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Financing the Global Transition

Introduction

I want to thank the Atlantic Institute for Market Studies (AIMS) for the invitation to speak here in Halifax. One of Halifax's greatest entrepreneurs was Samuel Cunard, whose shipping empire, like this centre, still bears his name. Launched more than 100 years ago, the Cunard business prospered in the last great era of global change.

In my remarks today, I will speak about the transformation currently under way in the global economy. In touching on the situation in Europe, and the challenges of the international monetary system, I will concentrate on the central role of an open, resilient financial system to sustained global growth.

The Transition to a Multi-Polar World

I would like to start by putting the recent darkening of the global economic outlook in perspective. Europe has built a single market of 500 million people and 27 countries, with free movement of goods, services, capital and people. In the process, it has transformed the economies of southern and eastern Europe. It has also played a consistently positive role in rising above national interests to address global problems.

On a global scale, never in history has economic integration involved so many people, such a variety of goods and so much capital.

This process lifted hundreds of millions of people out of poverty and created the potential for hundreds of millions more to follow in their path. The gap between rich and poor countries has narrowed dramatically and soon the global middle class will outnumber the poor. The shrinking disparity between the United States and China is particularly striking. In 1990, GDP per capita in the United States was almost 30 times higher than in China; by 2010, this ratio had fallen to just six times.

The crisis is accelerating this transformation.

But this transition will not be smooth, and it is not preordained. Downside risks to Europe are materialising, threatening the pace of global growth. More broadly,

the rebalancing of the global economy is stalled, as much of the advanced world remains mired in a prolonged deleveraging.

During this challenging time, we must remember that realising Europe's and globalisation's potential requires an open system.

It is reasonable to expect capital to flow, on a net basis, from advanced economies towards higher expected returns in emerging-market economies. This is what happened during the last wave of globalisation at the turn of the 20th century when Canada, then an emerging economy, ran current account deficits averaging 7 per cent of GDP over three decades.

These were good imbalances. Imported capital was invested in productive capacity that later served to pay off the accumulated debts.

Global imbalances over the past decade have too often been bad, if not positively un-Canadian. In some cases, public capital has flowed from emerging-market economies to advanced economies to be invested in non-tradable goods such as housing. In others, private flows overshot in a complacent, deregulated "new era."

Large current account imbalances are an inherent part of strong global growth, but in order to be sustainable, they must be:

- the product of private decisions taken in a context of sound macroeconomic policies and robust market structures; and
- financed by an open, resilient financial system.

In many respects, the problems we face today are the product of two flawed monetary unions: one formal—the European monetary union; the other informal—Bretton Woods II. In both cases, financial reforms will be integral to the solution.

European Monetary Union

Europe's problems today are partly a product of the initial success of the single currency. After the euro's launch, the European financial system quickly became integrated, and cross-border lending exploded. Easy money fed booms, which flattered government fiscal positions and supported bank balance sheets.

In aggregate, the euro area's debt metrics may not look daunting: the total euro-area public debt burden is lower than that of the United States or Japan, and its current account with the rest of the world is roughly balanced, as it has been for some time.

But as is now blindingly obvious, these aggregates mask large internal imbalances.

For example, since 2007, public debt in Spain increased by 30 percentage points of GDP, in Portugal by 40 percentage points, in Greece by 50 percentage points and in Ireland by 80 percentage points...and counting. Much of these increases are the consequence of private losses in real estate and banking sectors. Indeed, the euro crisis reminds us that, one way or another, excessive private debts usually end up in the public sector.

Further, price stability across the euro area has been composed of large differences in national inflation rates. In the eight-year run-up to the crisis, inflation in the crisis economies was about twice that of the core countries.

Most importantly, unit labour costs in peripheral countries shot up relative to those in the core economies, particularly Germany. The resulting deterioration in competitiveness has made the continuation of past trends unsustainable.

Europe is now stagnating. Its GDP is still more than 2 per cent below its pre-crisis peak, and private domestic demand sits a stunning 6 per cent below.

The contraction is driving banking losses and fiscal shortfalls. These are understandably receiving much attention, but it should be remembered that these challenges are symptoms of an underlying sickness: a balance-of-payments crisis.

What Should the Europeans Do?

To repay the creditors in the core euro area countries, the debtors of the periphery must regain competitiveness. This will be neither easy nor quick.

A sustained process of relative wage adjustment will be necessary, implying large declines in living standards in one-third of the euro area.

A comprehensive adjustment is necessary. The burden cannot only be on increasing unemployment and falling wages in countries like Spain. Deflation in the peripheral countries will not likely prove any more tolerable than it did in the United Kingdom under the gold standard of the 1920s. An increase in German wages and private demand (and inflation) would ease the transition. It is striking that German real wages barely grew in the two decades before the crisis.

Moreover, it is essential that the structural reforms now under way across the deficit countries boost productivity.

With domestic incomes squeezed, some of the required investment will have to be financed abroad.

Unfortunately, the European financial system has aggressively renationalised in recent months. Intra-European cross-border lending—which had been growing by 25 per cent per year in the run-up to the crisis—has been falling at a rate of 10 per cent per annum since. While the European Central Bank (ECB) has adroitly stepped into the breach, reliance on central bank lending is not a recipe for robust private investment.

Bold steps are required to restore the single financial market. And bold steps are now under consideration. One example is the current European proposal to create a banking union. By centralising bank restructuring, re-capitalising banks with European rather than national resources, moving towards centralised (or federalised) supervisory oversight and harmonising (or better still mutualising) deposit insurance, Europe can break the increasingly toxic links between banks and sovereigns.

The recent agreement to recapitalise the Spanish banking system marks progress towards a greater financial and fiscal union that will reinforce the

monetary union. It is further evidence of Europe's resolve to address its problems.

If such measures are combined with swift implementation of the Financial Stability Board's (FSB) financial reform agenda, which I will outline in a moment, there is a prospect of relaunching a deeper, more robust pan-European financial system.

Bretton Woods II

The second flawed monetary union is at the heart of the current international monetary system: the so-called Bretton Woods II arrangement, which is centred on China and the United States.

The current international monetary system is a hybrid of, on the one hand, mainly major advanced economies with floating exchange rates and liberalised capital flows and, on the other, a group of countries that actively manage their exchange rates. The result is a system that does not facilitate timely and symmetric adjustment to shocks or structural change. For example, despite its economic miracle, China's real exchange rate did not appreciate in the two decades before the global financial crisis.

In the decade before the crisis erupted, China's relentless accumulation of reserves contributed to low real interest rates and, for a time, subdued macroeconomic volatility.

Market participants increasingly assumed this stable macroeconomic environment would persist—prompting a search for yield, rising leverage and a dramatic underpricing of risks.

When combined with inadequate supervision of the financial system and ill-conceived deregulation of housing and financial markets, U.S. private non-financial debt quickly rose to levels last seen during the Great Depression.

With 20 per cent of global output, the United States imported 60 per cent of global capital (on a net basis) on the eve of the crisis. This would not have been a problem if this capital had been invested in expanding productive capacity. Unfortunately, not enough of it was.

Now, the debt cycle has decisively turned. Creditors demand repayment, and global growth will require global rebalancing.

How To Pay Down Debt

Austerity is a necessary condition for rebalancing, but it is seldom sufficient. There are really only three options to reduce debt: restructuring, inflation and growth.

Whether we like it or not, debt restructuring may happen. If it is to be done, it is best done quickly, and on a sufficient scale to restore sustainability. Policy-makers need to be careful about delaying the inevitable and merely funding the private exit.

Some have suggested that higher inflation may be a way out from the burden of excessive debt. To be effective, this would need to be coupled with various forms of financial repression, including capital controls and forced holdings of government debt.

This is a counsel of despair.

An inflation surprise needs to be very large or very sudden to work. Moving opportunistically to a higher inflation target would risk unmooring inflation expectations, destroying the hard-won gains that have come from the entrenchment of price stability, and increasing real rates that would exacerbate unfavourable debt dynamics.

Financial repression would have to be both massive and sustained. It would undermine the system that has helped bring us the prosperity of the past three decades.

The most palatable strategy to reduce debt is to increase growth.

Private growth will not flourish in an environment of macro instability. Fiscal sustainability and price stability are essentials, not luxuries.

Private growth needs an enabling environment, including tax competitiveness and a framework for infrastructure investment. It needs a sound financial sector that is diverse, resilient and open.

Sustainable Private Growth and the Role of Financial Reform

This is not yet assured.

Most immediately, there is a risk that a series of contingency measures could extend to a global scale the current European trend towards renationalisation. That is one reason why the European initiatives expected in the coming weeks are so important.

More broadly, the financial reform agenda must address legitimate emerging-market concerns over the resiliency of the advanced-economy financial systems. Because of these worries, there is pressure for localisation to protect domestic systems and renewed use of capital controls to dampen the volatility of cross-border flows. If allowed to persist, these nascent trends could seriously restrain the global capital flows necessary for the next stage of the global transformation.

The Imbalance Between States and Markets

I recall the German Finance Minister, Peer Steinbrück, at a fateful G-7 meeting in the wake of Lehman's failure, relating that he had met a woman in East Germany earlier that week who told him that: "I have seen the fall of communism and now I am seeing the fall of capitalism."

The complete loss of confidence in private finance at that time could only be arrested by the provision of comprehensive backstops by the richest economies in the world.

Even with these heroic efforts, the global financial crisis has cost $4 trillion in lost output and 28 million lost jobs, and built perilous fiscal deficits. As is typically the case, much of the cost has been borne by countries, businesses and individuals who did not directly contribute to the fiasco.

To restore confidence in the system, we must create a truly global system, in part by rebalancing the relationship between governments and markets. Governments must discard the myth that finance is self-regulating and self-stabilising, and financial policy-making can no longer be concentrated at national levels.

Given the reality of global finance, it is not enough to have our own house in order unless we seal ourselves off from the world—and if we were to do that we will end up much poorer.

An open, resilient global financial system will be central to the transformation of the global economy. In order to achieve that, financial sector reform is a must. The G-20 has a serious agenda, being aggressively implemented. The current intensification of the euro crisis has only sharpened our resolve.

Building Resilient Financial Institutions

Achieving a stronger banking system is the overriding priority, hence the importance assigned to full implementation of Basel capital and liquidity standards. A simple, but effective, leverage standard has been imported from Canada. It will protect the system from risks we think are low but in fact are not.

These measures have lowered the probability of failure. However, our goal is not a fully risk-proofed system. That is neither attainable nor desirable.

Ending Too-Big-To-Fail

Since failures will still happen, there remains the need to reduce their impact, which is one of the reasons to focus on ending too-big-to-fail. More fundamentally, 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. Most importantly, the knowledge that major firms in markets far away can fail, without meaningful consequences at home, will restore confidence in an open global system.

To achieve this objective, bondholders, shareholders and management—rather than taxpayers—must bear the brunt of losses. To this end, all FSB member countries have committed to have in place a bail-in authority. In addition, each global systemically important bank must have in place a Resolution and Recovery Plan within the next six months, to be supplemented by cross-border co-operation agreements.

The framework for systemic institutions is now being extended to domestic banks, global insurers, and key shadow banks. When implemented, greater supervisory intensity and higher loss absorbency will ensure that the 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 systemic firms. It is unacceptable that core markets seized up during crisis, and that relatively small firms had to be saved because of concerns that they would take markets with them if they failed. 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

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.

Timely, Consistent Implementation

Finally, the FSB is increasingly focused on timely, full and consistent implementation of agreed reforms. This is essential to preserve the advantages of an open and globally integrated financial system. Recent experience demonstrates that when mutual confidence is lost, the retreat from an open and integrated system can occur rapidly. A return to a nationally segmented global financial system would reduce both systemic resilience and financial capacity for investment and growth.

Conclusion

Let me conclude with some comments on the current economic environment.

The recoveries in advanced economies continue to be dampened by the ongoing need to repair sovereign, bank and household balance sheets. While the U.S. economy is expanding at a modest pace, some of the risks around the European crisis are materialising and risks remain skewed to the downside.

The emerging world continues to be the engine of global growth, although weak demand in advanced economies and the effects of past policy tightening are slowing the pace of expansion in China and other major emerging-market economies.

As a result of more modest global economic momentum and heightened financial risk aversion, commodity prices have fallen in recent months, although they remain at historically elevated levels.

Despite these ongoing global headwinds, the Canadian economy continues to grow with an underlying momentum consistent with the gradual absorption of the remaining small degree of economic slack. Total CPI inflation is expected to fall below 2 per cent in the short term, as a result of lower gasoline prices, while core inflation is expected to remain around 2 per cent.

Canada’s relatively favourable economic performance continues to rely significantly on the resilience of Canadian household spending, supported by very accommodative monetary policy and a well-functioning financial system. Our economy cannot, however, depend indefinitely on debt-fuelled household expenditures, particularly in an environment of modest income growth. Notably, housing investment rose further in the first quarter, accounting for an unusually elevated share of the overall Canadian economy. In this context, Canadian authorities are co-operating closely to monitor the financial situation of the household sector, and are responding appropriately. Today, federal authorities have taken additional prudent and timely measures to support the long-term stability of the Canadian housing market, and mitigate the risk of financial excesses.

Against this backdrop, to the extent that the economic expansion 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.

As I have argued today, these global developments will depend importantly on sustaining an open, global system. At the G-20 meeting this week in Los Cabos, Mexico, leaders reaffirmed that “multilateralism is of even greater importance in the current climate, and remains our best asset to resolve the global economy’s difficulties,” and committed to “timely, full and consistent implementation of agreed policies to support a stable and integrated global financial system.”

This resolve bodes well for securing the global transformation and, with it, realising the full potential of Canadian prosperity.