructuring we need to do in our economy. There is also a risk—in the spirit of the discussion today—that the agenda of the G-20 will not be properly implemented in a timely fashion. This is going to get very technical very quickly. It would serve us all well if people were well informed about the key technical aspects.

Yes, the devil's in the detail, but this is an important agenda. It's been agreed on by heads of state. Canada can help lead on it, but it needs to get done. Going back to the division of labour, it's our job to work with those who have primary responsibility to ensure that this gets done.

The Chair: Thank you, Mr. Mulcair.

Thank you, Mr. Carney and Mr. Jenkins, for being with us here today and responding on a whole series of very challenging and thoughtful issues. We want to especially thank you for being with us and engaging parliamentarians for a full two hours. We appreciate that. We look forward to your visit in the next six months, or any time you want to come back.

Colleagues, I think we had a very good discussion today. We will have the Minister of Finance with us here this afternoon, so we'll see you back here at 3:30.

Thank you again.

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