

## Tim Lane: Risks to Canada's financial stability in an uncertain world

Remarks by Mr Tim Lane, Deputy Governor of the Bank of Canada, at the Winnipeg CFA Society, Winnipeg, Manitoba, 22 June 2010.

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Good afternoon. It's a pleasure to be here.

The recent past has underscored the fact that, in finance and the economy, most things are interconnected on a global scale. Throughout its history, Canada has been powerfully affected by events elsewhere. Manitobans in particular are well aware of this reality. Waves of immigration, rapid changes in commodity prices, the Great Depression, two World Wars, and technological advances – all have had an enormous impact here. More recently, the global financial crisis has been a stark reminder that everyone – even citizens in countries with sound “fundamentals” – is affected by major shocks, regardless of where those shocks originate.

Global realities and their impact on the domestic financial system inform much of the Bank of Canada's most recent issue of its *Financial System Review* (FSR), which was published yesterday. In the FSR, the Bank identifies and evaluates risks and vulnerabilities in the financial system. Our goal in doing this is to contribute to the long-term resiliency of the Canadian financial system by promoting informed discussion of various relevant issues and developments.

In my remarks today, I'd like to discuss two issues that are discussed in the FSR, which, directly or indirectly, pose risks to financial stability. These issues are sovereign debt and global macroeconomic imbalances. Both are “global” issues, but they will have to be managed at the national, as well as the international, level. As such, they are at the core of ongoing G20 discussions, including those taking place this week in Toronto.

I'll start by taking a very brief look at the Canadian economy – where we are now, and where we appear to be headed. Then, I'll elaborate on the two issues I've identified. I'll welcome comments and questions at the end.

### The Canadian economy

The global economic recovery is under way, but it is an uneven one. In the emerging-market economies, growth has been vigorous – indeed it has been stronger than we expected a few months ago. At the same time, in most advanced economies, the recovery has been subdued and heavily dependent on the exceptional stimulus provided by monetary and fiscal policies. In recent months, concerns over European sovereign debt have dampened prospects for the recovery in Europe. So far, these concerns have had limited effects on Canada – mainly, a modest fall in commodity prices and some tightening of financial conditions – but they are an important risk to the recovery.

In Canada, the economic recovery is proceeding somewhat more rapidly than expected. Growth has been very strong in the past two quarters, although we expect it to moderate, starting this quarter. Several factors have been supporting the recovery: fiscal and monetary stimulus, improved financial conditions, the rebound in global economic growth, more favourable terms of trade, and increased business and household confidence. At the same time, the persistent strength of the Canadian dollar, our poor relative productivity performance, and the low absolute level of demand in the United States are acting as a drag on the recovery. The Bank projects GDP growth of 3.7 per cent in 2010, with a gradual slowing to 3.1 per cent in 2011 and 1.9 per cent in 2012. Inflation is expected to remain close to our 2 per cent target through this period.

In view of this outlook, the Bank of Canada indicated in late April that the need for extraordinary monetary policy stimulus – which we had been providing since the beginning of the financial crisis and through the recession – was passing. On 1 June, we increased our policy interest rate from  $\frac{1}{4}$  of a per cent to  $\frac{1}{2}$  of a per cent. Of course, that still leaves interest rates at a very stimulative level. But because of the uncertainties – particularly those emanating from Europe – we've been careful to emphasize that the extent and timing of any additional withdrawal of monetary stimulus would depend on how the outlook for economic activity and inflation evolves. In making those decisions, we will always stay focused on achieving the 2 per cent inflation target.

In our monetary policy decisions, we are mindful of the risks to the economic outlook, both on the upside and the downside. In assessing financial stability, the downside risks are our main focus. So let me turn now to a discussion of two areas of risk that may bear on the health and stability of the financial system, both here and abroad. First, I'll look at the issue of sovereign debt.

## **Sovereign debt**

Sovereign debt – and unsustainable fiscal deficits – have been front and centre in recent global economic events. Concerns about sovereign debt have flared up in recent months in a number of European countries. But in the coming years, many advanced countries will face major challenges in achieving and maintaining sustainable fiscal positions. In Canada, we are fortunate that this task will be more manageable than elsewhere, and continued resolve is required.

The current sovereign debt problems were exacerbated and brought to a head by the global financial crisis and recession. Of course, a number of countries entered the crisis with weak fiscal positions, but their situations have deteriorated substantially. In part, this reflects the direct support many governments provided to keep troubled financial institutions afloat. Although the final bill for this support is not yet known, it could be very large. Another important element is the massive fiscal stimulus that governments in all major countries delivered to mitigate the recession. And, of course, reduced tax revenues, associated with the recession, have added substantially to the problem.

Both financial system support and fiscal stimulus were necessary, since the alternative would have been much worse. When private sector spending was no longer sufficient to support growth, governments had to step in to fill the gap. But the result was a shifting of the debt build-up from the private sector to the public sector.

Growing sovereign debt is a source of risk for two main reasons. First, high levels of public debt tend to constrain economic growth.<sup>1</sup> Second, when concerns about sovereign debt become acute – even if they are limited to a few countries – they can have pervasive effects on the financial system. These effects stem from the fundamental importance of government liabilities in the financial system. Government debt instruments are typically viewed as risk-free and highly liquid assets that are held by financial institutions and individual investors, and are used as a benchmark for pricing other financial assets. What happens, then, when these assets are perceived as risky – and when they become increasingly illiquid (as we saw in early May, when European sovereign debt markets seized up)?

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<sup>1</sup> See Carmen M. Reinhart and Kenneth S. Rogoff, "Growth in a Time of Debt," available at [http://www.economics.harvard.edu/faculty/rogoff/files/Growth\\_in\\_Time\\_Debt.pdf](http://www.economics.harvard.edu/faculty/rogoff/files/Growth_in_Time_Debt.pdf): "...whereas the link between growth and debt seems relatively weak at 'normal' debt levels, median growth rates for countries with public debt over 90 percent of GDP are roughly one percent lower than otherwise; average (mean) growth rates are several percent lower. Surprisingly, the relationship between public debt and growth is remarkably similar across emerging markets and advanced economies" (page 2).

First, consider the chain of exposures to the credit risk – from the holders of those government securities, to their creditors, and their creditors' creditors, and so on. And since many of these exposures are uncharted, the uncertainty about where the exposures lie may cause a spike in perceived counterparty risk, and thereby affect short-term financing decisions. As a result, funding markets become increasingly illiquid, with widening spreads and diminishing access to financing.

Finally, there is a general retrenchment in risk-taking, which results in a decline in the prices of risky assets – including currencies and commodities. We saw all of these transmission channels in Europe in early May. If the situation had deteriorated further, the impact on Canada's financial conditions, and on financial conditions more generally, could have been substantial.

The market turmoil in Europe was met by a forceful policy response. In the affected countries – as happens with most sovereign debt crises – there are two dimensions to the problem: the short-term challenge of rolling over debt, and the medium-term challenge of attaining a sustainable fiscal position. Of course, these two challenges are mutually reinforcing: the markets' skepticism about the medium-term fiscal position makes it more difficult to roll over debt, while the higher debt-refinancing costs make it more difficult to balance the budget. Thus, both problems have to be addressed in a credible manner. The funding problem is currently being addressed with the massive financing packages being provided by the European governments and the International Monetary Fund. The medium-term fiscal challenge will require hard decisions, painful adjustment, and perseverance.

The fiscal austerity that is required in such a situation involves a painful dilemma. Such adjustment can impede the economic recovery. On the other hand, as I've stressed, in countries where sovereign debt concerns have become paramount, failing to adjust will have adverse financial effects – which will also harm the recovery. In theory, this dilemma could be sidestepped by committing to undertake serious adjustment only later, when the economy is stronger; but promises of future action are rarely enough to convince markets. The solution typically involves taking the bull by the horns: making a bold start with serious structural measures that will have a lasting effect on the fiscal position. The pension reforms that have been undertaken in some European countries are a good example.

But there is a problem here for the global economy. For the past several months, there has been concern about the risks associated with the “hand-off” from public demand to private demand. The concern is that if fiscal stimulus runs out before the private sector has gathered sufficient momentum, the global economic recovery could falter. This points to the need for the pace of fiscal austerity to be consistent with continued recovery.

So far, I have been focusing on two channels through which excessive sovereign debt at the global level can create risk for the financial system here in Canada – more difficult liquidity and funding conditions, and a weaker global economic outlook. These are two of the five areas of risk examined in the current FSR. I would now like to focus on a third, and related, area of risk: global macroeconomic imbalances.

### **Global imbalances**

An important backdrop to the global financial crisis and the ensuing recession was the configuration of large current account imbalances in major economies. These global imbalances were evident in the high levels of savings, and the persistent current account surpluses in China and many Asian countries, counterbalanced by the credit-fueled spending by households and governments, and the large and persistent current account deficits in the United States and some other Western economies.

These imbalances were not the proximate cause of the crisis, but they contributed to its scope and intensity. In the years leading up to the crisis, high savings rates in surplus countries, together with inflexible exchange rates, helped to keep global interest rates low, encouraging

consumers and governments in some advanced economies to take on more debt than was wise. The low interest rates also led to a “search for yield”, meaning that investors and financial institutions acquired riskier assets. At the same time, debt was being repackaged in various ways – sometimes into hard-to-understand, and often illiquid, products – and distributed throughout the financial system. Many of these products then unravelled – with devastating consequences – during the crisis. Global imbalances engendered financial fragility because there were also underlying weaknesses in the financial systems of many countries – including deficiencies in supervision and regulation and inadequate risk management within financial institutions. Addressing these underlying weaknesses is one of the principal objectives of the G20 agenda.

Global imbalances have narrowed significantly during the past couple of years. However, this was largely the temporary effect of the recession and the policies adopted to counter it. In the United States in particular, savings rates have increased as households have been trying to recuperate from the loss of housing and equity wealth. In China, substantial stimulus measures have boosted domestic demand – including consumer spending and infrastructure. And the sizable drop in commodity prices from their 2008 peak contributed importantly to the narrowing of global imbalances.

What is worrying, however, is that global imbalances appear to be growing once again as the recovery advances, and their nature is changing. Whereas before the crisis, these imbalances primarily corresponded to unsustainable household spending in the United States, they now increasingly reflect unsustainable government deficits in a number of countries.

It is clear that what is needed is a “rotation of demand”: surplus countries need to increase their domestic spending, while deficit countries need to decrease theirs. Together with those adjustments in spending, exchange rates need to adjust – with a depreciation of the U.S. dollar against Asian currencies – to support the corresponding adjustment of external current accounts. In this regard, China’s recent decision to enhance the flexibility of its exchange rate is an important step forward; its full implementation will contribute to strong, sustainable, and balanced global economic growth.

In the absence of these necessary policy changes, there are three main risks to the global financial system and to the global economy. One is that the status quo becomes increasingly untenable. If the surplus countries do not increase their domestic demand, the United States and other deficit countries will have trouble weaning their economies off fiscal stimulus. The result could be a buildup of public debt relative to the size of these economies, which could not continue indefinitely. These higher debt levels would tend to drive up long-term interest rates, by both increasing demand for available funds and by feeding concerns about how the ever-increasing debt burden would be resolved. Recently, the Bank of Canada looked at the implications of this status quo scenario for global economic growth. Following a short-term boost, global economic growth would fall steadily from the 4 per cent average of 2002–07 to below 3 per cent by 2013. In addition, macroeconomic imbalances would continue to grow, possibly setting the stage for another crisis.

A second risk is that adjustment may be lopsided. Even if the surplus countries do not expand their demand, the deficit countries may be forced by markets to reduce their fiscal deficits. In that case, there would be a deficiency of demand worldwide. With monetary policy constrained by the zero lower bound, deflation could emerge. As a result, real interest rates would increase, fiscal consolidation would be more difficult, and growth would stall.

A third risk is that exchange rates may adjust, but in a disorderly way. If increasing concerns about the U.S. current account triggered a portfolio shift away from the U.S. dollar, the resulting exchange rate adjustment could overshoot the level required to bring current accounts to sustainable levels. If that occurred, it would likely send shock waves throughout the global financial system, adversely affecting the world economy. Such an adjustment did not happen during the recent financial crisis; on the contrary, the retrenchment of risk-taking

that occurred led to a shift into U.S.-dollar-denominated assets, resulting in an appreciation of that currency. But disorderly exchange rate adjustment remains one of the important risks associated with global imbalances.

It is because of these risks that the G20 is placing so much emphasis on policies to achieve strong, sustainable, and *balanced* growth, in tandem with measures to build a more robust global financial system. The rotation of demand required to achieve such balanced global growth will require policy changes in both deficit and surplus countries. It will also involve adopting greater flexibility in exchange rates, which would facilitate adjustment to both current imbalances and future economic shocks.

How can this adjustment come about? An important step is the G20 Mutual Assessment Process, now under way, through which G20 members strive to ensure that the “policies pursued by individual G20 countries are collectively consistent with more sustainable and balanced trajectories for the global economy.”<sup>2</sup> Each member country will submit its policies to the G20 for assessment by other members, with a view to promoting coherence among macroeconomic policies. Details of this process are now being worked out, but the most important thing is that the required policy changes *be implemented*, and in a timely manner. Failing that, we leave ourselves on the same unsustainable, and risky, path.

Allow me to conclude.

## **Conclusion**

The financial system makes a vital contribution to our welfare. A *sound* financial system, one that is stable, efficient, and resilient to shocks, is crucial to a well-functioning economy.

While the world’s financial system is stronger than it was during the crisis, risks and vulnerabilities remain. The G20 agenda for financial and macroeconomic reform is sound and far-reaching. It provides a blueprint for building a sound foundation. But the time for action has arrived.

We cannot afford to be complacent. Although Canada fared relatively well in the crisis, we are not immune to risk. We must continue to make our own financial system more resilient. Together with its partners, the Bank of Canada works to do just that. The Bank will also continue its work in international forums to reduce systemic risk in the global financial system. The issues I discussed – sovereign debt and global imbalances – are important, and they must be resolved effectively, and in a timely fashion. Our future well-being is at stake.

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<sup>2</sup> See “Leaders’ Statement: The Pittsburgh Summit,” available at: <http://www.pittsburghsummit.gov/mediacenter/129639.htm>.