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Chair

Mr. James Rajotte

Standing Committee on Finance

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● (1030)

[*English*]

The Chair (Mr. James Rajotte (Edmonton—Leduc, CPC)): I call to order meeting number 55 of the Standing Committee on Finance, orders of the day, pursuant to Standing Order 108(2), a study on the report of the Bank of Canada on monetary policy.

I want to welcome our witnesses from the Bank of Canada and thank them for rescheduling the meeting which was scheduled to take place on October 22. We want to thank them very much for making themselves further available.

We have with us the Governor of the Bank of Canada, Mr. Stephen Poloz. Welcome back to the committee. We have, in her first appearance before the finance committee, the senior deputy governor, Ms. Carolyn Wilkins. Welcome to the committee as well.

I understand, Governor, you have an opening statement. Then we'll have questions from members. Please begin.

Mr. Stephen S. Poloz (Governor, Bank of Canada): Thank you, Chair, and good morning to the committee members.

It's my pleasure to introduce you to Carolyn Wilkins, who assumed the post of senior deputy governor of the bank on May 2 of this year. She is like a house on fire.

Before we take your questions, let me give you some of the highlights of the economic outlook. I'll draw mainly on the October monetary policy report, which was published about two weeks ago. I'll also reflect back a little bit further, since it has been some time since we last met.

I'm going to touch on some new advances in our thinking and talk about how the environment that we're living in is affecting that thinking and driving an evolution in the way central bankers conduct monetary policy.

[*Translation*]

Our outlook for the global economy continues to show stronger momentum in 2015 and 2016, but the forecast profile has been downgraded since July. In the two weeks since we published the MPR, new data on retail sales and monthly GDP have given us a stark reminder that data do not follow a straight line. The good news for Canada is that the U.S. economy is gaining traction, particularly in sectors that are beneficial to Canada's exports.

And our exports do appear to be responding, with some additional help from the lower Canadian dollar. Our conversations with exporters indicate that they are seeing a better export outlook from the ground.

[*English*]

Our exports do appear to be responding with some additional help from a lower Canadian dollar, as we saw in this morning's data report. Our conversations with exporters indicate that they are seeing a better export outlook from the ground, but it is clear that our export sector is less robust than in previous cycles.

Last spring, as you may recall, we identified which non-energy subsectors could be expected to lead the recovery in exports and which would not. We have since investigated in more detail the subsectors that have been underperforming. After sifting through more than 2,000 product categories, we found that the value of exports from about one-quarter of them—some 500 export categories—has fallen by more than 75% since the year 2000. Had the exports of these products risen in line with foreign demand, they would have contributed about $30 billion in additional exports last year.

By correlating these findings with media reports, we could see that many of these were affected by factory closures or other restructurings. In other words, capacity in these subsectors has simply disappeared. This analysis helps us understand a significant portion of the gap in export performance.

[*Translation*]

Most of the sectors expected to lead the recovery in non-energy exports still have some excess capacity. Our Business Outlook Survey interviews indicate that, while companies plan to invest in new machinery and equipment, few are planning to expand their capacity, at least so far. This helps explain why business investment might be delayed relative to what would be expected in a normal cycle.

[*English*]

This research has important implications for Canada's employment picture. We know that when companies restructure or close their doors, the associated job losses are usually permanent. If companies can meet increased export demand with existing capacity, the associated employment gains can be fairly modest with most of the increase in output coming in the form of higher productivity.

The bigger employment gains will come later when we enter the rebuilding phase of the cycle, when companies are sufficiently confident about future export demand that they begin to invest in new capacity and create new jobs.

● (1035)

These considerations enter into our estimation of the output gap. This is the difference between GDP and potential GDP, and that is the key macro-economic determinant of the outlook for underlying inflation.

When the economy moves into a position of excess supply, inflation declines, and when it moves into a position of excess demand, inflation rises.

[*Translation*]

There is no single preferred measure of capacity in the economy. Traditionally, we have put the most weight on measures based on output, or GDP. Each October, we do a full analysis of the determinants of potential output, and its future trend. We have done so in this MPR, but in future, we will update this analysis in every MPR. This time, we also offer a special technical box that considers the dynamics of excess capacity in longer business cycles like this one.

[*English*]

The reason this is important is that in longer business cycles like this one, the restructuring or closure of firms reduces potential output while creating permanent job losses. This means that the output gap can appear smaller than the labour market gap, which is our current situation. This is why we pay additional attention to measures of slack in the labour market.

For example, our composite labour market indicator, which we call the LMI, which was first presented in last spring's "Bank of Canada Review" provides a measure of slack based on several underlying labour market data series. The difference between the output gap and the labour market gap persists until after the rebuilding phase of the recovery, which I discussed a moment ago, when the excess capacity measures eventually converge.

Our judgment is that we have considerable excess capacity and that continued monitoring of stimulus is needed to close the gap and bring inflation sustainably to target. However, we take account of our uncertainty around the degree of slack by considering a range of possible slack estimates in our deliberations.

Another important building block of our policy framework is the neutral rate of interest, which is the rate that should emerge once all the dust is settled. Inflation is on target. The economy is operating at full capacity and all the shocks have been worked out.

There is uncertainty about this rate too and we estimate that it now lies between 3% and 4%, which is well below pre-crisis levels, but since the difference between current rates and the neutral rate is our best estimate of monetary stimulus, understanding the risks around this is also very important.

After weighing these considerations, it is our judgment at this time that the risks around achieving our inflation objective over a reasonable timeframe are roughly balanced. Accordingly, we believe the current level of monetary stimulus remains appropriate.

Some of our observers have commented that the considerable monetary stimulus around the world may be sowing the seeds for the next financial crisis. Certainly, financial stability risks, especially those related to household imbalances, remain a concern to us here in Canada, but our economy clearly faces significant headwinds and continued monetary stimulus is needed to offset them in order to achieve our inflation objective.

It is our judgment that our policy of aiming to close the output gap and insuring inflation remains on target will be consistent with an eventual easing of household imbalances.

Just as our analysis of the economic forces has been evolving with events as they transpire, so is the way we conduct monetary policy, adapting in real time to the changing environment. There is now particular emphasis on the incorporation of uncertainty into policy decision-making. We published a discussion paper on the subject earlier this month.

[*Translation*]

We have begun putting our growth and inflation forecasts in the form of ranges rather than points, and have given even more prominence to uncertainty and risks in the MPR.

We've refined our analysis of financial stability risks and raised the profile of our Financial System Review. And, we've begun to offer a more thorough description of how those risks are entering our policy deliberations, particularly in the opening statement that precedes our press conferences.

● (1040)

[*English*]

These changes have brought more transparency to our decision-making and our policy narrative has shifted from one traditionally seen almost as mechanical engineering to one now characterized as risk management.

One powerful risk management tool that policy-makers have in their tool kit is so-called forward guidance, the ability to provide the market with more certainty about the future path of interest rates.

This effectively takes uncertainty out of the market and places it firmly on the shoulders of the central bank. There are costs as well as benefits to using this tool. We decided that forward guidance will be reserved for times when we believe the benefits to its use are clear: periods of market stress, periods when traditional monetary policy tools are constrained, and so on. Otherwise, we will let markets do their job, which is to deal with the daily flow of new information and grind out new pricing without specific interest rate guidance from the bank, but supported by the increased transparency around our outlook for inflation and the risk that we are managing.

Finally, Mr. Chair, if you'll indulge me for one moment more, the Bank of Canada is as good as it is only because of it's superb staff. We are absolutely delighted with the announcement today that the bank has been named one of Canada's top 100 employers for the fifth year in a row. That's a proud moment for the organization.

With that, Carolyn and I will be very pleased to answer your questions.

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

Congratulations on that accolade once again.

We'll begin members' questions with Mr. Cullen, for a seven-minute round.

Mr. Nathan Cullen (Skeena—Bulkley Valley, NDP): Welcome, Ms. Wilkins, to the committee, and thank you, Governor, for your comments.

With regard to a couple of things that you've said recently about the expectations of what recovery now looks like in Canada, and without overgeneralizing, is it fair to say that a low-growth or zero-growth recovery is possible in terms of the job market and new job creation?

Mr. Stephen S. Poloz: Yes. It's definitely what we're seeing. After a very robust recovery after the recession itself, we've kind of moderated into a more steady and yet slow-growth plateau. Primarily, this is a result of the fact that the global recovery has done the same thing.

Mr. Nathan Cullen: As most Canadians hear the news that a recovery is under way, one would naturally assume that it's associated to new job creation, yet we see that the private sector is not creating those jobs. At the end of the summer, in replying about the job market in the *Financial Post*, you said:

> It's been pretty weak. It's been almost all part time so therefore it's not generating the kind of income you would get from a usual 1 percent employment growth. We know that's significantly less than we would expect to see in a well-performing economy.

The government has said that virtually 85% of all jobs created last year were full-time, yet this is noting a report that only a quarter of the jobs that were created were full-time and of lower quality.

I'm seeing two world views collide here, but yet the stats are the stats. The statistics point to something quite damaging, particularly on the manufacturing side.

I know you hesitate toward policy prescription, yet according to the Canadian manufacturers, we've lost 700,000 manufacturing jobs in Canada since 2002, and 400,000 manufacturing jobs since this government took office. They have not been replaced in overall terms.

Is there any particular monetary effort you would see from the government to reverse this worrisome trend, or are these jobs gone and not coming back?

Mr. Stephen S. Poloz: The context is important to remember. The world economy has lost more than 60 million jobs during this global financial crisis and the subsequent great recession, and then of course the slower recovery than typical. So, over 60 million jobs.... The statistics you quote I'm sure are exactly right. However, in that context Canada has done extremely well as a relative matter. That, I think, stems from having the most robust banking system in the world and having policies put in place at exactly the right time.

It's important to remember that it could have been far worse without this; however, as I said, we did have a strong recovery in jobs as we typically have in the post-recession period. Then what happened is the global recovery sort of stalled. Now we're in a period where that building phase is just starting to catch speed, especially in the United States. It's our outlook that we will continue to benefit from that through a stronger export recovery.

● (1045)

Mr. Nathan Cullen: You've readjusted for 6% lower in terms of trade. We talked earlier and my question was, what price of oil does the bank assume when doing its forecasting? Can you inform the committee what price that is? What assumption is made by the bank in terms of that energy price?

Mr. Stephen S. Poloz: In the monetary policy report, rather than construct a detailed forecast for the price of oil, what we do is we adopt a convention, which is that it will stay steady at an average price in its recent market observation. The price that we chose for this particular monetary policy report is $85 and we hold that constant for our projection exercise. Similarly, we hold the Canadian dollar constant in our exercise. Then we analyze the risk to the economy of either upside or downside scenarios on the price of oil. There are a number of risks on both sides of that, so it's an important thing to take into account. We have calculated that growth in 2015 will be about a quarter point lower as a result of this decline in the oil price since our last forecast.

Mr. Nathan Cullen: To translate that, what does a quarter point lower mean to the average Canadian? Is that significant? Is it just a margin of error rounding?

Mr. Stephen S. Poloz: It is within the usual margin of error. When we have a growth rate projected somewhere between 2% and 2.5% for next year, a quarter point is somewhere in there. Of course, it's also in the context where growth is low enough for a quarter point to be meaningful.

Mr. Nathan Cullen: I suppose that's my point. With the 2% to 2.5% prediction for growth in the GDP, saying that the suppressed price of oil right now—excuse me, I loaded the term, a lower price of oil right now—could impact that GDP growth by as much as one-quarter point is significant when we're only talking about a growth rate of 2% to 2.5%, that sum may be as much as....

Mr. Stephen S. Poloz: To give you some idea of how this would work, given the way exports behaved in the third quarter—and when we did the MPR we had only two months of data—at that point we were in the process of revising up our view for the outlook for GDP because of the stronger starting point, and at the time, the oil price began to decline. Those two effects were roughly offsetting, and for that reason, our outlook was almost the same as what we had in our previous monetary policy report. It gives you some idea of how a couple of months of data on exports can be sufficient to offset the kind of shock that we're discussing. It is within the margin of error and we don't overplay it, but there's no question that for the last few years there has been extra income boosting the Canadian economy throughout the country, because of a higher price of oil.

Mr. Nathan Cullen: I have a last, very brief question.

Consumer household debt is now at record highs. You've raised this alarm before. Is there anything the Government of Canada should be doing to address this and the impact it has on our Canadian economy?

The Chair: A very brief response, Governor, please.

Mr. Stephen S. Poloz: We acknowledge that the risks in household balances are edging slightly higher. They're not declining, as we had hoped; however, we do think with the outlook we have, and we're confident in that, that they will be easing down over the course of that projection.

The Chair: Thank you, Mr. Cullen.

We'll go to Mr. Saxton, please, for seven minutes.

Mr. Andrew Saxton (North Vancouver, CPC): Thanks to Governor Poloz as well as to Mrs. Wilkins for being here today.

Governor, my first question is in regard to the following. First of all, in your opening statement you alluded to the fact that Canada posted a trade surplus in September that was much greater than expected, about $1 billion greater than expected, thanks in part to a bounce back in the auto sector, which helps to underscore the importance of the assistance our government gave to the auto sector during the recent recession.

In your speech yesterday you noted that a “sustained expansion in our exports will not only represent new demand, it will ignite the rebuilding phase of our business cycle, which...will create new supply....”

There are many contributing factors that can help spur this economic growth, one of which is a weaker Canadian dollar, and another of which is our government's low-tax plan, which has made Canada one of the top countries in the world to invest in. Another aspect is to open up new markets for Canadian companies.

In your opinion, will Canadian exporters be able to benefit from rising global growth as a result of our government's ambitious free trade plan, which has led to new trade agreements with almost 40 countries, most notably the European Union and South Korea?

● (1050)

Mr. Stephen S. Poloz: Absolutely.

Over the course of this cycle, with the U.S. economy having taken the brunt of the financial crisis, Canadian exporters have had to invest much more in pursuing new business in new, non-U.S. markets. Those efforts are paying off, and of course will be enhanced greatly by new infrastructure, that is to say, new trade agreements or things that take things out of their way.

If you saw today's data in particular, the surprise, if you will, is where the extra growth was. It's in markets other than the United States, and yes, of course, cars are primarily a U.S. export, but other categories. We can't get carried away with the data this morning; they don't mean a trend, but they are adding to the sense of encouragement that the pieces are coming together.

The point I was trying to make yesterday is that we will require a sustained accumulation of this before the companies in the export sector are convinced that it's for real and will continue sufficiently to use up their excess capacity and begin to invest in new capacity. It's the investment follow-through that will give us the new job growth, which will affect the dynamics we were discussing in the previous question.

That sort of natural sequence is proving to be relatively slow, and I think it's primarily because the global environment remains a highly uncertain place. When you're in business, it's real money and you wait until you're more sure, having lived through these past five years.

Mr. Andrew Saxton: Thank you.

You alluded to this briefly, but perhaps you could expand on how the increased markets for Canadian exporters will help to increase job creation here in Canada.

Mr. Stephen S. Poloz: In particular, when a company is trying to build its sales book.... Take a typical company. It might have lost 40% to 50% of its sales book during the great recession, primarily because of the U.S., and it may have downsized or restructured in response. If they're still in existence today, what they're looking for is new ways to grow, and their U.S. customers are starting to phone them again. That combination can be very powerful, but it's something from which we've not yet seen sufficient follow-through.

The important thing is that the higher growth rates to attach your business to are in the emerging markets, so catching just a small piece—one or two customers in a place such as Brazil, China, Indonesia, Vietnam, or some place like those—is going to give a lot more growth to the sales book over time than would getting one more U.S. customer.

That strategy is beginning to pay off. As I said, it will take quite some time for it to add up, considering the $30 billion of lost exports that I talked about before, which is the damage not just from this past recession but from more than 10 years of difficult times for that sector.

Mr. Andrew Saxton: One of the contributing factors as to whether or not businesses invest in the economy is their level of confidence in the economy. Likewise, one of the strongest signs of a stable and growing economy is a balanced federal budget. Our government made balancing the budget a top priority, and we're on track to balance the budget in 2015. In your opinion, will a balanced federal budget have a positive impact on new business investment decisions by Canadian as well as global companies?

Mr. Stephen S. Poloz: That's a difficult call to make. Certainly it is a factor in business confidence; I can certainly agree with that. The thing is that throughout this entire stretch, there's been a very coherent plan in place for Canada's fiscal policy. That has been widely acknowledged in financial markets as a positive. Even when there was a deficit, there was a clear plan, a credible plan, for when we would no longer be in deficit. Whether there's another incremental confidence effect of getting there is something we'll have to wait and see about.

● (1055)

Mr. Andrew Saxton: Would you agree that having a balanced federal budget gives the government the opportunity to continue a low-tax plan and also takes pressure off interest rates because the government is no longer as big a participant in the debt market?

Mr. Stephen S. Poloz: One of the headwinds we've identified, which is a global headwind, is that almost all governments are looking for ways to move themselves closer to balance, and Canada appears to be ahead of this process. It's one thing that the private sector may be recovering beneath the surface, but in the big numbers you can't quite see it because the government is rebalancing its posture. To the extent that those headwinds are diminishing, that's a positive for private sector growth to emerge more strongly.

Mr. Andrew Saxton: One thing that sets Canada aside is that, in balancing the budget, we've actually been able to maintain our low-tax plan. In fact we have even lowered taxes, whereas many other countries have to raise taxes in order to balance the budget. Would you consider that to be an important factor?

Mr. Stephen S. Poloz: It's potentially an important factor, but I don't have a specific analysis to offer you this morning.

Mr. Andrew Saxton: Okay.

Finally, in my last seconds, there are some external shocks in other parts of the world. Where would you say the biggest risk is for those external shocks?

The Chair: If you would just give us a brief response, Governor, you could return to it later.

Mr. Stephen S. Poloz: The biggest risk facing us today is coming from Europe, where growth has been extraordinarily slow. It will be an uphill battle for all the restructuring to take place there. I will leave it at that.

The Chair: Thank you.

Mr. Brison, go ahead, please.

Hon. Scott Brison (Kings—Hants, Lib.): Governor and Deputy Governor, welcome to the committee.

Your report refers to business investment having been very weak and says that a rotation away from household spending towards business investment is essential. Given that you're saying investment is essential in terms of growth today, is there a case to be made, and I think David Dodge may have made it recently, that we ought to take this opportunity of historically low bond yields, real interest rates in a negative territory, slow growth, and soft employment to invest in infrastructure, and what sorts of investments in infrastructure could be stimulative? Should we be encouraging our pension funds and pension funds from other countries to invest in Canadian infrastructure so it doesn't all have to be on government balance sheets? What is your view of the timing today for long-term infrastructure investment?

Mr. Stephen S. Poloz: Certainly infrastructure is almost always a good thing to invest in. It's a key ingredient in our economic growth story. Upgrading it or modernizing it can only add to it. If that infrastructure development requires borrowing money, with interest rates at truly a generational low, we're in a position to borrow 50-year money at very low rates, so all the conditions are very favourable. As well, the private sector, as you suggest, has capacity. We have a lot of ingredients there. The missing ingredient is probably the uncertainty that I mentioned before. For all types of investment, whether it's buying a new machine or just expanding your plant or it's building a bridge that will be a toll bridge or something like that, what the future will bring is a question mark. That high level of uncertainty drives a wedge between the positive decisions, those investment decisions, and what you might expect to see, just because prices are low.

Most of what you say I can't disagree with. It's totally right. I think to the extent that there is a failure of the private market to build infrastructure, it's usually for a very good reason: public participation is needed, hence the P3 model, which is great at some ends and less able to do it at other ends. But in general, the whole sense of infrastructure is very active. I was at a conference yesterday at which there were 1,200 people interested in infrastructure. There's definitely a very strong business sector at this stage in Canada.

● (1100)

Hon. Scott Brison: On infrastructure, do you agree that Canada probably has among the greatest concentration of expertise in the design, construction, and financing of infrastructure in the world resident here in our pension funds?

Mr. Stephen S. Poloz: I think that's a fair characterization. I became familiar with those shops while I was with EDC. I've seen them investing all around the world, and here of course, in infrastructure. There's not just the investment but the management of those assets, which is a capability that has been well developed in our pension plans. They're widely recognized as that expertise, not just investors but managing active investors that take an airport somewhere and make it run better.

Hon. Scott Brison: In a speech yesterday, you spoke about the weak job creation rate in Canada, which is less than 1%. You said it was "well below what one would expect from an economy that is recovering". You also spoke at some length about the issue around youth underemployment and unemployment, referring to the fact that there are around 200,000 underemployed youth, and referring to adult children living in the basement of their parents' home.

Can you comment on the long-term economic cost to what some, including TD Economics, refer to as the scarring effect on the Canadian economy, the scarring effect of sustained youth under-employment and unemployment?

Mr. Stephen S. Poloz: Yes, well, it's very hard to be concrete about that. We all acknowledge that if you come out of school and you spend a year or two failing to get something and each year there's another crop of new graduates coming out and competing for the new job that is created, the scarring effect can last for some time. Our belief is that over the next two years, we will manage to close up that gap and use that excess capacity. We're hopeful that it does not last a really long time.

We have to acknowledge that it exists. That's why when I was asked yesterday, I suggested, as I have privately to young folks who ask me what they should be doing in this job environment, that people volunteer to do something which is at least somewhere related to their expertise, so that it's clear they are gaining some learning experience during that period. That's not the same as advocating for very aggressive apprenticeship programs or so on. What I mean is having experience on the CV so the scarring effect is minimized.

The Chair: A brief question.

Hon. Scott Brison: In what you're suggesting, do you acknowledge that even unpaid internships and getting that experience contributes to income inequality? Children from wealthier families can afford to take those kinds of positions, whereas those in low-income families simply need to get work at any pay.

The Chair: A brief response, please.

Mr. Stephen S. Poloz: I acknowledge that there are issues like the ones you're raising. I wasn't trying to go deeply into this. It's not a monetary policy matter.

I still think that when there are those opportunities, one should grab them because it will reduce the scarring effect, all other things being equal.

The Chair: Thank you.

We'll go to Mr. Keddy, please.

Mr. Gerald Keddy (South Shore—St. Margaret's, CPC): Welcome to our witnesses. Congratulations. Good to see you again.

I have a couple of questions especially around our export capacity and the room for export expansion. You stated:

> The implication is clear: a sustained expansion in our exports not only will represent new demand, it will ignite the rebuilding phase of our business cycle, which will create new supply.

I think we all understand that. You also go on to say, it will take about two years to use up this excess capacity that's in the system now. You go on to say further that continued monetary stimulus is needed.

I want to go a little bit beyond monetary stimulus. We have t a build in Canada plan. We look at our trading partners and the quantitative easing that the Americans have used. They have been much more robust in rebuilding their economy. I think they had to be more robust in rebuilding it. We've been much more prudent, quite frankly, and much more cautious and we've been able to get away with that.

However, in the long term—that's where I'm headed—what happens is we fill that excess capacity that's available to us in the export sector. The Americans are our closest neighbour and our largest trading partner. Regarding the long-term effects of quantitative easing in the States, what happens when they have to start paying back that money over the long term and some of that capacity starts to shrink in their demand for imports?

● (1105)

Mr. Stephen S. Poloz: Well, I would not expect the last part of the question you posed. In fact, the U.S. did a lot more work than the rest of us because they bore the brunt of this cycle, so it's understandable. I characterize it as a crater that comes after a bubble bursts. Basically you fill that crater up with this extra liquidity that has been created through the quantitative easing and so on and ultra-low interest rates, but while the economy gathers its own natural growth processes again, you're able to pull that away without the negative effect that you have in your question. I don't expect that there will be a setback of that sort at all, but rather that the private sector will be doing the growing and that will be largely investment-based growth, company-to-company growth, which is exactly where our exports have been weak to this point. We're just beginning to see that linkage showing up in our own trade data, and that is the most encouraging element of what we've seen in the last few months. The bottom line is that we need this for a fulsome cycle for us and to get back export and investment demand to offset the need for consumption to slow down.

Mr. Gerald Keddy: Thank you for that.

So, you're not expecting to see any retreating in the American economy. They've certainly gone into some substantial debt, and future generations will have to recover that. One of the things we've looked at and one of the things we've used in our export industry in Canada, which you are very familiar with, has been the accelerated capital cost allowance program. At a time like this, when we have capacity we can fill, and we have an export industry looking at new jobs in various parts of the world and expansion in that industry, should we have an enhanced accelerated capital cost allowance?

Mr. Stephen S. Poloz: It's not for me to comment on specific fiscal measures. We know what ingredients we're looking for, so I think I should leave it at that today.

Thank you.

Mr. Gerald Keddy: Okay, thank you for that. I'm going to take that as a maybe.

One of the issues, and you said this in your October monetary policy report, is that certainly the Prime Minister and Minister Oliver continue to say that the recovery is fragile. I think most of us would agree with that. Much of it depends upon the American economy, but how much of our recovery is going to depend on, quite frankly, new markets and the rest of the world? It's similar to the question that Mr. Saxton asked. We'll be looking for a recovery in the EU, which is still sluggish, and with traditional trading partners like Japan, which are still sluggish, so how much of our recovery will be all about new markets in Asia and Southeast Asia and other parts of the world that are not traditional trading partners today?

Mr. Stephen S. Poloz: I think these things are important building blocks to a future growth strategy for most companies in Canada. We have to admit that in the case of Europe, we won't see much growth over the next couple of years and yet it's still possible for Canadian companies to grow their business there by capturing new customers and more market share in Europe. It's not impossible for us to have growing exports to Europe even if they're flat for a couple of years, and importantly, we look at other markets for which slow means growing at 6% or 7%. That means you can have a very strong increase in sales in a market like that with just one or two customers. You go on one of those trade missions to China or Indonesia or some place, and one contract can make a big difference, because it will grow fast. I think we will be relying on this in the future. I'd like to think of the longer future as one in which most trade in the world will happen between these major emerging markets. I think the trade between Canada and the United States will still be very important to us, but small compared to the big trade flows. We need to get attached to those.

● (1110)

The Chair: Thank you, Mr. Keddy.

[*Translation*]

Mr. Caron, you have seven minutes. Please go ahead.

Is the interpretation coming through?

[*English*]

Mr. Guy Caron (Rimouski-Neigette—Témiscouata—Les Basques, NDP): I'll do it in English this time.

[*Translation*]

Thank you, Mr. Chair.

I would also like to thank the governor and the senior deputy governor for joining us today.

[*English*]

I'll ask my questions in English because much of the language is hard to translate.

I want to go back to your decision to move away from forward guidance, to remove it from the tool kit you have at your disposal. The question is on the timing of it. You have emphasized many times that we're not out of the woods, that we still have a large output gap. Why now? Why not wait until the conditions are better in the Canadian economy, which is still uncertain?

Mr. Stephen S. Poloz: It's an interesting question. I'm going to turn the floor over to Ms. Wilkins, who's an expert on this. Thank you.

Ms. Carolyn Wilkins (Senior Deputy Governor, Bank of Canada): If I understand your question correctly, it's why we decided now to drop the forward guidance, particularly when at the same time we're saying there's some uncertainty.

We're of the view that the forward guidance we had in there—and that we were neutral with in respect to the future direction and timing of interest rate changes—was implicit in everything else we were saying. If we weren't saying anything new, or that people didn't know, then it really wasn't worthwhile to say it again.

What was underlying that was a view that the most important form of transparency that a central bank could give is about the models we're using, how we're thinking about the data as it evolves, and how we're thinking about the different risks and the quantitative impacts those risks might have. For example, what would happen if oil prices were higher or lower? Those are the kinds of things we've put an emphasis on in the last year and increased in our monetary policy report, including the ranges around the forecast.

From the point of view of helping market participants and people understand where we're coming from, and being transparent in terms of what's underlying our decision, we think we've increased our transparency.

We also said there may be a time when we think uncertainty is particularly high, like it was during the crisis when we did have a forward-looking statement that was fairly precise, or when we're constrained by interest rates that can't go below zero, when we find that useful. We don't think that markets need that kind of guidance today.

Mr. Guy Caron: That is consistent with what you said, Governor, when you mentioned that it should be reserved primarily for use at the zero lower bound. We're not far from that at this point with the uncertainty of the economy. Some countries are still using forward guidance, but they used it at a time when they were not at the zero lower bound. I'm thinking about New Zealand or Sweden, for example.

Have you done an analysis of the way the tool has worked in those countries and in that specific time?

Mr. Stephen S. Poloz: We have. I've attempted to put my best thoughts forward in the discussion paper we published earlier this month that tries to put all that uncertainty we face into a full context and where forward guidance fits in that menu of possibilities.

What we need to acknowledge is that there are not only benefits to forward guidance, but there are costs. Those costs are associated with markets that function in an asymmetric manner because you've provided specific information on one side of the distribution and not on the other. Forward guidance has its main effect when the market stacks its positions and takes bigger speculative positions on the side of forward guidance. That's why it has an extra effect on interest rates. It means that when you change that forward guidance even a little bit, you can have these massive adjustments in the marketplace that can be very distorting.

In our view, it was time to remove that so the market would no longer be addicted to that statement. Then we can use it with full effect when we believe we need it, and the benefits outweigh the costs.

● (1115)

Mr. Guy Caron: Thank you.

I know that you don't necessarily like to comment on fiscal policy, but I'll keep my question very general. We're at a point right now, and I'll refer to your speech from yesterday when you talked about dead money. It's not really that much of a problem because companies find it very uncertain to assume the risks that are inherent in this economy right now.

If we're talking about fiscal policy and tweaks, such as reduction of corporate income tax rates or even the measure of reducing EI premiums for small businesses, how effective are those types of fiscal policies in an environment where, even when companies have the financial leeway to invest and don't because of the risks, that flow of money won't be invested anyway?

Mr. Stephen S. Poloz: I'm afraid that's a very complicated question, especially for us since it's not our area. We'll take our fiscal assumptions as they are, as they're given, and we'll embed them in our own forecasting, but we're not in a position to judge the validity of individual tax or other changes.

Mr. Guy Caron: I guess what I meant is the fact that fiscal policy.... How much importance does fiscal policy have in an environment which is still uncertain and in which companies actually have the leeway to invest and don't, not because they don't have the money but because of the risks they are facing?

Mr. Stephen S. Poloz: I appreciate that. It's as if all the ingredients are present but investment is still lagging. As I said before, the uncertainty is coming from whether the export demand is for real or if it will peter out again and we face another false dawn, of which we've had several. Still in that context, what you really want.... If that's one of the elements of their uncertainty, I'm sure there are 10 others. They'll mention things like frugals, or environmental studies, or other things that add...electricity costs, all kinds of things that enter into that set. If you're able to find others to reduce their uncertainty, I think they'll see it as a welcome development.

That's a very general response to your question; it's not a very specific one.

The Chair: Thank you.

Mr. Allen, please.

Mr. Mike Allen (Tobique—Mactaquac, CPC): Governor Poloz and Deputy Governor Wilkins, thank you for being here today.

When you talked, Governor, about the change in product categories and the decrease in exports, in other words, capacity in these subsectors has simply disappeared, and if we talk about $30 billion in additional exports if it had stayed in the base case, how does that compare? If you look at analyses in previous decades on this, businesses fail and new businesses come in to replace them, all those types of things. It sounds to me like there might be a couple of factors that are contributing to the fact that these businesses have not been replaced on exports. Is it a factor of a couple of things, such as non-growth in those export economies, or is it that businesses simply haven't been replacing them as they have in the past?

Mr. Stephen S. Poloz: That's a very good fundamental point. It's important for me to underscore that when we took those 2,000 export categories, the filter we used was to tell us which ones have had at least a 75% drop in exports since 2000, which is a very long term. If you add in a sunset industry that was going to go out of business for other reasons, we can't blame that on the financial crisis, and so on. That's a very fair point, and we don't make that claim.

In that, what we had though was a long period of dollar appreciation that was associated with the rising terms of trade in Canada, primarily driven by oil prices, but other resource pricing, too. As we've said before, that rise in oil prices in that period, say from $25 or $30 per barrel up to over $100 per barrel, had important income effects for Canada, and it caused underneath that a transformation of the Canadian economy, extra growth in the resource sector, a two-speed economy, lower growth in other parts of the economy. That can be stressful for certain companies, and we see some of the results of that. Then the crisis comes and the downturn, which is icing on the cake. If you're already experiencing problems, that could be the thing that puts you out. The sectors that come to mind are things like large transport trucks, locomotives—you can guess the companies probably—kraft paper, pulp, wood products for houses, wood furniture, knitted fabrics, those kinds of things.

All I'm saying is that we need another period of building to replace that, and as far as we can tell, it may be barely getting started.

● (1120)

Mr. Mike Allen: Thank you.

In your monetary report, the chart on page 17 talks about the slack capacity, and on page 14 you talk about three measures. You have your conventional measure; you have your integrated framework that takes into account the demographics, the macro-economic; then you have your business outlook survey. Are you using all three of those factors more? How has the conventional measure maybe not been so helpful in this lack of capacity, and how are these three measures helping you to kind of bind that a little bit?

Mr. Stephen S. Poloz: That's a great question and tied to the very nature of the cycle we're in.

I think Ms. Wilkins is best placed to answer it.

Ms. Carolyn Wilkins: Sure. Thanks.

We've always put a great emphasis on looking at a wide range of indicators when it comes to measuring the amount of slack in the economy. This time we chose to feature some of those a little bit more prominently.

The conventional measure basically looks at the output side and in fact probably misses some of the extra slack that we are seeing in labour markets at this time. This is really just a function of the cycle that we've seen where you do get output that's really hit and you've got a destruction of capacity and people leaving their jobs, either voluntarily or involuntarily, and a spike in unemployment. It takes time through the phases for that labour market slack to be absorbed up.

One really good way to look at this is the chart that shows our labour market indicator, which the governor spoke about. What that does is it looks at a number of other factors aside from the unemployment rate and sees what's the big difference, why the labour market indicator is showing way more slack than the conventional unemployment rate.

There are a couple of things I can point to that give a tangible example of why that is. One is the amount of involuntary part-time employment. It's true that part-time employment has been a major source of employment growth, but not only that, it's that about 28% of it is not voluntary. Another factor is just the average duration of unemployment. We talk about the scarring; whether it's young people or prime age people, the longer they're unemployed, the more likely it is that it will be difficult for them to become re-employed. We see that the duration of unemployment is up to about 22 weeks. You add that with the decline in the participation rate. We calculate that the climb we've seen this year is about twice as much as you would have expected given the demographic change. We know people are retiring, but the prime age people or the young people who are leaving the labour force are probably not retiring.

The good news is it means that there is room in the economy to grow and for the labour market to grow without being inflationary. That's why we have put some emphasis on it now as we're looking towards how much slack is left in the economy and what's the appropriate monetary policy.

Mr. Mike Allen: On the business outlook side of that, when you go to them, when you talk about the trade deals and other things that we've tried to aggressively sign, is that one of the questions that you're asking the businesses in terms of the business outlook survey? How do they see maybe in terms of their businesses how these trade deals may impact them and help them grow in the future?

Ms. Carolyn Wilkins: We do spend a lot of time with the businesses. In our business outlook survey we ask them some questions with respect to where they see their growth coming from. Certainly we did see some improvement in expected sales in the future. Some of the deals that are there won't come into force within the time period that we're talking about, which is the next couple of years, but certainly we did see some increased optimism, if you want to put it that way, with respect to future sales.

● (1125)

The Chair: Thank you.

We'll go to Mr. Rankin for seven minutes.

Mr. Murray Rankin (Victoria, NDP): Thank you very much to both of you for attending this morning.

I found the analysis that you did and discussed today about the 2,000 product categories and the 75% fall-off and so on to be very sobering. The excess capacity that you described coupled with what has been termed dead money in other contexts.... You mentioned that companies have been restructuring, closing their doors and that the “bigger employment gains will come when we enter the rebuilding phase of the cycle—when companies are sufficiently confident”.

With all of the money that's around, is the failure to enter that rebuilding phase merely a function of lack of confidence in the economy? What can explain that remarkable statistic that you've provided?

Mr. Stephen S. Poloz: I think lack of confidence is a good summary given what we've been through and the fact that several times now we've had a false dawn in the global economy, including the U.S. economy, where we think the recovery is real and then it backtracks on us. It has made companies understandably cautious about putting their hard-earned money on the line into new investments. The good news is that their balance sheets are strong. They are ready to grow their business but they need the demand side to be there. We're seeing the first ingredients of that showing up in our trade data. That adds up to a lot of positives. I don't think of it at all as dead money but as ready money.

The basic analysis is that in our textbooks we talk about how a lower rate of interest will cause more investment. That, of course, assumes everything is equal, but of course in the world nothing is equal. If you ask what the expected rate of return on a dollar of new investment is today, well, it has risk associated with it. That risk is fed by things like the Ukraine-Russia crisis, the Middle East, the price of oil, the price of other commodities, and the movement in the exchange rate. All kinds of things go into that. And of course, there is just what you live through.

If you go to your board of directors today and say, “I'm ready to make this investment; I'm the CEO”, they'll say, “Wait just a minute. Let's be a little more sure before we make that commitment.”

That's the environment we're in and so the risk-adjusted rate of return is lower than it seems to us because risks are high. If risks go down, confidence will rise. As that happens, then of course we get more work from that part of our demand side.

Mr. Murray Rankin: This is a question about the discouraged workers.

You elaborated just a moment ago, Senior Deputy Governor Wilkins, on some of what I wanted to talk about. You talked about the increasing duration of unemployment, the declines that are twice as much as expected that could be explained by demographic issues, and what you termed involuntary part-time employment. You talked about scarring, youth unemployment, and youth underemployment. We have, in short, a problem, I think you've identified, of discouraged workers in Canada, large numbers of them.

I wonder if you could expand a little bit more on your analysis of discouraged workers. I think you used that expression in an earlier speech.

Mr. Stephen S. Poloz: Discouraged workers is a specific category in StatsCan's survey. When they phone you up, you can classify yourself as willing to be employed but unable to and discouraged. We take a somewhat broader view of this. When we see, for example, 200,000 or so youths not in the workforce who normally would be, they aren't classified officially as discouraged workers because they haven't gotten their first job yet. They're kind of discouraged young people. We just assume that it's very unlikely that they are taking early retirement. I think that's a fair assumption. They are particularly vulnerable to this scarring effect that we discussed earlier.

All that is lacking, I think, is that underlying movement in the global economy, particularly the U.S. We do see the signs there so we have a fair degree of confidence around that, that over the next two years it's going to make a big difference to the way it seems to those folks.

Mr. Murray Rankin: I'm sure you're aware of the problem Canada is facing with respect to an aging workforce, and you alluded to that just now as well.

This may be outside the purview of monetary policy, but I'm going to ask anyway. Do you agree that a child care policy that meaningfully boosts labour force participation can help cope with the problem of a declining workforce due to demographic factors?

● (1130)

Mr. Stephen S. Poloz: As an economist, I think if we look at all things being equal, increased participation in the workforce is a positive.

We see in Japan, for example, a long-term issue in terms of labour force participation. It's an open question about whether it makes a meaningful difference when it changes, as again we can see Japan as a case study because you can't make necessarily supply changes and expect them to be magic without the demand side pulling people into the workforce. What we think is most important is that we make sure that the demand side is percolating nicely.

You do have a point that our estimates of the trend participation in the labour force are beginning to decline because we're all aging. That's a natural demographic force, of course, and there's very little we can do about that, so across the world we'll have to get used to a lower trend growth rate. Can we make a little difference around the edges? Potentially, but it's pretty hard for me to put any measures against that.

The Chair: Thank you, Mr. Rankin.

We'll go to Mr. Van Kesteren, please.

Mr. Dave Van Kesteren (Chatham-Kent—Essex, CPC): Thank you, Governor and Deputy Governor for being here. It's been a great discussion.

Governor, I wonder if you would indulge me.

You correctly stated that nothing is equal in life. There's always a yin and a yang. As a businessman I'm very happy to see low interest rates, but there is a downside, of course.

Mr. Brison talked about pensions being invested in infrastructure long term, but the reality is we're talking about very low returns. We need higher returns.

At what stage do we hit a tipping point? Do you see a return to more traditional interest rates at some point? What stage do you feel that it's critical that we get there?

Mr. Stephen S. Poloz: You're absolutely right, and you premise it well. If it weren't for these low interest rates and the policy response back in 2008, we could be in the second great depression right now.

People should bear that in mind when they ask why interest rates aren't up where they need them to be. The answer is that the headwinds remain significant and we're still pushing against them in order to create what we do see. Obviously the U.S. economy is not in equilibrium even though it's growing at perhaps 3% and interest rates are zero. It's mostly induced growth, not natural, so we have to wait for that to happen.

Where we're going to end up is a question of what we call the neutral rate of interest. Carolyn did an important piece on that and gave a speech on that, so I'd like her to elaborate.

Ms. Carolyn Wilkins: Sure, Governor.

One thing we look at, which the governor alluded to, is where we think the neutral rate of interest is. That's the short-term, risk-free interest rate. It's basically that the difference between that and our actual policy rate measures the degree of stimulus.

However, it's also important for investors and others to know where that is because it's where we think in the medium term we would be once the output gap is closed, inflation is back at target, and all of the headwinds have dissipated, or all the effects of shocks, as the economists like to put it, have dissipated. That's what's going to tie all of the other rates of return.

What one needs to keep in mind is not only where we are in terms of the cycle, but also where we are in terms of bigger structural changes globally. In Canada, that rate is going to be influenced by that. What we're seeing are the demographic changes that are occurring not only in Canada but globally. That means that global potential output growth is slower than it was in the early 2000s. That means the returns to interest are likely to be lower.

You have all of these factors, and you have global savings that are higher, so we're going to see lower rates than what we've seen in the past for a pretty long time.

Mr. Dave Van Kesteren: There was an interesting case in Germany where one of the banks had charged a negative rate. I hope we don't see that in Canada. I don't expect that to happen.

We have had some interesting discussions here too.

I want to talk to you about austerity. I want to talk to you about whether that is something we should pursue. I'm thinking not so much in terms of the infrastructure; most of us probably would agree that infrastructure is something that will contribute to the overall growth of the economy. However, in terms of governments managing and not spending in areas where.... Let's take as a simple illustration an office that was making a foot of paper and we reduce that to a half. There are those—and I was witness to that at the recent OECD conference—for whom austerity was something that was not only frowned upon, but governments were asked to back away from. It would appear to me—I don't remember the philospher's name from the 1900s, but it's a story about the broken glass. I'm sure you as an economist know which one I'm talking about. Isn't that something that we are meddling in, if we don't encourage that kind of austerity? That certainly can't be something that's going to contribute to growth in the economy. Wouldn't you agree?

● (1135)

Mr. Stephen S. Poloz: Austerity as a principle I think has an important foundation, but one has to qualify it by the context you find yourself in. My own sense of it is that the more important thing, and I mentioned this earlier, is to have a credible plan around the fiscal future. That is what markets find reassuring. It's what taxpayers find reassuring.

Given the context we found ourselves in, almost every government on earth in 2008, 2009, and 2010 found that it would be the wrong day to practise austerity. That's a good thing, because as I said before, we had all the ingredients of a second global depression there and we avoided it through smart policy-making.

What the debate enters into is when is the right time to get things back on track. Given the cycle, it is possible to figure out whether, cyclically adjusted, you are still on an austerity plan. I think that's the OECD method of figuring out where you are relative to your plan. You may have a fiscal deficit, but if you adjust for the business cycle in your economy, actually it's a cyclical or cyclically adjusted structural surplus or balance, which means that your plan is on track. I think that kind of tool is very helpful to help others understand what is the net effect on the economy. We're not experts on that. We take that as an input to our forecast.

Just to give more of a round thing around that question, you simply can't look at it as the knife edge: do we practise austerity today or do we wait one more year? Those are questions that boil down to how every country is different and every situation is different.

Mr. Dave Van Kesteren: Very quickly, I want to shift gears. It has been brought up a number of times about the spectrum rising with the oil prices dropping. I for one believe that most of this is brought on by the Saudis and their policy. Which group do you think is more vulnerable, the shale oil or the oil sands? Have you done a study on that?

Mr. Stephen S. Poloz: Roughly speaking, they seem to be similarly vulnerable. Of course, in each of those fields, you have various break-even points in the price spectrum, so you can't generalize, really.

The fact is that this lower oil price is a product not just of the supply effect, that is, extra supply, but also around a third of the decline, we'd guess, is because there has been an easing off of global demand. Both of those things are contributing in the same direction, and it's why it's so hard to forecast and why we simply choose not to. We choose to adopt a convention and then shock our outlook around that price. Right now, we think we'll get up to $85. That's our analysis.

The Chair: Thank you, Mr. Van Kesteren.

We'll go to Mr. Adler, please.

Mr. Mark Adler (York Centre, CPC): Thank you, Governor and Senior Deputy Governor, for being here today.

I want to quote Ms. Wilkins. You made a speech, Mr. Poloz, that you've referred to a number of times during your presentation today, and you said, “The legacy of a financial crisis is a heavy burden for any country, and paying down debt impedes normal economic growth for a long time.”

Given that quote, how significant a decision was it by our government when we assumed power in 2006 to pay down $30 billion in debt? Could you answer that? Also, how significant is it that, of the G-7 countries, we are going to have the first balanced budget in 2015?

● (1140)

Mr. Stephen S. Poloz: As I said earlier, I think throughout that piece the good news was that we had the flexibility to be able to respond to a very adverse development. It's one of the ingredients that helped Canada to have a better great recession than other countries, and then what really made it clear to markets that everything was on track was the credible fiscal plan that came with it.

I would leave my comments at that, but those ingredients were helpful to markets and of course to the economy at a time when exports fell very dramatically. That's the most important growth ingredient of our economy ongoing. Low interest rates combined with some fiscal action made the difference.

Mr. Mark Adler: Deflation on the global scene is certainly not a problem in emerging economies, but may be a problem in some of the rich nations' economies, if you will. How much of a threat is the deflation and what problems may that pose for Canada?

Mr. Stephen S. Poloz: Deflation is a significant threat.

When it arises we get falling prices interacting with existing debt loads making debt burdens go up uncontrollably. That combination makes them very difficult to deal with. We've seen in Japan since 1990 this ongoing struggle with the downward forces coming from deflation occasionally going away but always coming back. It's the sort of place that we don't want to go ourselves. Of course it means that if it's a problem elsewhere, since we're part of the global economy, it has impacts on us.

For instance, given the situation we're in here in Canada, it's why we would say here in our monetary policy report that the forecast risks around our plan for inflation are balanced. If there were an upside risk, we would realize that's a lot easier for us to deal with than if there were a downside risk. A downside risk is harder to deal with because we don't have much room to manoeuvre as a monetary policy-maker ,whereas on the upside risk we know exactly what to do. There's an asymmetry in there. That's why policy-makers are so preoccupied with downside risks in this environment.

Mr. Mark Adler: Monetary policy is somewhat of an exercise in risk management, if you will. I'm curious. We know some of the potential pitfalls on the global scene. Perhaps this is an unfair question. What do we know that we don't know? In other words, are there any potential pitfalls on the global scene that the bank is keeping an eye on that others may not be?

Mr. Stephen S. Poloz: There are an awful lot of things that we know we don't know. Let me select a couple that I find most concerning.

We always talk as if we know what our output gap is here in Canada, what we should do, and what the consequences from inflation would be. That is subject to a lot of different methodologies and a wide range of possible estimates. We talk about financial stability issues, which Carolyn may wish to speak to. What's your biggest concern on the financial stability front that you don't know?

Voices: Oh, oh!

Ms. Carolyn Wilkins: I guess it's where to start?

The biggest concern is it has to be domestic so it has to be the housing sector. What we don't know is, given the strength seems to be concentrated in cities where you can have reasonable explanations why it's very strong—Toronto, Calgary, or Vancouver—there are underlying structural reasons that you would expect those markets to be strong. We don't know for sure the extent to which there may be overbuilding and overvaluation. We don't know why overvaluation builds and what can trigger it to unravel. That's a thing that worries me domestically.

● (1145)

Mr. Stephen S. Poloz: I'll just put some icing on that cake, if I may. That is, we don't know what this new global financial architecture is doing. We think it's very important to enhance the resiliency and the safety of the financial system. We rely on the financial system every day to make the economy move, so we need a whole new cycle to live through before we'll understand that.

Mr. Mark Adler: Our government is moving aggressively. We talked earlier about international and bilateral trade agreements, but we're moving more aggressively on the internal trade barriers too.

How important would that be to break down those internal trade barriers?

The Chair: May we have a brief response, please.

Mr. Stephen S. Poloz: It would be fantastic if you were able to remove internal trade barriers. It would probably have more of an effect on Canada than the external trade barriers.

The Chair: Thank you, Mr. Adler.

I'm going to ask a few questions as the chair.

First of all, the U.S. Fed has announced it is moving away from its nearly six-year policy of quantitative easing. What impact will that have from your perspective?

Mr. Stephen S. Poloz: QE, quantitative easing, was, of course, something we always knew was in the central bankers' tool kit. We always hoped we'd never have to pull it out. It was pulled out in the U.S. to big effect. The jury's still out on measuring the actual effects, but I'm confident that it did have an important boosting effect on the U.S. economy. Certainly it had an effect on long-term interest rates, which matter. It had an effect on confidence, which also mattered quite a lot.

It's important to bear in mind that QE is not over in the sense that all the expansion of the Fed's balance sheet remains in place; they have just stopped adding to it. That's because they can see that the economy is getting traction of its own and that it's self-sustaining, so it's unambiguously good news for us that QE is coming to an end. It means that in their judgment, there is good momentum in the U.S. economy, and that matters a great deal to us.

The Chair: I appreciate that.

I want to return to the issue of business investment, which has been raised by a number of colleagues here. As you point out, businesses do have healthy balance sheets. I think it's fair to say that's in part due to corporate tax reduction policies.

From a number of presentations by you and others regarding the lack of business investment, it seems to me there are two reasons: one is uncertainty, and the other is the reason you outline on page 21 of your report. I'll come to that later.

With regard to uncertainty, you'll never find a period in human history when world affairs are completely certain. Also, a market economy is by its very nature dynamic and therefore uncertain. I have to say that personally, I'm not that sympathetic to the uncertainty argument. You can comment on that in your answer.

With respect to your response on page 21 with respect to reasons for not investing, you say that “most sectors expected to lead the recovery in non-energy exports currently have sufficient excess capacity to meet demand”, so therefore they don't actually need to spend to actually meet the current demand. You point out that we therefore need exports to increase. You obviously link that to the value of the Canadian dollar.

I want you to comment on that from a business investment point of view. Then I want to tie it into another issue, which is that some observers have said that the bank is moving to actually account for more factors in terms of what it's doing. Traditionally the role has been simply to target inflation. Many people have said that since you have become the governor, you've moved more into looking at things like the value of the Canadian dollar and exports, in terms of what the bank is doing, so you're actually expanding the bank's role beyond the strict monetary policy of inflation targeting.

I'm wondering if you can address the business investment point, and then the point about whether the bank's role is expanding and should expand to take into account trade, the Canadian dollar, and other such matters.

Mr. Stephen S. Poloz: Sure. Thank you.

To speak to the uncertainty point, you're absolutely right that there has never been a time when there wasn't uncertainty. Companies get used to taking business decisions in an uncertain environment. A lot of things about this business cycle are unusual, which make it more difficult and therefore hard to measure, and I would argue, much more uncertain, especially looking to the future rather than in the past.

Of course, you can get that by asking them directly what they are actually seeing. The answer often is that they're not sure or they don't know. You can see in their actions what kinds of investments they make. There are investments to modernize or cut costs or remove impediments to productivity as opposed to those to expand.

If we go a little bit deeper, our model suggests that as the economy accelerates, investment accelerates, so it compounds the acceleration. That's why we call it the accelerator model. Well, it's not really working yet. When we ask the deeper question of why, we find that the companies that are experiencing the increased flow through the exports sector say they still have room to grow without investing in more capacity. Not everyone says that, but many do.

That means they can accommodate those higher orders without expanding, and they don't have to add more people either. Measured productivity goes up, which is not a bad thing, but we have to be a little more patient until we get the rest of the follow-through.

Tying that to the second half of your question is very important. The Bank of Canada has only one goal, and that's to keep inflation on its target within a timeframe of around six to eight quarters. That's our horizon of flexibility.

We perceive that to be totally consistent with the other goal that people often mention, which is that the economy needs to be operating at its capacity, at full employment, and those things. Other central banks like the Fed have a dual target: they're responsible for inflation and for employment. To our mind, there's no inconsistency between those two things because getting inflation to be stably and reliably at 2% will require that we get the economy to its full employment level. Otherwise it will drip down and we'll miss our target. Those things are consistent.

We're saying this cycle is different in the sense that it's more prolonged, and we have to look more deeply at some of these reasons to understand them better. That's why we have to behave differently from how we would if we just said inflation is at 2%, so it's fine.

● (1150)

The Chair: Okay.

I have only a minute left in my time. You talked about the labour market. Can you address the regional differences in the labour market? Alberta, and perhaps Saskatchewan and even Manitoba, are very much different from other regions in Canada.

Just give a brief response to that.

Mr. Stephen S. Poloz: Absolutely.

Very briefly, it's important to bear in mind that even though oil prices have come down recently, the rise in oil prices from around the lows of $25 or $30 to say, the $75 to $100 zone or something like that is the big shock of our times. The underlying structural adjustment gives rise to more job creation in energy rich provinces and a lower-speed economy in the others. As a result, we get a regional divergence in employment patterns and housing patterns. All those things are totally predictable from our basic economics.

The Chair: Okay. I appreciate that.

We have a brief round for Mr. Cullen, and it will be the final round.

Mr. Nathan Cullen: Thank you, Chair.

Governor, is there a compounding concern and some thought from the bank, with the headwinds coming from Europe and some of the new numbers coming out of China and some tailwinds coming from the U.S. that these could offset one another in the Canadian economy?

Mr. Stephen S. Poloz: In principle they are roughly offsetting at this stage.

As for updating our view, our view really didn't change that much overall. It was slightly downgraded globally. In other words, the headwinds were a little more than the upgrade from the U.S., but they are offsetting fundamentally, yes.

Mr. Nathan Cullen: Is labour force participation of interest in the bank, and are there identifiable groups whose labour participation we need to increase in the Canadian economy?

Mr. Stephen S. Poloz: It's absolutely of interest to us, because it drives the potential growth of the economy, and so we watch it with much care. When we see elements such as we discussed earlier around youth and so on, we know that this is lost potential, which we would hope to see reversed through time.

Mr. Nathan Cullen: Does the bank pay attention to women's labour force participation at all? Is that something you study?

Mr. Stephen S. Poloz: Absolutely. All of our analysis is done, for all the data that comes out, by gender, by age group, etc.

Mr. Nathan Cullen: Is there a threat of de-leveraging that holds your hand when it comes to interest rates? We have very high personal indebtedness. We have high house prices in Canada. Does that stay the hand of the bank and influence you when you are setting interest rates, knowing that a de-leveraging threat exists in Canada such as was exposed in the U.S.?

● (1155)

Mr. Stephen S. Poloz: It is certainly a factor for us to take into account. We believe if we were to raise interest rates now, they would have a larger impact, for the reason you suggest, than they would in normal times, say five or ten years ago, precisely because households are more indebted. The sensitivity of the economy has changed because of where we are.

Mr. Nathan Cullen: I want to question you about that sensitivity.

There are many factors that affect the level at which you set the interest rate and that therefore affect commercial lending. One concern we've had is about the ability to move money through the economy in reinvestment. I sympathize with the comments from the chair with respect to there being uncertainty.

If these factors are staying your hand, this de-leveraging threat that Canadians owe a lot of money—the personal debt rates and household rates—there would be a shock to the system if the bank were to raise rates right now, just because of those two factors, personal indebtedness and the mortgage rates that people are paying right now. Is that a fair comment to make?

Mr. Stephen S. Poloz: I don't perceive it as some sort of constraint on monetary policy, but rather as something we would need to take into account through our models, as we normally would do. It would mean, all other things being equal, a different trajectory for the economy and inflation, depending on the inputs.

Mr. Nathan Cullen: As a last question, with respect to that headwind-tailwind factor concerning the U.S., China, and Europe, because the U.S. is in part so reliant also on the strength or lack of strength in the Chinese economy, can there be a compounding effect if China continues to downgrade its economic performance, in that the U.S. also tails off and that what was a tailwind turns into a headwind for the Canadian economy?

Mr. Stephen S. Poloz: It remains an open question how much of the downgrading of the rest of the world feeds back upon the U.S. It is a separate channel.

You're absolutely right, but I would remind you that today China's economy is massively bigger than it was five years ago. As a result, 6% feels just the way 7% formerly did. It's important for us to remember that.

Companies that I talk to aren't particularly worried. Their order books are strong.

Mr. Nathan Cullen: Thank you, Governor.

The Chair: Thank you, Mr. Cullen.

Governor Poloz, Senior Deputy Governor Wilkins, thank you so much for being with us. We appreciate your time here. If there's anything further you wish the committee to consider, please submit it.

Mr. Stephen S. Poloz: We're good. Thank you very much.

The Chair: Thank you.

The meeting is adjourned.