Tiff Macklem: The role of the G-20 in sustaining the recovery and protecting financial stability

Remarks by Mr Tiff Macklem, Senior Deputy Governor of the Bank of Canada, at the FICCI-IBA (Federation of Indian Chambers of Commerce & Industry – Indian Banks' Association) Conference on "Global Banking: Paradigm Shift", Mumbai, 24 August 2011.

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Introduction

In some respects, Canada and India could not be more different. Canada is the world's second-largest country in geographic size, with a population of 34 million. India, as one of only two countries with more than a billion people, is the world's second largest in population and is expected to be the largest within 15 years. However, there is much we share, not least, vast and diverse geographies, diversity among our citizens, a common democratic heritage as members of the British Commonwealth, and market-based economies.

In my remarks today, I will focus on these and other similarities between India and Canada, as well as our strong, joint interest – indeed, our leadership role – in the G-20 reform program to achieve durable financial stability and sustainable and balanced economic growth.

My message, in a sentence, is that while the G-20 has made considerable progress in strengthening the microeconomic rules governing the regulated financial system, we have fallen short in correcting the imbalances that are plaguing the global economy and fuelling financial vulnerabilities. And this is having consequences. The slow progress by some countries in implementing adjustments needed to address macroeconomic imbalances is holding back the global recovery and increasing the risk of financial instability.

Canada and India are caught in the crosshairs. What can we do?

Individually, we can ensure our own macroeconomic policies – monetary, fiscal and exchange rate – are sound and supporting necessary adjustments. We can advance the implementation of higher global regulatory standards in our own financial systems. And we can ensure rigorous regulatory supervision of our financial sectors.

Together, Canada and India can provide a strong voice encouraging G-20 countries to accelerate their efforts to develop and implement concrete, measurable plans to reduce macroeconomic imbalances, address financial vulnerabilities and support a sustainable expansion.

Canada and India weathered the financial crisis better than most

Worldwide, the cost of the financial crisis that broke out in 2007 and escalated dramatically in the fall of 2008 has been enormous. The ensuing recession was the worst the world had seen since the 1930s and the most globally synchronized in history. Almost 28 million jobs were lost globally. Economic output in the major advanced countries, as represented by the G-7, fell by 5 per cent from peak to trough. For emerging-market countries, a collapse in trade led to a marked growth slowdown.

And today, four years from the start of the crisis and two years into the recovery, we are still not out of the woods. The European sovereign crisis has intensified, the U.S. credit rating has been downgraded, and a broad range of data has come in weaker than expected. All have led to an abrupt loss of risk appetite in financial markets. The implication is somewhat weaker economic momentum globally together with elevated risks.

Both Canada and India weathered the financial crisis better than most, and remain well-positioned to absorb aftershocks. To an important degree, this reflects the guidance we took from our own past mistakes. A central lesson we both learned is that adjustment deferred is inevitably adjustment magnified and intensified. And in response to this bitter experience, we put in place sound economic frameworks that have increased the resilience of our economies.

In the early 1990s, Canada and India both experienced serious economic crises and deep recessions. These crises produced similar epiphanies, which galvanized the political will necessary to make substantive policy reforms: in particular, to liberalize trade; to strengthen monetary, fiscal and financial policy frameworks; and to undertake needed structural reforms.

In Canada, a series of factors coalesced, including the lack of a credible nominal anchor for monetary policy, inefficient production, large and chronic fiscal deficits, and structural rigidities in labour markets. The resulting crisis led to key reforms. These included a free trade agreement with the United States and Mexico, an inflation-targeting framework for monetary policy, and a major fiscal consolidation that reduced the federal deficit from almost 6 per cent of GDP in 1992–93 to near zero five years later. Our employment insurance and public pension plans were also reformed as were regulations governing the financial sector.

The initial impact of each of these separate reforms was modest, but the benefits quickly cumulated and reinforced each other to become very substantial: low and stable inflation, declining government debt, stronger and more stable output growth, lower unemployment and financial stability.

I won't presume to lecture on the history of the reforms instituted here in India, but I would suggest the world needs to hear more about India's success story. The impact of the changes put in place is both impressive and instructive. As the Indian economy became more open to the rest of the world and its economy more market-oriented, economic growth doubled, rising from about 4 per cent in the early 1990s to more than 8 per cent by the end of the decade and this trend of strong growth performance has continued since the turn of the century. India's exports of goods and services, as a share of GDP, more than tripled, rising from 7 per cent in 1990 to 22 per cent in 2010. But the most remarkable measure of success was that from 1994 to 2005, almost 29 million people – or close to the entire population of Canada – were lifted out of poverty.

The reforms adopted by Canada and India left our economies better able to adjust to the financial crisis and ensuing recession. This was a crisis that did not ignite within our borders. Yet our sound policy frameworks, combined with diligent implementation, have fortified our countries against the international shock waves and afforded us greater policy flexibility to respond to adverse real and financial spillovers.

Canada, India and the G-20

So it should perhaps not be a surprise that as the G-20 emerged as the premier forum for economic co-operation, Canada and India were approached to take on a leadership role in forging a global consensus around needed policy reforms. In particular, our countries were asked to co-chair two critically important G-20 working groups.

First, the G-20 Working Group on Enhancing Sound Regulation and Strengthening Transparency was established in the lead-up to the London Summit to tackle weaknesses in the financial system that had been laid bare by the crisis. In a remarkably short period of time, our working group was able to achieve agreement among G-20 members on the broad directions of financial sector policy reform. The recommendations in our report were adopted by G-20 leaders at the London Summit and set in train an ambitious financial reform agenda.[1] I will come back to this in a moment.

Second, the G-20 Working Group on the Framework for Strong, Sustainable and Balanced Growth, which is ongoing, was launched following the Pittsburgh Summit to build a consensus around the policies required across the G-20 to sustain the recovery and ensure that policy frameworks and actions are consistent domestically and globally.

Let me say a few words about both projects – what has been achieved and what remains to be accomplished.

Financial sector reform

The financial crisis revealed all too starkly that liquidity buffers were glaringly inadequate, and that the global banking system as a whole was dangerously undercapitalized and overleveraged. To redress this core vulnerability, new global standards in the form of Basel III have been agreed. They substantially increase the loss-bearing capital that financial institutions must hold and establish new liquidity standards and a limit on leverage. These new standards represent a significant strengthening of the global rules. The combination of greater emphasis on true loss-bearing capital – namely, tangible common equity – and increased minimum capital levels has effectively raised the minimum global capital requirement seven times. Moreover, for the largest and most interconnected global banks, these requirements are being supplemented with additional loss-absorbing capital. These are major accomplishments.

The new rules must now be assiduously implemented in every institution. All jurisdictions must ensure strong supervision and oversight. Scrupulous international assessment must ensure equivalent implementation of these new higher standards.

Furthermore, we must agree on and implement a perimeter of regulation and oversight that encompasses all systemically important financial institutions, markets and instruments. And a new system of firewalls needs to be built to prevent the failure of one counterparty in the over-the-counter derivatives market from creating systemically perilous knock-on effects.

In short, much has been achieved *and* much remains to be accomplished. It is critically important that the momentum driving financial sector reform be maintained.

G-20 Framework for Strong, Sustainable and Balanced Growth

Progress on the Framework for Strong, Sustainable and Balanced Growth has lagged that of financial sector reform – and needs to accelerate.

The G-20 leaders launched the Framework in 2009, just as the global economy began recovering. Their goal was to safeguard the nascent recovery and achieve stronger global growth over the medium to long term. Leaders recognized the importance of beginning in the early stages of the recovery to put in place policies that would foster the adjustments needed to sustain recovery, prevent a re-emergence of global imbalances and support financial stability.

At the Toronto G-20 Summit in 2010, agreement was reached on a comprehensive, three-pillared policy package to support stronger, more sustainable and more balanced growth. It included:

- fiscal consolidation in advanced countries that is credible and clearly communicated;

[1] G-20 Working Group on Enhancing Sound Regulation and Strengthening Transparency, “Final Report.” 25 March 2009, which can be found at: <http://www.g20.org/Documents/g20_wg1_010409.pdf>.

- for emerging markets, strengthened social safety nets, infrastructure spending and, for some, increased exchange rate flexibility; and,
- for the entire G-20 membership, the pursuit of structural reforms to increase and sustain our growth prospects.

Advanced countries made their commitment to fiscal consolidation more concrete by agreeing to at least halve their fiscal deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016.

Six months later, in Seoul, G-20 leaders called for indicative guidelines to identify large and persistent macroeconomic imbalances and for corrective policy actions to address the underlying root causes.

But actions have not always kept pace with commitments.

In advanced countries, the difficult task of legislating credible, well-defined fiscal consolidation plans is under way, but in some of these countries, current plans have yet to gain the full confidence of markets. Moreover, the consequences of inadequate progress have become more immediate. Sovereign debt concerns have contributed to a retrenchment in risk taking in global markets, sending the prices of safe-haven assets to record highs and pushing those of risky assets sharply lower.

In emerging markets, the pace of foreign exchange reserve accumulation has not slowed; on the contrary, it has accelerated. In 2010, aggregate reserves of G-20 emerging-market economies reached nearly US$5 trillion, or 32 per cent of their GDP. At US$3.2 trillion, China's reserves alone have increased by almost a third since January 2010. This is also having more visible consequences.

The slow pace of exchange rate adjustment between the United States and China is holding back the recovery in the former and fuelling inflation in the latter. With only very modest adjustments of the renminbi against the U.S. dollar, China's real effective exchange rate against its full range of trading partners has actually depreciated since June 2010. Moreover, as the consequences of this lack of adjustment spill over onto others, G-20 members are increasingly taking individual actions that collectively risk further thwarting needed global adjustment. The number of G-20 countries that are intervening against exchange rate movements has increased. And more emerging markets are taking measures to reduce capital inflows. As a result, countries representing more than 50 per cent of the U.S.-dollar trade weight are actively thwarting foreign exchange adjustment, either through quasi-fixed exchange rates or with newly introduced capital controls. Canada and India are not part of this group. But we are bearing the not insubstantial consequences of a weakened global recovery and the re-emergence of global imbalances.[2]

As co-chairs of the Framework working group, Canada and India are working together to develop concrete and measurable policy commitments to be tabled at the Cannes G-20 Summit in November. We have made good progress at the G-20 table on indicators and guidelines to define significant and harmful economic imbalances. This experience has helped to foster a common understanding of the issues and problems across the G-20 which, in turn, serves as a first step in achieving greater policy coordination. The working group's focus now is on the key challenges of fostering greater exchange rate flexibility in emerging markets, encouraging deeper and more significant structural reforms, and strengthening the fiscal commitments made in Toronto. Both co-chairs also believe that there is a symmetry of interests between advanced and emerging economies in reducing the pace of reserve accumulation and are pursuing measurable commitments on this front. Achieving consensus

[2] Projections made by the International Monetary Fund show that imbalances narrowed from 2008 to mid-2009, but have been widening ever since and, without policy adjustments, are expected to worsen.

on all of these issues will require a shared understanding of the mutual benefits and, here, Canada and India have an important role to play.

Conclusion

Let me conclude.

The G-20 countries have had considerable success outlining what must be done to enhance the resilience of the global financial system and to achieve stronger, more balanced growth. And the potential achievable benefits of taking collective action are large. The Bank of Canada conservatively estimates that the average net economic benefit to be gained over time by G-20 economies from the stronger agreed capital and liquidity standards is 30 per cent of GDP in present-value terms, or about US$13 trillion.[3] Further, if the G-20 initiatives to unwind global imbalances are realized, the Bank estimates that the level of global demand could be $6 trillion to $9 trillion dollars higher by 2015 than when compared to a scenario of deficient global demand.[4]

But to achieve this promise, the pace of implementation of the G-20 Framework must step up. We are already bearing the consequences of inadequate adjustment. Unsustainable macroeconomic policies are increasing uncertainty, undermining a sustainable economic recovery and raising financial stability risks. And the longer needed adjustments are delayed, the more serious the consequences will ultimately be. Financial stability that is durable cannot be achieved without balanced sustainable growth – nor can growth be sustained without financial stability.

As the recent extreme market volatility has made all too stark, we hand financial markets the opportunity to speculate against needed adjustments at our collective peril. Financial markets are content until they are not. Policy-makers cannot predict when market sentiment will shift, but every delay in implementing policies to safeguard and support sustainable economic growth increases the likelihood of another calamity.

Canada and India are a world apart. My country is a medium-sized, advanced economy. India is an emerging giant. But the elements we have in common are significant and powerful, including our democratic heritage, our market-based approach to economic policy and our commitment to a prosperous global economy. We are strengthening the ties between our countries. And together we share a leadership role on the world stage to achieve a global economy that sustains strong and balanced growth to the benefit of all citizens.

Thank you.

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[3] Bank of Canada, "Strengthening International Capital and Liquidity Standards: A Macroeconomic Impact Assessment for Canada," August, 2010. See also Mark Carney, "Bundesbank Lecture 2010: The Economic Consequences of the Reforms," speech to Deutsche Bundesbank, Berlin, 14 September 2010.

[4] K. Beaton, C. de Resende, R. Lalonde, and S. Snudden, "Prospects for Global Current Account Rebalancing," Bank of Canada Discussion Paper 2010-4. See also Mark Carney, "Restoring Faith in the International Monetary Sysem," speech to Spruce Meadows Changing Fortunes Round Table, Calgary, 10 September 2010.