Mark Carney: Canada's economic outlook and framework for unconventional monetary policy

Opening statement by Mr Mark Carney, Governor of the Bank of Canada, to the Standing Senate Committee on Banking, Trade and Commerce, Ottawa, 6 May 2009.

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Good afternoon, Mr. Chairman and committee members. Before Paul and I begin to answer your questions, allow me to take a moment to review some of the highlights and the conclusions from our latest *Monetary Policy Report*, released on 23 April. In particular, I would like to outline for you some of the details from the Bank's framework for unconventional monetary policy, which was published as an annex to the latest *MPR*.

The economic outlook

- These are difficult economic times, with the Canadian economy being buffeted by an intense and synchronized global recession. In recent months, that global recession has been exacerbated by delays in implementing measures to restore financial stability around the world.
- G-20 policy-makers are now responding to the global crisis with a renewed commitment to concrete initiatives and comprehensive plans. Our base-case projection is that these policies will be implemented in an effective and timely manner, and their impact will reach full force next year. Discussions in Washington at the end of April were consistent with that outlook.
- As a result of the current global economic and financial situation, the Bank now projects that the Canadian recession will be deeper than we projected in the January *MPR Update*. Our return to growth will be delayed by one quarter, to the end of 2009, and our recovery will be somewhat more gradual.
- The broad outlines of the Canadian outlook are the same as those in January, but its profile has shifted.
- Canada's real GDP is projected to decline by 3.0 per cent this year, and growth is expected to resume in the autumn and accelerate to 2.5 per cent in 2010, and 4.7 per cent in 2011.
- Our outlook for inflation is broadly consistent with that in January. Total inflation will temporarily fall below zero in 2009, but core and total CPI inflation are expected to return to the Bank's 2 per cent inflation target in the third quarter of 2011.
- In that context, on 21 April the Bank lowered the policy interest rate by 1/4 of a percentage point to 1/4 per cent, or 25 basis points, which is judged to be the *effective lower bound* of the policy rate. Conditional on the outlook for inflation, the Bank has committed to holding this rate at 1/4 per cent until the end of June 2010. I will elaborate on this conditional commitment in a moment.
- In total, since December 2007, we have cut interest rates by 425 basis points to their historic lows and lowest possible levels. It is the Bank's judgment that this cumulative easing, together with the conditional commitment to keep rates low for a considerable period, is the appropriate policy stance to move the economy back to full production capacity and to achieve the 2 per cent inflation target.

A framework for conducting monetary policy at low interest rates

- However, these are uncertain times and if additional stimulus were to become necessary, the Bank retains considerable flexibility in the conduct of monetary policy at low interest rates.
- We have outlined in detail how we would use that flexibility in conducting monetary policy at the effective lower bound, in the framework published in our recent *MPR*. In this document, we describe the unconventional instruments that are available, the principles that would govern our use of these tools – should we decide to apply them – and the exit strategies that we would employ when these instruments were no longer necessary.
- The three key instruments we have identified for conducting monetary policy at the effective lower bound include: conditional statements about the future path of policy interest rates; *quantitative easing,* which involves the creation of central bank reserves to purchase financial assets; and credit easing, which includes outright purchases of private sector assets.
- If required, these instruments could be used separately or in tandem to improve financial conditions in order to support aggregate demand and ultimately achieve the inflation target.
- As you are aware, the Bank deployed the first instrument on 21 April. As a result of our conditional commitment to keep rates at 25 basis points through the end of June 2010, interest rates across the maturity horizon of the commitment fell. They also dropped relative to those in the U.S.
- Let me reiterate that the Bank's conditional commitment is not a guarantee. It is conditional on the outlook for inflation. We will always set our policy rate at a level consistent with achieving our 2 per cent inflation target over the policy horizon.
- Similarly, if the Bank were to deploy either quantitative easing or credit easing, it would act in a deliberate fashion based on the following principles:
  - (i) The **focus** of these operations would be to improve overall financial conditions in order to support aggregate demand and achieve the inflation target.
  - (ii) Asset purchases would be concentrated in maturity ranges in order to have the maximum **impact** on the economy.
  - (iii) Actions would be taken in as broad and **neutral** a manner as possible.
  - (iv) The Bank would act **prudently**, mitigating the risks to its balance sheet and managing its ultimate exit from such strategies at an appropriately measured pace.
- If we were to use these unconventional policy measures, the Bank would closely monitor a number of indicators to assess their effectiveness.
- The most important would be the effect on overall financing conditions faced by households and businesses.
- Other indicators would be used to judge the direct impact of a particular instrument. For example:
  - o The effectiveness of conditional statements about the future policy rate can be judged by their impact on longer-term interest rates. As I mentioned a moment ago, we saw almost immediately the impact of our 21 April policy interest rate announcement.

- The effectiveness of quantitative easing would be judged in the first instance by a change in the yield curve and more generally by movements in broader financial conditions.
- That of credit easing would be judged by reductions in risky spreads and increased issuance activity.
- Changes in credit terms and in the conditions faced by firms can also be assessed using the Bank's *Business Outlook Survey* and its *Senior Loan Officer Survey*.
- In addition, the Bank has constructed measures of borrowing costs and an overall financial conditions index for the economy.

- To enhance transparency, the Bank now offers a comprehensive website that details credit conditions in Canada. The link can be found on the left side of our home page.
- The unwinding of the Bank's various facilities and its acquisition of assets – or the exit strategy – would be guided by the Bank's assessment of conditions in credit markets and the inflation outlook.
- A number of exit alternatives are available, including a natural runoff through the maturing of assets, the refinancing of acquired assets, and asset sales.
- Finally, the framework also describes how the Bank would communicate its use of unconventional policy measures. Press releases on each fixed announcement date would remain focused on the target overnight rate and on conditional statements about the future direction of policy rates.
- The press release would also indicate any intention to carry out purchase programs and the approximate size of purchases. The Bank would explain the broad objectives of any purchases and how they are to be financed. Detailed operational decisions would be communicated in separate announcements.
- Press releases on fixed announcement dates and *Monetary Policy Reports* would continue to provide an ongoing assessment of the economy and the outlook for inflation. Speeches and parliamentary appearances, such as this one, would provide additional venues for reporting on the details of the Bank's conduct of monetary policy.
- As always, the Bank reserves the right to announce policy measures in periods between fixed announcement dates to address exceptional circumstances.
- We welcome the opportunity, following my remarks, to discuss with your committee this framework and its potential role in achieving the Bank's inflation target.

Conclusion

- Allow me to conclude with a few words on the outlook for the Canadian economy.
- While there remains a high degree of uncertainty – particularly with the Canadian economy dependent on forces beyond our borders – we remain confident in the prospects of eventual economic recovery in Canada.
- This recovery should be supported by the following factors:
  - the gradual rebound in external demand;
  - the end of the stock adjustments in Canadian and U.S. residential housing;
  - the strength of Canadian household, business, and bank balance sheets;

- our relatively well-functioning financial system and the gradual improvement in financial conditions in Canada;
- the past depreciation of the Canadian dollar;
- stimulative fiscal policy measures;
- the timeliness and scale of the Bank's monetary policy response.

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