Mark Carney: Globalisation, financial stability and employment

Remarks by Mr Mark Carney, Governor of the Bank of Canada and Chairman of the Financial Stability Board, to the Canadian Auto Workers (CAW), Toronto, Ontario, 22 August 2012.

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Introduction

Thank you, Ken Lewenza for the invitation to be here today. You said last December that you would write to me to make sure you "get at least a couple of years as CAW National President, without having to face another world crisis." The least I could do is show up to discuss how we are doing to fulfill such an entirely reasonable request.

The global financial crisis has had a devastating impact. In the wake of Lehman's demise, global trade fell 10 per cent and industrial production 18 per cent. Canadian manufacturing output dropped about 20 per cent and auto production 70 per cent. Twenty-eight million jobs were lost worldwide, including at its peak, 430,000 here in Canada. Your membership was particularly hard hit, with reverberations that continue today.

The financial crisis and ensuing global recession demonstrated the fundamental interconnectedness of the global economy. When built on bedrock, interconnections of trade and investment create jobs and prosperity, including the $400 billion in goods exports in industries represented by your members.

However, when built on sand, as was the case for too much of financial activity pre-Lehman, the global economy can transmit instability, uncertainty and unemployment.

I want to discuss today what we can do to build the foundations for the right kind of globalisation, so that you can concentrate on creating prosperity for your families and fellow Canadians. Some of this is the direct responsibility of central banks; some is the work of the international policy-makers at the Financial Stability Board (FSB). And some is your responsibility: to continue to help grow flexible, productive companies that can succeed in a fiercely competitive global marketplace.

Securing financial stability for jobs and growth

Let me start with what policy-makers can do to ensure that businesses can get the capital they need to invest and hire, and further, that we do not experience a sudden shock in Canada from events abroad.

Building resilient financial institutions

Achieving a stronger global banking system is the overriding priority. This means more capital. Before the crisis, international banks operated with $50 of assets for every dollar of capital. With only a 2 per cent decline in the value of their assets, banks saw their capital wiped out. Not far off from your description, Ken, of having "no money in the vault" to back up their loans.[1]

In response, international regulators have increased the minimum amount of capital banks must hold by about five times and are making the largest, most complex firms hold even more. In addition, we have added a safety belt imported from Canada with a simple, but effective, leverage standard. This protects the system from risks we think are low but in fact are not.

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[1] Canadian Auto Workers (CWA) President Ken Lewenza speech to the CAW Council, p. 6, December 2, 2011.

Ending too-big-to-fail

These measures have lowered the probability of failure, but since failures will still happen, their impact must be reduced, which is one of the reasons to focus on ending "too-big-to-fail." We must address, once and for all, the unfairness of a system that privatises gains and socialises losses. By restoring capitalism to the capitalists, discipline in the system will increase and, with time, systemic risks will be reduced. In addition, the knowledge that major firms in markets far away can fail, without meaningful consequences at home, will restore confidence in an open global system and allow Ken and all of us to focus on our day jobs.

To ensure that bondholders, shareholders and management – rather than taxpayers – bear the brunt of losses, all FSB member countries have committed to have in place a bail-in authority and will have specific plans by the end of this year to recover or, if necessary, resolve these firms.

The framework for systemic institutions is now being extended to domestic banks, global insurers, and key shadow banks, such as hedge funds. When implemented, greater supervisory intensity and higher loss absorbency will ensure that the financial system is never again beholden to the fate of a single firm or group of firms.

Creating continuously open markets

An important element of ending too-big-to-fail is ensuring that key markets can withstand the failure of firms. Creating continuously open core markets requires changes to the plumbing of derivative and repo markets, along with better data and tracking of exposures.

Moving from shadow banking to market-based finance

Finally, the FSB is working to strengthen the oversight and regulation of shadow banking so that it is a source of competition (to promote efficiency) and diversity (to promote resilience) to the regulated sector. This will require changes to how money-market funds are managed, the terms of securitisation and, most importantly, how links between the regulated banking sector and shadow banks are managed.

Let me give a Canadian example of why this is important. In the summer of 2007, the Canadian non-bank ABCP market froze (***Chart 1***). As a consequence, auto leasing disappeared almost overnight (***Chart 2***).

Prior to this point, about 40 per cent of cars in Canada had been purchased with a lease. Canadian banks stepped into the breach helping to ensure that Canadian auto demand dramatically outperformed American demand. Now we need to rebuild securitization so that Canadian consumers have low-cost financial alternatives.

These reforms will make a huge difference – if they are implemented. Canada learned during the last crisis that having our own house in order is not enough. We need others to raise their game. That is why the FSB is increasingly focused on *timely and consistent implementation* of agreed reforms. We will identify those who drag their feet or bend the rules and hold them to account.

Recent developments in Canadian labour markets

Globally, workers felt the brunt of the financial crisis.

Yet, given its severity, Canada's labour market has performed well, both in absolute terms and relative to other advanced economies. All of the jobs lost in the recession have been recovered and a further 304,000 jobs have been created (***Chart 3***). Since the trough, the vast majority of these jobs have been full-time and in the private sector. Nearly all new jobs are in industries that pay above-average wages.

After peaking at 8.7 per cent in August 2009, Canada's unemployment rate has fallen to its current level of 7.3 per cent. While it has not yet returned to its pre-crisis low, this is in part because our working-age population has continued to grow and potential workers have continued to look for work.

This stands in stark contrast to the situation in the United States, where a large number of workers have become discouraged and left the labour market. Over 40 per cent of unemployed U.S. workers are long-term unemployed (compared with 18 per cent of Canada's unemployed workers). And the American unemployment rate stands 1 percentage point above Canada's (and a full 2 percentage points when measured on a like-for-like basis).

While Canada's labour market has performed better than most other G-7 economies, we all know there is still slack (***Chart 4***). The participation rate has not fully recovered and the percentage of involuntary part-time workers has risen about 5 percentage points (***Chart 5***). In addition, wage growth has been moderate and is expected to remain so.

This is one reason why monetary policy has been so exceptionally accommodative for so long. Interest rates have been at or near historic lows since the crisis began. Adjusted for CPI inflation, the policy real interest rate has been negative, on average, since the end of 2008. With a well-functioning financial system, the Bank has provided exceptional policy stimulus to our economy, consistent with growing activity and employment and consistent with achieving our inflation target.

Longer-term trends

Any analysis of recent employment performance should consider the broader context of an evolving workplace in the global economy.

First, the share of employment in manufacturing has steadily declined across advanced economies, falling from 25 per cent to 14 per cent in the three decades leading up to the crisis. Even in Germany, the share of employment fell from 32 per cent to 19 per cent over this period. In this context, Canada's record is about average, with a decline from 18 per cent three decades ago to about 10 per cent today (***Chart 6***). In part, this reflects the substitution of capital for labour, such as the increased use of robotics on assembly lines. It also reflects the changing nature of globalisation.

In both goods and services, the current wave of globalisation is changing the nature of production and the demand for labour. In the first wave of globalisation at the turn of the last century, the combination of sharp falls in transportation costs and large economies of scale in factories promoted the concentration of production and manufacturing employment.

In the current wave, which began in the late 1980s, huge advances in communications and computing technologies have dramatically lowered the costs of *coordination* across stages of production. This has promoted the distribution of these stages to the most cost-effective locations. One consequence has been a shift of fabrication jobs to low-wage locations in emerging markets. Even in services, complex tasks, such as professional and health services, are now being separated into their higher-value-added and routine components, leading to outsourcing and job displacement.

With companies increasingly part of global supply chains, competitive advantage will increasingly be concentrated in stages of production (such as engineering and design or fabrication) rather than specific sectors (such as aerospace or automobiles).

In general, these trends mean that the demand for unskilled workers in advanced economies is falling relative to that for skilled workers. Some estimates show that by the end of this decade, there will be a shortage of 18 million skilled workers and a surplus of 35 million unskilled workers across advanced countries.[2]

These broad shifts in the demand for and supply of labour are contributing to rising inequality. Over the past 20-plus years, incomes in Canada have increased nearly twice as fast for earners in the top 10 per cent as for those in the lowest 10 per cent. The share of the top 1 per cent is now the third highest among member-countries of the Organization for Economic Co-operation and Development (OECD) after the United States and the United Kingdom.[3] The last time inequality in the United States was this severe was during the 1920s. Moreover, labour's share of national income is now at its lowest level in half a century across most advanced economies, including Canada. When income inequality is measured using the Gini coefficient, the most widely-used metric of income inequality, Canada falls in the middle of OECD countries.

We all need to recognise that the durable, high-paying manufacturing jobs of the future will be located in companies that invest to equip and train their workers and that are fully engaged in the global economy.

Macroeconomic context

A strategy to grow good jobs in this environment must also take into account the global economic transformation currently under way.

It starts by recognising the limits of relying on our home market. In the immediate aftermath of the crisis, the broad economic strategy in Canada has been to grow domestic demand and to encourage Canadian businesses to retool and reorient to the new global economy.

Stimulative monetary and fiscal policies proved highly effective in supporting a robust growth in domestic demand, particularly household expenditures. For example, after falling almost 20 per cent in the recession, Canadian auto sales rebounded strongly and now are slightly less than 4 per cent above their pre-recession level.

As effective as it has been, the limits of this growth model are becoming clear. In particular, we cannot grow indefinitely by relying on Canadian households increasing their borrowing relative to income. In the decade leading up to the recession, Canadians tapped the wealth in their homes to finance up to one-fifth of consumption growth. Housing activity is now near a record share of GDP, and there are increasing signs of overbuilding and overvaluation in segments of the real estate market.

In response, the federal government has instituted four prudent and timely tightenings of mortgage insurance terms. OSFI has introduced tougher underwriting standards for home-equity loans and enhanced supervisory scrutiny. Monetary policy has remained focused on the inflation target, although under flexible inflation targeting the Bank of Canada is prepared to support regulatory efforts, if necessary, and consistent with price stability over the medium term, to ensure balanced and sustainable growth.[4]

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[2] R. Dobbs et al., "The World at Work: Jobs, Pay, and Skills for 3.5 Billion People," McKinsey Global Institute, June 2012.

[3] This share grew from 9 per cent in 1990 to 13 per cent in 2007 (United States: 18 per cent; United Kingdom: 14 per cent). See S. Matthews (2011), "Trends in Top Incomes and Their Tax Policy Implications," OECD Taxation Working Papers, No. 4, OECD Publishing, 2011.

[4] Bank of Canada, "Renewal of the Inflation-Control Target: Background Information – November 2011."

Even though desirable, eliminating the household sector's net financial deficit will eventually leave a noticeable $50 billion gap in our economy over two years. This gap can only be sustainably filled by additional exports and business investment.

But investment for what purpose and exports to where?

The U.S. economy is experiencing the slowest recovery since the Great Depression as the repair of bank, household and government balance sheets slows growth. The only good news is that some progress is being made.

U.S. banks have substantially increased their capital (common equity to total assets is up by more than 25 per cent). American households have recovered more than two-thirds of the $16 trillion fall in their net worth in the aftermath of the crisis, though we estimate that it will take several more years for households to make up the balance.

Despite this, total debt in America has barely fallen from its peak of 250 per cent of GDP – a level last seen in the Great Depression.[5] This is because U.S. government debt has increased $4 for every $1 reduction of household debt. Such treading water will persist for some time since private domestic demand is still not sufficiently robust to outweigh an aggressive fiscal tightening.

The Bank expects the U.S. expansion to average 2.5 per cent over the next few years (compared to 3 per cent in the decade prior to the crisis).

Bottom line, the U.S. economy is not what it used to be. With less capital investment and more structural unemployment, even once the U.S. economy recovers its cyclical losses, the Bank estimates that it will remain over $1 trillion smaller in 2015 than we had projected prior to the crisis. Already, U.S. weakness means that Canadian exports are $30 billion lower than they would normally be at this stage in the cycle.

Given our dependence on the U.S. market, our exports are still below their pre-recession peak. More broadly, with only 9 per cent of our exports going to the fast-growing emerging-market economies, our export performance has been the second worst in the G-20 over the past decade. Since 2000, our share of the world goods export market has fallen from about 4.5 per cent to 2.7 per cent.

Some blame this on the persistent strength of the Canadian dollar. While there is some truth in that, it is not the most important reason. Over the past decade, our poor export performance has been explained two-thirds by market structure and one-third by competitiveness. Of the latter, about two-thirds is the currency while the rest is labour costs and productivity.[6] So, net, our strong currency explains only about 20 per cent of our poor export performance.

In short, our underperformance prior to the crisis was more a reflection of who we traded with than how effectively we did it. We are overexposed to the United States and underexposed to faster-growing emerging markets.

Recommended response

To find and compete in new markets will require a concerted, multi-year effort of workers, firms and governments.

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[5] This excludes the debt of the financial sector.

[6] Caveat: relative unit labour costs vis-à-vis the United States are a useful proxy to assess Canadian competitiveness. They might not tell the whole story, however. For instance, they might not adequately capture the further opening of world trade to emerging and developing economies (e.g., China joining WTO in 2001).

First, we need an aggressive, emerging-market-focused trade strategy. That is why Canada is in a series of bilateral trade discussions with countries such as India, and will participate in the multilateral negotiations of the Trans-Pacific Partnership involving a number of Asian countries. It is not just that emerging-market economies now account for one-half of all import growth, but it is also that they are essential to secure our positions in global supply chains.

Second, as the CAW has long recognised, the quality of our workforce is one of our greatest strengths – one in which we must continuously invest. With technology and trade transforming the workplace, the need to improve skills across the spectrum of work has never been greater. Both workers and management must continuously improve in order to take full advantage of new technology by making changes to design, marketing and processes.

Third, we need to maintain an open and resilient financial system that at a minimum fulfills Ken's wish not to be at the mercy of "global bankers...[who] have learned nothing from the last crisis."[7] More broadly, we need a system that provides sustainably low-cost financing to businesses and consumers in the real economy so that we can grow output, jobs and incomes.

Conclusion

The global environment remains challenging. In recent months, there has been a widespread slowing of activity across advanced and emerging economies. Europe has slid back into recession and its crisis, while contained, remains acute. The U.S. economy continues to grow modestly, restrained by ongoing deleveraging and considerable uncertainty surrounding the fiscal cliff and the European situation.

While these global headwinds are restraining Canadian economic activity and there are some short-term special factors weighing on growth, current underlying momentum is at a pace roughly in line with the growth of the economy's production potential. Economic growth is expected to pick up through 2013. Consumption and business investment are expected to be the primary drivers of this moderate growth, reflecting very stimulative domestic financial conditions. While Canadian exports are projected to improve, they are likely to remain below their pre-recession peak until the beginning of 2014. This reflects weak foreign demand and ongoing competitiveness challenges, including the persistent strength of the Canadian dollar.

As the Bank noted in its most recent interest rate announcement, to the extent that the economic expansion in Canada continues and the current excess supply in the economy is gradually absorbed, some modest withdrawal of the present considerable monetary policy stimulus may become appropriate, consistent with achieving the 2 per cent inflation target over the medium term. The timing and degree of any such withdrawal will be weighed carefully against domestic and global economic developments.

In a volatile global environment, we need to plan for the long term. We cannot devalue ourselves to prosperity or cut ourselves off from the world and hope to rely on ever-increasing borrowing by Canadian consumers.

All of us – labour, business and governments – need to build on Canada's advantages:

- sound fiscal and monetary policy;
- a resilient financial sector;
- domestic inefficiencies that can be eliminated to boost employment and profit;

[7] Canadian Auto Workers (CWA) President Ken Lewenza speech to the CAW Council, p. 5, December 2, 2011.

- under-exploited opportunities in the most dynamic economies in the world; and, most importantly,
- a highly trained, dedicated and productive workforce, eager to learn new skills.

At the FSB, we will concentrate on designing and implementing a series of financial reforms that ensures the financial system supports the real economy so that businesses can invest and hire and Canadian workers, including their leaders, can plan for the future with confidence.

Thank you.

Chart 1: Securitization of Auto Loans has Declined Relative to Total Auto Loans (Big 6)

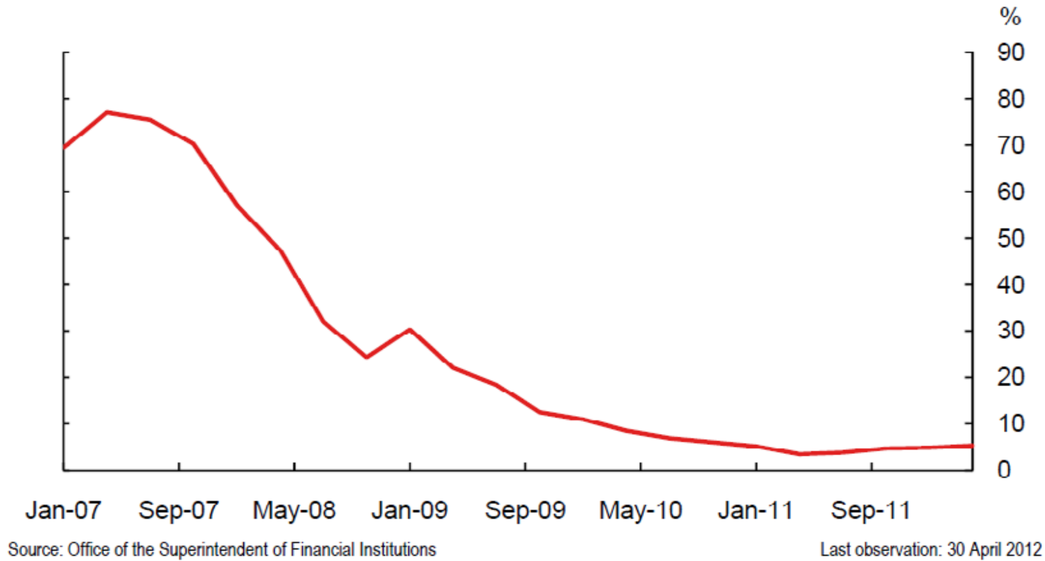
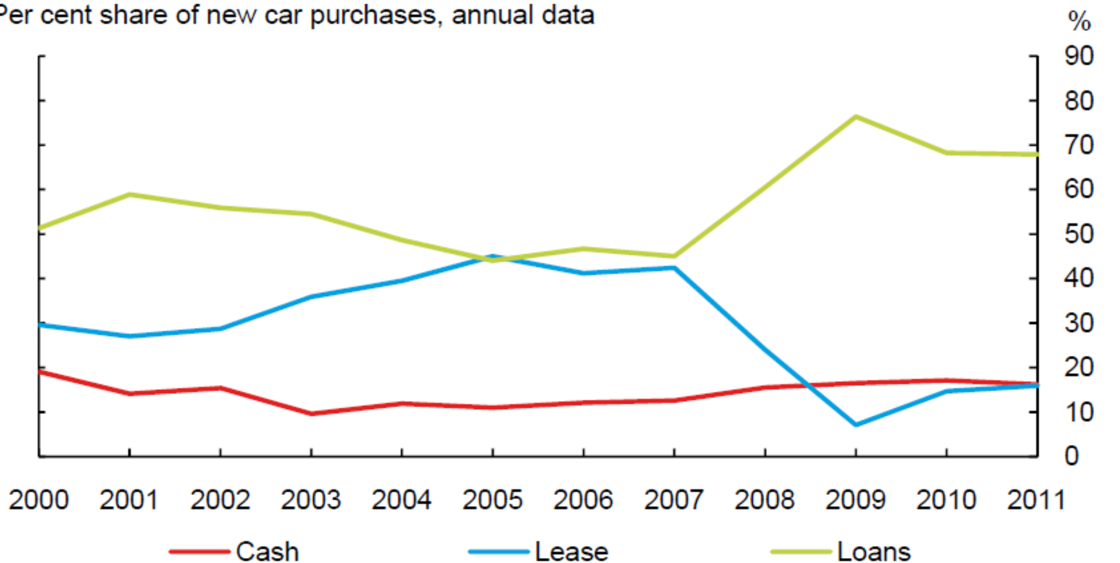
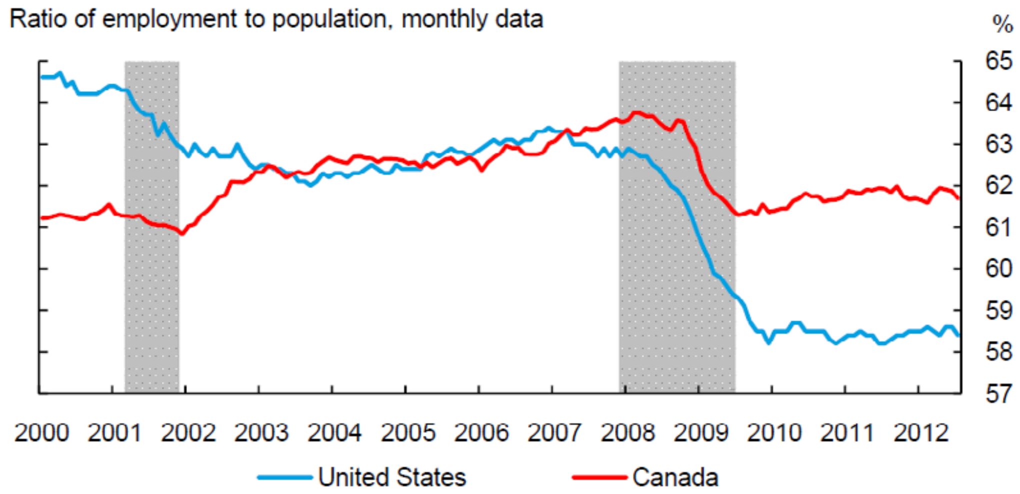


Chart 2: Auto Leasing Disappeared Almost Overnight



Source: DesRosiers Automotive Yearbook 2012 Last observation: 2011

Chart 4: Subdued Labour Market Conditions in the United States are Expected to Restrain the Growth of Consumption



Note: Shaded areas represent U.S. recessions
Sources: U.S. Bureau of Labor Statistics and Statistics Canada
Last observation: July 2012

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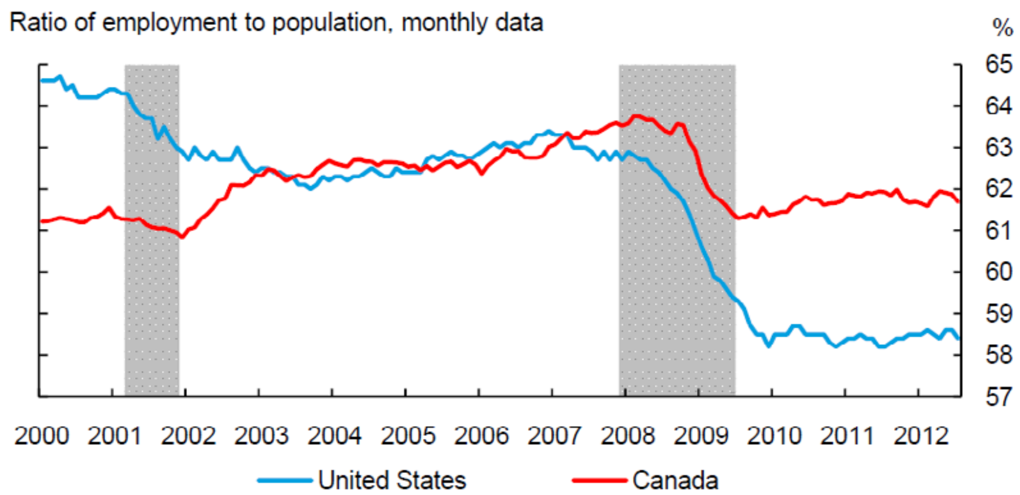
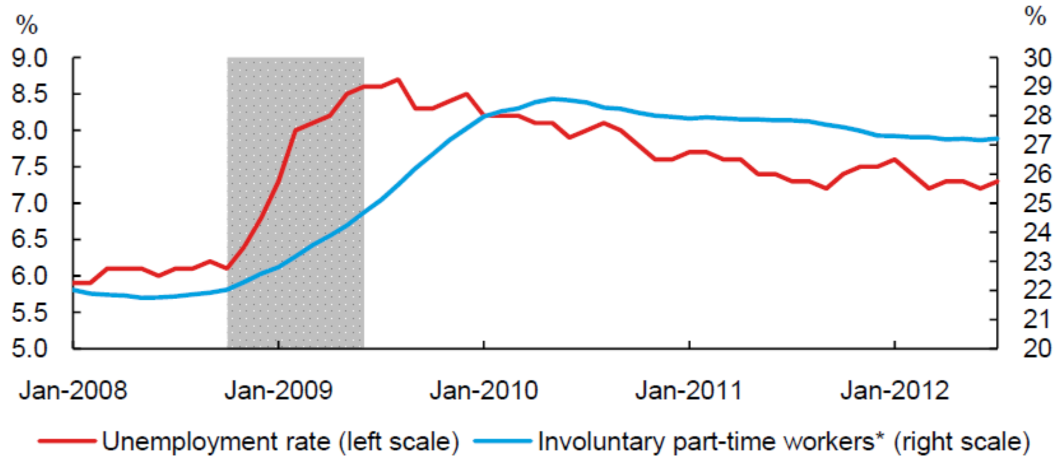


Note: Shaded areas represent U.S. recessions
Sources: U.S. Bureau of Labor Statistics and Statistics Canada
Last observation: July 2012

Chart 5: Some Slack Remains in the Canadian Labour Market

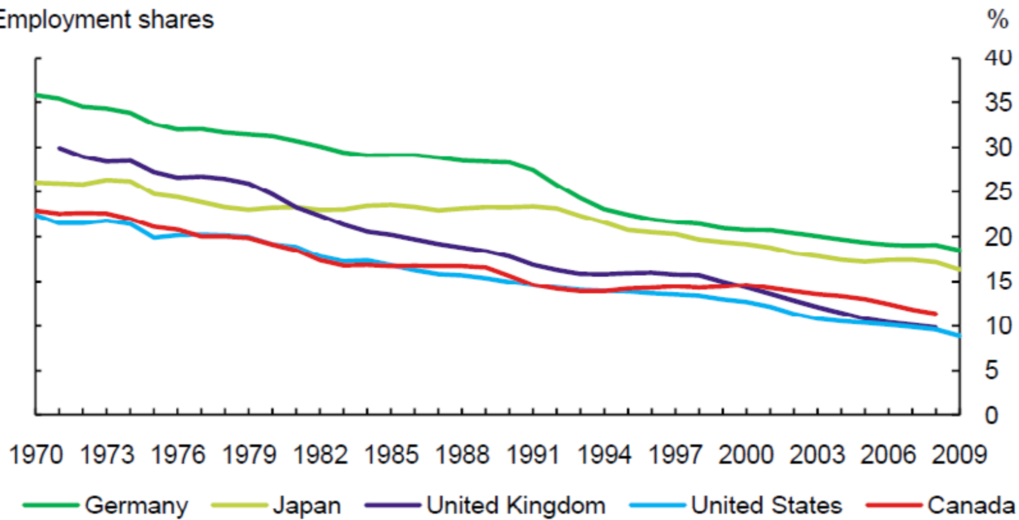
Monthly data



Note: shaded area represents the recession period based on quarterly real GDP
*Expressed as a percentage of total part-time employment, seasonally adjusted, 12-month moving average
Source: Statistics Canada

Last observation: July 2012

Chart 6: Manufacturing Employment Shares in OECD Economies, 1970-2009



Source: Organisation for Economic Co-operation and Development STAN Database

Last observation: 2009