Mark Carney: Reflections on recent international economic developments

Remarks by Mr Mark Carney, Governor of the Bank of Canada, to the Canadian Club of Montreal, Montréal, Quebec, 25 September 2008.

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As always, it is a great pleasure to be here in Montréal, and I would like to thank the Canadian Club for inviting me to address its members this afternoon. I would like to take this opportunity to speak in some depth about international economic developments.

The events of the past few weeks in global financial markets have been dramatic. Money and credit markets seized up. There was a massive flight to the safety of the highest quality of government debt. Equity markets convulsed and some of the most storied names in finance succumbed. Fortunately, even this ferocious storm has a silver lining: its cathartic nature and the decisive policy response it is prompting could mark the beginning of the end of a 14-month crisis that has gripped the global financial system. A restructuring that for some countries took a decade is now likely to take only a few years in total in the United States. This will greatly reduce the cost in terms of lost output and employment in that country, as well as the negative spillovers to the rest of the world. Nonetheless, the months ahead will bring more financial losses, significant consolidation in the financial industry and further increases in the cost of capital. The eventual reordering of the financial system will be historic.[1]

To some extent, we are experiencing the inevitable correction of a period of unbalanced growth. These are the famous global imbalances, which are characterized by excess savings and underconsumption in major emerging markets, and by negative savings, rapid credit expansion and asset-price booms in many western economies. This correction has not been pretty. The world is now grappling with three major shocks, which have had important effects on the Canadian economy. The U.S. economy is undergoing its first consumer-led slowdown in almost two decades. Global financial turbulence is increasing the cost of capital and decreasing its availability. Finally, commodities have been in a supercycle, with the prices of agricultural commodities nearly doubling, base and precious metals nearly tripling and energy products more than quadrupling since 2002. In the face of these developments, global inflationary pressures have risen even as the global economy has begun to slow.

I would like to address each of the three in more detail.

Commodity-price volatility

The increase in a broad range of commodity prices over the past few years suggests a combination of very favourable and mutually reinforcing factors. These include robust global economic growth and the slow increase in supply of many commodities. Importantly, emerging-market demand has been strong, reflecting sustained growth in per capita income, rapid industrialization and a more intensive use of commodities in production.

The outlook for commodity prices matters to Canada for a number of reasons. Primarily, higher commodity prices increase national income by improving our terms of trade. The roughly 25 per cent rise in our terms of trade since 2002 is responsible for about two-thirds of the 14 per cent gain in real per capita disposable income over the same period. Higher

[1] J. Lipsky, "The Global Economy and Financial Turmoil: Finding Our Footing" (speech to the Center for Strategic and International Studies, Washington, D.C., 18 September 2008).

commodity prices have other benefits, such as increased investment, portfolio gains for Canadians and our pension funds and a contribution to the appreciation of our currency, which in turn lowers the cost of imported goods and services. These benefits are felt across Canada – not just in resource-heavy sectors and regions.

Some of these effects are now being unwound owing to the recent sharp fall in some commodity prices, particularly those for energy. In our July *Monetary Policy Report Update*, we highlighted this possibility as a downside risk for the outlook for inflation in Canada. Slower economic growth in emerging markets, as well as in Europe and Japan, appears to be the primary factor behind declines such as the roughly one-third fall in the price of oil from its peak in the summer. Even with this decline, oil prices are back around levels of only six months ago and are still one-quarter higher than a year ago. With both supply of and demand for commodities highly inelastic in the short term, inventories remaining tight and emerging-market growth prospects more uncertain, we can expect continued volatility in commodity prices.

Let me turn now to the renewed weakness in the U.S. economy.

Weakness in the U.S. economy

As the effects of the U.S. government's spring fiscal stimulus package wear off, a fall in U.S. domestic demand seems likely. Household credit growth has slowed sharply and will likely slow further. Indeed, credit conditions faced by U.S. households have tightened despite the cumulative 3.25-percentage-point reduction in policy interest rates. The most recent survey of U.S. senior loan officers showed an expectation of still tighter credit conditions for business and consumers in the months ahead as banks reduce their tolerance for risk and react to the unfavourable economic outlook. Recent financial market events will reinforce these tendencies.

The U.S. housing sector is central to that country's economic and financial outlooks. Housing has been contracting since the end of 2005, with steep declines in the construction of new homes, the sales of existing homes and the prices of both. There are reasons to expect that housing will continue to act as a drag on the U.S. economy for a few quarters yet. Inventories of unsold new and existing homes remain well above historical averages, both in terms of actual units and months of supply remaining, with existing-home inventories near all-time highs. At the same time, the availability of mortgages has become increasingly restricted, and mortgage costs have fallen only marginally despite the sharp reductions in policy interest rates. Most importantly, even if residential construction stops shrinking later next year, as we now expect, the usual sharp rebound in housing activity is unlikely. The overhang of inventories and tight financial conditions will restrain the housing recovery for some time.

Any slowdown in the U.S. economy would have consequences for Canada, but the current situation poses particular problems. The prolonged housing slump has affected Canadian exports of lumber and building materials. In addition, the fall in U.S. motor vehicle sales – by 35 per cent at annual rates in the second quarter for vehicles assembled in North America – has adversely affected our auto sector. Even the spring fiscal stimulus package does not appear to have boosted consumption in the areas that matter most for Canada.[2] We will continue to monitor closely both the composition as well as the rate of U.S. growth for its overall impact on Canada.

The Bank is currently revisiting its projection for the U.S. economy as part of our preparations for our October *Monetary Policy Report*. In our interest rate announcement earlier this month, we identified the possibility of a negative feedback loop between a weaker U.S. economy

[2] Data for the second quarter show declines in areas that have a large impact on Canadian exports, including industrial production, investment in machinery and equipment and automobile sales.

and tighter credit markets as the main risk to a modest U.S. recovery next year. Subsequent events have further weakened the U.S. financial sector, making this risk more probable.

Global financial turmoil

After 14 months of turmoil, global financial markets are at a critical juncture. Risk aversion across the system has risen to unprecedented levels, and an aggressive deleveraging process is under way. Many foreign financial institutions need to raise significantly more capital at a time when their ongoing earning power appears to have been permanently reduced. These dynamics could intensify the current global slowdown and will have an impact on the cost of capital in Canada, despite the relative strength of our financial institutions. In order to illustrate the potential magnitude of these concerns, I would like to emphasize three points.

First, the deleveraging process in the global system is far from finished. There are only three ways for a financial institution to reduce leverage: raise capital, sell assets (at a price at or above their carrying values) or restrain the rate of credit growth. Over the past year, financial institutions in many countries have raised over US$350 billion of new equity, which covered only 70 per cent of announced losses. As a result, leverage has actually increased. With virtually all of these shares now trading below issue price, the ability of firms to raise capital appears very constrained. Similarly, private asset sales have been limited by the complexity of the underlying assets, the ongoing impairment of securitization markets, difficulties in supplying financing to leveraged buyers and the desire of investors to "time the market." In sum, banks have an increasing need for capital, but it has become more difficult to raise it.

In this environment, the U.S. government's initiative to buy distressed assets is critically important. The plan announced by Treasury Secretary Paulson and being developed through discussions in the U.S. Congress is bold and timely. The size and breadth of support provided by this measure will help firms "rightsize" their balance sheets, re-liquefy closed markets and establish market prices for these distressed assets. This should eventually encourage private buyers to re-enter the market and complete the deleveraging process. A well-executed program will undoubtedly speed the resolution of this crisis and limit its economic cost.

Asset sales alone will be insufficient, and additional capital will still be needed. Over time, acquisitions of the weak by the strong will play an important role. At the moment, valuation uncertainties, some accounting standards and investor caution are all restraining mergers and acquisitions in the sector.[3] In the end, reflecting the likely scale of the shortfall, it is possible that, in countries other than Canada, public capital may be necessary to complete the deleveraging process in an orderly and timely manner.

The second point regarding the current financial situation is that while the Canadian financial system does not need to reduce leverage, we are not immune from the fallout from this process elsewhere. Canadian institutions are in considerably better shape than their international peers. Their losses on structured products have been relatively modest.[4] More importantly, their absolute leverage is markedly lower. As a simple illustration, major Canadian banks have an average asset-to-capital multiple of 18. The comparable figure for U.S. investment banks is over 25, for European banks is in the 30s, and for some major

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[3] For example, changes to purchase-accounting rules for goodwill would be welcome in the current unique environment.

[4] Losses for Canadian financial institutions are roughly 10 per cent of total capital, compared with 28 per cent so far in the United States.

global banks is over 40.[5] While foreign banks are in the process of moving towards Canadian levels, our banks obviously face no such pressures. Indeed, Canadian banks could modestly increase leverage by growing their lending relative to their current capital base.

This flexibility gives our economy a rare advantage. Reflecting better domestic credit conditions, there are few signs that Canadian financial institutions are restricting the availability of credit to households. In fact, such growth has remained surprisingly robust to date. While growth in Canadian business credit has slowed in recent quarters to rates around historical norms, there is no evidence at this point that our corporations are facing unusual credit restrictions. That said, especially in light of the intensified global financial strains, we will continue to watch closely the evolution of credit availability in Canada, through analysis of monetary and credit aggregates, industry visits, and surveys.

While the globalization of financial markets and services has led to a more efficient allocation of capital on a global scale, it has also made it easier for financial difficulties to spread across national borders.[6] The absolute borrowing costs for U.S. and other financial institutions has risen significantly, and this has put upward pressure on borrowing costs for Canadian financial institutions.

All else being equal, this would have increased the financing costs for our businesses and households. However, all else is not equal. The stronger financial position of Canadian banks means that they now borrow at rates considerably lower than those of many of their international peers. In addition, the Bank of Canada has eased its overnight rate substantially since the onset of the crisis. As a result, the effective borrowing costs faced by banks, businesses and households are estimated to have fallen over the past year. This decline contrasts with the experience of most other developed countries.[7] In its upcoming *Monetary Policy Report* and in light of recent events, the Bank will revisit its current assumption that borrowing spreads will begin to narrow in 2009.

My third point regarding the current financial situation is that market liquidity becomes strained during times of acute financial distress. The Bank of Canada has taken several actions over the past months to maximize the effectiveness of the monetary policy transmission mechanism. When necessary (such as on Monday of last week), we have reinforced our target rate through overnight operations. Over the past week, in response to exceptional circumstances, the Bank has also provided term liquidity and expanded our list of eligible collateral. The Bank will continue to provide additional term liquidity as long as conditions in financial markets warrant. We will then withdraw term liquidity as conditions normalize, as we did in the spring of this year.[8]

In addition, as part of an unprecedented US$180 billion coordinated action by the world's major central banks, the Bank of Canada entered into a US$10 billion reciprocal currency-swap arrangement with the U.S. Federal Reserve. This is a prudential move during a volatile

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5 One of the advantages of the Canadian regulatory system is that the banks' asset-to-capital multiple is generally limited to 20.

6 In the case of Canada and the United States, an IMF study found that "while trade linkages are sizeable, financial conditions – broadly defined as changes in U.S. bond yields, equity prices, and short-term interest rates – are the largest source of U.S. spillovers to Canada." See International Monetary Fund, "Canada: Selected Issues" (Country Report No. 08/70, 2008).

7 Since August 2007, absolute all-in borrowing rates are about 60 basis points higher for AA- and AAA-rated U.S. banks and about 250 basis points higher for BBB- and A-rated U.S. banks, while all-in borrowing costs for non-financial U.S. corporations are about 50 basis points higher. By comparison, effective all-in funding costs for major Canadian banks have *declined* by about 50 basis points, and all-in borrowing costs for non-financial firms are about 60 basis points *lower*.

8 A list of the types of indicators that the Bank will look at in deciding when to stop the provision of extraordinary liquidity can be found in M. Carney, "Principles for Liquid Markets" (speech to the New York Association for Business Economics, New York, New York, 22 May 2008).

period. The facility would be activated in the event of an acute shortage of U.S. dollars in Canada. The agreement provides the Bank with additional flexibility to address rapidly evolving developments in financial markets.

Last week's coordinated action was a public demonstration of the extraordinary degree of communication and co-operation among the G-10 central banks that has taken place throughout this crisis. This is a testament to a shared recognition of the interdependence of the global financial system. I am convinced that this dialogue, and concerted action when appropriate, has led to better policy outcomes and helped contain the negative international spillovers from this series of financial shocks. I also believe that rapid implementation of the measures proposed by the Financial Stability Forum[9] to enhance the resilience of the global financial system will help create a more stable international financial order.

The message, as expressed in this week's communiqué of G-7 finance ministers and central bank governors, is clear: the G-7 is ready to take whatever actions may be necessary, individually and collectively, to ensure the stability of the international financial system.

Conclusion

The global economy is undergoing a difficult period. Moreover, in recent days, several articles of faith in the financial system have been shaken. These include: that good collateral can always be used to raise liquidity; that certain institutions are too big or too interconnected to fail; or that this was merely a liquidity crisis.

However, there is one constant on which Canadians can rely. The Bank of Canada will not deviate from its relentless focus on its monetary policy mandate to achieve low, stable and predictable inflation. Events beyond our borders have important influences on the outlook for inflation in our country. They must be considered in tandem with domestic factors, including the strength of domestic demand, the evolution of potential growth, and the health of our financial system.

As we prepare to publish our *Monetary Policy Report* in October, we will continue to monitor carefully economic and financial developments in the Canadian and global economies, together with the evolution of risks. Most importantly, we will continue to set monetary policy consistent with achieving the 2 per cent inflation target over the medium term. This remains the best contribution that monetary policy can make to sustained growth.

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[9] Available at http://www.fsforum.org/publications/r_0804.pdf.