John Murray: The Great Frustration – hesitant steps toward global growth and rebalancing

Remarks by Mr John Murray, Deputy Governor of the Bank of Canada, to the New York Association for Business Economics, New York, 27 November 2012.

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Introduction

The collapse of Lehman Brothers on 15 September 2008 triggered a precipitous worldwide economic collapse. What had previously been viewed as a passing bout of "financial turbulence" was suddenly transformed into a full-blown panic. The U.S. economy, which was at the epicentre of the crisis, suffered its most severe downturn since the Great Depression. It could have been much worse.[1]

Prompt and aggressive countermeasures by fiscal and monetary policy authorities eventually helped to stabilize the situation, and output began to recover toward the end of 2009 (***Chart 1***). However, a full four years after the collapse, real economic activity in the United States is scarcely above its pre-recession peak, and more than 4.5 million (net) jobs that were lost during the crisis have yet to be recovered. U.S. GDP is roughly 10 per cent below the level it would have reached had it continued to increase at the same trend rate of growth it experienced prior to the crisis (equivalent to more than $1 trillion).[2]

Europe's GDP has yet to return to its pre-recession peak, and is not expected to do so until 2015 at the earliest. The emerging-market economies (EMEs), including the BRIC countries (Brazil, Russia, India and China), which were growing at extraordinary rates prior to the crisis, did much better, but were still affected. Decoupling proved to be illusory.

Several international institutions and respected researchers warned that recoveries following a financial crisis, especially one involving banks and real estate, were typically protracted and painful, but few expected the process to be this slow and this painful. The Great Moderation of the 1990s and early 2000s was followed by the Great Recession of 2008–09 and now, what one central bank governor has termed the "Great Frustration."[3] I am not here to depress you, however. My speech today actually contains a message of hope. I will examine why the major advanced economies are where they are, and I will then describe what the future might hold. My message of hope does not come with any guarantees, however. It only points to the possibility of a more positive outcome. In order to reach it, a significant degree of enlightened self-interest will be required.

I will begin with a quick review of the current situation, and compare it with where many of us thought, or hoped, we would be today. I will also show you where we might have been if timely and aggressive corrective action had not been taken. "Be thankful for what you have" might be the appropriate epitaph for the Great Recession – it could have been worse. This is followed by a discussion of the economic game plan that was laid out by the G-20 leaders at a meeting convened by President Obama in late 2009. This G-20 Framework for Strong, Sustainable and Balanced Growth was designed to deliver what the name suggests.[4]

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1 U.S. GDP fell by roughly 4 per cent from peak-to trough, while real economic activity in Europe and Japan fell by 6 and 8 per cent, respectively.

2 This assumes, of course, that the previous trend rate of growth was sustainable.

3 Remark by Glenn Stevens, Governor of the Reserve Bank of Australia, at a recent private meeting.

4 For details of the G-20 Framework for Strong, Sustainable, and Balanced Growth.

The third part of my presentation assesses what has transpired since 2009 – identifying those policy commitments that were fulfilled and those that were not, highlighting, in particular, the major failings. The fourth and final part of my presentation reviews where we need to go from here. That is the uplifting part of what I will say today.

It's not good, but it could have been worse

The U.S. economy, as I noted a moment ago, has passed the peak that it reached just prior to the crisis, but it is well below where it would have been were it not for the collapse. Unemployment remains near 8 per cent, compared with an earlier (and perhaps unsustainable) trough of 4.4 per cent just before the crisis, and is well above consensus estimates of the structural or natural rate of unemployment. Excess capacity is judged to be in the range of 3 to 4 per cent of potential output.

Chart 2 shows the state of the U.S. economy over the past five years (the solid red line), and where the Bank of Canada projects it will be going over the next two years (the dashed red line). The upper and lower bounds of the grey area represent the fastest and slowest recoveries of the U.S. economy following all of the previous post-Second World War recessions. As you can see, the red path is well below the lower bound.

The experience in Europe has been even more disappointing relative to previous postwar recoveries (***Chart 3***). The outcomes for both the United States and Europe, however, have been much better than what was witnessed during the Great Depression (***Chart 4***). Make no mistake: This is where the major advanced economies were heading in late 2008. Indeed, output was falling at a far faster rate during this period than in late 1929. Only coordinated and exceptional policy measures prevented another Great Depression.

G-20 Framework for Strong, Sustainable, and Balanced Growth

By late 2009, output had started to rise at a reasonably robust rate in many, if not all, economies, and authorities were hopeful that the global economy was on the road to recovery. What little fiscal space the major advanced economies had been able to draw on in the midst of the crisis had been largely exhausted, however, and many central banks had lowered their target interest rates as far as they could go. As a result, a variety of unconventional monetary policy measures were deployed, involving large-scale asset purchases and exceptional forward guidance regarding the expected future path of short-term interest rates. Although these extraordinary measures helped to stabilize economic activity, and reverse the sharp declines, a longer-term strategy was clearly needed to restore global growth and put it on a more sustainable footing.

What came forward from the G-20 was a four-point policy plan, the Framework for Strong, Sustainable and Balanced Growth. Each point was necessary on its own, but was also needed to ensure the success of the other three.

The first point involved significant fiscal consolidation by countries that had run large, unsustainable budget deficits prior to the crisis and had seen them escalate even further during the recession, on the back of falling revenues and rising expenditures. Of course, banks and households in many of the same countries were also paying for past excesses, hastily deleveraging and working to repair broken balance sheets.

The second point of the Framework called for sweeping financial system reforms. These were designed to rebuild financial institutions and markets in a way that would minimize the chances of future crises and make the system better able to withstand any that might occur.

The third point focused on ambitious structural reforms to liberalize labour and product markets and improve governance and institutional arrangements, thereby raising long-term efficiency and potential output.

The fourth and final point involved a rebalancing of global demand. Excess domestic demand in countries with current account deficits would be eliminated or reduced to manageable levels, and replaced by increased external demand from other, surplus, countries. Meanwhile, surplus countries were expected to boost their domestic demand and become less reliant on export-led growth strategies. Although these growth strategies had proven amazingly successful in many EMEs, they were often supported by persistent, large-scale, foreign exchange intervention and extensive capital controls intended to keep their currencies undervalued. With most deficit countries now played out and in the process of shrinking their demand, this was a strategy that couldn't continue. Structural reforms in these EMEs, supported by more flexible, market-determined exchange rates, are required to sustain growth.

The good, bad and ugly scenarios

At the outset, observers were cautiously optimistic about the plan and, contrary to the warnings of Reinhart and Rogoff, believed that this time it might really be different.[5] Ideally, the appropriate combination of policies would shorten the recovery time and lead to a much better long-term equilibrium. The experiences of the five advanced countries that Reinhart and Rogoff had identified in their study, and that had been hit by financial crises earlier in the postwar period, would not be prologue to what advanced economies were about to achieve through concerted action.

Regrettably, the trajectories of both the U.S. and European economies to date have been remarkably similar to these five countries (see the blue line on ***Charts 5*** and ***6***). It would be a mistake, however, to assume that this experience represents some sort of immutable path toward which economies must necessarily gravitate following a crisis. Such an attitude is too defeatist and fatalistic. Good policy can – and does – make a difference.

It is important to understand that the four points of the G-20 Framework that I described earlier are mutually reinforcing. The first three points, though they are essential for stable and welfare-improving outcomes in the future, were known to have deflationary effects in the short to medium term, depressing global demand. The fourth point, the rebalancing of global demand, was necessary to counter these sizable headwinds, supporting global growth until the positive effects from the other three kicked in.

In an effort to highlight the costs of policy failure or, stated more positively, the potential gains from policy success, economists at the Bank of Canada used their global economy model in early 2011 to map out three possible scenarios. Although any econometric model needs to be treated with a great deal of caution, this one has proven to be very useful in the past, and the results were viewed as reasonable approximations of what one might expect under different states of the world.[6]

The first scenario, called the "good" one, assumes that everyone does what is necessary to fulfill the G-20 commitments made in 2009 and at the three subsequent leaders' summits. This scenario was not intended to be as good as it gets – a Goldilocks solution – but simply good enough to get the job done. The second, or "bad" scenario, assumes that most of what was promised is eventually accomplished, but with a three-year delay. The third scenario, called the "ugly" one, is a variant of the first two and assumes that only half the job is done, at least initially. Fiscal consolidation is undertaken, as is financial sector reform, but several

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5 C. Reinhart and K. Rogoff, This Time Is Different: Eight Centuries of Financial Folly (Princeton, NJ: Princeton University Press, 2009).

6 For more information on the model and the critical assumptions embedded in the scenarios, see C. de Resende, C. Godbout, R. Lalonde, É. Morin and N. Perevalov, "On the Adjustment of the Global Economy," Bank of Canada Review (Spring) 2012.

important structural reforms and a shift toward more flexible exchange rate regimes in some EMEs are omitted.

The different growth trajectories implied by the three scenarios are evident in the results shown in ***Chart 7***. The policy delay embedded in the bad scenario causes world output to fall roughly 8 per cent below the level of output that would have been realized under the good scenario (or US$6 trillion). Doing half the job, as in the ugly scenario, is even worse, at least for the first few years. This is mainly because the deflationary effects of fiscal consolidation are front-loaded.

Where are we now?

This is all very well, you might say, but how do these model results relate to the real world and what we see today? Where are we now, and how are we doing four years after the crisis started in earnest?

The outcome in the real world has been decidedly mixed, despite additional rounds of quantitative easing and other unconventional monetary policy initiatives undertaken by major central banks. The deflationary forces in many countries appear to be winning. While global growth has not stalled completely, neither is it as strong or as widely distributed as many had hoped.

Fiscal consolidation, with one or two notable exceptions, is being pursued by many of the countries that require it. However, there is a risk that market forces (or legislation, as in the case of the United States) may be pushing it too quickly in the short run. The International Monetary Fund and other policy institutions are now recommending that consolidation be pursued in a resolute but gradual manner, where possible.[7] In other words, don't overdo it in the short run, since the fiscal multipliers are believed to be much larger than previously estimated. That said, there is a need for some countries, most notably Japan and the United States, to set out credible longer-term paths to restore their fiscal health. Their debt and deficits are on explosive tracks and will only be made worse by demographic forces.

Financial system reform is where success has been the most evident, despite the ambitious nature of the agenda.[8] The design phase of the financial reform effort is nearing completion, but full, timely and consistent implementation of the reforms will be critical. Peer-review mechanisms have been established to help drive the process forward and maintain cross-jurisdictional consistency in implementation.[9] The cross-border challenges involved in implementing this reform effort are particularly daunting.

The report card on structural reform is slightly better than some commentary might suggest, but progress has been extremely uneven. The structural initiatives announced by some countries lack ambition and are directed at easier, less politically sensitive, issues. Many other countries, however, whether of their own volition or under duress, are pursuing more far-reaching reforms. As one might imagine, many of these are deficit countries, subject to intense market pressures or operating under the surveillance of official support programs. Surplus countries, in contrast, have been less motivated and seem to have adopted a more relaxed approach.

[7] "Coping with High Debt and Sluggish Growth," International Monetary Fund World Economic Outlook, (October 2012).

[8] "Progress of Financial Regulatory Reform," letter from Financial Stability Board Chairman M. Carney to G-20 Finance Ministers and Central Bank Governors, 31 October 2012.

[9] T. Macklem, "Raising the House of Reform" (speech to Rotman Institute for International Business, Toronto, 7 February 2012).

The final critical part of the Framework, the rebalancing of global demand, is where slippage has been the greatest, although at first glance things seem to have gone well. The real effective exchange rates of several important surplus countries have appreciated, and their current account balances have generally fallen (***Chart 8***). Export sales have declined and domestic demand now accounts for a larger share of their GDP growth. Appearances can be deceiving, however.

While some legitimate progress has been made in the rebalancing of global growth, most of the "correction" that has occurred has been driven by demand compression in the deficit countries. The same is true for the rising share of domestic demand in many surplus countries. It is not a case of domestic demand growing significantly faster but, rather, declining export sales in the face of falling incomes and aggressive belt-tightening in deficit countries (***Chart 9***).

In those instances where surplus countries have increased their contribution to global domestic demand, it has often been concentrated in fixed investment, which was already inordinately high and frequently misallocated. Investment as a share of GDP in China, for example, is roughly 50 per cent, while household consumption is roughly 35 per cent – extraordinarily low by any standard and declining over time (***Chart 10***). When growth returns to the deficit countries, the current account surpluses of these countries are likely to re-emerge. Without a conscious effort to rotate demand and support global growth, true re-equilibration will be a long and painful process.

Another apparent sign of progress concerns the path of real exchange rates. In some surplus countries, exchange rates have shown signs of increased flexibility. However, these developments are quite limited compared with the movements observed in other, more truly flexible, regimes (***Charts 11*** and ***12***). They are also much less than fundamentals would suggest is appropriate. Many surplus countries continue to rely on capital controls and active foreign exchange intervention to enhance their competitive advantage.

Taking all of this together, we appear to be trapped in the bad scenario. But if the situation continues, it could easily turn ugly.

This is not to suggest that all of the difficulties that we have experienced are because of failed or partial policy implementation. There are two things worth noting in this regard. First, Reinhart and Rogoff are correct when they assert that recoveries after a major financial crisis, especially one that has gone global, are different than recoveries from "normal" recessions. Some allowance has to be made for this. Second, new shocks have hit the global economy since 2008. The earthquake in Japan and the crisis in Europe are the most obvious examples, although some would argue that the latter is simply an extension of the initial financial crisis.

Even allowing for these factors, however, there is a sense that we could have done better.

What needs to be done?

Can we get back to where we want to be? In a word, yes. What is needed is very similar to what was first proposed and agreed in late 2009, but with some necessary modifications. The following list is not meant to be comprehensive but simply hits the highlights.

First the United States must deal with its fiscal cliff. Action is required to bring the budget into line. But something with a smoother profile over the next two to three years, coupled with a credible long-term track would be preferable to the aggressive tack now in play.

Second, Europe must set itself right. Certain things are required just to contain the crisis. These include activating the Stabilization Mechanism to help support sovereign debt re-financing and recapitalize banks, and the Outright Monetary Transactions program, which will help eliminate the risk of euro redenomination and improve the monetary policy transmission mechanism in the euro area.

Of course, it will take several years to fully resolve the crisis in Europe. Key elements are further fiscal consolidation in many countries, repair of the broken banking systems, deep reform in labour and product markets, improved governance, and eventual completion of the banking, fiscal and political unions.

Third, surplus countries that are delaying necessary global adjustment by frustrating necessary exchange-rate changes should move more expeditiously toward market-determined rates. In addition, they should undertake the structural changes necessary to boost domestic demand, with particular emphasis on consumption. This would allow more of their citizens to realize the full rewards of their labours and improve general economic welfare.

Conclusion

There is an old joke about a lost traveller who asks for directions and is told by a local, "I wouldn't try to get there from here." Unfortunately, we have no choice about our point of departure. It would be easier if we were starting from a better place, but we aren't. Happily, the original road map established in 2009 remains broadly appropriate.[10] More may be required, since we have lost valuable time and capacity through delay, but the mission is not impossible.

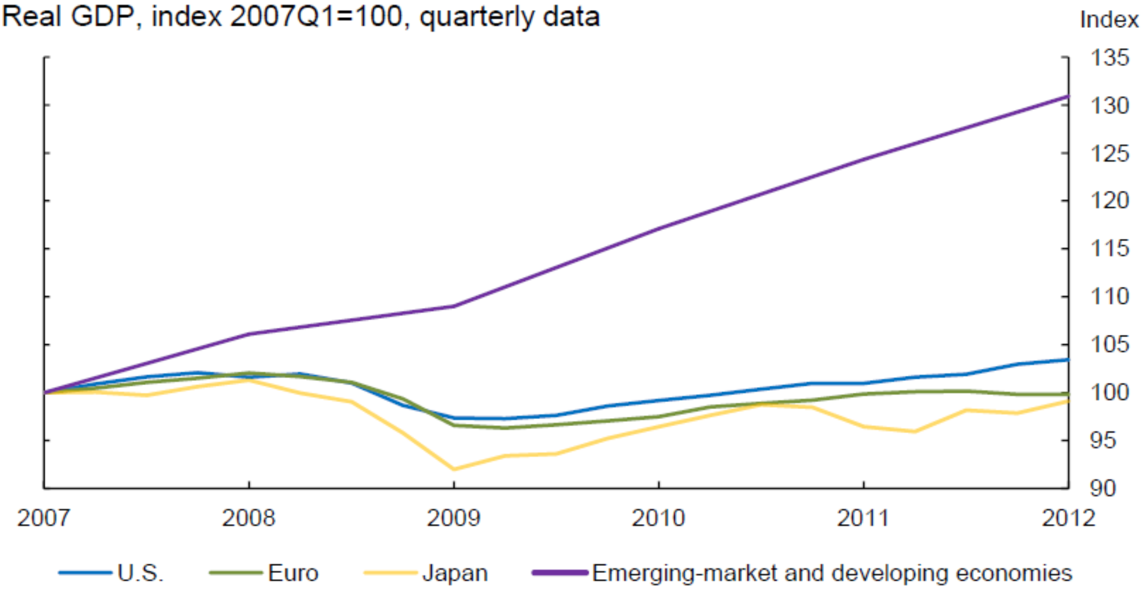
Let us first do what has been promised and then see what remains to be done. The good news is that many of the risks that we face are related to policy slippage and should therefore be amenable to policy correction. We have the means. Let us hope that lessons have been learned, and that the challenges will be met with renewed determination.

Thank you.

[10] Canada, along with India, co-chairs the G-20 Working Group on the Framework, whose mission is to drive progress on the agenda. Its current focus 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.

Chart 1: Prompt action helped stabilize output, but performance has varied

Real GDP, index 2007Q1=100, quarterly data

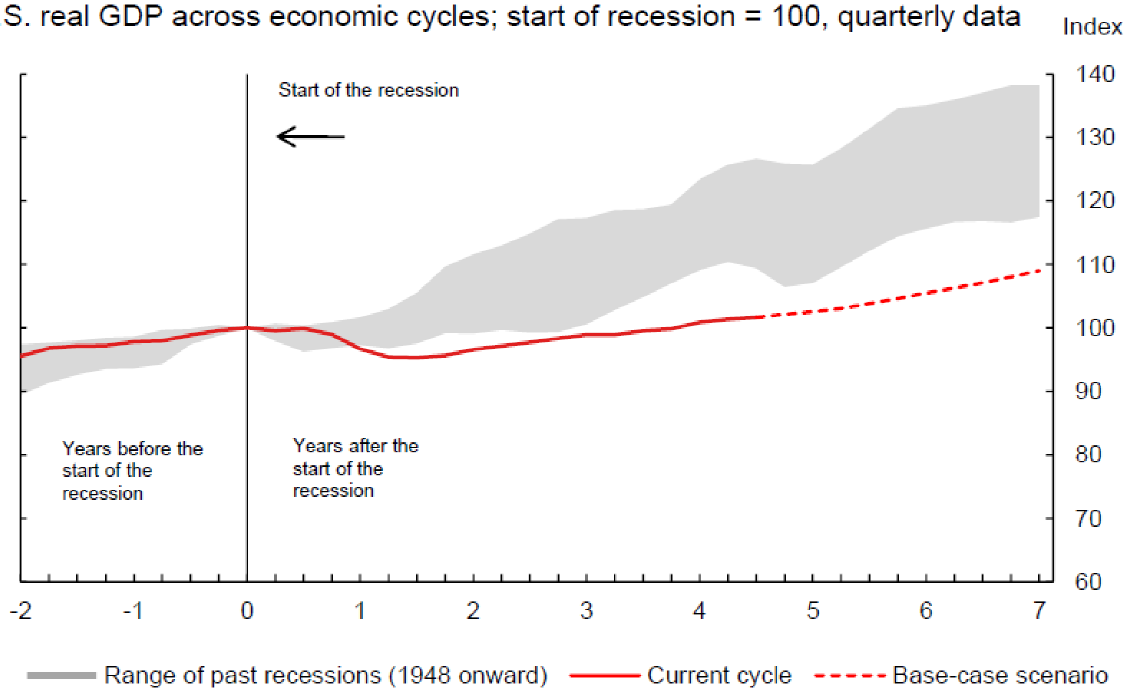


Note: The emerging market and developing economies (which includes China) figure is calculated using annual growth rate from IMF WEO October 2012.
Sources: Bureau of Economic Analysis, Eurostat, Cabinet Office of Japan, International Monetary Fund (IMF) *World Economic Outlook*, October 2012.

Last observation: 2011Q4

Chart 2: U.S. GDP is weaker than in previous recoveries

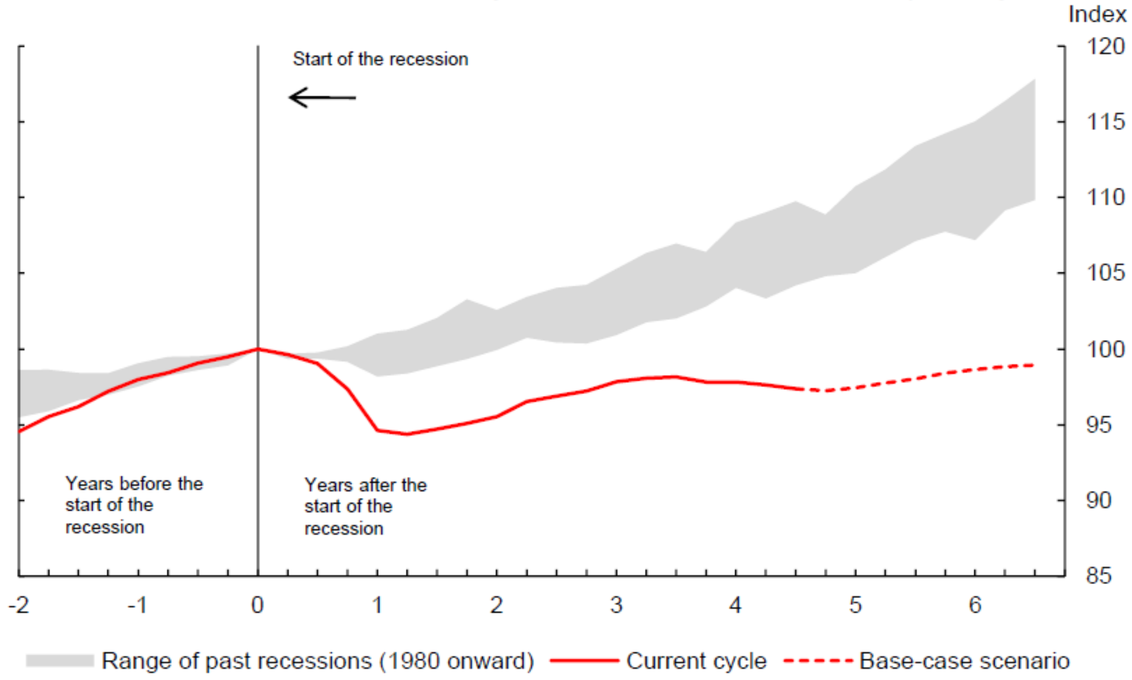
U.S. real GDP across economic cycles; start of recession = 100, quarterly data



Sources: U.S. Bureau of Economic Analysis, Organisation for Economic Co-operation and Development and Bank of Canada projections

Chart 3: European GDP is much weaker than in previous recoveries

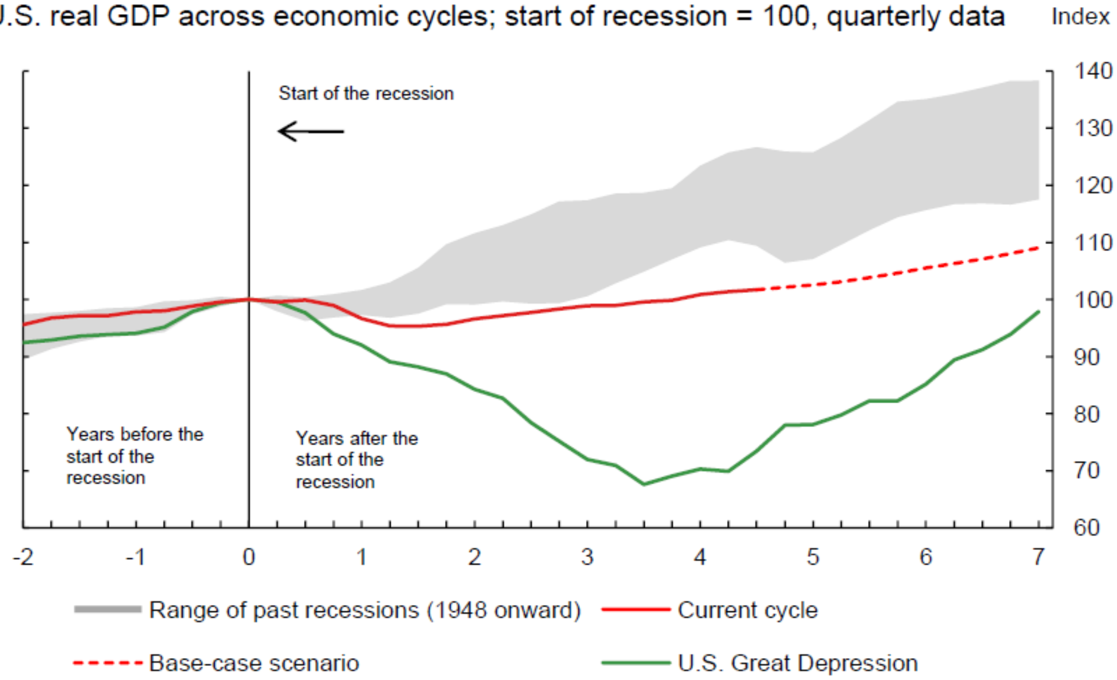
Euro-area real GDP across economic cycles; start of recession = 100, quarterly data



Sources: Eurostat, Organisation for Economic Co-operation and Development and Bank of Canada projections

Chart 4: Prompt policy measures helped prevent another Great Depression

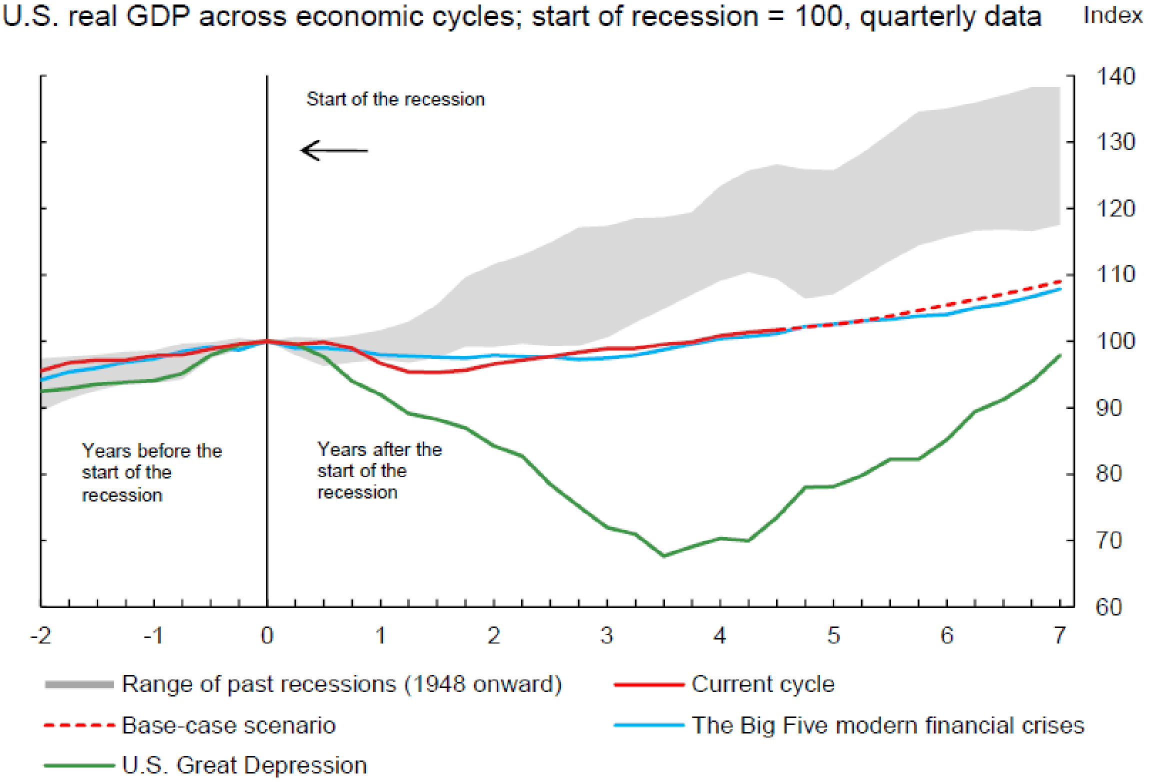
U.S. real GDP across economic cycles; start of recession = 100, quarterly data



Sources: U.S. Bureau of Economic Analysis, Organisation for Economic Co-operation and Development, Gordon and Krenn (2009) and Bank of Canada projections

Chart 5: U.S. GDP is very similar to the "Big Five" modern financial crises

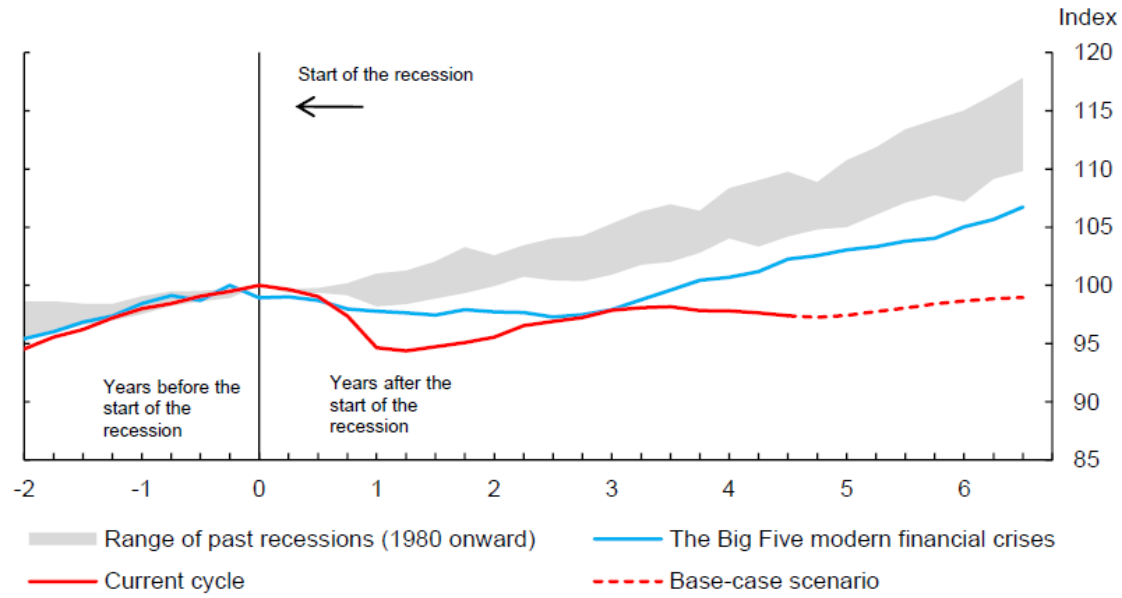
U.S. real GDP across economic cycles; start of recession = 100, quarterly data



Sources: U.S. Bureau of Economic Analysis, OECD, Gordon and Krenn (2009), Reinhart and Rogoff (2008) and Bank of Canada projections

Chart 6: European GDP is weaker than the "Big Five" crises

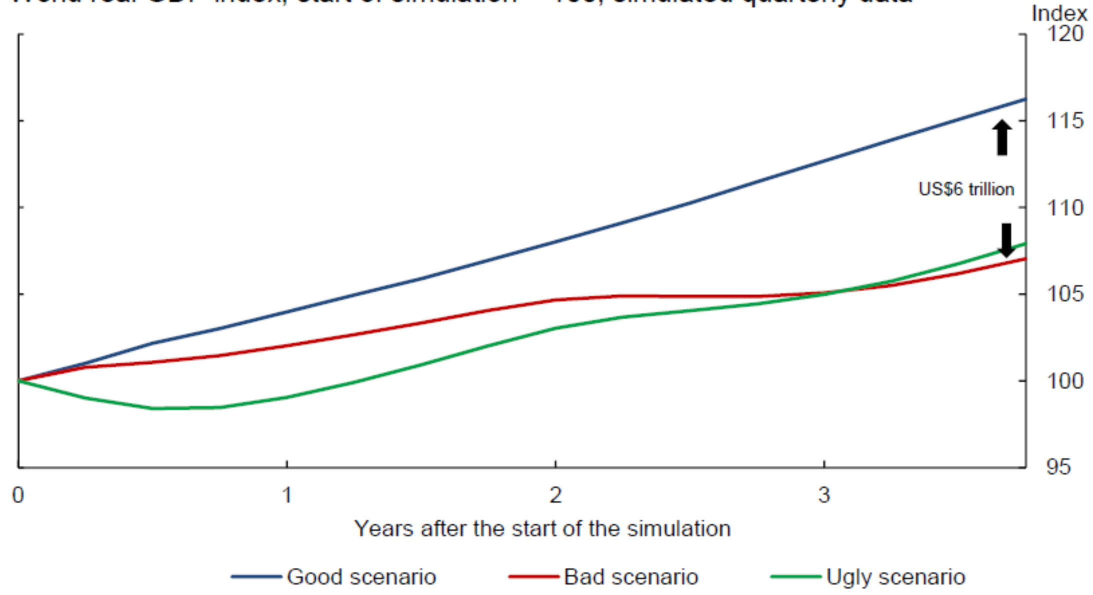
Euro-area real GDP across economic cycles; start of recession = 100, quarterly data



Sources: Eurostat, OECD, Reinhart and Rogoff (2008) and Bank of Canada projections

Chart 7: "Good," "bad" and "ugly" scenarios

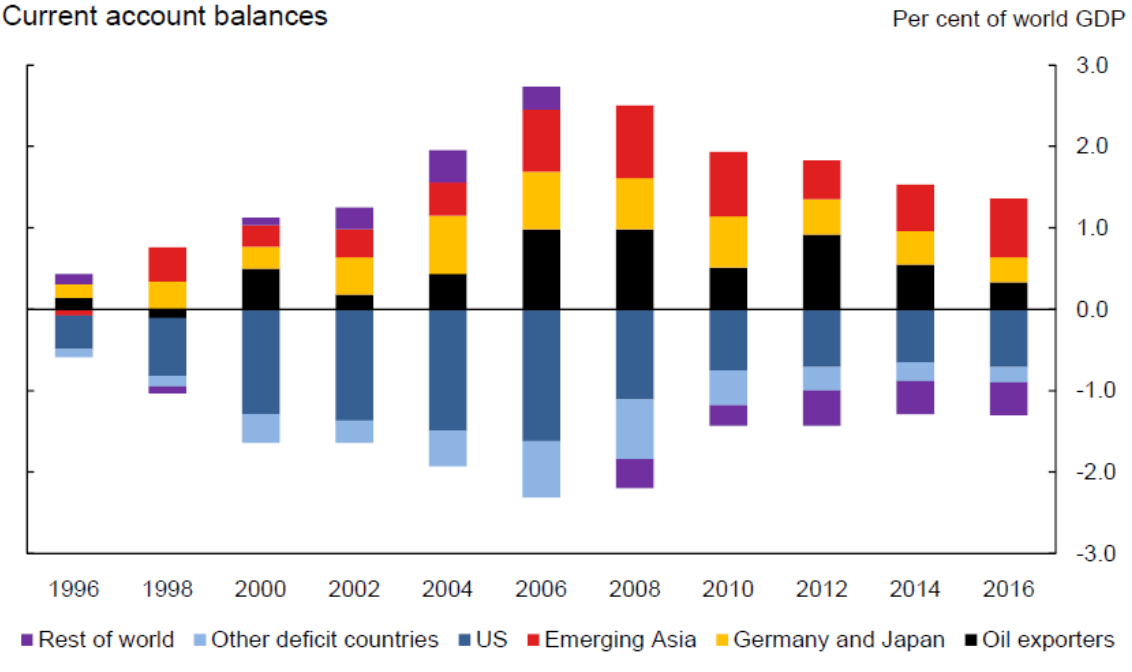
World real GDP index; start of simulation = 100, simulated quarterly data



Sources: de Resende et al. (2012) and Bank of Canada simulations

Chart 8: Global imbalances appear to have declined, temporarily

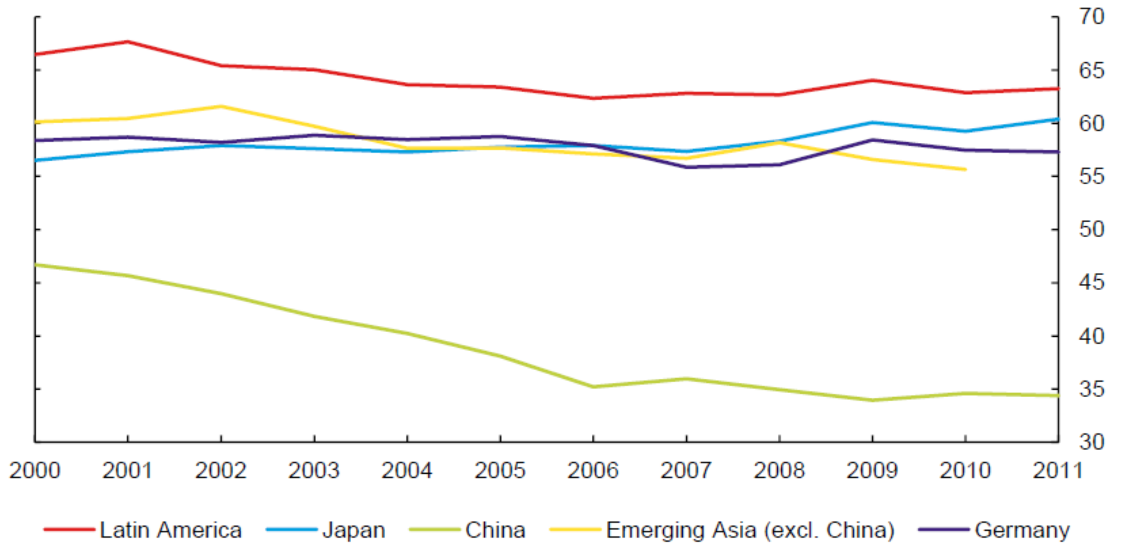
Current account balances



Source: IMF *World Economic Outlook* October 2012

Chart 9: China's consumption is extraordinarily low

Nominal household consumption expenditures as a percentage of GDP, annual data

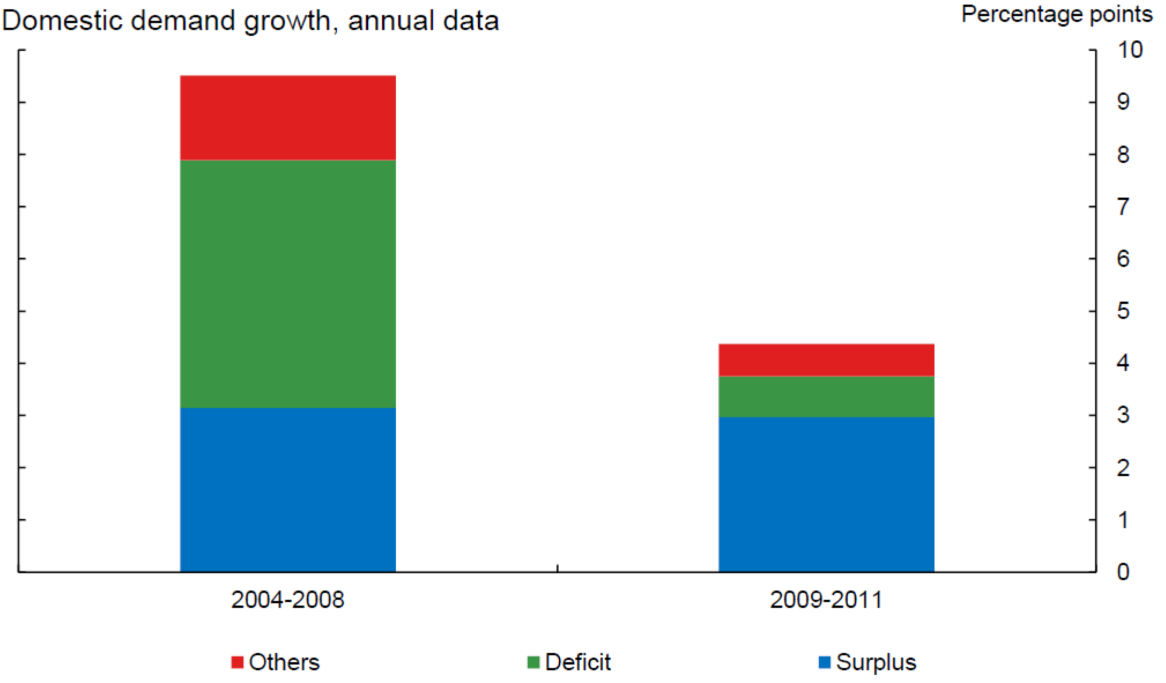


Note: The group "Emerging Asia" is a weighted average composed of India, Indonesia, South Korea, Malaysia, the Philippines and Thailand. The country weights are determined by their 2011 GDP levels.
Sources: World Bank Development Indicators and Cabinet Office of Japan

Last observations: Emerging Asia, 2010; other countries, 2011

Chart 10: Contribution of surplus countries to G-20 domestic demand growth is roughly unchanged

Domestic demand growth, annual data

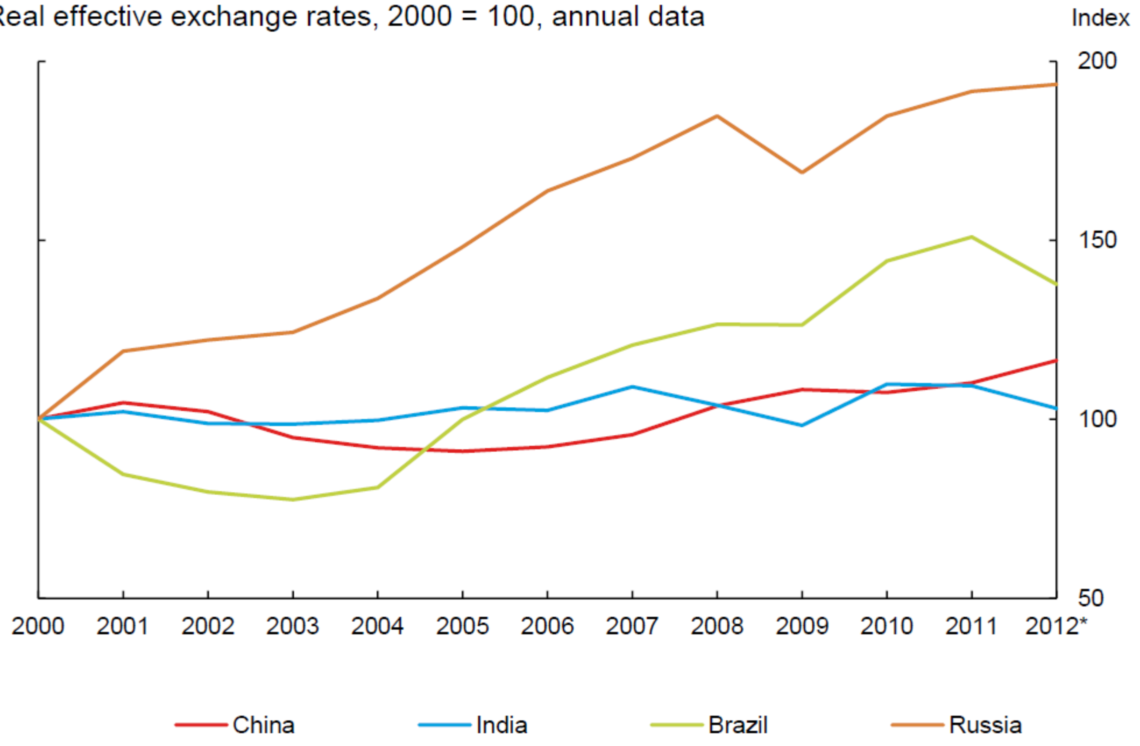


Note: Surplus countries (excluding China) include Argentina, Korea, Indonesia, Germany, Japan, Netherlands, Luxembourg, Russia and Austria. Deficit countries include Australia, United States, United Kingdom, Turkey, India, Mexico, South Africa, Greece, Portugal, Cyprus, Malta, France, Italy and Spain. "Others" includes the remaining G-20 countries, excluding Saudi Arabia.
Source: Haver Analytics

Last observation: 2011

Chart 11: Exchange rates in some EMEs have risen sharply, others not as much

Real effective exchange rates, 2000 = 100, annual data

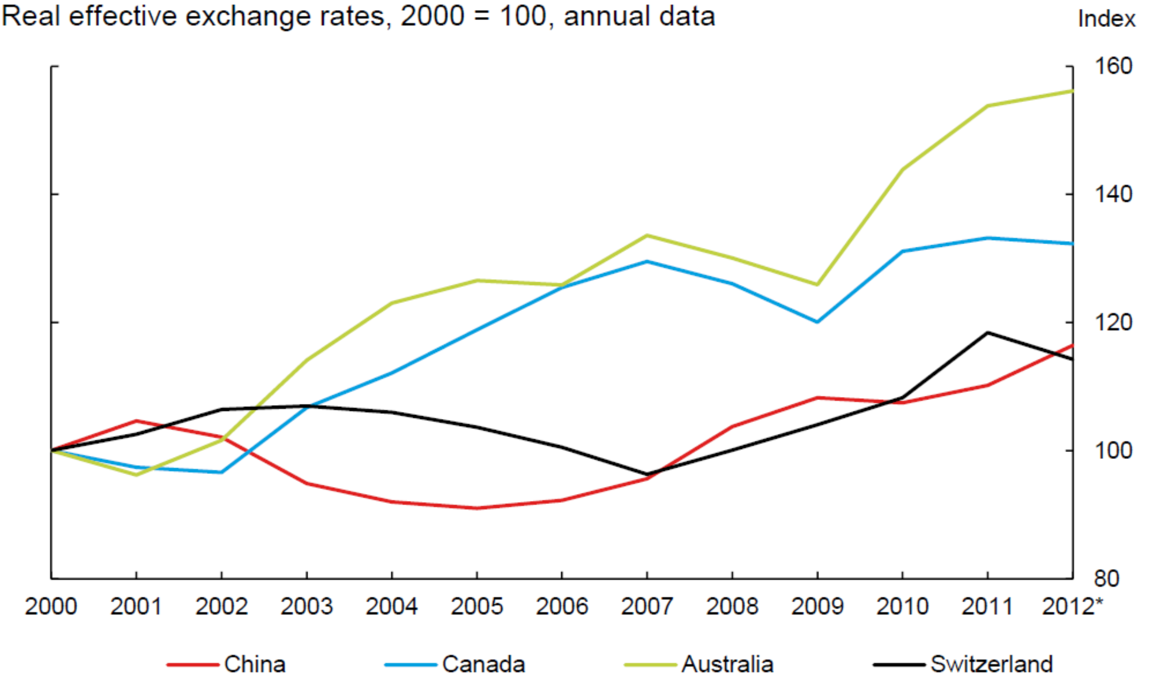


* Data for 2012 are an average of available monthly data.
Source: Bank for International Settlements

Last observation: 2012

Chart 12: Exchange rates in some advanced countries have also risen sharply

Real effective exchange rates, 2000 = 100, annual data



* Data for 2012 are an average of available monthly data.
Source: Bank for International Settlements

Last observation: 2012