

## Carney signals further interest rate cuts

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Canada's economic prospects have deteriorated in the past month, and the central bank may continue to cut its key interest rates in order to stimulate growth, Bank of Canada Governor Mark Carney said Wednesday.

In a speech in London's financial district, Mr. Carney laid out a blueprint to fix broken global financial markets, building on agreements already reached by decision makers to keep money flowing freely. He also hinted strongly that he would continue to cut interest rates in Canada in order to address the slowdown in Canada's economy. The central bank's last official forecast predicted 0.6 per cent growth in 2009, but things have gotten worse since the forecast was published a month ago, Mr. Carney said. He pointed to tighter credit conditions and falling commodity prices as key factors for the deterioration. Mark Carney, Governor of the Bank of Canada, delivers a speech on 'Building Continuous Markets' before the Canada/United Kingdom Chamber of Commerce conference in London on Wednesday. *(Lefteris Pitarakis/The Associated Press)*

"While domestic demand in Canada remains relatively healthy and the depreciation of the Canadian dollar will offset some of the declines in external demand, the risks to growth and inflation in Canada identified in [October] appear to have shifted to the downside," he said.

Economists interpreted that remark to mean interest rate cuts will come swift and deep.

Most of his speech, however, focused on how leaders should repair the dysfunctional credit markets around the world.

He offered what he called "a dispassionate and ultimately optimistic perspective on how to build sustainable markets in the age of global capital."

Regulators also need to examine inappropriate incentives for market players, but they should not actually cap executive pay, Mr. Carney said.

"I firmly believe that regulation of compensation is not appropriate, even though it is in vogue," he said. Instead, regulators should examine compensation schemes in their broader monitoring of how sound an institution's risk management is.

Canadian Finance Minister Jim Flaherty has said executive compensation should be aligned with the objective of long-term economic stability.

A bigger role for central banks is at the centre of Mr. Carney's plan. They need to make sure that certain key money markets – interbank lending, commercial paper, and high-quality securities – are functioning all the time.

"The...strategy requires central banks to act as market-maker of last resort," he said.

If central banks become the counterparty for major market participants, those participants will start lending more freely and stop hoarding their cash, Mr. Carney explained.

Today's full-blown credit crisis, punctuated by frozen markets, would only be a credit crunch – with sharply higher costs of credit – if central banks had taken on this role more fully, he argued.

In Canada and elsewhere, central banks have wound up acting as the market-makers of last resort, but on an ad-hoc basis, and only after credit markets seized up so badly that no other solution could be found.

Each country needs to make sure its own banks and credit markets are solid, Mr. Carney said, but in order to prevent and fix a financial crisis, a much stronger international framework to monitor markets and leverage is required.

“While it is undeniable that good financial regulation begins at home, it is equally clear that it cannot end there,” he said. “Even if the domestic system is sound, there is no guarantee that core financial markets will always be available.”

The world has a “pressing need” for international institutions that can monitor systemic risk and coordinate reform of how best to regulate banks and markets, he said.

However, he stopped short of recommending a new international order that would force banks and markets to change their ways. Rather, his emphasis was on monitoring and oversight, rather than a European approach that would have a new organization enforce new rules.

With international organizations keeping an eye on market behaviour and setting standards, each country should adopt its own rules, he said.

“The current crisis has made it crystal clear that, as designed, the form and conduct of financial regulation is not fit for purpose,” he said.

Regulators need to make sure financial products are more transparent, he said.

Mr. Carney touted the benefits of Canada's banking regulations and conservative banking culture as the key explanations of why Canada's financial markets are not as stricken as elsewhere.

But he warned that huge problems could be brewing in the global marketplace.

Because the world is moving away from market-based finance back towards bank-based finance, banks will require very large amounts of capital, he pointed out.

“If not managed properly, this threatens to exacerbate the global economic slowdown,” he said.

He also said he fears a significant slowdown in emerging markets, since investors are “furiously repatriating capital,” pulling money out of foreign markets in order to plug holes in their balance sheets close to home.

And he warned that some credit markets could be frozen for good, now that the assumption that market participants could always borrow against good collateral has been shaken.

“All of these risks are the consequence of relying on markets built on sand,” he said. “To find the bedrock on which to rebuild open continuous markets, all of us – market participants and policy makers alike – must learn the lessons of this crisis.”