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# The Legacy of the Financial Crisis: What we know, and what we don't

## Introduction

I am delighted to be here with you today, thank you. I applaud the Council's efforts to foster stronger partnerships between the public and private sectors in the development of infrastructure, which is absolutely critical to our economic future.

I'll speak today from the perspective of a monetary policy-maker, whose mandate also is to contribute to the economic and financial well-being of Canadians. I'd like to talk about two subjects today: what we know, and what we don't know.

I'm sure it won't be a surprise that the first part will be shorter than the second part. My goal is to help you understand better the risks that we face. If I do my job well, I'll leave you with a sense of how the Bank weighs the known and the unknown when setting monetary policy.

## What We Do Know

Let's start with what we do know about our current situation. Most of us acknowledge that it all began with a period of exceptionally strong global economic growth in the mid-2000s, some creative financial engineering, an explosion of leverage and a speculative bubble that touched a lot of markets. The bubble burst when the U.S. housing market rolled over and some significant financial vulnerabilities were laid bare.

The ensuing global financial crisis in the fall of 2008 was truly dire. Monetary policy and fiscal policy were quick to respond around the world, with collective G-7 and G-20 announcements on Thanksgiving weekend that year. Since then, we've seen policy rates near zero in several countries and an unprecedented use of unconventional monetary policy, including quantitative easing.

We will never know how bad things would have been without that aggressive, coordinated policy response. But as a student of economic history, I can say that all the ingredients of a second Great Depression were present. We've managed

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to avoid that extreme scenario, but the damage wrought by the Great Recession has been brutal nonetheless. By the end of last year, the loss to global output from the crisis was roughly US$10 trillion, which is close to 15 per cent of global GDP. Today, there are over 60 million fewer jobs around the world than had the crisis not occurred.

Still, memories of that near-disaster are fading, and today people are wondering why our policies have so far failed to foster a true global recovery, one that is natural and self-sustaining.

The G-20 has acknowledged this disappointing growth outlook, and has set out a plan to collectively boost global GDP by 2 per cent over the next five years. Success will hinge on such policy actions as reforms to improve the functioning of labour markets, international trade liberalization and investment in infrastructure—your favourite area—just to name a few. These things are clearly worth doing, and that boost to global GDP will be worth having.

## What We Don't Know

Even so, when we see a world economy that is growing this slowly, despite the fact that interest rates are at historic lows, it is natural to ask some pretty basic questions. So, let's turn now to what we don't know.

Let me focus on three questions that people have been asking me of late. First, what is preventing a full-fledged global economic recovery? Second, will there be any permanent damage to the economy due to the crisis and its aftermath? And third, by trying so hard to improve our situation, are policymakers simply sowing the seeds of the next financial crisis?

### *What is preventing a full-fledged economic recovery?*

If interest rates are at zero or nearly zero, it follows that something is holding the economy back. Think of paddling a kayak against a strong headwind—it can take a lot of effort just to hold your position, let alone make real progress.

It is widely agreed that the conditions that led to the financial crisis included taking on excessive leverage. As individuals and financial institutions have attempted to deleverage in the wake of the crisis, economic growth has been held back. It is difficult to say when the deleveraging process will be complete, at least at the global level.

To illustrate, in the United States, private sector deleveraging was painful and swift as people cut back on debt and walked away from their over-mortgaged, devalued houses. In Europe, in contrast, this process is less well advanced, while in Canada, households continue to add to their debt loads.

Another headwind has come from governments, which responded to the global recession with additional fiscal stimulus. As the situation stabilizes, though, it is natural for governments to aim to bring their fiscal situation back into balance. This reversal of fiscal stimulus creates a headwind for the economy as a whole, masking the private sector recovery that is happening underneath. Again, the status of this headwind varies from country to country, but it is clearly in play at the global level.

The third, and probably the most important, headwind is lingering uncertainty about the future, whether from geopolitical developments, market volatility or just

the trauma that companies have been through. Some people look at companies with strong balance sheets and wonder why they are not investing. Some have suggested that we have too much risk taking in financial markets, but not enough risk taking in the real economy.

But that’s not what we're hearing from the companies we talk to here in Canada. In this uncertain economic climate, companies actually feel like they are taking a lot of risk. And until the recovery is more certain, especially in export demand, for many, it is too risky to expand their businesses.

What that seems to mean is that the expected risk-adjusted rate of return on a new investment can appear low to a company, and we can settle into a temporary low-confidence/low-investment equilibrium, even when borrowing costs are extraordinarily low, until uncertainty subsides and confidence returns.

It seems to me that we must allow for the possibility that the combined effects of deleveraging, fiscal normalization and lingering uncertainty will continue to restrain global economic growth for a prolonged period. We are confident that these headwinds will dissipate in time, but in the meantime interest rates will remain lower than in the past in order to work against those forces.

***Will some of the post-crisis economic damage be permanent?***

Still, it is important to acknowledge that global economic growth is simply not heading back to the high rates we saw before the financial crisis. For one thing, those rates were boosted by unsustainable leverage. For another, we have entered the retirement window for the post-war baby boomers, and that means that global economic capacity is moderating as growth in the workforce slows.

In Canada, for instance, potential economic growth has drifted down to around 2 per cent and will remain there for the next few years. Globally, potential growth is probably down to around 3 to 3 1/2 per cent. Both figures are lower than before the crisis.

But this modest deceleration in global growth potential is a natural consequence of demographics, not the product of the crisis. The more important question is whether any of the problems we see today will become permanent. This question is relevant at the global level, but let me illustrate it with direct reference to our own situation here in Canada.

Historically, a typical recession/recovery cycle has taken a couple of years to complete. During the recession—let’s say it originates with a drop in export demand—companies cut back production, lay off workers, and investment and consumption spending fall. Monetary and fiscal policies respond, exports recover, companies rehire their workers and move production back to normal.

But this cycle has not been a typical one. The downturn was deep and has proved to be long lasting. Canada’s export sector not only cut back on production and laid off workers, many companies restructured, many simply disappeared.

Recent Bank of Canada research on exporters sifted through more than 2,000 categories of underperforming, non-energy exports. We found that the value of exports from about a quarter of them has fallen by more than 75 per cent since the year 2000. Had the exports of these products instead risen in line with foreign demand, they would have contributed about $30 billion in additional exports last

year. By correlating these findings with media reports, we found that many were affected by factory closures or other restructurings.

Obviously, not all of this can be blamed on the financial crisis and the ensuing downturn, but for companies that were already struggling with competitiveness, the crisis surely accelerated things. The point is, when companies downsize, relocate or close their doors, the effects on the economy are permanent. Those specific lost exports will not recover—something else is more likely to take their place, but that requires that surviving companies expand, or new exporting companies be created. And both such processes are bound to be much slower than in the typical recession/recovery scenario.

A destructive downturn also creates long-lasting effects in our labour market, since the associated jobs are lost permanently. We have recovered well from the employment losses during the downturn, but our labour market has not yet returned fully to normal.

Indeed, labour conditions in Canada point to material slack in the economy. We have been creating jobs at a trend rate of less than 1 per cent, well below what one would expect from an economy that is recovering. Furthermore, much of the recent employment growth has been part time. There are over 900,000 people in Canada who are working part time but would prefer to be in full-time positions, and total hours worked are barely growing at all.

And then there are the young people who are out of work, underemployed or trying to improve their job prospects by extending their education. We estimate that there are around 200,000 of these people, and I bet almost everyone in this room knows at least one family with adult children living in the basement. I'm pretty sure these kids have not taken early retirement.

The good news is that these destructive effects should be reversible over time. Once we have seen a sustained increase in export demand, uncertainty about the future will diminish and firms will respond. Our research indicates that many of the export sectors that we expect to lead the expansion still have some excess capacity to meet higher demand. This is one reason why our productivity growth has picked up recently—firms are responding with what they have, and job creation has remained modest. But once those capacity limits are reached, exporting firms will begin to rebuild their production capacity with new investments and job creation will pick up. Those same conditions will be ideal for fostering new firm creation, and as we all know, new companies create a disproportionate share of new jobs.

The implication is clear: a sustained expansion in our exports not only will represent new demand, it will ignite the rebuilding phase of our business cycle, which will create new supply. This virtuous cycle continues until the excess capacity in the labour market is reabsorbed.

By our estimation, it will take around two years for us to use up our excess capacity, at which point inflation will be sustainably at our target. In the meantime, continued monetary stimulus is needed to keep the process in motion, and if the headwinds discussed earlier persist, continued policy stimulus may still be needed to offset them even after our excess capacity has been absorbed.

***Are we simply sowing the seeds of the next financial crisis?***

To summarize to this point, the global headwinds that are preventing a return to natural, self-sustaining growth remain considerable, and some of the damage already experienced in our economy will be long lasting. On the positive side, though, our conservative assessment is that global momentum is building, Canada is beginning to benefit, and with the assistance of continuing monetary stimulus, we can return to natural growth at full capacity over the next two years.

This leads to my third question: Is all of this monetary stimulus simply sowing the seeds of the next financial crisis?

The side effects of aggressive and prolonged monetary stimulus are well known—it promotes excessive risk-taking in financial markets and excessive borrowing by individuals. These are the very ingredients that led to the 2008 financial crisis in the first place. Accordingly, this question merits a serious response.

To begin, we knew back in 2008 that stimulative monetary policies would encourage people to borrow more to buy more homes and cars. That is why we do it—to buffer the downturn in the economy. This happens in every business cycle, not just this one. What distinguishes this cycle is its duration, which is leading to a buildup of financial stability risks over time. We study these risks in detail in our *Financial System Review*, which is published twice a year. The next issue will be released on 10 December.

Importantly, the world has changed since 2008. A key commitment of the G-20 in 2008 was to strengthen the global financial system. That work is very well advanced, and the system is far better capitalized and more resilient today.

Furthermore, there have been a variety of macroprudential policy changes that have made the system safer. Here in Canada, for example, we have strengthened the rules around the mortgage market in several ways. Those changes, combined with very high-quality underwriting even before those changes were made, make the Canadian situation very different from what we saw in the United States just before the crisis.

That being said, some critics would still say that we are running the risk of creating the next financial crisis through our actions. I might ask in response: What is it you would have us do, then?

As the central bank, we only have one real channel of influence, which is to set short-term interest rates. Right now, we are providing monetary stimulus sufficient to bring inflation sustainably to our target within a reasonable time frame, around two years from now. To argue that we should instead set interest rates in a way that reduces financial stability risks, then, is clearly a call for higher interest rates.

Let’s walk through a thought experiment together. What would our world look like today if, instead of keeping interest rates low to stimulate the economy, both Canada and the United States had moved their policy rates back up to neutral at the beginning of 2011? We estimate that the neutral rate of interest today is between 3 and 4 per cent for Canada, and use a similar number for the United States, so our thought experiment is to raise rates to about 3 1/2 per cent in both countries.

Such a move would of course allow those headwinds we talked about earlier to blow us backwards. We estimate that, under this hypothetical scenario the output gap in Canada would have been around 5 1/2 per cent today, instead of around 1 per cent. Unemployment would have been around 2 percentage points higher than it is today, and core inflation would be running somewhere between 0 and 1 per cent.

Most of the impact would be felt in reduced housing construction and renovation and auto production, as these were the sectors that responded to the policies put in place after the crisis. Moreover, these estimates do not capture the range of confidence effects that would permeate the rest of the economy under such a difficult scenario, so the story could even be worse.

From this monetary policy-maker's perspective, that's an unattractive alternative. Our primary job is to pursue our 2 per cent inflation target, with a degree of flexibility around the time horizon of its achievement; that flexibility permits the Bank to give due consideration to financial stability risks, provided they do not threaten macroeconomic performance.

Currently, inflation is close to target, but some of its strength is due to temporary factors, such as increases in prices for meat, electricity and telecommunications, and the pass-through of past exchange rate depreciation. Unless the output gap closes as expected over the next two years, inflation will drift back down significantly below 2 per cent as the temporary effects of these factors wear off.

Meanwhile, financial stability risks are clearly on our radar. In particular, housing activity is showing renewed momentum and consumer debt levels are high, so household imbalances appear to be edging higher. But it is our judgment that our policy of aiming to close the output gap and ensuring inflation remains on target will be consistent with an eventual easing in those household imbalances. Accordingly, we judge that the overall risks of attaining our inflation target over a reasonable time frame fall into the zone of balance at this time.

## Conclusion

Let me conclude. I have put a lot of emphasis today on the things we don't know. But it is important to underscore that we have a wide range of tools, some of them very sophisticated and others as simple as having conversations with Canadian companies, to help us reach judgments on those issues.

The Bank's approach to policy is evolving in light of these developments. We have made some major advances in our thinking in the past year, and in the transparency with which we present these issues to you. Many of the key variables that are essential to the policy decision—measures of capacity, the neutral rate of interest, our outlook for growth and inflation, and so on—are now conveyed in ranges. These elements of uncertainty are being explicitly incorporated into our decision making.

All of this demands that we think of monetary policy as an exercise in risk management. Although we regard the risks around attaining our inflation target over a reasonable time frame to be balanced, as policy-makers, we acknowledge that, in the current situation, the consequences of an upside risk would be more manageable than those associated with a downside risk. If this makes central

bankers seem overly preoccupied with downside risks, and seem gloomy to you, then take heart—we are just doing our job.