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True North in Canadian public policy

# Commentary

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# Laying the Groundwork: How Policies Adopted After the Great Financial Crisis Are Threatening the Global Economy

Philip Cross

The International Monetary Fund (2019) recently downgraded its outlook for the world economy while identifying four major threats that may further reduce global growth: rising tariffs and trade tensions, financial tightening, uncertainty related to Brexit, and the accelerated slowdown in China. While all four pose real threats to growth, they have a common source.

Underlying all these threats are the distortions created from policies adopted to address the Great Financial Crisis in 2008-2009. This makes the risks generically very much like those behind every major downturn dating back to at least the 1980s – the actions policy-makers take to correct the immediate weakness of the economy lays the groundwork for the next downturn by creating distortions in the economy that eventually mutate and metastasize.

## Recessions are connected over time

The inter-connection of cycles over time is evident when reviewing the evolution of recessions and recoveries since 1987. Monetary policy easing after the 1987 stock market crash helped fuel the subsequent burst of inflation and housing speculation that ended with the prolonged 1990/1991 recession and slow recovery, partly due to the lingering Savings and Loan debacle. Keeping US interest rates low in the 1990s encouraged capital flows to Asian countries in search of higher returns. The sudden reversal of these capital flows in 1997 triggered sharp devaluations, much higher interest rates, and recession throughout Southeast Asia.

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Along with the Russian crisis of 1998, the Asian crisis encouraged US monetary policy to stay loose in the late 1990s. Two Fed interest rate cuts late in 1998 sparked a speculative bubble in North American stock markets that culminated in the 2001 recession. The memory of steep capital losses in investments in Asia in the late 1990s and then in the US stock market in 2001 incited Asian investors to seek the apparent security of US debt instruments between 2002 and 2008 that helped set in motion the US housing bubble. Dealing with the fallout of the financial crisis that began in 2007 resulted in nearly a decade of unprecedented monetary stimulus and distortions of financial incentives, the long-term consequences of which are not yet fully revealed.

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The threat of a global recession is hardly far-fetched. Italy has already returned to recession, its third in the past decade. The UK is not far behind as an agreement on Brexit flounders. Real GDP in Germany has fallen over the last two quarters and France was slowing amid growing 'yellow vest' protests late in 2018. So is the US after the temporary stimulus from last year's tax cuts wanes. Canada is tottering on the brink of recession, despite the benefit of continued growth in the US.

Most analysts do not seem to appreciate how rapidly Canada's economy has slowed. The MLI leading economic indicator (LEI) has fallen for three straight months, a longer and deeper decline than 2015's near-recession. Between July and November, real GDP rose only 0.2 percent, reflecting a miniscule annual rate of 0.6 percent. A quick tour of the major monthly economic indicators reveals the breadth of this slowdown. Retail sales volume has fallen 2.5 percent since May; manufacturing sales are down 2.6 percent from July while capacity utilization tumbled from 82 percent to 76 percent in the past year; building construction is off 7.9 percent since December; wholesale sales have slipped 2.2 percent from May, and nominal exports are down 5.3 percent since May. Higher oil output helped prop up GDP as long-planned oilsands projects came on-line, but this temporary support will soon be reversed as industry cutbacks take effect in December and January.

## Policy responses to the Great Financial Crisis

In 2008-2009, policy-makers around the world implemented a number of extraordinary steps to avoid a 1930s-style downturn. In particular, most central banks in the advanced market economies undertook unprecedented monetary stimulus. First, they lowered interest rates to near or even below zero. Then they tried Quantitative Easing, engaging in a vast expansion of their balance sheet to lower interest rate spreads and bid up the price of assets.

As well, governments in both the advanced market economies and emerging markets reinforced monetary stimulus with massive fiscal stimulus. In the US and the UK, this pushed government borrowing to levels normally associated with major wars when national survival was at stake. It is noteworthy that in emerging market nations, especially in Asia, governments relied primarily on fiscal stimulus to combat the 2009 recession, resisting the monetary stimulus favoured by most western nations. Asian nations learned the lesson of their 1998 crisis that risky financial behaviour is to be minimized at all cost, and their recovery has surpassed most western countries (Prins 2018, 248).

## The limits and costs of stimulus

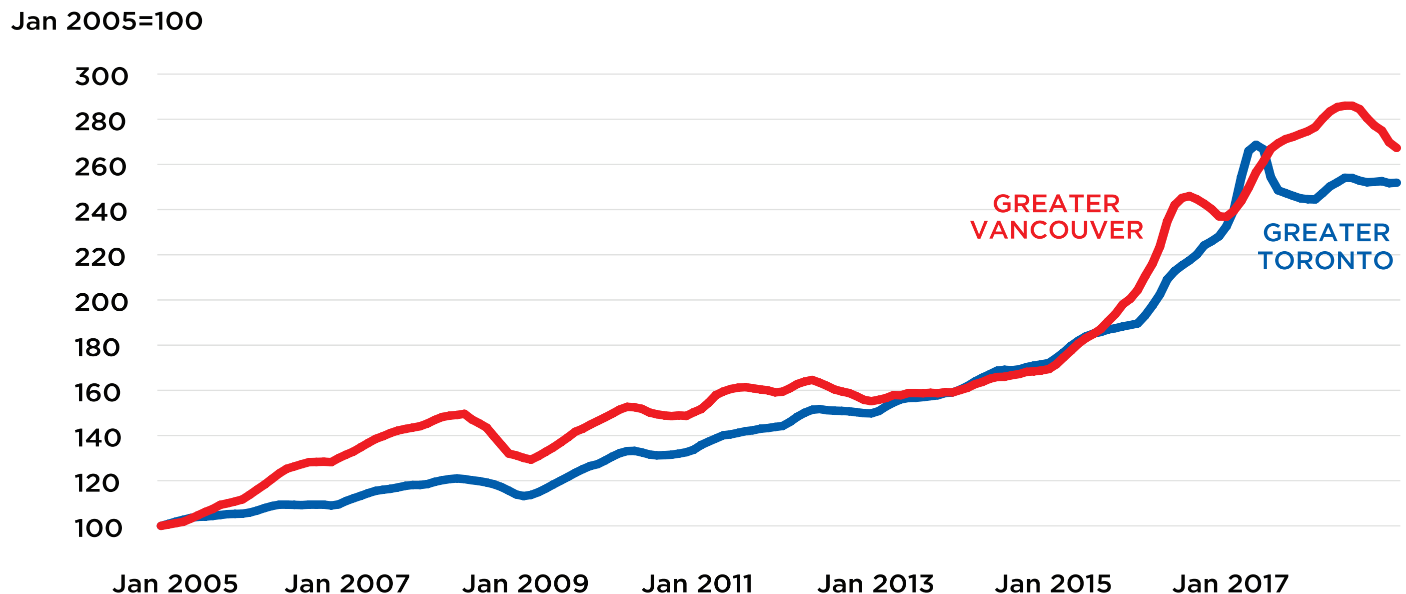
It is arguable that these extraordinary monetary and fiscal measures were necessary and effective in minimizing the damage from the Great Financial Crisis. However, the problem is that these measures were only intended for short-term use at the depths of a crisis. Instead, most countries maintain this stimulus ten years later, greatly amplifying the distortions they introduce into financial markets and reducing potential long-term growth. If the precedent that actions taken to fight recessions create the conditions for the next correction holds, then the long-term implications of this extraordinary stimulus throughout the G7 are sobering.

As well, monetary and fiscal policy are reaching the absolute limits of possible stimulus: interest rates in North America, Europe and Japan already are near or below the zero bound, while the capacity to increase government debt is approaching the limits of public willingness to borrow or the tolerance of financial markets to fund. It is an open question whether bond markets would balk at the prospect of financing another sharp increase in government deficits when the next recession occurs. This would leave the uncomfortable choice of either adopting austerity in the middle of a recession, as Greece did in 2014, or asking central banks to step up their purchases of government bonds – a real threat to central bank independence.

There are other reasons to believe monetary and fiscal policies are exhausting their ability to stimulate growth in the short run. One is diminishing returns, partly reflecting that after years of stimulus, less spending is available to shift from the future to the present. As the Bank for International Settlements observes, "tomorrow eventually becomes today" (Bank for International Settlements 2016, 14).

Canada is a good example of how stimulative measures can be exhausted in one cyclical downturn and not replenished before the next arrives. In response to the oil price crash, the Bank of Canada in early 2015 surprised markets by lowering interest rates, accelerating the devaluation of the Canadian dollar. Lower interest rates sparked the surge in Vancouver house prices and accelerated Toronto's (see Figure 1). The Bank of Canada expects the drop in oil prices in 2018 to depress growth less than in 2015. This literally may be true for the oil sector, but the broader economy may suffer more due to waning monetary stimulus. For example, the housing sector is constrained by regulations introduced to curb the house price bubbles induced by interest rate cuts in 2015. Meanwhile, exports are limited by the weaker outlook for the global economy.

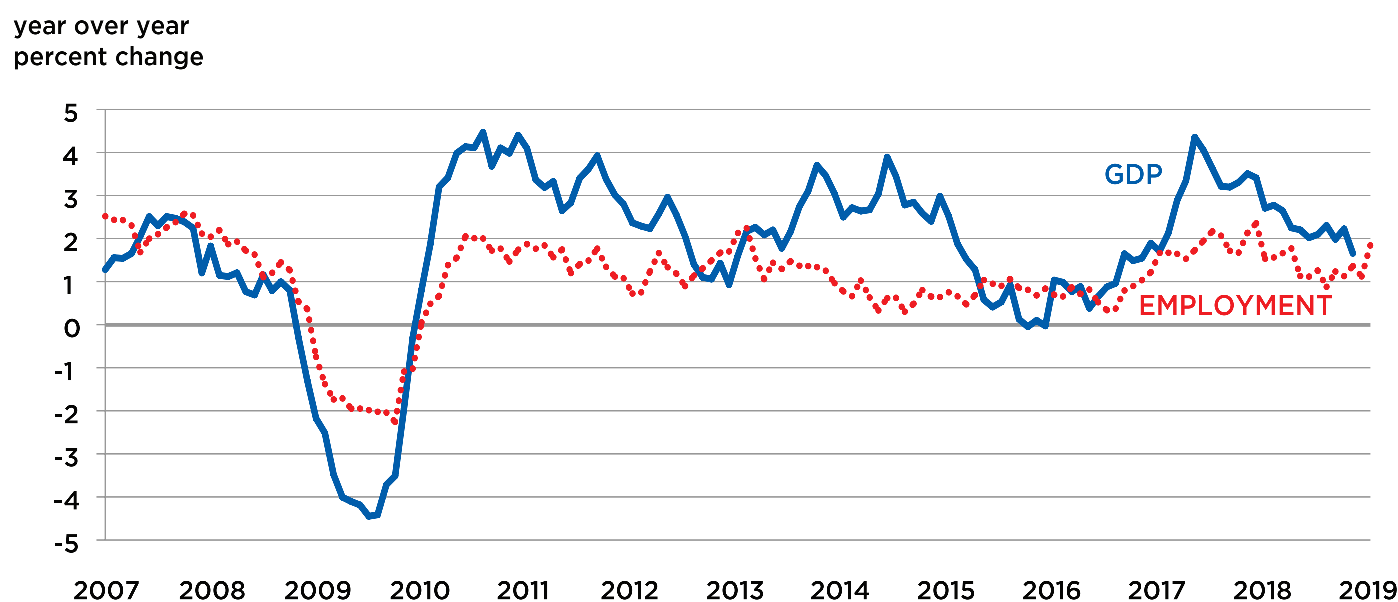
Figure 1: House Prices



There is a trade-off between the short-term stimulus that monetary and fiscal policy lend to the economy and their harm to growth in the long-term. This reflects how most stimulus either involves shifting spending from the future to the present or encourages risky investments that may sour in the long run (Cross 2016). Firms understand that stimulus policies that shift spending forward mean future demand will be weaker, reducing their incentive to invest. Indeed, chronic weak business investment has been a defining characteristic of the recovery in almost all advanced economies.

Canada's experience over the past decade demonstrates the failure of short-term stimulus to kick-start sustained high growth. On three occasions in the recovery, growth in Canada approached the break-out rate of 4 percent. However, instead of being sustained, in each case growth quickly subsided to 1 percent or less (see Figure 2). Employment growth has been much more stable than GDP over the past decade, staying mostly between 1 and 2 percent and at times even surpassing GDP growth, as it seems to be doing again at the end of 2018.

**Figure 2: Output and Employment**




## Secular stagnation and malinvestment

Policies designed to stimulate the economy were not meant to cure persistently slow growth, which is increasingly what they are being asked to do in the world's advanced economies. Chronically slow growth reflects structural forces, notably low productivity gains, which can only be addressed by structural reforms and not short-term stimulus policies. Lowering inter-provincial trade barriers is a good example of a structural reform that could be implemented with few if any adverse impacts on the short-term course of the economy. Statistics Canada found that inter-provincial trade in Canada behaves as if there were an internal tariff of 6.9 percent, versus the absence of any tariff effect on trade within the United States (Bemrose et al 2017).

In fact, most macroeconomic stimulus policies inhibit productivity growth. Edmund Phelps observes that government deficits over a long period "ultimately threaten increased costs of credit and depressed valuations of business assets, and are thus bad for innovation and investment" (Phelps 2013, 319). The trade-off between more short-term stimulus and less long-term growth exacerbates the reduction of potential output growth during

recessions, on top of the lower business investment and the erosion of human capital that recessions cause. At worst, they encourage excessive debt growth that results in unstable financial conditions. In many countries, excessive reliance on short-term stimulus policies is undercutting the motivation to adopt structural reforms.

This line of analysis has clear implications for the "new normal" thesis of why the Western world is mired in an era of slow growth. The secular stagnation hypothesis holds that growth is weighed down by weak demand, less innovation and the aging of the population. The Bank for International Settlements holds an alternative view: slower growth reflects the dulling impact on long-term growth of maintaining stimulative monetary and fiscal policies long past their best before date. Worse, the possible formation of bubbles in several asset markets raises the possibility of another financial crisis, for which policy-makers will have much fewer tools than in 2008.

> "Years of ultra-low interest rates have undermined financial stability, which threaten serious economic damage."

The trade-off between the short-term benefits of stimulus and their long-term costs can extend over very long periods when badly allocated investments – or malinvestments – are involved. Canada provides one example of malinvestments resulting from a policy that was stimulative in the short-run but costly in the long-run. Throughout the 1990s, Canada's low exchange rate encouraged the expansion of manufacturing, notably in the lowest-paying sectors, such as clothing, textiles and furniture. For a few years this paid off and Canada was the only major western nation where the share of manufacturing in GDP rose during the 1990s. However, after the loonie began appreciating and China joined the World Trade Organization, Canadian manufacturing underwent a painful restructuring, with the lowest-paying sectors virtually disappearing. All the apparent stimulus that resulted in more jobs and investment in low-paying factory jobs was ultimately revealed to be a misallocation of resources. While total manufacturing output continued to grow slowly after 2002, the restructuring within manufacturing dampened overall potential growth, with total factor productivity in manufacturing falling after 2000 as the capital stock shrank.

Growing public frustration with chronically slow growth lies behind many of the specific threats identified by the IMF. It is not surprising that people elect leaders with policies hostile to global trade or vote for Brexit when the track record of slow growth clashes so dramatically with the promise of the extraordinary stimulus injected into major economies over the last decade. For many people, the false promise of globalization or the perceived injustice of policies such as quantitative easing (which boosted asset prices benefiting the rich the most) reinforces the public perception that the system is "rigged." Nor is it surprising that growth is slowing the most in countries like China and Canada that have relied on sharply higher debt to temporarily boost growth, ignoring the lesson from the problems created by high indebtedness in the US and much of Europe during their recent crises.

## Less financial stability

Years of ultra-low interest rates have undermined financial stability, which threaten serious economic damage. Financial markets have demonstrated a proclivity for volatility, going back to the 'taper tantrum' in 2013 when the Federal Reserve first tightened monetary policy through to the Greek banking crisis and Chinese stock market swoon in July 2015 to repeated sell-offs of European bank stocks in 2016 and then to last December's frenzied selling in stock markets. These recurring bouts of sharp decline suggest investors have little confidence

in the underlying value of some of their investments; instead, they appear motivated by the search for yield when fixed income returns are paltry.

The continued use of stimulus encourages risky investments in the frantic search for yield in a low interest rate environment. Robert Shiller's statistical assessment of stock market values found their overvaluation recently to be comparable to 1929. Another example of increasing risk is the rising share of credit going to lower-rated companies. More exposure to risk creates vulnerabilities when market conditions shift rapidly. Adam Tooze points out that the Federal Reserve was indispensable in providing trillions of dollars of liquidity to the global financial system during the 2008-2009 crisis. It is a very open question whether the Trump administration would be disposed to provide similar aid to other countries under similar circumstances (Tooze 2018). If the Trump administration's trade policies can be characterized as 'beggar thy neighbour,' of even more concern would be a policy of 'ignore thy neighbour' during a crisis.

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Canada's pension system demonstates the negative structural impact of easy money policies. Sustained low interest rates have been the primary reason defined benefit pension plans have disappeared in the private sector (Hamilton and Cross 2018). Obviously, this puts the long-term retirement plans of private sector workers at risk. Less visibly, public sector pension plans responded by shifting risk to governments and ultimately the taxpayer. This increases the possible exposure of governments to higher deficits in the future, at a time when the aging of the population will be straining government finances. So an unintended consequence of low interest rates could be to reduce the flexibility of fiscal policy in the long run.

## Conclusion

Some things have improved since the last recession. The leverage of the US financial system is much lower, so it seems unlikely that we would see a repeat of the carnage in US banks. However, the situation in Europe is less reassuring, as large stresses remain in the banking systems of weaker economies such as Italy. Meanwhile, soaring indebtedness puts China's banking system at increased risk.

Is the global economy headed for a recession? That seems the inevitable result of the policies maintained over the past decade. Of greater concern is that these same policies may prevent governments from responding as forcefully.

A recent cover story in *The Economist* asked: *The next recession, how bad will it be?* This is not scare-mongering, just an acknowledgement that the business cycle will always be part of market-based economies. One cannot predict the incident that will provoke a re-pricing of risk in financial markets, but the end of the experiment with zero or even negative interest rates will be disruptive. Given the inevitability of recessions, governments should adopt policies that reflect this reality. Turbulence in the global economy favours nations that have taken out some insurance against these risks through high savings, budget surpluses and structural reforms to boost long-term growth.

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# About the Author

Philip Cross is a Munk Senior Fellow at the Macdonald-Laurier Institute. Prior to joining MLI, Mr. Cross spent 36 years at Statistics Canada specializing in macroeconomics. He was appointed Chief Economic Analyst in 2008 and was responsible for ensuring quality and coherency of all major economic statistics. During his career, he also wrote the "Current Economic Conditions" section of the Canadian Economic Observer, which provides Statistics Canada's view of the economy. He is a frequent commentator on the economy and interpreter of Statistics Canada reports for the media and general public. He is also a member of the CD Howe Business Cycle Dating Committee.

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