

THE CANADIAN EXCEPTION TO THE FINANCIAL CRISIS:
Canada's Macroeconomic Policy Framework
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Introduction

Although far from unscathed by the current crisis, Canada has for a number of reasons experienced a lower degree of financial turmoil than the United States. Undoubtedly, many of the reasons relate to the nature of Canada's financial sector and its regulatory regime. These factors are examined elsewhere (see papers by Bhushan, Heidrich and Letourneau, and Porter). But did Canadian macroeconomic policy also play a role? The focus of this paper is to examine the Canadian experience through a macroeconomic policy lens. Canadian monetary policy was, in the early 1990s, significantly different from that in the U.S. After the inauguration of the George W. Bush administration in 2001, Canadian and U.S. fiscal policy also diverged. The paper will examine the critical differences in the design and objectives (to the extent there were differences in objectives) of monetary and fiscal policy in the two countries. Whatever its explicit objectives, did Canadian macroeconomic policy nonetheless have the effect of reducing vulnerability to the financial shocks that were visited upon the United States?

The specific question examined in this paper is whether Canadian macroeconomic policy played an important role in reducing the growth of asset bubbles and speculative lending and investment more generally. A theoretical framework is provided by Minsky's (1992) financial instability hypothesis, according to which prolonged periods of economic stability, underpinned by low interest rates, generate increasingly risky behaviour among creditors and investors, leading ultimately to a credit crunch and possibly an economic downturn.

It should be emphasized that restraining the growth of asset bubbles was not an explicit objective of Canadian macroeconomic (particularly monetary) policy, which was focused on restraining price inflation. But an unintended benefit may have been that relatively more restrictive monetary and fiscal policies, along with less financial deregulation and less speculative or risky behaviour by financial institutions, served to limit the growth of credit and hence (according to the Minsky hypothesis), the growth of risky lending and investment and asset bubbles in Canada.

The paper is organized as follows. In the next section, the conceptual framework is briefly reviewed, focused on the Minsky hypothesis. In the third section monetary and fiscal policy in Canada and the U.S. are compared, along with indicators of asset price inflation. In the fourth section, some tentative conclusions are drawn based on the evidence presented. It is suggested that more restrictive fiscal policy and a flexible

¹ I am grateful for comments on an earlier draft from Gerry Helleiner, Aniket Bhushan, Pablo Heidrich, Mario Seccareccia, and Eric Santor, and for research assistance from Dina Shadid. However, the views and conclusions expressed in this version are my own.

exchange-rate policy, rather than a distinct monetary policy, may have helped to contain the buildup of excessive debt in the Canadian economy.

From Efficient Markets to Financial Instability

Mainstream thinking on the relationship between the stability of financial markets, and the role of monetary (and to some extent fiscal) policy, has evolved rapidly in the current financial crisis. The crisis is largely the legacy of the Efficient Markets Hypothesis (Fama 1970), which holds that financial asset mispricing cannot take place – that asset prices, in other words, correctly reflect their true values. Asset price “bubbles”, on this hypothesis, do not exist, are beneficial for growth, or could not be spotted. Intervention is therefore unnecessary and counter-productive (Vayanos and Woolley 2009).

The efficient markets hypothesis was the ruling paradigm in capital markets theory from the 1980s until the present crisis. In no small way the pre-eminence of the hypothesis laid the foundation for financial market deregulation and liberalization during the 1980s and 1990s, and subsequently for the financial meltdown of 2007-8. Of course, economic policy is seldom determined by theory alone. Deregulation and liberalization were the order of the day in the 1980s and 1990s, not just in the financial sector. Moreover, political economy considerations might suggest that financial sector liberalization abroad served the interests of financial centres in Wall Street and the City of London, by enabling them to expand their global reach.

There was, nonetheless, a competing hypothesis – Hyman Minsky’s financial instability hypothesis, developed in the same period. Minsky’s hypothesis ascribes to financial crises a leading role in economic cycles including major downturns such as the Great Depression (Kindleberger 1996).

Minsky’s financial instability hypothesis puts considerable weight on the extent and composition of debt in the market economy. Debt, as characterized by Minsky, falls along a continuum which at one end is stable (when debt is completely hedged), but becomes increasingly speculative and unstable at the other end, which includes highly risky leverage arrangements such as Ponzi finance, that inevitably fail. All three elements of debt financing are typically present at any time in the market economy. However, the longer stability persists, the greater the propensity of risk-takers toward speculative and Ponzi financing. These tendencies are heightened by protracted low interest rates when a growing number of investors seek higher yields notwithstanding the higher risk.

What is particularly important about the Minsky hypothesis is the role it ascribes to loose monetary and credit policy in the evolution from financial stability to crisis. Accordingly, a macroeconomic policy informed by the Minsky hypothesis would necessitate greater interventionism and countercyclicality aimed at constraining the growth in credit, asset bubbles, and more risky forms of indebtedness during prolonged boom periods.

While the thrust of the Minsky hypothesis is aimed at monetary policy, the role of fiscal policy in the dynamics of financial instability is also important because of its impact on

debt in the economy. If fiscal deficits accompany loose monetary policy the growth of indebtedness in the economy is further enhanced as governments borrow to fund the deficits. Moreover, by crowding out private borrowing, chronic fiscal deficits have an impact on the structure of indebtedness in the economy by inducing investors/lenders seeking higher returns to take greater risks.

In defence of mainstream policy and its theoretical foundations, Minsky himself expressed considerable uncertainty as to why another major collapse like the Great Depression did not recur during his own lifetime (Minsky 1982). Notwithstanding a series of local and global financial crises during the 1980s and 1990s, recovery ensued within a relatively brief period. Minsky's moment had to await the crisis of 2007-8 the severity of which shook the ruling paradigm to its foundations.

It is worth reviewing why the Minsky moment took so long to arrive, since it helps shed further light on the relationship between macroeconomic policy and financial instability. Keynesian macroeconomic policy prevailed in the immediate postwar decades, when the principal preoccupation was to avoid another Great Depression. This 'golden age' of Keynesian policy came to an end with the multiple economic shocks and stagflation in the 1970s. But, it should be said that despite the discrediting of Keynesian macroeconomic theory in the economic turbulence of the 1970s, a case can be made that countercyclical policies of sorts made a comeback in the 1980s and were implemented for the following three decades. This helped to ensure that sharp downturns and accelerating inflation were arrested before spinning out of control².

In other words, assiduous deployment of countercyclical policies likely served to defer the Minsky moment, despite the fact that they resulted in relatively long periods of growth and prosperity.

However, the burden of countercyclical policies was shifted largely onto monetary policy, with central banks playing the leading role. Starting with the 'Volcker shock' of 1981, central banks pursued aggressive anti-inflationary measures by increasing interest rates to unprecedented levels in the postwar era. Ultimately, by the 1990s, monetary policy had settled in to a policy of 'inflation targeting' in the U.S., Canada and other OECD countries. Meanwhile fiscal policy, in the 1980s, became expansionary with mounting fiscal deficits (brought about through the Reagan Administration's tax cuts and expenditure increases in the United States; there were similar trends in Canada). This had the effect of offsetting to some extent the negative impact on output and employment levels of the extraordinary interest rate hikes, but it also meant that both real and nominal interest rates remained high because of pressure to fund the growing public debt.

By the 1990s, the accumulation of debt was exerting considerable fiscal drag in many OECD countries, necessitating high interest and debt servicing costs. In response to the instability in currency and financial markets in many countries during the period 1990-

² A case in point is the stock market crash of 1987, which featured a larger one-day drop (22.5 percent) on the New York stock exchange than in 1929. The Fed reacted by pumping billions of dollars of liquidity into the market. Unlike the 1929 crash and the dot.com crash, an economic downturn did not ensue.

95, corrective fiscal measures were taken in the U.S., Canada and other OECD countries to bring mounting deficits and public indebtedness under control. In the U.S. (under the Clinton Administration) and Canada (under the Chretien Administration) fiscal deficits were turned into fiscal surpluses. In Europe, the Maastricht Treaty of 1992 specified convergence criteria, which included budgetary positions "without excessive deficits", i.e. annual government deficits not exceeding 3 percent of GDP, and a ratio of government debt to GDP below 60 percent.

Deficit reduction and the restoration of greater fiscal balance helped to reduce pressure on interest rates in the later 1990s; as a result they fell to their lowest levels in three decades. Unemployment in the U.S. also fell to below 4 percent for the first time since 1970 (Krugman, 143). However, the prolonged period of expansion since the early 1980s (apart from a short and shallow recession in the early 1990s), and low interest rates, also helped precipitate the "dot.com" boom in the latter part of the decade, consistent with the predictions of the Minsky hypothesis. This stock market bubble was a forerunner of the bubbles and financial meltdown a decade later. But at the time, and even a decade later in his memoirs, then Fed Chairman Alan Greenspan dismissed the stock market bubble as "irrational exuberance" beyond the control of the central bank's arsenal of monetary policies (Greenspan 2007).

The ensuing dot.com crash led to a short recession in the U.S. in 2001-2. But by this time the George W. Bush Administration had implemented a huge tax cut. Moreover, the U.S. response to the terrorist attacks of 9/11 and the wars in Afghanistan and Iraq, led to mounting fiscal deficits, reversing the Clinton surpluses of the 1990s but they also led to a quick recovery and resumed growth.

The George W. Bush Administration's macroeconomic policy mirrored that of the Reagan Administration two decades before. The task of fine-tuning output and inflation levels fell to monetary policy. Meanwhile, fiscal policy took a different, indeed often contrary tack, characterized by tax cuts, expenditure increases and rising deficits and debt. The upshot was that inflation and unemployment were both maintained at relatively low levels.

Given the brevity and shallowness of the 1990-91 and 2001 recessions in the U.S. subsequent to the Volcker shock and the dot.com crash, it was not surprising that mainstream economists such as Robert Lucas spoke of solving the central problem of depression prevention³. Meanwhile policymakers such as Ben Bernanke pronounced the advent of the "Great Moderation"⁴. By this, Bernanke referred to the reduced volatility of output and inflation since the mid-1980s, accompanied by reasonably robust economic growth, and suggested that macroeconomic management had helped to bring about an era of durable stability and prosperity.

This sense of complacency in the early years of the 21st century, along with the reassuring experience of recovery from the dot.com crash, set the scene for the stock market and

³ Robert Lucas in his 2003 presidential address to the American Economic Association.

⁴ Ben Bernanke, then a Governor of the Fed, in a 2004 speech to the Eastern Economic Association.

housing bubbles in 2007-8. In particular, the growing contradictions and inconsistencies in macroeconomic policy meant that Minsky's moment would finally arrive.

It is remarkable how much mainstream thinking has changed on the issue of the relationship between accommodative monetary policy and asset bubbles. For example, confronting the doctrine articulated by Greenspan that there is little central banks can or should do to prick asset bubbles; the Bank for International Settlements (2008) opined that "it is not fanciful, surely, to suggest that these low levels of interest rates might inadvertently have encouraged imprudent borrowing, as well as the eventual resurgence of inflation."

By the following year, in its annual report the BIS stated that:

Low real interest rates had a variety of important effects, some more predictable than others. On the more predictable side, by making borrowing cheap they led to a credit boom in a number of industrial economies. For instance, credit in the United States and the United Kingdom rose annually by 7% and 10%, respectively, between 2003 and mid-2007. It is always difficult to establish clear causal links, but in this case it seems reasonable to conclude that cheap credit formed the basis for the increase in home purchases as well as for the dramatic rise in household revolving debt.

The 2009 BIS annual report goes on to suggest, consistent with the Minsky hypothesis:

Among the less expected effects of the low interest rates were the incentives they created in the asset management business. Again, increasing risk (and, in this case, hiding it) is one way of meeting clients' demands. So, low interest rates increase risk-taking (Bank for International Settlements 2009).

Similarly, in its October 2009 *World Economic Outlook*, the IMF argued that:

Monetary policymakers should put more emphasis on macrofinancial risks. This would imply tightening monetary conditions earlier and more vigorously to try to prevent dangerous excesses from building up in asset and credit markets, even if inflation appears to be largely under control. Past asset price busts were often foreshadowed by rapidly expanding credit, deteriorating current account balances, and large shifts into residential investment. With inflation typically under control, central banks effectively accommodated these growing imbalances, raising the risk of damaging busts (IMF 2009a).

Canadian and U.S. Macroeconomic Policies compared

The above discussion suggests that mainstream opinion on the financial meltdown of 2008 has come a long way to accepting the Minsky view that extended periods of low

interest rates and economic prosperity instigate increasingly risky behaviour on the part of investors, lenders and borrowers, which in turn helps to precipitate a financial crisis. In this section we take a closer look at the experiences of Canada and the United States, particularly in the last two decades. To what extent does the evidence suggest divergent macroeconomic policies between the two countries? In particular, did monetary and fiscal policy differ, and to what extent? Finally, are there other macroeconomic indicators suggesting a divergence in policies leading to the different outcomes in the two countries in the financial crisis?

Monetary Policy. A comparison of Canadian and American macropolicies yields some interesting observations. Before looking at the historical evidence, it should be stated that in neither country has monetary policy set its sights on asset inflation as an explicit objective. In that regard, Canadian and U.S. policy has been similar to that pursued in OECD countries in general. Instead, the objectives of monetary policy have been clearly fixed on price inflation. In the case of the U.S., this objective was complemented with the objective of maintaining a reasonably high level of employment⁵. To the extent that asset bubbles have been regarded as a problem, official monetary policy has adopted a *östandbyö* posture. That is, the monetary authorities, under the assumption that they were not empowered, or in any event were not able, to control asset inflation, would stand by until the asset bubble burst. Thereupon, if the ensuing financial turmoil was serious enough to threaten the stability of the *öreal sectorö* (for example, via price deflation) they would provide enough liquidity and lower interest rates sufficiently to restore calm and confidence. This was the policy pursued after the stock market crash in 1987 and the dot.com crash in 2000. More on the latter below.

So the purpose in examining the historical evidence is to try to ascertain whether monetary policies differed between Canada and the U.S. In particular, if Canada pursued a stricter monetary policy, notwithstanding its lack of an explicit policy on controlling asset price inflation, could it thereby have had an inadvertent (and positive) impact in the form of containing an asset bubble?

To begin with, monetary policy in the two countries has not diverged a great deal, at least not since about 1995. From 1990 to 1995, it is true, Canada pursued a much more aggressive anti-inflation policy than the U.S. Accordingly, during the period 1990-92, the Bank of Canada's target overnight rate was up to 5.8 percentage points higher than the U.S. counterpart, the Fed Funds rate. (In May 1990 the Bank of Canada's target rate was 14.05 percent while the Fed Funds rate was 8.25 percent.). However, the positive Canada-US interest rate differential narrowed between 1991 and 1995 and disappeared entirely in April 1996, when the Canadian rate dipped below the U.S. counterpart. The Canadian rate again rose above the U.S. rate from 2001 to 2005, reaching a maximum positive differential of 2.5 percentage points in June 2003 (Canada: 3.5 percent; U.S.: 1

⁵ In this sense, the U.S. policy has been the anomaly, adopting a broader set of objectives than other central banks such as Canada's. In Canada's case, the fixation on price inflation alone has been rationalized by the doctrine of *öone instrument, one targetö*. The interest rate is the sole policy instrument in the Bank of Canada's remit; this permits the pursuit of only one target, notably price inflation.

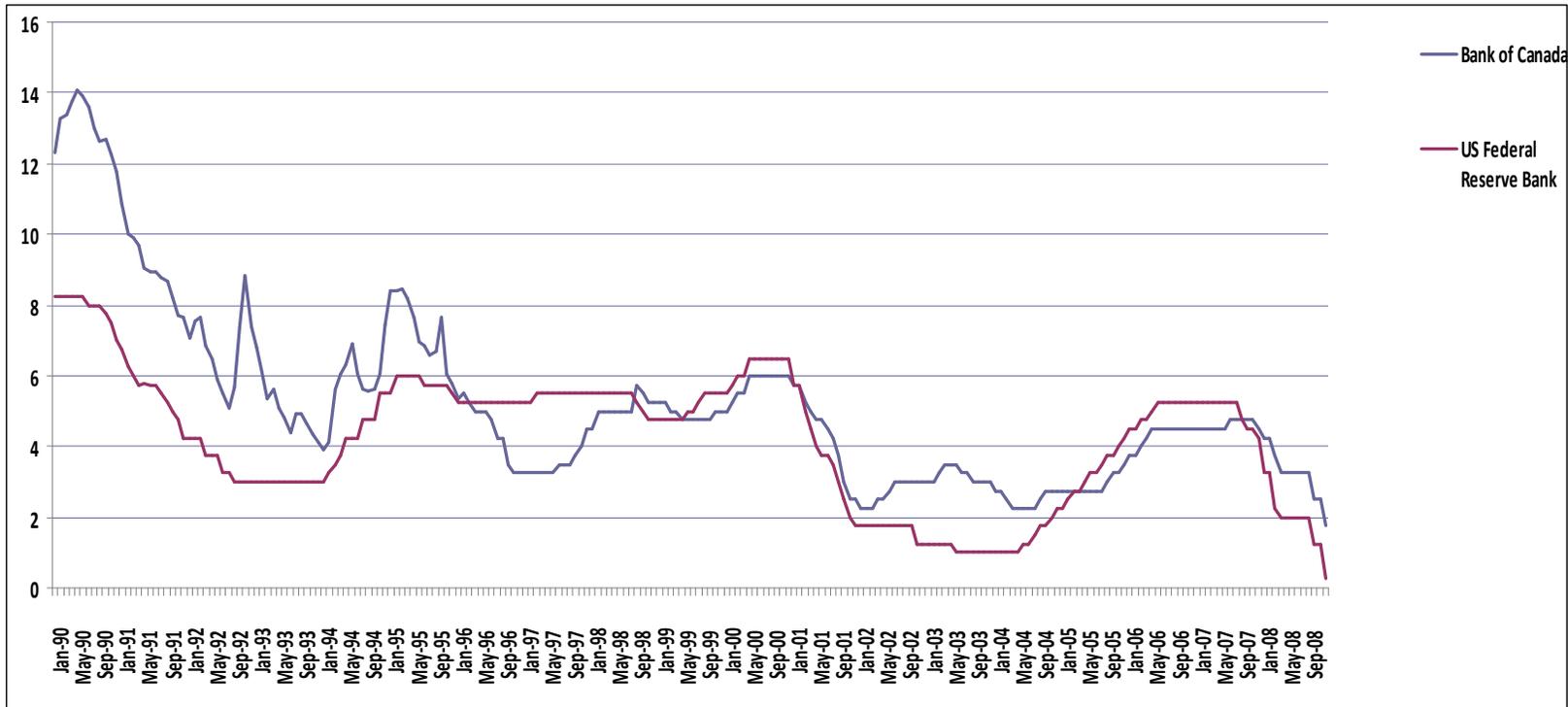
percent). In April 2005, after a year of increases by the Fed the two rates coincided and US rates remained higher until September 2007 at the onset of the crisis (Figure 1).

The data provide some evidence that Canadian interest rates were at times significantly higher than those in the U.S. during the two decades prior to the crisis. However, the period from 1990-95, when the Canadian-U.S. positive interest rate differential was at its highest, occurred well over a decade before the financial crisis of 2007-8. (A more pertinent question, perhaps, not explored here, is whether the relatively higher Canadian interest rates in 1990-95 helped to constrain the dot.com bubble in Canada during 1995-2000.)

However, the period March 2002-November 2004 may be more relevant. The Canadian target rate was kept between 2.25 and 3.5 percent while the Fed Funds rate fell from 1.75 percent to 1 percent in June 2003; the positive Canada-U.S. differential reached a maximum of 2.5 percentage points in June 2003 (Canada: 3.5 percent; U.S.: 1 percent). From June 2004 the Fed Funds rate was increased until it intersected the Canadian target rate (2.75 percent) in March 2005; thereafter until the outbreak of the crisis the U.S. rate exceeded the Canadian rate. Indeed the Fed increased rates steadily from 1 percent in May 2004 to 5.25 percent in June 2006 (the Bank of Canada also increased the target rate, but only to 4.5 percent, indicating a negative differential of 0.75 percentage points).

The question is: did somewhat tighter Canadian monetary policy during 2002-5 have a role in constraining asset prices and irrational exuberance in Canada in the run-up to the crisis? While it is true that interest rates were higher in Canada relative to the U.S. in this period, in absolute terms they were low by historical standards. Moreover, it is clear that in the two years after May 2004 the Fed was clearly seeking to tighten credit in the U.S., while in Canada the Bank tightened monetary policy, but to a lesser extent and over a shorter period (six months vs. two years in the U.S.). This could suggest much clearer signaling in the U.S. than in Canada that the monetary authorities wished to tighten credit in the immediate run-up to the crisis.

Figure 1: Interest Rates Canada and US



<http://www.federalreserve.gov/fomc/fundsrate.htm>

<http://www.bank-banque-canada.ca>

In summary, the interest rate data do not present strong evidence that in Canada monetary policy was noticeably tighter than in the U.S. in the decade up to the crisis. On the contrary, they suggest that Canada's monetary policy followed that in the U.S., with a lag and some differentials. These differentials do not seem compelling enough to argue that Canada's monetary policy was noticeably more stringent than in the U.S. Therefore, it would be difficult to argue that the different outcomes in Canada and the U.S. stemmed from monetary policy alone. This is not at all to argue that monetary policy was unimportant in preventing the problematic asset bubbles associated with the financial crisis; rather, it is simply to suggest that the "Canadian exception" does not seem to have been related primarily to monetary policy in Canada. Other factors are more likely (This conclusion was also reached by Krugman, 2009).

Fiscal Policy. A much more plausible explanation for the Canadian exception may reside in fiscal policy. In particular, from 1997 until 2008, the Canadian federal government ran fiscal surpluses. Between 1998 and 2001, both the U.K. and the U.S. central governments also ran surpluses, but from 2002 to 2008 the Canada was the only G7 country whose central government ran fiscal surpluses. Over this period Canada's surplus averaged +0.6 percent of GDP, compared to -2.5 percent of GDP for the entire G7 (Table 1).

It should be stated at the outset that Canada may have paid a price for its more restrictive fiscal policy, in terms of higher unemployment. Compared to other OECD and G7 countries, and particularly compared to the United States, unemployment was noticeably higher in Canada in the seven years leading up to the crisis (Figure 2).

Figure 2

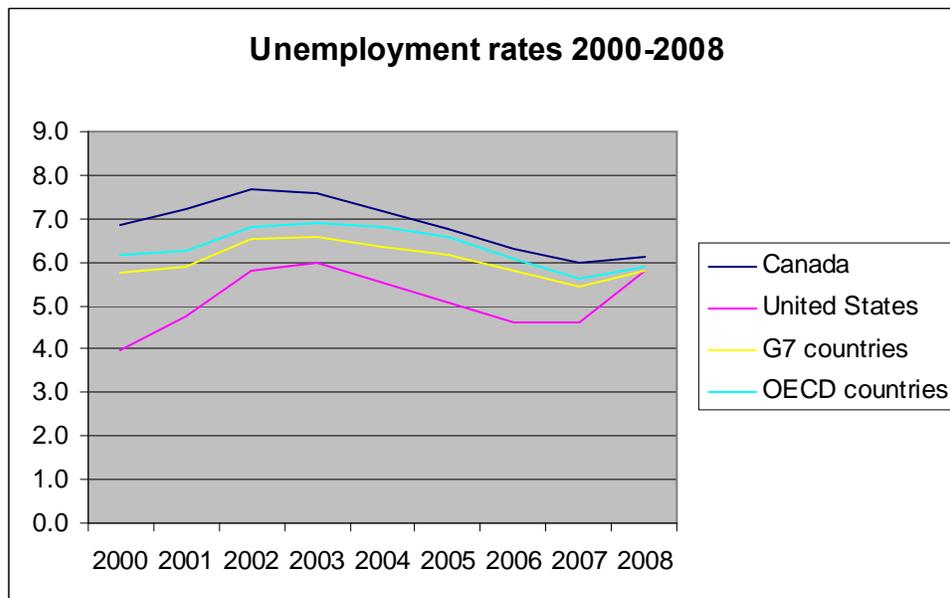


Table 1

. Central government financial balances															
Surplus (+) or deficit (-) as a percentage of nominal GDP															
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Canada	-4.6	-3.9	-2.0	0.7	0.8	0.9	1.9	1.1	0.8	0.3	0.8	0.1	0.7	1.0	0.2
France	-4.6	-4.5	-3.6	-3.1	-2.8	-2.4	-2.1	-2.1	-3.1	-3.6	-2.6	-2.6	-2.1	-2.3	-2.9
Germany ¹	-1.1	-7.9	-1.9	-1.6	-1.8	-1.5	1.4	-1.3	-1.7	-1.8	-2.4	-2.1	-1.5	-1.1	-0.6
Italy	-8.9	-7.5	-6.8	-2.6	-2.5	-1.5	-1.2	-3.1	-3.1	-3.0	-3.0	-4.0	-2.6	-2.3	-2.6
Japan ²	-4.1	-3.5	-10.6	-7.3	-6.4	-5.9	-6.7	-6.7	-5.2	-6.2	-1.0	-2.6	-2.9
United Kingdom ³	-6.6	-5.5	-4.1	-2.0	0.2	1.1	3.9	0.9	-1.8	-3.4	-3.1	-3.0	-2.6	-2.6	-5.2
United States	-3.1	-2.7	-1.9	-0.6	0.5	1.1	1.9	0.4	-2.6	-3.8	-3.6	-2.8	-1.9	-2.1	-4.6
less social security	-4.0	-3.5	-2.8	-1.6	-0.7	-0.4	0.4	-1.2	-4.2	-5.2	-4.9	-4.1	-3.3	-3.5	-5.8
Total of above countries	-3.8	-4.2	-2.8	-1.5	-1.8	-0.9	0.3	-1.1	-3.0	-3.7	-3.4	-3.2	-1.7	-2.0	-3.5

Note: Central government financial balances include one-off revenues from the sale of mobile telephone licenses.

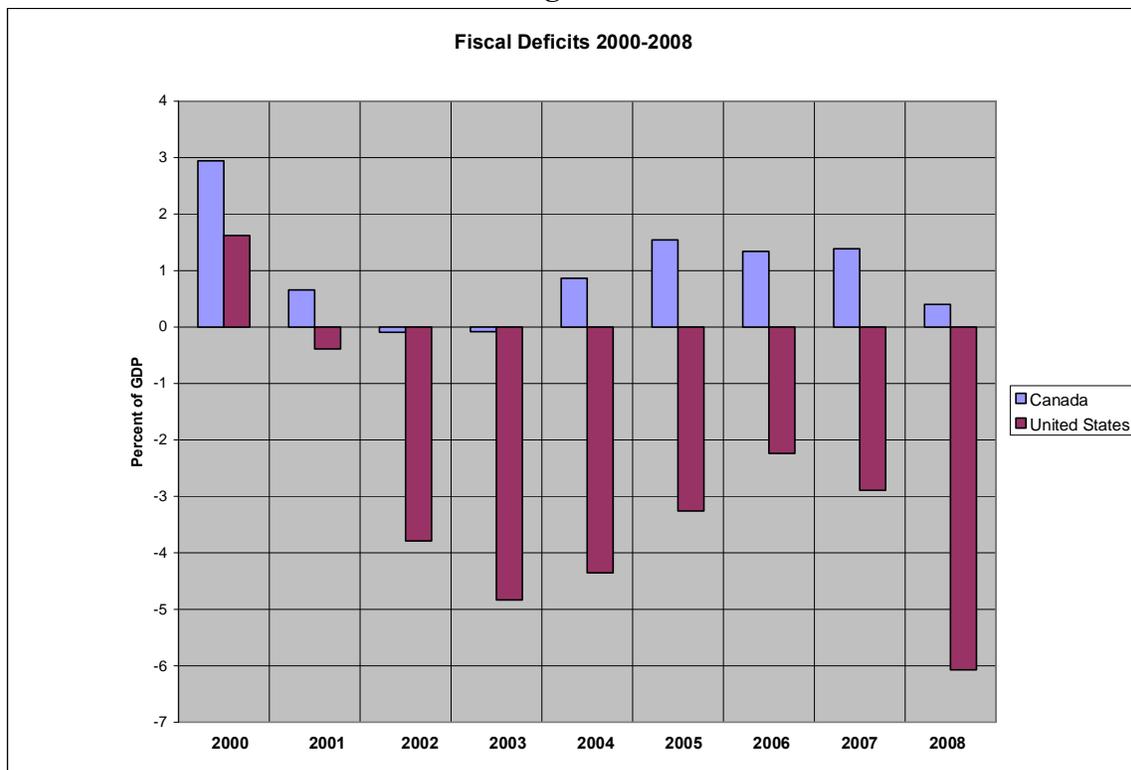
1. In 1995, this includes the central government's assumption of the debt of the Inherited Debt Fund.
2. Data for central government financial balances are only available for fiscal years beginning April 1 of the year shown. The 1998 deficit includes the central government's assumption of the debt of the Japan Railway Settlement Corporation and the National Forest Special Account which represent some 5.3 percentage points of GDP. Estimation for 2008.
3. The data for 2000 and onwards reflect Eurostat's decision concerning the recording of one-off revenues from the sale of the mobile telephone licenses.

Source: OECD Economic Outlook 85 database.

Within the G7, the contrast between fiscal outcomes in Canada and the United States after 2001 is very dramatic. To make a long story short, while Canada's aggregate fiscal balances remained near balance or in a modest surplus position (around 1 percent of GDP or less), in the U.S. the aggregate fiscal position deteriorated sharply into deficit territory, reaching almost -5 percent of GDP in 2003 before retreating to around -2 percent by 2006 then increasing again to -3 percent in 2007 (Figure 3).

There is also a potentially significant structural difference in the tax systems of Canada and the U.S. Canada has had federal sales (i.e. consumption or value-added) taxes of one sort or another for many years, while the U.S. (at the federal level) is one of the few industrial countries with no such national taxes. (At the state/provincial level, there are such taxes in both countries, although they vary among states/provinces.) Sales taxes have an automatic counter-cyclical impact— during booms, consumption levels rise, pulling up tax revenues, and conversely during downturns. With a broader tax base it is easier for the Canadian federal government to achieve fiscal balance than for its U.S. counterpart.

Figure 3



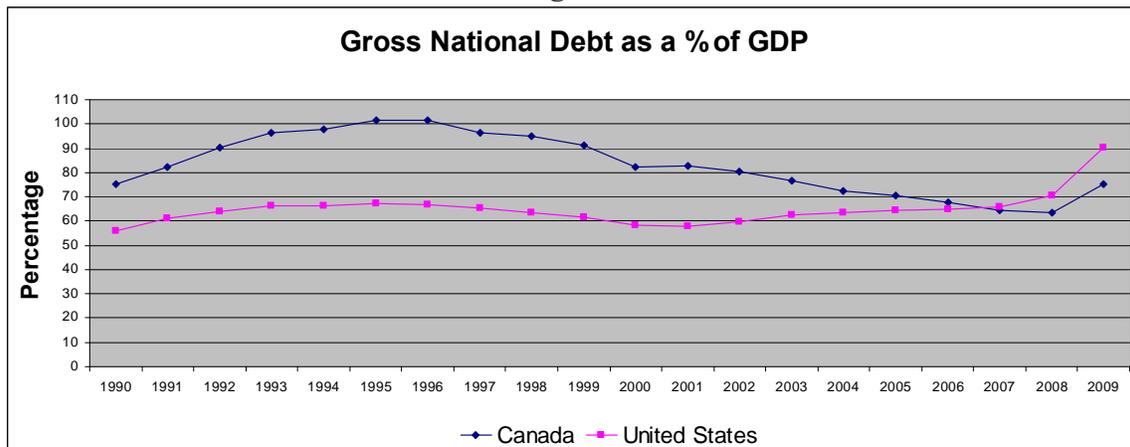
Clearly, the contrast between Canadian and U.S. fiscal policies in the last decade is much greater than that between their respective monetary policies. The question is, does this matter? In particular, did Canada's more restrictive fiscal policy play any role in constraining the financial turmoil of 2008-9?

The answer revolves around the debt markets. We might seek an explanation in Minsky's model, in which the nature and extent of the accumulation of debt matters greatly in determining the timing and severity of financial crises. During extended periods of prosperity (i.e. growth) and relative financial stability, the tendency is for investors to become increasingly speculative by taking higher risks in order to achieve higher rates of return.

In the U.S., mounting deficits led to ballooning government debt. The result was that in the U.S., investors' appetites for relatively risk-free debt was sated by the availability of a surfeit of U.S. debt obligations, yielding very low rates of return. This crowding-out effect induced a growing number of investors to seek higher returns elsewhere in riskier assets. Foreign investors played an important role in this process—seeking a safe haven in riskless U.S. Treasury securities, while U.S. investors gravitated toward more levered claims on local mortgage risks, and more generally toward riskier, higher-return assets (Caballero and Krishnamurty 2009).

Meanwhile in Canada, a series of fiscal surpluses actually led to a shrinking of government debt since part of the surpluses was deliberately targeted by the Federal Government towards debt reduction. Accordingly, the central government debt-to-GDP ratio was halved in the decade from 53 percent in 1997 to 25 percent in 2007. The comparable ratio in the US, which had been lower in the 1990s than that in Canada (and falling), bottomed out at about 33 percent in 2001. Thereafter, driven by the ballooning deficits under the George W. Bush Administration, the US ratio began to rise and exceeded that in Canada by 2006 and has remained higher subsequently (Figure 4).

Figure 4



In Canada, therefore, there was no crowding-out effect comparable to that in the U.S., given the shrinking quantum of risk-free government obligations. Indeed, there may have been a "crowding-in" effect, by creating more room for lower-risk borrowers at lower yields than would have been possible if public sector had higher borrowing requirements. In terms of the Minsky model, it can be hypothesized that in Canada the composition of debt was skewed more toward the "hedged" or relatively riskless end of the spectrum,

whereas in the U.S. the accumulation of debt skewed the composition more toward the speculative and Ponzi-financed end of the spectrum.

The abundance of cheap debt led all domestic sectors of the U.S. economy— households, businesses as well as government— to increase their borrowing particularly after 2002. Overall, indebtedness increased from 269 percent of GDP in 2002 to 329 percent in 2008. This was accompanied by an erosion in the quality of assets lenders accepted to sustain the expansion.

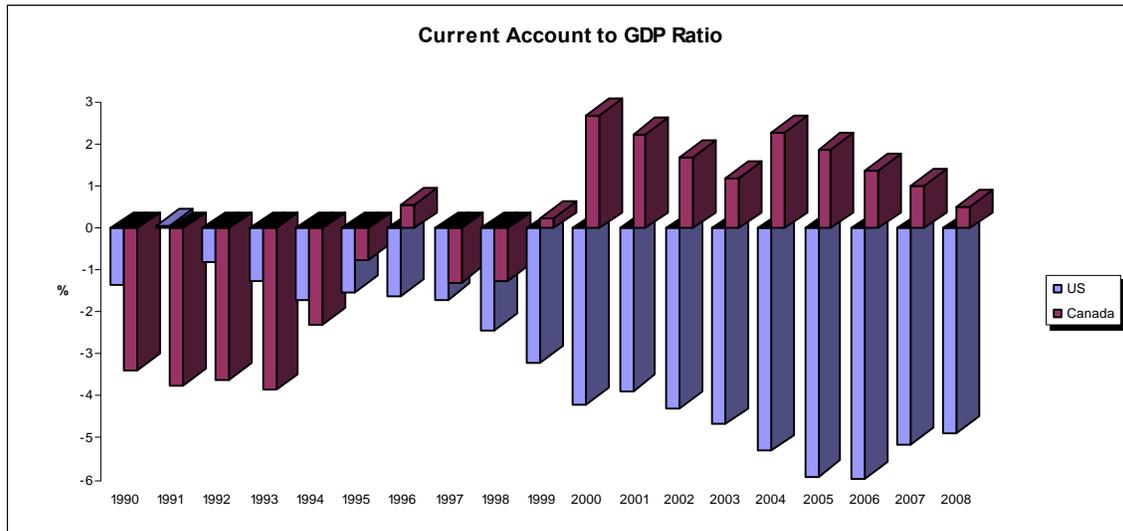
By comparison, Canada's indebtedness ratio rose by only half as much in the same period, from 228 to 255 percent, or thirty rather than sixty percentage points. While household debt in Canada rose to 85 percent of GDP, non-financial corporations and governments actually paid down their debt. As to financial corporations, the Canadian financial system had debt equivalent to 60 percent of GDP, half the American level, while resisting the tendency to invest in low-quality assets (Cross 2009).

In summary, there are grounds to argue that a more restrictive fiscal policy in Canada eased the growth of indebtedness in general and may have helped restrain the tendency of some investors to seek higher returns in more risky assets engendered by a relatively low-interest environment. In other words, fiscal policy in Canada may have helped counteract the growth of credit and of asset bubbles due to relatively low interest rates, in contrast to the expansionary fiscal policy in the United States, which reinforced the concurrent lax monetary policy.

External Imbalances. The final factor differentiating Canada's and U.S. macroeconomic policy relates to the management of the external balance of payments. It was suggested above that the growth of debt in the U.S. after 2001 was partly fuelled by foreign investors. This, of course, is the issue of "global imbalances" which have been integral to the global crisis (Wolf 2008; Krugman 2009).

The contrast between Canada and the U.S. current account of the balance of payments is as striking as the contrast in their fiscal balances. As with its fiscal balances, Canada's external payments position in the last decade shows deficits in the 1990s gradually diminishing to a position of approximately zero balance by the end of the decade, thence leading to surpluses in the decade after 2010. In the U.S., continuing a trend that started in 1980, with a brief return to balance in 1990 (Wolf 2008: 62) current account deficits have simply grown over the last two decades (Figure 5 charts current account balances relative to GDP).

Figure 5



The implication of these divergent external balances is consistent with the story on the divergent fiscal balances. In both cases, net indebtedness in the U.S. increases (commensurate with the size of the deficit) while that of Canada decreases (commensurate with the size of the surplus). The difference between the fiscal (or internal) and external deficits relates to the composition of the debt. In particular, current account deficits imply an increase in claims by foreigners on domestic assets, i.e. an increase in the extent of net foreign indebtedness. On the other hand fiscal deficits, to the extent they are financed principally through domestic borrowing, imply an increase in domestic net indebtedness.

To what extent, however, were the differences in current account positions the outcome of explicit policy choices? The answer to this question revolves around the management of the exchange rate. In the run-up to the crisis, the East Asian countries (China being the most conspicuous example) conducted a policy of managing the exchange rate as part of a highly successful export-centred growth strategy. Part of this strategy involved the accumulation of foreign reserves to provide “self-insurance” against the possibility of sudden capital outflows and/or speculative attacks on the currency, similar to the Asian financial crisis of 1997-8. In China’s case, an integral part of the strategy also involved capital controls. The regime of “exchange-rate protectionism” pursued by the East Asian countries was dubbed “Bretton Woods II” in homage to the fixed but adjustable system in effect after World War II (Wolf 2008: 81-97).

However, Canada’s policy regime could not be more different from those in East Asia. In particular, Canada has followed a policy of letting the exchange rate float freely without any intervention, a policy pursued even during the early years of Bretton Woods I in the postwar period⁶. It has also had an open capital account and has not felt the need to

⁶ Between 1950 and 1962, Canada pursued what was then a heterodox policy of a freely floating exchange rate, inconsistent with the fixed exchange rate regime of Bretton Woods. In 1962 Canada maintained a

accumulate foreign exchange reserves beyond what is considered "normal" to facilitate commercial transactions with the rest of the world. The capital account is an active determinant of the exchange rate in Canada, and in other countries (including the United States) with open capital accounts.

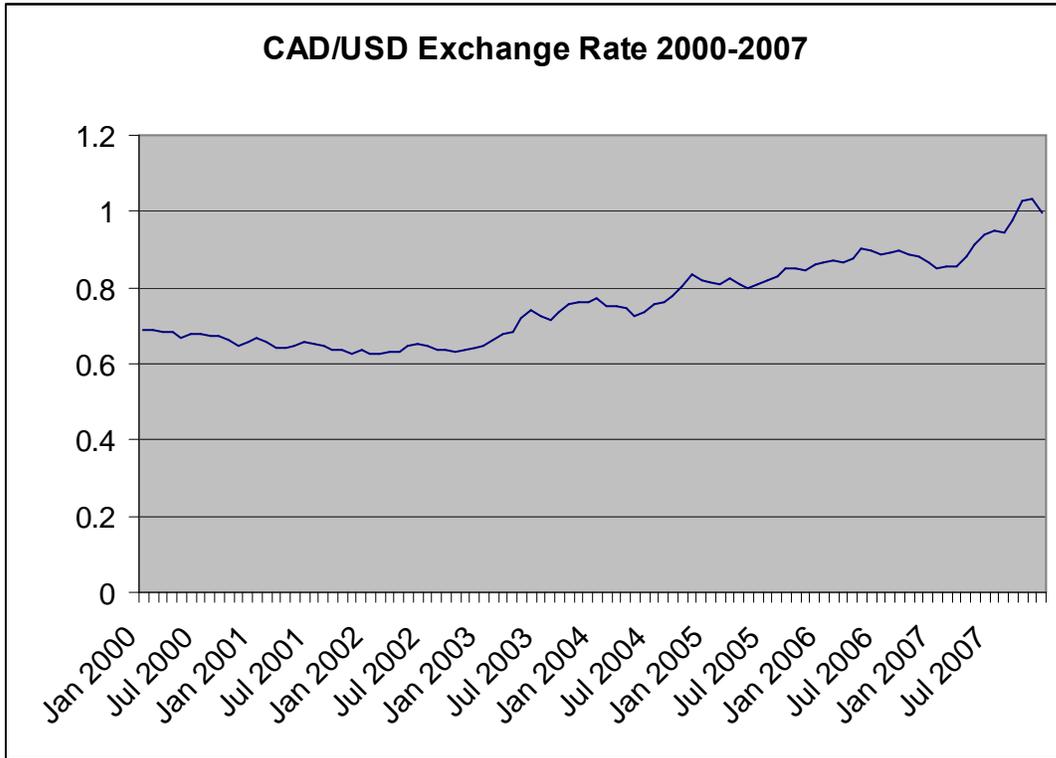
This policy stance (of floating exchange rates and an open capital account) has enabled Canada, in principle, to be able to conduct an independent monetary policy⁷. The floating exchange rate has provided for automatic adjustment against external shocks – for example, a decline in the prices of the commodities that Canada exports results in a trade deficit in the short term. However, the Canadian dollar will then depreciate, restraining imports and stimulating exports, to restore trade balance in the longer term. This does not necessarily mean such adjustments are "easy": indeed, they are often painful. When the Canadian dollar appreciates as a result of a positive shock, its export sectors suffer as has been the case for the past five years; and when it depreciates, import costs rise, affecting import-intensive sectors and the cost of living.

As mentioned, in the decade after 2000, Canada's current account swung into surplus. This did not come about as a result of exchange-rate intervention by the Canadian authorities; rather it occurred as a second-order outcome of developments in the global economy. The export-promotion strategies being pursued by the newly emerging market economies (the "BRICs") resulted in a commodity boom, driving up the price of oil, hydrocarbons, and other commodities (foodgrains, minerals) produced and exported by Canada. As a result of the growing current account surplus, the floating Canadian dollar began to appreciate dramatically, from a value of 62.5 cents U.S. in April 2002 to above parity and a high of \$1.09 U.S. in November 2007 (Figure 6; Figure 7 indicates the real effective exchange rates). To a considerable degree, the appreciation of the Canadian dollar also reflected weakening economic fundamentals in the U.S. and a depreciating U.S. dollar against all other major currencies (Holden 2007).

pegged exchange rate until 1970, when it restored floating rates, before the collapse of the Bretton Woods system in 1973.

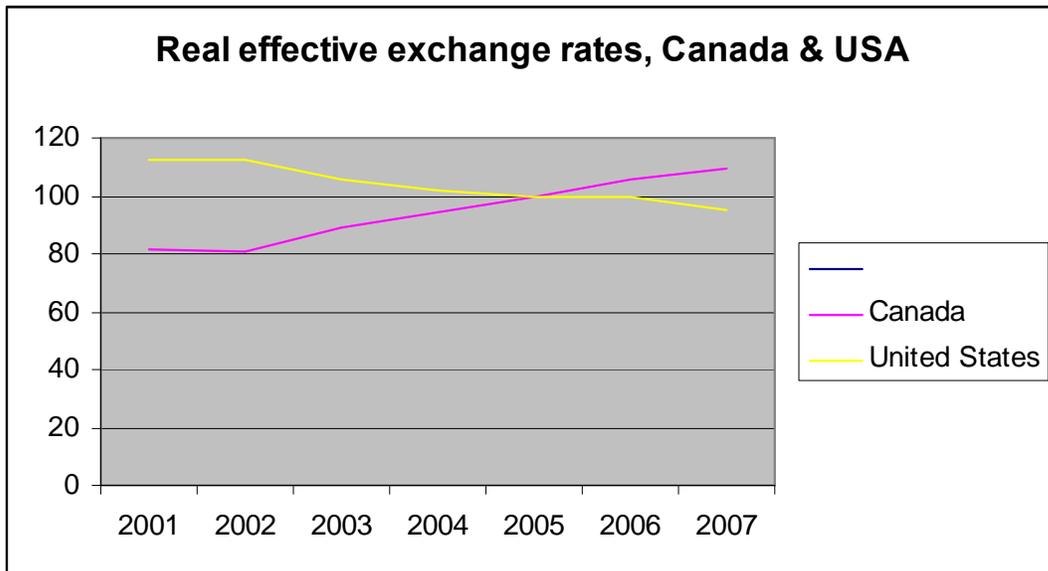
⁷ According to the well-known Mundell-Fleming "trilemma", it is impossible to maintain a fixed exchange rate, open capital account, and independent monetary policy: one of these must be sacrificed. In Canada's case the fixed exchange rate was sacrificed. In China's case, it sacrificed the open capital account. An independent monetary policy does not necessarily mean one that differs markedly from that of the U.S., its chief trading partner. As discussed above, in the early 1990s, Canada's monetary policy was significantly tighter than that of the U.S., although subsequently they have tended to converge.

Figure 6



Source: Bank of Canada

Figure 7



Source: OECD

In conclusion, Canada's exchange-rate policy has militated against chronic imbalances of any kind—either surpluses or deficits. In particular, the relatively large current account deficits of the early 1990s were succeeded by approximate balance at the end of the decade and then by a series of relatively small current account surpluses. In the climate of accumulating debt in the current decade, this was an important development, even though it was not actively brought about by policy. For it meant that the expansion of foreign indebtedness was reduced in Canada, unlike in the U.S. where it expanded to the point that the U.S. became the world's largest international debtor. In contrast, by the end of 2008, Canada had no net external indebtedness for the first time on record since 1926 (Cross 2009).

In the United States, the policy regime has been based on selective intervention in foreign exchange markets for strategic reasons related to the role of the U.S. dollar as the world's key reserve currency as well as the competitive position of the U.S. economy in world markets. In the 1980s, the U.S. cajoled the Japanese and Germans to revalue their currencies (and hence to bring about a dollar devaluation) through the Plaza and Louvre Accords. Subsequently the official position of U.S. authorities has been not to intervene in currency markets in order to influence the exchange rate. However, this claim may be challenged—for example, in response to the growing U.S. current account deficits (and Chinese surpluses) after 2000, growing pressures have been put by the U.S. on China to revalue the renminbi, along with accusations against China of "currency manipulation". But partly given the role of the dollar as the world's principal reserve asset, it is difficult, if not impossible, for the U.S. authorities to intervene in foreign exchange markets. This is especially the case when countries such as China, whose currency the U.S. authorities have wished to revalue against the dollar, are prepared to buy dollars virtually without limit. The rest of the world's support of the dollar has resulted, so far, in the U.S. not facing an external constraint. Unlike any other country it has been able to borrow seemingly without limit at low interest rates (Wolf 2008: 100). In uncertain times dollar assets have also represented a "safe haven" against currency turmoil. Thus, the U.S. dollar appreciated during the financial crisis as footloose capital flooded into U.S. securities.

In other words, the role of the U.S. dollar as the world's key reserve currency has made the U.S. less subject to the limits of growing foreign indebtedness than other countries, including industrial countries such as Canada. Accordingly the discipline of markets is less of a constraint on the growth of debt, which has the tendency to over-leveraging and excessive debt in the U.S.⁸.

But there have been macroeconomic downsides to this strategy. An unusually strong U.S. dollar has depressed production in tradables, as its exports become uncompetitive and imports flood the American market. In order to offset deflation and maintain high

⁸ Ultimately, however, the "Triffin dilemma" is operative. With the increasing glut of dollars in international markets, confidence in the stability and strength of the dollar is eroding. Any sudden move away from dollar assets will bring about considerable and more sudden adjustment in the U.S. (higher interest rates, demand and output compression, lower growth or recession) as well as substantial disorder in international markets.

employment, the U.S. authorities adopted expansionary monetary and fiscal policies. The effect was to maintain demand above output, thereby generating the current account deficit necessary to absorb the growing surpluses of China, other Asian countries, and the petroleum exporting states. The excess demand stimulated activity in the non-tradables sector, notably the housing market, creating the bubble that subsequently burst after 2007.

The alternative macroeconomic policy choices which the U.S. could have considered involved tighter fiscal and monetary policy. This would have helped correct the growing external imbalances, but at a cost: unemployment would have increased and growth would have declined. The exports of the surplus countries would not have found a U.S. market that acts as a "consumer of last resort". Sooner or later the export-promotion strategy of China and other countries would have yielded falling benefits and those countries would have had to reconfigure their economic strategies to promote domestic rather than external demand, so they too would undergo an adjustment, just as they have been forced to do after the crisis erupted.

Conclusion

In summary, a few major conclusions can be drawn from a comparative analysis of macroeconomic policies in Canada and the United States. The analysis draws upon the conceptual framework of the Minsky model, which places emphasis on the rapid accumulation of debt in the economy as a key factor in building up financial fragility and eventually precipitating a crisis.

There are grounds to argue that the key macroeconomic policies distinguishing Canada from the U.S. relate to fiscal and exchange-rate policies rather than monetary policies. The monetary policies of the two countries have been broadly similar—interest rates maintained at low levels, encouraging a buildup of debt in both countries, particularly in the household sector. However, fiscal and exchange-rate policies have diverged. In Canada, fiscal policies have been more restrictive since 2002, leading to a fall in indebtedness of the government and the non-financial sector, whereas in the United States, debt increased significantly in all sectors.

The impact of fiscal policy in Canada was reinforced by its exchange-rate policy which generated current account surpluses and led to the elimination of Canada's net external indebtedness for the first time since 1926. In the U.S., the role of the dollar as the key reserve currency led to the persistence of a relatively overvalued dollar, leading to growing current account deficits and the buildup of external debt. A more proactive approach would have led to slower growth and higher unemployment in the run-up to the crisis, but it may have helped to avoid the buildup of the external imbalances which ultimately are not sustainable.

Finally, as stated at the outset, if there is a "story" about Canadian exceptionalism—Canada's relatively less turbulent experience in the financial crisis—macroeconomic policy (particularly fiscal policy) may have been a factor but did not necessarily play the

most significant role. Likely at least as important were the regulatory framework and the nature of Canada's financial system, particularly its banks. However, these factors can also be integrated into the framework of the Minsky hypothesis, by helping to explain how the Canadian regulatory framework, and the nature of its banking system, helped to constrain the slide toward increasing laxity in lending standards, during the boom years preceding the crisis.

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