David Longworth: Promoting stability, confidence and well-being

Remarks by Mr David Longworth, Deputy Governor of the Bank of Canada, to the Greater Kitchener Waterloo Chamber of Commerce, Waterloo, Ontario, 6 February 2007.

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Good afternoon. It's good to be in Kitchener-Waterloo, an urban region well known for its dynamism. GDP growth here is among the fastest of all regions in the province.

The strengths of the twin cities – in research, advanced manufacturing, and information technology, among other sectors – are well known. Less well known, perhaps, is the region's success in responding effectively to changes in the world economy. From the making of shoes and buttons to digital imaging and advanced communications, this ongoing success in dealing with change is a testament to your flexibility and entrepreneurial spirit. It may also reflect the emphasis this region has long placed on training and education. Education acts as a kind of bedrock, a foundation that helps people deal with change and face the future with confidence.

Change is often difficult. As you know, this region has had to cope with a good deal of difficult economic adjustment. What *can* make change easier to deal with is a backdrop of stability in underlying policy fundamentals. That is what the Bank of Canada can help to provide.

As the nation's central bank, the Bank of Canada has a mandate to promote economic and financial stability and well-being. To fulfill this mandate, we work in three main areas: conducting monetary policy, promoting a safe, sound, and efficient financial system, and designing and issuing secure bank notes. In my remarks today, I'd like to explain this work. A useful way to do this is to outline, for each area of responsibility, the goal, and the means by which we try to achieve that goal, and then provide an assessment of how we've been doing, as well as our plans for improvement.

Let me start by describing our work in monetary policy.

Monetary policy

The ultimate aim of Canadian monetary policy is to help our economy achieve its maximum sustainable growth, and thus contribute to rising living standards for Canadians. The best way to achieve this objective, we've learned from experience, is by working towards a specific, concrete goal – that of keeping inflation low, stable, and predictable.

Inflation control contributes to better economic performance in many ways. Let me highlight two of them. First, low and stable inflation allows us to read price signals clearly, which in turn helps both individuals and companies to make sound, long-term economic decisions. If you recall the 1970s and early 1980s, when inflation was *not* contained – when it was both high and variable – you'll remember the high degree of uncertainty that prevailed then. Prices were hard to compare and hard to predict. As a result of this uncertainty, people found it difficult to make sound spending and investment decisions. Investors wouldn't commit resources for long periods of time; labour negotiations were acrimonious; and the overall economy was not as productive as it could have been. Happily, this experience can now be relegated to the "bad old days." So that's one advantage of inflation control – greater certainty about the future value of money.

Second, when inflation is contained, and monetary policy is set to keep the economy running close to capacity, we can deal more effectively with economic shocks. Resources can more easily be reallocated from sectors where demand is relatively weak to sectors where demand is relatively strong. This is especially important during periods when there are large movements in relative prices – that is, in the prices of some goods and services relative to other prices – such as we've seen in recent years. Over the past five years, energy and non-energy commodity prices have gone up a good deal in comparison with those of non-commodity manufactured goods, and the exchange rate has changed considerably, further affecting the prices of many goods. Yet overall, the economy has adjusted well against the backdrop of low, stable inflation.

To summarize: keeping inflation low and stable gives people confidence – confidence in the future value of their money, confidence in their financial decisions, and confidence in the ability of the economy to withstand shocks and grow in a sustainable fashion.

Since 1991, to help us keep inflation low and stable, the Bank of Canada and the Government of Canada have had an explicit inflation target. And since 1995, the target has been the 2 per cent midpoint of a 1 to 3 per cent range. The inflation target helps to anchor people's expectations of inflation, and that in itself helps to keep inflation low and the economy relatively stable. The target also helps us in our deliberations and decision making at the Bank of Canada. I should also mention that the inflation target has another important benefit – it makes us more accountable for our actions.

How does the target guide our decision making at the Bank? Well, if the economy is moving above the limits of its capacity, so that the trend of inflation threatens to exceed the target, we tend to raise interest rates, all other things being equal. This restrains demand in the economy and brings it back into balance with supply, thus helping to reduce inflation pressures and return inflation to target. Conversely, if the economy is moving below its capacity limits and the trend of inflation is likely to fall below the target, we tend to lower interest rates. This stimulates demand and brings it back in line with supply, thus bringing inflation back up to target. This symmetric approach to monetary policy has a stabilizing influence on the economy, and thus helps to prevent costly boom-and-bust cycles.

So, that's the goal and the strategy for achieving it. How well have we done in pursuing the objective? The simple answer is: very well indeed. Let's look at developments in four key areas.

First, inflation, as measured by the all-item consumer price index. Since 1995, inflation has been low and on target, averaging 2 per cent per year. Over the same period, inflation has also been stable – it's been within the 1 to 3 per cent control range 80 per cent of the time – and thus significantly less volatile than it was in the period before targeting. Finally, inflation has become predictable – forecasters and financial markets appear to believe that the Bank will continue to keep inflation near the target. In fact, the consensus forecast for 2008 and beyond is for an inflation rate of almost exactly 2 per cent.

Second, interest rates. Interest rates are important to all Canadians. Again, with inflation targeting, both short- and long-term interest rates have been lower and less volatile than in the past. As a result, borrowing and investment decisions can now be made with greater certainty. And interestingly, in contrast to what might have been deemed possible just a decade ago, interest rates in Canada are currently lower – and long-term rates have become more stable – than they are in the United States.

The third variable I'll mention is output. The growth of output, which is a good indicator of the overall health of the economy, has been generally higher, and significantly more stable over this time period. Part of the reason for this stability is inflation control. A stable price environment can help the economy to adjust quickly and effectively to economic shocks – events such as 9/11 and the Asian financial crisis of 1997-98. And in fact, Canada has not experienced a recession since 1991.

Finally, labour markets. Labour markets have also shown a significant improvement. Time lost to labour disruptions has decreased, the length of union contracts has increased, and the unemployment rate has fallen to a 30-year low.

So that's the big picture, and it's a favourable one. I'd like to say a few words now about the current situation – how we've done recently in pursuing our monetary policy objective. In a nutshell, the economy is doing well, and inflation is close to target. Total CPI inflation is 1.6 per cent, or 2.1 per cent if adjusted for the change last year in the GST and other indirect taxes. Core inflation, which excludes eight of the most volatile components of the consumer price index, as well as the effect of changes in indirect taxes, provides a useful guide for the conduct of monetary policy. It is now at 2 per cent. The economy is currently judged to be operating at, or just above, its potential, and the outlook to 2008 is for it to remain close to potential. The outlook is for core inflation to remain near 2 per cent from now to the end of 2008, and for total CPI inflation to return to the 2 per cent target early next year. If you're interested, you can read more about our take on the Canadian economy in last month's *Monetary Policy Report Update.*

So, as you can see, low and stable inflation is a means to a very important end – sustained economic growth.

Overall, then, monetary policy has been successful in achieving its objective. But can we do better?

We might be able to improve upon the current inflation target. Last November, you may have heard that the Bank and the Government of Canada renewed the 2 per cent inflation target for a five-year period. What you may not have heard was that the agreement committed the Bank to continuing its research on how monetary policy might be improved for the decades ahead. The goal, as always, is to have a monetary policy regime that contributes most effectively to overall economic performance.

Two of the key issues we'll be looking at are, first, the costs and benefits of having a lower inflation target, and second, the costs and benefits of having a "price-level" target instead of an inflation target. A price-level target is similar to an inflation target, except that higher-than-target inflation in one time period needs to be offset by lower-than-target inflation in the next time period, and vice versa. If inflation comes in lower than target over a certain time period, monetary policy will be focused on raising inflation beyond the target over the subsequent time period. In price-level targeting, the past is not "forgotten," but must be offset, so that average inflation becomes somewhat more predictable over longer periods of time than it is with inflation targeting.

Over the next few years, we'll also be focusing our research efforts on several other important issues. We'd like to better understand the implications of globalization for the Canadian economy, including the implications for inflation in Canada. We'd like to improve our understanding of the sectoral and regional aspects of economic adjustment. And we'd like to look at how productivity and demographic change affect the economy's potential to grow.

Now I'll turn to the second area in which we promote economic well-being – the financial system.

The financial system

I should start here by saying just exactly what I mean by the financial system. The financial system consists of three main elements – institutions, such as banks and credit unions; financial markets, such as the bond and equity markets; and clearing and settlement systems, such as the Large Value Transfer System, which handles large-value and time-sensitive payments.

It's through the financial system that savings become productive investments, money and financial claims are transferred and settled, and risks are effectively allocated. Because it deals with promises to pay, the financial system depends to a very large extent on confidence. Individuals and institutions need to be confident that commitments will be honoured, and that the system will work, even in times of turbulence.

The Bank of Canada's objective here, then, is to promote the stability and efficiency of the financial system – which in turn encourages people to have confidence in it.

There are three direct means by which the Bank promotes financial system stability, and one indirect means by which we promote both stability and efficiency.

First, we oversee Canada's main clearing and settlement systems. These are the systems that transfer hundreds of billions of dollars of financial assets each day. These systems are designed to make sure that all financial claims they deal with will be honoured – even if a large participant were to fail. The focus of the Bank's work is making sure that key systemic risks are identified, and establishing minimum standards to control that risk. With these risk-control standards in place, the private sector operators of the system can find the most efficient way to meet them.

Second, we provide liquidity, both on a routine basis and in times of system-wide financial stress. An appropriate amount of liquidity helps to keep markets operating smoothly, and is thus vital to the stability and efficiency of the financial system. On a routine basis, the Bank provides overnight credit to financial institutions to cover any temporary shortfalls that arise in the payments system. These overnight loans help to stabilize the system, and they reduce the need for participants to hold large precautionary balances at the central bank. From time to time, there are shocks that can stress the whole financial system – a stock market crash, for example, or a terrorist attack – and these shocks can increase the demand for liquidity. In such a situation, the Bank of Canada can increase the supply of liquidity to support the smooth functioning of the system, and/or indicate publicly that it is willing to provide liquidity as needed. For example, following the terrorist attacks of 9/11, the Bank increased the supply of liquidity in the payments system to $1 billion from the then-typical $50 million.

Third, as the country's "lender of last resort," the Bank of Canada can step in to provide "Emergency Lending Assistance" to a solvent bank (or to other deposit-taking institutions covered by our policy) in the event of a serious liquidity problem. This kind of lending is aimed at preventing a loss of confidence in a solvent financial institution, as well as any spillover effects.

And fourth, we promote the stability and efficiency of the Canadian financial system by working in close co-operation with federal and provincial regulators, and public sector partners, and as a member of international bodies to strengthen the financial system worldwide. One of the main activities here is monitoring the domestic and international risks that have a bearing on the stability of the financial system. We communicate our research in speeches, in reports, and in our *Financial System Review*. I should also mention that as "fiscal agent" to the federal government, the Bank has a number of other responsibilities that also have an influence on stability and efficiency. For example, we provide policy advice to the government on how to fund the federal debt in a stable and low-cost manner. Related operations that we conduct on behalf of the government also tend to support the stability and efficiency of fixed-income markets.

Now, how well are we doing with this objective? Well, I said that the objective is to allow Canadians to have confidence in the country's financial system. On the financial stability side, we carry out a regular assessment of the risks in our *Financial System Review*. In December, our overall conclusion was that Canada's financial, non-financial, and household sectors are in good shape. This assessment reflects favourable fundamentals – especially solid domestic and global growth, and the prudent financial behaviour of business. Of course, there are always risks. In December, we mentioned the possible spillover effects of an abrupt slowdown in the U.S. economy, which may affect the financial health of customers of Canadian banks, and a possible disorderly resolution of the large, global current account imbalances, but the Canadian financial system appears to be in a good position to withstand such shocks, should they occur.

On the efficiency side, our view, as expressed in the Governor's December speech to the Economic Club of Toronto, is that Canada could be doing better in a number of areas, especially in the regulation of financial institutions, securities markets, and pension plans, and in the enforcement of laws governing securities markets.

In carrying out our financial system work, can we do better? A sound and efficient financial system requires constant vigilance. We plan to maintain this vigilance, and to continue our research into financial system issues to help us promote stability and improved efficiency. Specific goals for the next two or three years are: to develop a more formal framework to assess financial system stability; to improve the collection and use of financial data; and to enhance the ability of the financial system to continue operations in the face of serious disruptions. We also plan to have our financial system research and policy evaluated by an external party.

The third and final responsibility I'd like to look at is the design and distribution of bank notes.

Bank notes

Bank notes are the most tangible part of a central bank's work. Everyone uses paper money. I should point out something that might surprise some of you here in the "Technology Triangle" – despite the many alternatives to cash, the demand for cash continues to grow, roughly in line with nominal GDP growth.

The main objective of our bank note work is to provide Canadians with paper money that can be trusted – money we can use with (here's that word again) confidence. Of course, bank notes should also be beautiful, durable, and easy to handle, but if they can't be used with confidence, either because of high inflation or because of widespread counterfeiting, they lose much of their value.

What's our strategy for achieving this objective? Well, as I said earlier, the Bank is committed to keeping inflation low and predictable, and we have a pretty good track record on that front. To deter counterfeiting, we do three key things. First, we take a great deal of care in designing bank notes. As I speak, my colleagues at the Bank are hard at work designing the next generation of bank notes, planned for introduction beginning in 2011. A significant part of the design effort goes into making the notes secure against counterfeiting. Second, we conduct broad-ranging education efforts to help the public, retailers, and law-enforcement officers to authenticate genuine bank notes and detect counterfeit ones. In fact, if any of you would like some help in this regard, I invite you to go to our website and click on "Bank Notes," where you'll find some useful training material. Third, we promote vigorous law enforcement. We work closely with police forces and the Crown, and provide them with information and training that can help in the prosecution of counterfeiters. In 2004, the Bank launched an annual Law Enforcement Award of Excellence for Counterfeit Deterrence.

How well have we done in pursuing our bank note objective? I think a reasonable assessment would be "fairly well." Canadians *do have* confidence in their money. They use bank notes for day-to-day transactions without worrying unduly about counterfeiting.

Can we do better? We think we can. In addition to examining whether refinements to the monetary policy target would be worth pursuing, as I mentioned earlier, we believe that we can further reduce the incidence of counterfeiting. Specifically, by 2009, we aim to reduce the level of counterfeiting to fewer than 100 counterfeits detected annually per million notes in circulation, down from about 225 per million last year, and 470 two years ago. We also have plans to work with the RCMP to build a database of counterfeiting information. Finally, we intend to improve our bank note distribution system, and to monitor the use of alternative means of payment.

I'll conclude my remarks now.

Conclusion

I've discussed the three major areas of responsibility in which the Bank of Canada pursues its mandate – often together with partners – to promote the economic and financial well-being of the country. I'm sure you noticed how often I used the words "stability" and "confidence" in my remarks. Stability and confidence are the preconditions for strong economic and financial performance.

We aim to build on our successes as we continue to promote stability and earn the confidence of Canadians – and by doing so, we will further enhance the economic and financial well-being of Canadians.