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Uncertainty and the Global Recovery

Introduction

It is a pleasure to be in Nanaimo at the Vancouver Island Economic Summit. With British Columbia serving as Canada's gateway to Asia, you are well aware of the interconnectedness of the global economy. To the benefit of billions of people, goods, capital and ideas flow across borders as never before.

Unfortunately, so too does angst. This is my topic today.

While the "Great Recession" is over, what has followed is an unfamiliar process of repairing public and private balance sheets across advanced economies. The depth and duration of this deleveraging are unclear. Deleveraging is holding back the global recovery and laying bare distinct challenges in different parts of the world.

The euro area is stagnating as it struggles with an underlying balance-of-payments crisis. The United States is at the edge of a fiscal cliff. China and other emerging markets are trying to sustain rapid growth amid weak demand in their traditional export markets.

There is a synchronous slowdown under way in the global economy. This past weekend in Tokyo, when the International Monetary Fund (IMF) marked down its growth forecast, no region or major economy was spared. Further, the IMF warned that downside risks have risen.¹

Against this background, it is not surprising that uncertainty over the global economic outlook is high. It is being reinforced by concerns over how policy-makers will address these challenges. This combined uncertainty is further complicating the recovery, prompting firms and consumers to retrench. There is some evidence of this dynamic here in Canada as businesses feel the weight of darkening global prospects.

¹ See the IMF's World Economic Outlook (WEO), "Coping with High Debt and Sluggish Growth," October 2012, which also includes a discussion of uncertainty. Available at <http://www.imf.org/external/pubs/ft/weo/2012/02/index.htm>.

While I will not be able to dispel all of these concerns today, my objective is to explain how policy-makers are addressing some uncertainties and to put some others in their proper context.

Uncertainty and Its Impact

It is only human to respond to uncertainty with caution. Faced with a highly volatile environment, households shy away from spending on big-ticket items such as houses or cars, and firms put off making large capital investments and hiring new workers. The effect on business investment can be particularly significant. This is because uncertainty increases the value of waiting for new information when firms decide whether to undertake big projects, leading them to reduce current investment.²

That uncertainty has such real effects is clear. However, the precise degree of uncertainty at any given point in time and its impact on economic activity are themselves uncertain.

According to standard measures of financial market volatility, such as the VIX, or implied volatilities from options prices in other asset classes, the current environment does not appear to be particularly uncertain.³ In fact, many of these measures are at post-crisis lows.

The comfort offered by these market-based measures may be misleading. For one, they may be importantly influenced by the extraordinary liquidity provided by central banks. This liquidity has supported financial markets and thereby provided insurance against downside risks. The dampening effect of central bank action may not persist if economic fundamentals do not ultimately improve, meaning that there could be a discontinuous shift in volatility at some point in the future.

Moreover, trading volumes across asset classes have generally been low in recent months, as many market participants with large cash holdings sit on the sidelines. Paralysis, not confidence, may better account for the observed declines in actual and implied volatility. This apparent lack of conviction in markets can itself be considered a sign of unusual levels of uncertainty.

Other indicators, such as surveys of households and businesses, tend to be more consistent with what many feel. For instance, the most recent *Small Business Problems & Priorities* survey of the U.S. National Federation of Independent Business finds that “uncertainty over economic conditions” ranked second in their list of most “critical” problems. “Uncertainty over government actions” was fourth.

² B. Bernanke, "Irreversibility, Uncertainty, and Cyclical Investment," *The Quarterly Journal of Economics* 98, no.1 (1983): 85–106.

³ The VIX refers to the Chicago Board Options Exchange Volatility Index, a popular measure of the implied volatility of S&P500 index options. It represents a market estimate of short-term stock market volatility.

Another index of economic policy uncertainty for the United States, constructed by researchers at Stanford, has shown a clear upward trend in recent years.⁴ They estimate that the rise in policy uncertainty between 2006 and 2011 reduced the level of real U.S. GDP by approximately 3 per cent and was associated with a loss of about 2.3 million jobs.

Using a similar methodology, Bank of Canada researchers estimate that the increase in policy uncertainty observed since the reintensification of the euro-area crisis late last year may have lowered the level of euro-area GDP by roughly 1 per cent.

Analytically, there is a clear question of causality here—does uncertainty cause slower growth or is it the other way around, with difficult economic times inducing greater qualms about the future? Surely it works both ways. Thus, the current combination of economic weakness and heightened uncertainty may be forming a vicious circle in the global economy.

That there is uncertainty about how the global economy will respond to an unprecedented period of deleveraging is not surprising. More troubling is the apparent uncertainty about the stance and perceived effectiveness of economic policy.

The question is what can policy-makers do about it?

Europe

Let me start with Europe.

The euro-area economy is stagnating, with GDP still 2 per cent below its pre-crisis peak and private domestic demand a stunning 6 per cent below. The causes of this underperformance are deep-seated.

An adverse feedback loop between weakening economic activity and sovereign and banking sector vulnerabilities has made the task of fiscal consolidation even more difficult.

Europe's banking losses and fiscal shortfalls are merely symptoms of a more serious underlying illness—a balance-of-payments crisis. To repay the creditors of Europe's core economies, the debtors of peripheral economies must regain competitiveness. Although there has been some progress, this process will be neither easy nor quick.

There are two ways to address the uncertainties plaguing Europe.

First, Europe is often said to be suffering an existential crisis—meaning that the very existence of the euro is being questioned. Recent actions, particularly by the European Central Bank (ECB), are now directly addressing this risk. The ECB has recently introduced a new program—the Outright Monetary Transactions (OMT) program—that is specifically designed to eliminate the risk of euro redenomination.

⁴ S. Baker, N. Bloom and S. Davis, "Uncertainty and the Economy," *Policy Review* 175 (2012). The index incorporates newspaper coverage of policy-related economic uncertainty, the number of tax code provisions set to expire in future years and the extent of disagreement among economic forecasters.

Simply put, subject to certain conditions, the ECB will act to ensure that yields on any particular euro-area country's short-term government bonds should reflect only the credit risk of that sovereign, not the risk that the country will leave the euro.⁵ By lowering yields in this manner, the ECB will substantially improve the transmission of monetary policy, and thereby increase the prospects for economic recovery in Europe.

Second, it would be helpful if European authorities would reframe the expectations of citizens and market participants regarding the time horizon over which European monetary union will be refounded. You are no doubt aware that there has been a seemingly endless series of crisis summits held about the euro in recent years—nineteen meetings at the Leader level in the past two years. Although there has been important progress, there was never any chance any *one* meeting could *solve* the issue.

For the euro area to be a viable currency union, several reforms over a 3 to 5 year period will be required. These include:

- necessary institutional changes, including a banking union;
- a closer fiscal union, including a fiscal transfer system and some form of mutualisation of sovereign debt;
- reforms to enhance labour market flexibility and mobility, as well as measures to promote competition and productivity in product markets; and
- steady reductions in (cyclically adjusted) budgetary deficits.

By reframing expectations to a realistic timeline, and ensuring that any financing assistance program for countries is sufficient for this period, European authorities could arrest the cycle of crisis summits, and thereby reduce policy uncertainty.

The Slowdown in China

In emerging economies, growth has slowed at a greater-than-anticipated rate in recent months. In China, real GDP grew 7.6 per cent in the second quarter, its slowest pace in three years, and recent data suggest continued softening in the third quarter.

The slowdown in China's growth reflects two broad influences. First, external demand for China's exports has weakened, owing in particular to the recession in Europe, China's largest trading partner.

Second, past policy actions in China are having an effect. With large vulnerabilities building in the housing sector, increasing evidence of overinvestment, and inflation above target, policy-makers appropriately tightened monetary and macroprudential policies once the economy shook off the effects of the 2008–09 global crisis.

⁵ Under the OMT, the ECB will be able to purchase sovereign debt with maturities of 1 to 3 years without limit. Participation in the program is restricted to member countries that undergo a European Financial Stability Facility/European Stability Mechanism program. This condition is critical, as "strict and effective conditionality" is needed to ensure that countries continue to undertake required reforms.

Given these excesses, the reduction in China's growth to more sustainable rates is welcome. However, recent signs that the slowdown in the Chinese economy may become too intense have prompted authorities to unwind some of the past policy tightening. This process has begun, with notable fiscal stimulus measures announced recently.

Nonetheless, there remains significant uncertainty over how quickly China can adjust its growth model. With the limits of an export-led growth strategy now obvious, rebalancing to encourage domestic sources of growth is needed. Yet prior rounds of stimulus appeared to stoke already very high levels of residential and business fixed investment, rather than consumption, which remains exceptionally low.

The risk is that, once again, the right stimulus will end up in the wrong places.

For outside observers, the uncertainty surrounding the economic outlook in China is compounded by the difficulty in obtaining reliable information regarding the extent to which the economy has already slowed.

That said, it is important to put China's recent performance in context. The Bank of Canada expects growth in China's GDP to average about 7.5 per cent over the next few years. While this is substantially below the unsustainable double-digit rates seen in recent years, it is still considerable. In fact, 7.5 per cent real growth in Chinese GDP in 2012 will add roughly \$800 billion to the global economy, an amount equivalent (in real terms) to the 14 per cent rate of growth in China in 2007, and approximately twice the dollar value of U.S. growth this year.

The U.S. Outlook

The U.S. recovery remains modest, consistent with the experience of other advanced economies that have faced financial crises. Although the fiscal challenges continue to loom, the recovery appears to be on a somewhat surer footing.

American households have recovered more than two-thirds of the \$16 trillion in net worth lost in the aftermath of the crisis. While it will take several more years to make up the balance, the process of household deleveraging appears well advanced, particularly now that the U.S. housing market is beginning to recover.

In addition, major U.S. banks have substantially increased their capital, and U.S. corporate balance sheets are very strong.

Despite this progress, aggregate debt across all sectors of the U.S. economy has not budged from its peak of about 250 per cent of GDP. The burden of deleveraging in the United States has, in a sense, been transferred from the private to the public sector.

It is clear that the U.S. public debt burden needs to be reined in over the medium term. Precisely how is less obvious. Existing legislation incorporates automatic tax increases and spending cuts, set to kick in next January, amounting to roughly 4 per cent of GDP—the so-called “fiscal cliff.” If authorities do not change these provisions, this massive fiscal drag will likely push the U.S. economy back into recession next year. That is not what we expect, but like others, we cannot be sure.

There is evidence that uncertainty surrounding the resolution of the fiscal cliff issue is already having an adverse impact. While the general tone of the U.S. data has improved slightly of late and financial markets have held up, high-frequency indicators related to U.S. business investment—where one would expect to see the greatest impact of uncertainty—have weakened. For example, new orders for capital goods have fallen sharply, declining by 26 per cent over the most recent three months. This is by far the weakest result since the end of the recession.

The Bank assumes that the United States will, in the end, step back from the fiscal cliff. Even with that assumption in place, the Bank projected in its July *Monetary Policy Report* that fiscal tightening in the United States will remove 1 percentage point from U.S. growth in 2012, and 1.5 percentage points in each of 2013 and 2014. Under such a scenario, the near-term hit to the economy is largely avoided, but the need for fiscal consolidation persists—as indeed it does under any plausible scenario.

A clear, consistent and committed medium-term U.S. fiscal plan, one that demonstrates how this consolidation will be achieved, would be helpful in mitigating a major uncertainty that would otherwise endure.

More positively, recent Fed actions have actually reduced uncertainty. Specifically, the Fed has provided greater certainty by indicating that its policy rate could be expected to remain at extremely low levels until mid-2015. It has also provided more certainty with respect to its reaction function, linking future unconventional monetary policy to substantial improvements in the outlook for the U.S. labour market. In addition, the Fed has indicated that it will leave highly accommodative policy in place “for a considerable time after the economic recovery strengthens.”

If conditions were to deteriorate and further easing were required, the U.S. central bank could provide even greater certainty with further refinements, such as precise numerical targets and a time frame for achieving these targets.

The Fed did not just sharpen communication, it also announced its intention to purchase \$40 billion in securities per month—a strategy nicknamed “QE3.” As with previous rounds of monetary stimulus, QE3 can be expected to support the American recovery, both directly by lowering interest rates, and more broadly, through the so-called portfolio-balance effect. This channel tends to lift asset prices and reduce the value of the U.S. dollar. The overall impact of QE3 for Canada is estimated to be modestly positive, reflecting its supportive implications for U.S. and global activity and the resulting boost to commodity prices.

What Does All This Mean for Canada?

Elevated global uncertainty is holding back global economic growth and, thus, the demand for Canadian exports. In addition, there is some evidence that global uncertainty is affecting domestic activity. According to the Bank’s most recent quarterly *Business Outlook Survey*, released this morning, Canadian firms have become more circumspect about new capital expenditures and less inclined to

hire new workers.⁶ In this environment of slow global economic growth and uncertainty about demand, firms have also tempered their sales expectations for the next 12 months.

However, while Canada's economy is being affected by the global angst, the key areas of uncertainty abroad are all points of justifiable confidence here at home. Canada's public finances are sound. Monetary policy is clear and credible. Canada's financial system showed itself to be among the most resilient in the world through the crisis. Since then, it has strengthened further. One thing Canadian businesses can expect is that their financial system will be there if times get tough again.

In this uncertain world, then, Canada is rightly viewed as an attractive investment destination. This is having an important effect on Canadian financial conditions. Capital inflows are tending to push up the value of our dollar, thus acting as a headwind to the Canadian economy. However, foreign capital is also tending to push domestic asset prices up and longer-term interest rates down, which has a supportive effect on domestic growth. The Bank takes all of this into account when setting monetary policy.

The Bank provides as much certainty as it can in the conduct of monetary policy. While we obviously cannot determine events over which we have no control, we can be transparent about what we expect and how we would react to different scenarios. That includes being clear about the role of monetary policy in supporting financial stability in Canada. For example, if we were to lean against emerging imbalances in household debt, we would clearly declare we are doing so and indicate how long we expect it would take for inflation to return to the 2 per cent target.⁷

Conclusion

Let me conclude.

Eighty years ago, faced with a more dire set of economic circumstances than we are today, Franklin D. Roosevelt famously told Americans that "the only thing we have to fear is fear itself." But this is not the Great Depression. The IMF expects the global economy to grow by more than 3 per cent this year and next, or just under the average of the past 10 years. What we face now is better described as uncertainty rather than fear. Nonetheless, the spirit of FDR's comment applies—we must take care not to allow uncertainty to dominate our actions, letting profitable opportunities slip away and, more generally, compounding the very real, but still manageable, challenges facing the global economy.

At times of extreme economic and policy uncertainty, it pays to be quick and bold, as the central banks of the United States, the United Kingdom, and the euro area have been.

As Canadians, we need to focus on what we can control. We can't save the euro, fix America's fiscal cliff or restart the U.S. housing market. Should we just wait

⁶ Bank of Canada, *Business Outlook Survey*, Autumn 2012.

⁷ Bank of Canada, "Renewal of the Inflation-Control Target: Background Information—November 2011."

out a decade-long deleveraging process in the crisis economies? Should we lower our expectations? Or should we control our destiny by building on our strengths in the new global environment? We can improve Canada's low productivity growth and sharpen our focus on emerging markets. And we can continue to invest in our greatest resource—our people.

Against this backdrop, next week's *Monetary Policy Report* will provide a full update on the Bank's outlook for economic growth and inflation in Canada. It will take into account the impact of the uncertainty that I have been discussing today. The Bank will take whatever action is appropriate to achieve the 2 per cent CPI inflation target over the medium term. That certainty is our contribution to ensuring that Canadians can invest and plan with confidence.