# Tiff Macklem: Managing risks in the new global economic landscape

Remarks by Mr Tiff Macklem, Senior Deputy Governor of the Bank of Canada, at the National Insurance Conference of Canada, Vancouver, British Columbia, 27 September 2011.

* * *

It is a great pleasure to be speaking here in Vancouver at the annual National Insurance Conference of Canada. Few industries know more about the personal, economic and financial impacts of disasters – or "extreme events" as insurance experts like to call them. And few know more about risk management.

Today I want to talk about both topics – an extreme event and private and public risk management in its wake.

This morning you discussed earthquake insurance. Earthquakes, like other natural disasters – tsunamis, hurricanes and ice storms come to mind – are entirely exogenous, extreme events – acts of God, if you will. They are not preventable, although their impact can be reduced by building resilience and by timely and effective disaster response. Your industry, of course, plays a vital role in helping households and businesses to mitigate the consequences of natural disasters.

Other extreme events are endogenous – or manmade. The recent financial crisis falls into this category. The crisis that began in August 2007 and exploded in the autumn of 2008 was self-inflicted. The financial system was fragile and it failed. We are still paying. We will be paying for many years to come.

The global recession that followed the financial crisis was the deepest since the Great Depression. And today, we are two years into what is shaping up to be the weakest recovery since the Great Depression. This is the new economic and financial landscape we find ourselves in. And while it may be less than we desire, it should not be terribly surprising.

The lesson from history is that the recessions that follow financial crises are bigger than normal recessions. On average, the loss in output in a recession after a financial crisis is two to three times the loss in a normal recession. Output falls further in a recession after a financial crisis. Normally, the deeper the recession, the sharper the recovery. Not so with the recoveries after financial crises. Recoveries after a financial crisis are slower. Typically, it takes output twice as long to return to its pre-recession level after a financial crisis than in a normal recovery, and output is permanently lower compared with its pre-crisis growth trajectory.

The essential reason for this is that the legacy of a financial crisis is a lot of debt, and paying down that debt acts as a dragging anchor on the economy that takes many years to break free from. If we had forgotten this lesson from history, recent economic and financial data have provided a reminder that in a world awash with debt, repairing the balance sheets of banks, households and governments will take years.

In Canada, we weathered the crisis better than most advanced economies. Our recession, while sharp, was shallower and shorter than many, and we have few internal impediments to recovery. Our banks are among the strongest in the world, and we have the best fiscal situation among the G-7. Nonetheless, an anemic U.S. recovery, as well as a persistently strong Canadian dollar and elevated global risks, are all weighing on growth here.

This new, more modest global economic landscape has implications for a number of issues. I will develop three of these under the headings sovereign risk, shifting economic centre of gravity, and low for long. I will then say a few words about private risk management in this new landscape, as well as the public policy priorities that are necessary to sustain the recovery and support financial stability.

## Sovereign risk

Let me start with sovereign risk. The immediate issue is Europe: I don't need to tell this audience that the fiscal and financial strains in Europe are acute.

Widening sovereign spreads on an expanding group of euro-area country bonds are challenging fiscal sustainability in these countries. The leading-edge consequence is the buildup of funding pressures on European banks. Most have seen their funding costs rise sharply, their access to financial markets curtailed and their equities trading at historic lows relative to the value of their assets. These challenges are compounded by the impossibility of currency adjustments within a monetary union. Without the option of devaluation, prolonged deflationary adjustments are required in countries that must restore competitiveness.

While the situation in Europe is immediate, the need for agreed measures to restore fiscal sustainability in the United States and Japan is no less important. Increasing uncertainty about the ability of the political process to deliver the needed adjustments is reflected in recent sovereign downgrades.

These fiscal challenges are manageable with political will and sound execution, but as long as large debts need to be refinanced, sovereigns will remain vulnerable to changes in global growth and investor sentiment. This presents a fundamentally new landscape in which government debt can no longer be considered a risk-free asset in many advanced countries. Given the central role of government liabilities in the financial system, prolonged concerns over sovereign risk could have profound implications for the functioning of the financial system. In particular, the role of government bonds as the benchmark against which a broad array of financial assets are priced is likely to be eroded.

## Shifting economic centre of gravity

A second consequence of a weak recovery in advanced countries is an acceleration in the shift in the economic centre of gravity to emerging markets. This is not a new trend, but it has been turbocharged.

The growth differential between advanced and emerging economies has widened sharply. Emerging-market economies now account for close to 80 per cent of global growth – up from just one-third at the start of the millennium.

Improved economic management in emerging markets has both increased their potential growth and reduced their riskiness. And with most portfolios underweight in emerging-market exposure, increasing the allocation to emerging markets has the potential to boost returns without taking on excessive risk. Of course, emerging-market economies do not represent a homogeneous asset class. They offer a higher range of both volatility and opportunity that investors must take into account.

Large capital inflows and sudden outflows can present challenges for emerging markets and investors alike. In particular, there is a risk that large inflows could fuel asset-price bubbles. A reallocation of only 5 per cent of advanced-economy portfolios to emerging markets translates into a potential flow of $1.6 trillion, or eight times the portfolio equity flows to all emerging markets. This is a considerable shock.

The robust growth in emerging economies is a welcome source of strength for the global economy. With strong growth, however, comes the risk of overheating, followed by an abrupt correction. For investors, the exits could be crowded. These are risks that both private investors and public authorities need to manage.

## Low for long

The last feature of this new economic landscape I wanted to address is low for long.

With weak recoveries in the United States and Europe and a tentative hand-off from public stimulus to private demand, policy interest rates can be reasonably expected to remain below normal for some time to come. While providing needed stimulus, prolonged periods of unusually low rates could contribute to excessive risk taking. They can cloud assessments of financial risks, induce a search for yield and delay balance-sheet adjustments.

Low for long is a special concern for insurance companies and pension funds with guaranteed returns or benefits. You made promises that you need to keep. And by reducing yields on assets and raising the net present value of liabilities, a sustained period of low interest rates makes guarantees harder to fulfill.

To address potential shortfalls, investors may move funds into riskier assets to pick up yield. In the first half of 2011, we saw a significant expansion in a variety of risky exposures offering higher returns – and volatility – including assets such as high-yield bonds, leveraged loans, emerging-market equity and debt, and commodities. The signs of growing risk tolerance in financial markets were evident in data on issuance, pricing and flow across a range of markets, and financial instruments with a riskier and more complex structure were returning.

With the dramatic fall-off in risk appetite in recent weeks, investors have shifted from a search for yield to a search for safety. This has sent the prices of risky assets sharply lower and safe-haven assets to record highs. Indeed, in a world of high sovereign debt, weak growth and a low-for-long-induced search for yield, the impact of new information will tend to be magnified. For investors, this means contending with more volatility.

In short, the legacy of the crisis is a treacherous economic landscape that puts a premium on private sector risk management and public sector risk mitigation. Let me say a few words about both.

## Strengthening private sector risk management

For the long-term investor, a fundamental shift is required, from thinking about a return target to considering appetite for risk and measuring and managing risk to the desired risk tolerance. The experience of the crisis provides some clear lessons for risk measurement and management, and points to the need for better tools for risk assessment, better information systems and information sharing, improved governance and compensation practices, and better communication.

To assess the risk of an extreme event like a major earthquake, insurance experts do not rely on short spans of data because there would be very few, if any, major earthquakes in the sample. Yet, financial risk managers routinely use tools such as value-at-risk models that use relatively short windows of recent data to assess the likelihood of financial loss. To measure financial risk accurately, we need better tools that capture tail events and mitigate procyclicality. In particular, there is a need to draw on longer spans of data and to complement standard tools with other methods, such as stress tests, that allow risk managers to explore the implications of extreme events.

Better information systems will help firms to measure risk and identify vulnerabilities. The financial crisis exposed the need to perform due diligence with respect to new products and instruments. A crucial lesson from the crisis is to avoid embedded leverage, which is extremely difficult to measure. We must be able to measure and quantify risks, and these risks need to be understood and considered across business lines. This means developing limits and controls that absorb the amount of risk that a firm can take and putting in place reliable enforcement mechanisms.

Sound governance is fundamental to ensuring appropriate investment in risk management and application of its principles. Boards must be involved in establishing levels of risk tolerance and overseeing risk management. Directors need to question growth rates in businesses and assess whether controls are keeping up with risks and if the business is resilient to shocks. This requires board members with expertise in banking, insurance and risk management.

Boards also play an important role in ensuring that compensation systems are part of an integrated risk-management strategy. Tying bonuses to short-term profits without adequate consideration of long-term risk is a recipe for excessive risk taking. The Financial Stability Board has developed principles for compensation practices that align compensation with prudent risk taking. Implementation must be system-wide so that professionals and firms have a level playing field.

Finally, financial firms, credit-rating agencies and financial advisers need to do a better job of communicating the suitability of products, and their inherent risks, to their clients. This requires better plain language disclosure. It also requires improved financial literacy and improvements in consumer protection. This is a shared responsibility of the private and public sectors – and we both have much to learn about which methods are the most effective.

## Public policy priorities

Sound risk management makes the best of the situation at hand; mitigating risk improves the situation. And there is much public policy can do.

While the lesson from history is that recoveries after financial crises are disappointingly gradual and bumpy, the future is not preordained. Public policy has a critical role to play in securing the recovery and promoting financial stability.

There is no doubt that the timely and concerted actions of the G-20 countries in 2008–09 to inject considerable monetary and fiscal stimulus averted a much worse disaster. But, today, uncertainty about the willingness of policy-makers to respond has become part of the problem. This needs to change.

European authorities must move decisively to contain their sovereign debt crisis. This starts with delivering on fiscal austerity in key countries and full implementation of announced measures to make the European Financial Stability Facility more flexible. But more is required. The immediate priorities are to provide a funding backstop for vulnerable European sovereigns that is sized to the scale of the problem and a comprehensive capital plan for European banks. In our opinion, this can be done by using existing European resources more efficiently. These steps must be complemented by governance reforms and credible fiscal arrangements within the European monetary union.

In other advanced countries, the priority must be to agree on credible, concrete and executable plans to restore fiscal sustainability consistent with the commitments made at last year’s G-20 Leaders Summit in Toronto.

In many emerging-market economies, greater exchange rate flexibility is necessary to better manage demand pressures and inflationary risks, while facilitating a global rebalancing of demand. Greater exchange rate flexibility between the United States and China is required to help the recovery in the former and control inflation in the latter.

Finally, advanced and emerging countries alike must implement agreed financial sector regulatory reforms to build a more resilient financial system that better serves the needs of households and businesses.

In the face of a difficult external environment, the Bank of Canada will continue to support Canada’s economic expansion by keeping inflation low, stable and predictable.

Since the crisis erupted four years ago, the Bank has demonstrated its nimbleness in the conduct of monetary policy. We reacted quickly and forcefully during the downturn. As the Canadian recovery has progressed, we have emphasized that we would be prudent with respect to the possible withdrawal of any degree of monetary stimulus.

## Conclusion

I must conclude. Recoveries after financial crises feel more like a convalescence. For private sector investors, the fundamentals of sound portfolio management have not changed, but the economic landscape has. Sovereign debt is no longer a risk-free asset, the shift in the economic centre of gravity to emerging-market economies has accelerated, and low-for-long interest rates are changing behaviours and straining some business models. The private sector bears much responsibility for the excesses at the heart of the 2008–09 financial crisis. Risk management can and should be strengthened, and adapted to new realities.

Public policy has a critical role to play in mitigating systemic macroeconomic risks. More action is needed to contain sovereign risks, promote a rebalancing of global demand and implement financial regulatory reform.

The distant horizon of the new landscape is bright. Getting there will take some time, but moving steadfastly in the right direction will get us there safely.

Thank you.