# Mark Carney: Rebuilding confidence in the global economy

Remarks by Mr Mark Carney, Governor of the Bank of Canada, to the Northwest Territories Chamber of Commerce and Yellowknife Chamber of Commerce, Yellowknife, Northwest Territories, 1 April 2009.

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Good afternoon. These are very challenging times. The Canadian economy is in recession. The global economy is facing a crisis of confidence, triggered by the most severe financial meltdown since the Great Depression; fanned by sharp falls in trade, manufacturing output, and financial wealth; and intensified by steep increases in unemployment. In the throes of this crisis, fundamental certainties – about the structure of the financial system, the effectiveness of macro policy, and even the principles of capitalism – are being questioned.

In this environment, Canadians from coast to coast to coast are more concerned about their economic future than they have been in decades. These concerns are understandable given the economic realities we face: unemployment has risen sharply, and the job market can be expected to deteriorate further before it recovers. The prices for our exports have fallen, our personal finances are under increasing strain, and our economy is currently shrinking.

However, these concerns ought not be boundless. The Canadian economy has fundamental strengths, and has not been prone to the excesses that others have experienced. Moreover, globally and in Canada, policy-makers have mounted an aggressive three-pronged response to the current crisis. Monetary and fiscal policies have been eased substantially to support demand. Unprecedented measures have been taken to support the financial sector in order to keep credit flowing. And bold, longer-term reforms are being developed to create a more stable and efficient financial sector. If well executed, these measures will collectively begin to restore confidence and, with it, promote sustainable economic growth.

My message today is simple: there is a plan to restore confidence and growth, we are implementing it, and it will work. The impact of these policies will build over time and will be significant. For maximum effect, it is critical that measures be grounded in robust and principled frameworks: the objectives should be transparent; indicators of success clear; and entry and exit criteria well articulated. Citizens must be able to hold their policy-makers accountable. Policymakers must rise to the occasion.

Canadians can have confidence that the right policies are being put in place. They can manage their affairs in expectation – rather than hope – of a recovery. They can also expect that, once the global recovery begins, the Canadian economy will recover faster than many other industrialized economies.

Unfortunately, the exact timing of the recovery is uncertain, and the global recovery itself may be more muted than usual. Since these factors depend to a great degree on measures taken outside our borders, the Bank is working intensively with our international colleagues to re-establish confidence in the global financial system. At home, our priorities are to cushion the blow of the global recession on the Canadian economy and to preserve our advantages so that we remain well positioned for the recovery when it occurs.

## Current global outlook: synchronized and deep global recession

Global economic activity is currently falling at the sharpest rate since World War II. What began as a relatively controlled slowdown has become a synchronized and deep global recession. The proximate cause was the intensification of the global financial crisis that resulted from the failures of several prominent global financial institutions and from the growing realization that this was a solvency rather than a liquidity crisis. The recession that originated in the United States has spread around the world through confidence, financial, and trade channels.

The consequent drop in global demand can be seen in sharp relief in recent industrial production figures, which have – to use a too-familiar phrase – “fallen off a cliff.” U.S. industrial production is down 11 per cent from its peak – with a majority of the losses in motor vehicle production. This is the worst performance since the oil shock of 1973-75, when large swathes of U.S. manufacturing capacity were rendered uncompetitive. The picture is even worse in Japan, where industrial production has fallen by 30 per cent over the last year. Indeed, across the G-7 countries excluding Canada, industrial production has fallen an average of roughly 16 percent since its peak about a year ago. To put this into perspective, if Canadian industrial production had fallen by the same proportion, our GDP would have been 3 percentage points lower at year-end.

These declines have highlighted the fundamental interconnectedness of the global economy. For example, the reverberations of contracting U.S. consumer demand are spreading rapidly via global supply chains. World trade fell 5 per cent in the fourth quarter and will have fallen further still in the first quarter. The drop-off has been particularly severe across countries that supply goods to China. These economies are now suffering from China’s leverage to U.S. consumers.[1]

The sharp fall in industrial demand has had a direct impact on the prices of most major commodities. The Bank of Canada's commodity price index declined by roughly 50 per cent in the second half of last year, helping to fuel a 16 per cent decline in Canada's terms of trade over the same period.

The nature of the U.S. recession, with very weak auto and housing sectors, is particularly challenging for Canada. The U.S. household sector is very depressed, with sentiment at its lowest point in 30 years. Housing construction continues to be a major drag on U.S. growth, with housing starts now well below replacement rates. U.S. motor vehicle sales have fallen almost 40 per cent from their average monthly sales value reported between 2000 and 2007. With similar declines in Europe and Asia, there is a global auto crisis, with significant multiplier effects on global growth.

We expect that the eventual U.S. recovery will be much slower than usual. In our January *Monetary Policy Report Update*, we projected that it will take at least two and half years from the onset of the recession for U.S. GDP to return to its pre-recession level. This sluggishness reflects the lingering effects of the crisis on the U.S. financial system, the traditional lags in the impact of policy, and the expected slow recovery of domestic consumption owing to the magnitude of wealth effects and the deterioration in the labour market.

## Major secular shifts

It is increasingly apparent that the current downturn represents more than a cyclical shock. It also marks the advent of three major secular shifts, which any credible policy response must take into account.

First, the correction of unsustainably large current account imbalances in several major economies is now under way. The rapid spillover of declining consumer demand in the United States on Asian trade and output demonstrates the tight relationship between these two economic areas. That which was symbiotic is now virulent. In the very short term, these

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1 Chinese exports fell by 26 per cent in February of this year, compared with the same time last year. Over the same period, Taiwanese exports were off 25 per cent year-on-year in February, Japan's fell 46 per cent, and Korea's 18 per cent (versus an average growth of 18 per cent over the past five years in these four economies).

imbalances will narrow dramatically. For example, the Bank currently expects that the U.S. current account deficit will fall to around 3 per cent of GDP toward the end of 2009, or about one-half of its size in 2006. However, adjustment through a collapse in demand is hardly desirable. The sustainable rebalancing of domestic demand from deficit countries, such as the United States and the United Kingdom, toward surplus countries, such as China and Germany, will take some time and is likely to dampen the pace of growth in the global economy during that period.

Second, the crisis marks a watershed for the design and use of financial services. For three decades, major economies have undergone a process of financial deepening, whereby people and firms were able to borrow more readily and efficiently to finance investments and to smooth consumption over time. People also took increasing control of their retirement planning and became steadily more active in financial markets. With these changes, the importance of financial markets relative to banks – and of the financial sector relative to other sectors of the economy – increased. During this process, the level of household debt relative to GDP rose sharply. These trends were at their most extreme in the United Kingdom and the United States.

The reversal of these trends began with the current financial crisis and will be encouraged by changes both to the structure of the financial services industry and in the portfolio preferences of individuals. As a result, we can now expect a period of financial shallowing – characterized by reintermediation of transactions onto bank balance sheets, a relative decline in market-based finance, and a decrease in cross-border financial flows. In the process, financial leverage will fall. There has already been considerable deleveraging of the non-regulated financial sector (hedge funds, structured investment vehicles (SIVs) and captive finance companies of major industrial companies). However, there is still much to be done on the regulated side. The Bank of Canada estimates that for foreign banks to delever to Canadian levels, they will need to raise about US$1 trillion in capital prior to any additional write-downs incurred.

Third and most fundamentally, it would appear likely that the global economy is entering a period of lower potential growth. It is now readily apparent that there was substantial capital misallocation in the boom years, including heavy investment in non-tradable real estate and a global auto industry geared to outmoded demand patterns. It will take time to reorient, since household savings are likely to rise substantially in many industrialized countries. One of the lessons of Japan's "lost decade" is that an economy cannot really have sustainable growth until past excesses have been worked off.

In the meantime, frictions are rising that could reduce the efficiency of the global economy. Financial nationalism is emerging, not only because of a rise in home bias, but also because of the recognition that financial institutions are global in life but national in death.[2] Regrettably, the designs of some rescue packages and reforms are creating barriers to cross-border capital flows. This could gather momentum, which would be most ominous if it were to accompany a return to trade protectionism.

### Canadian outlook

The global downturn and declining demand for our exports will make this a very difficult year for Canada's economy. The first half of the year will be particularly challenging, with deep drops in activity and considerable increases in unemployment. The contraction in the first quarter now looks likely to be the worst on record since 1961. This reflects an exceptionally unfavourable combination of factors: further negative growth in the world economy that

[2] T. Huertas, "The Rationale For and Limits Of Bank Supervision." (Speech to the London Financial Regulation Seminar, London, England, 19 January 2009).

greatly depressed our exports and terms of trade; the beginning of a substantial inventory correction; worsening labour market conditions combined with falling income and declining household net worth, causing a further decline in household spending; and increasing spare capacity and reduced cash flows that further discouraged business investment.

The global recession has meant a significant decline in external demand for Canadian products. The U.S. auto crisis is forcing a wrenching adjustment to our industry. The U.S. housing crisis and the stresses faced by print media are conspiring to create intense challenges for our forestry sector. The drop in our terms of trade since July will translate into a significant reduction in Canadian incomes and thus in our ability to sustain real domestic spending in the economy.[3]

Domestic demand in Canada is softening for other reasons as well. Rising unemployment means less income and lower consumer spending. Losses experienced by Canadians on their financial holdings, either directly or via their pension funds, and concerns about the employment outlook will also restrain domestic consumption this year. In addition, uncertainty about the economic outlook and strained financial conditions will likely lead to declines in investment spending this year.

Given these factors, the Canadian economy could continue to contract into the second half of this year. As noted in our March interest rate decision, the Bank now expects the output gap will be considerably wider than before, and we do not expect it to begin to close until the first quarter of next year, at the earliest.

The Bank will provide a full update of its outlook for the Canadian economy on 23 April when it publishes its *Monetary Policy Report*.

**Prospects for recovery: restoring global confidence**

The timing of the global and Canadian recoveries depends crucially on two related factors: the stabilization of the global financial system and the restoration of confidence among households and businesses.

Across the world, the paradox of thrift is now in full force. Firms are postponing investment projects and building cash reserves. Households are delaying purchases and increasing their savings. Banks are curtailing lending and hoarding capital. These decisions, even if individually rational, are collectively damaging to our economic prospects – and are ultimately self-defeating.

Once this dynamic has been set in motion, it will only be broken by decisive measures to restore confidence. This will not happen overnight. To quote Montek Singh Ahluwalia, deputy chairman of India’s Planning Commission, “Confidence grows at the rate that a coconut tree grows, but confidence falls at the rate that the coconut falls.”

To restore confidence, policy initiatives must be sizable, forward looking, and credible. That is, they should be scaled to the severity of the shocks, take into account the secular shifts just outlined, and incorporate an exit strategy. Most fundamentally, policies must be fully consistent with well-articulated frameworks that support sustainable economic growth.

As the Bank has consistently emphasized, stabilization of the global financial system is a precondition for economic recovery, globally and in Canada. In this regard, there are three requirements: 1) keep the system functioning; 2) address legacy or toxic assets; and 3) develop more fundamental reforms.

3 This terms-of-trade shock can be expected to materially lower profits for our producers, reduce wages and employment for workers in our resource sectors, impair orders from related industries and services, and lower revenues for governments.

In order to keep the system functioning, central banks have responded aggressively and creatively to supply liquidity. These efforts have been largely successful with interbank lending rates narrowing substantially since the worst periods last fall. Reflecting both the strength of our financial system and the timeliness of the Bank of Canada's response, Canadian spreads have been the best performing of the major economies.

Conditions have been slower to improve in other markets. The issuance of commercial paper (CP) and asset-backed commercial paper (ABCP) has stabilized, but spreads remain wide and maturities relatively short. Corporate bond issuance has improved, though activity remains below trend, and spreads appear to incorporate unusually high liquidity premia. There are also concerns over possible crowding out of private finance by large-scale public debt issuance. Sovereign debt issuance – excluding guarantees – will rise threefold this year. In this context, some central banks have taken direct measures to improve the flow of credit; and governments will need to be prudent when considering additional borrowing.

Keeping the system functioning also requires action to mitigate the dramatic reversal in cross-border capital flows. The Institute of International Finance estimates that net flows from private creditors to emerging markets, which topped US$630 billion in 2007, will be negative this year.

The scale of these declines means that there is an urgent need for additional IMF resources. In addition, a sharp decline in the availability of trade finance has exacerbated the fall in international trade. G-20 countries could address this by providing additional export credits and trade insurance, as Canada has done. The G-20 summit beginning today could make substantial progress on these issues.

Second, the timely implementation of ambitious plans in the United States and other major economies to address toxic assets and re-capitalize financial institutions will be critical to stabilizing the global financial sector. Two weeks ago in Horsham, England, the G-20 agreed on principles for addressing such assets; the issue now is implementation.

Throughout this process of restructuring the financial system, policy-makers have made it clear that systemically important institutions will not be allowed to fail. G-20 finance ministers and governors reiterated that commitment earlier this month in Horsham. Moreover, no one should be in any doubt that G-20 countries can afford their banking sectors. The Bank calculates that even in the worst-case scenario, recapitalizing the banking system in an individual G-20 country would cost less than 20 per cent of GDP – a considerable, but still manageable, sum.

Third, G-20 nations need to move decisively to define the priorities for the new international financial architecture. In this regard, measures to improve transparency and integrity, to implement a macroprudential approach to regulation, and to widen the perimeter of regulation are vital.

If these national and multilateral measures are not timely, bold, and well executed, Canada's economic recovery will be both attenuated and delayed. The reality is that the financial crisis and subsequent recession originated beyond our borders, and the necessary triggers for a sustained recovery must be found there as well. Canada has much to offer, which is why we are working closely and tirelessly with our international colleagues.

## Managing demand

Stabilizing the global financial system is the top priority. However, success in this regard alone will not necessarily mark an immediate return to global economic growth. Exuberance – of any type – has been in short supply for some time. Confidence will be slow to return, and the rebalancing of global demand will take some time. In short, the global economy faces a period of deficient demand. Both monetary and fiscal policy can help address this shortfall.

The scale and appropriate mix of the response will vary by country and will depend importantly on the credibility of the policy frameworks.

Reflecting the seriousness of the shock, the global macroeconomic policy response has been unprecedented.

Fiscal policy initiatives have been robust, with the world well on its way to spending an average of 2 per cent of global GDP in discretionary fiscal measures. Simultaneous fiscal action is not only more powerful than measures taken in isolation, but also has the potential to provide some support for commodity prices. This is because government infrastructure spending is relatively commodity-intensive.

With respect to monetary policy, target interest rates have been substantially and rapidly reduced in major economies.[4] The Bank of Canada has lowered our policy rate by a cumulative 400 basis points since December 2007. Consistent with returning total CPI inflation to 2 per cent, the target for our overnight rate can be expected to remain at this level or lower at least until there are clear signs that excess supply in the economy is being taken up. It is important to recognize that central banks do not necessarily need to keep cutting interest rates to provide additional monetary easing. Duration matters. By keeping rates low for longer, additional stimulus can be provided.

The effects of the recent aggressive monetary and fiscal policy actions in Canada and other major economies will begin to be felt in the second half of this year and will build through 2010. Once the global financial system stabilizes and global economic growth recovers, the underlying strength of the Canadian economy and financial sector should ensure a more rapid recovery in Canada than in most other industrialized economies. However, as we highlighted in our last *Monetary Policy Report Update*, the global recovery will likely be more muted than usual, owing not least to the weight of past excesses in the United States economy.

In the coming months, there may be pressure for policy to do more. Such decisions must be taken carefully with an eye to the scale of what has already been done, the traditional lags to policy, and the paramount need to retain the credibility of fiscal and monetary frameworks.

Canada is well served in this regard, since inflation targeting gives us an important advantage in focus and communications. Our monetary policy mandate is clear: conduct policy in order to achieve our target of 2 per cent CPI inflation over the medium term. Low, stable and predictable inflation is the best contribution monetary policy can make to the economic and financial welfare of Canadians.

It is in this context that we will outline later this month a framework for the possible use of unconventional monetary policy measures, including credit easing and quantitative easing. As the overnight rate approaches zero, it is important that Canadians understand that the Bank retains a considerable number of policy options to achieve its mandate. Moreover, it is essential that these alternatives are outlined in a comprehensive fashion: with clear indicators of success identified, and transparent principles for both entry and exit. To be absolutely clear, outlining a framework does not necessarily imply that these policy options will be deployed. Their use will be a function of the outlook for output and inflation and of the relative effectiveness of the instruments in achieving the inflation target.

[4] The G-20 policy rate has fallen to 2.14 per cent from 4.27 per cent in August 2008.

## Conclusion

A deep and synchronized global recession is currently under way. It is being fed by a crisis of confidence. Reversing this will take concerted short-term macro measures, long-term micro reforms, and time.

Stabilization of the global financial system is a pre-condition for economic recovery. In this regard, implementation of recently announced plans to address toxic assets in banking systems outside Canada will be critical. In addition, this week's G-20 summit should provide the road map for a more stable and effective international financial system.

In the meantime, the freefall in domestic demand and an atmosphere of exceptional uncertainty has created an intense need for massive, credible policy action. This need is being met – there has been an unprecedented monetary and fiscal response. The effects of these policies will build over time and will be felt with full force next year.

Decisions to provide additional stimulus must be carefully considered. It is paramount to retain the credibility of fiscal and monetary policy frameworks. While considerable options for further monetary stimulus remain, their use is not preordained and will solely be determined by their appropriateness in achieving the inflation target.