

## **CANADA, THE USA, AND THE FINANCIAL CRISIS: RISKS AND OPPORTUNITIES**

What began with a burst financial bubble on Wall Street, created, in particular, with a sub-prime mortgage powered by congressional policy, has spread virally. And now the entire basis of the world financial system is in play. Detroit's Big Three begging for help. Are we on the cusp of another Great Depression? Is this the end of the American era? In the short term, government may have the power to arrest the situation by writing a cheque, but is that good public policy? And what are the implications for Canada?

In a London speech (November 19), Mark Carney, the Governor of the Bank of Canada, described the situation:

"The current crisis marks the reversal of a decades-long transition of the global financial system from being primarily relationship-oriented and dominated by banks to being primarily transactions-oriented and dominated by financial markets. This model had the potential to price risk and to allocate capital more efficiently. In some cases, however, the development of markets ran well ahead of the supporting infrastructure. Moreover, lulled by early successes, participants became increasingly reliant on opaque securitization, dependent on excessive leverage, and complacent about market liquidity. A system that appeared resilient (and enormously profitable) in times of low volatility proved brittle in the face of shocks."

Watching the crisis unfold I am reminded of my arrival in Hong Kong on October 19th, 1987. It was the day that the stock market there crashed, inspired by an overheated real estate market with minimal oversight or regulation. The fallout spread globally. The chair of the Hang Seng Exchange and a number of his colleagues were subsequently convicted of corruption. Ian Hay Davison, the former chief executive of Lloyds of London, was brought in to investigate. He made a series of recommendations in a report that he titled 'Lacking Regulation.' With an uncanny resonance for the current debacle, Davison observed that the exchange had been run 'largely as a private club rather than a public utility' and concluded: 'Never underestimate the human propensity for greed.'

While the current crisis may be 'Made in America,' like the virtual supply chains that now characterize global production, it is a situation that is swamping national treasuries from Iceland to the Ukraine, with layoffs stretching from Pennsylvania to the Pearl River Delta.

And in recognition of changed times, its not the 'old' club of G7/8 trying to cope with the situation but a G-20 that includes the BRIC – Goldman Sachs' now famous shorthand for Brazil, Russia, India, China, and others including Korea, Mexico and Saudi Arabia. The G-20 reflects an idea, articulated when Paul Martin was Finance Minister, whose time has come.

G-20 leaders converged on Washington in mid-November to discuss how to stimulate the slumping global economy, impose more government control over lending and create more transparency within financial markets. The Europeans wanted aggressive financial regulation that the United States is hesitant, probably rightly, to embrace. With justice, the BRIC expect a bigger voice in international finance. The Washington Post observed that "the historical importance of" the "meeting consisted less in what it accomplished than in who attended it."

Discussion will resume in March around a financial 'college of supervisors,' a stability forum for emerging nations, and an IMF Security action plan for the G-20. The situation requires broad international coordination involving monetary policy and fiscal stimulus or there continues to be a risk of a depression as a result of the breakdown of that globally integrated economy that we've reaped the benefit of for so many years. While the G-20 process is still unfolding, there is a growing international consensus around a formula of regulation, retrenchment, stimulus, and new institutions - all designed to restore trust and confidence in the system.

There is broad agreement that largely unregulated financial vehicles ought to be subject to greater disclosure. Financial managers warn of excessive regulation pointing to Sarbanes-Oxley as an example of what not to do. It is naïve to think that regulation will be the magic fix. Despite regulation, Fannie Mae and Freddie Mac were the first to fall. The European banks were also more regulated. But they were also more leveraged and their short term liabilities were much larger than banks in the United States. Hence, Iceland. It is not a matter of deregulation versus regulation but rather good regulation versus bad regulation.

In the short term, the American banking system has gone through a decade's worth of consolidation in a couple of months, with the American government as both matchmaker and principal investor. Investment banking has disappeared. With its initial \$700 billion Emergency Economic Stabilization Act and Troubled Assets Relief Program, 'Big Government' is back in its place. More companies looking for handouts can expect the government to want a share of their equity and a say in how they spend and invest. In the meantime, President-elect Obama and the Democratic Congress promise another stimulus package when the new Congress meets in January. It will include infrastructure like roads and bridges as part of a "two-year, nationwide effort to jump-start job creation in America."

The Obama proposal presents a source of funding for potential bilateral cooperation to improve our roads, rail, bridges as well as the grids that fuel our industries and light our homes. 'Think Big' and use the opportunity to address North American competitiveness and effect regulatory improvements. Properly framed this can provide the Obama Administration with a face-saving way to finesse the primary promises to reopen NAFTA through joint action that will create a renewed basis for shared prosperity. But Canadian leadership needs to quickly get its act together, and then reach out to integrate and coordinate plans at the local, state and national level.

The failure of one of Detroit's Big Three automakers would put a huge initial dent in American manufacturing, but in time, argue industry experts, foreign car companies would pick up the slack by stepping up production in their plants here. Whether Washington should let market forces prevail and indulge in what Schumpeter called 'creative destruction' or provide a bailout is the central question Congress will weigh as it continues to hear testimony from management, the unions and their supporters.

The Big Three argue that if they aren't bailed out, there will be ripple effects throughout the economy. Did the Big Three and unions do it to themselves by producing cars that no one wants to buy at a cost they could never pay? It will be tough to say no politically. A bailout for AIG, Bear Stearns and Wall Street but not Detroit's Ford, GM and Chrysler? The politics has split the Democratic coalition, pitting unions, parts of the 'Black caucus'

and 'rust-belt' Democrats, against environmentalists and 'blue dog' Democrats. Policymakers need to ask Detroit for change they can believe in.

Canadians have a particular interest in the outcome, for as Tony Clement observed during his Washington debut as Canadian Industry Minister, "it's not an American auto sector or a Canadian auto sector; it is really a North American auto sector." The challenges for Canada, as usual, will come from Congress. Observed Montana Democrat senator Jon Tester: "If Canada wants a dollar spent up there, go see the Canadian taxpayers. But if we're putting American taxpayer money on the line, it ought to be spent here." Tester's attitude is reflective of the now enhanced Democratic majority. Where the President-elect sits remains to be seen, but he is unlikely to stray far from Democratic orthodoxy, whatever that orthodoxy may turn out to be.

Canada needs to get involved in this still-brewing process early. Visits to Washington, like that of Clement and Ontario Economic Development Minister Michael Bryant, should become standard, systematic and extended to include state capitols. The Team Canada Inc approach has to encompass business and labour representation and bring legislators from all three levels of government into the effort. Labor is a critical component of the Democratic coalition and Canadian unions, uniquely, are closely affiliated with their American counterparts. AFL-CIO leader John Sweeney once remarked to me that he was surprised that official Canadian lobbying efforts ignored the value of the binational labor leadership connections.

The rapidly declining Canadian dollar reflects the role of natural resources in our economy. And our oil resources, which should be a plus in the relationship, may be targeted by the new Administration's environmental zeal and interest in a post-carbon economy. President-elect Obama's post-election video message on environmental action to Governor Schwarzenegger's recent climate summit in Beverly Hills underlines the requirement for Canadians to bring both cohesion and precision to the Harper Government's search for Canada-US 'common emission standards,' before the US determines its cap-in-trade approach, with or without Canadian involvement. Californian Henry Waxman's victory over Michigan's John Dingell, to take the chair of the House of Energy and Environment means legislation will come sooner than later, and it may be bitter medicine to many.

As Chair of Oversight and Regulation, Waxman was the architect of Section 526 'dirty oil' fuel purchasing requirement in the Defence Authorization Bill passed earlier this year that effectively prevents US agencies (read the Pentagon, the biggest single buyer of fuel) from buying "synthetic" fuel from non-conventional sources for any "mobility-related" uses. The measure passed despite the opposition of the US Department of Defence, Industry as well as Canada.

Depending on interpretation and 'enforcement,' the legislation has serious implications as we market oil sands production and counter the ENGO campaign, well-lubricated by cash, media-savvy and zealotry, to demonize our oil sands sector as 'dirty' oil. Sustained by a coalition that includes the National Environmental Defence Council and Greenpeace, their 'successes' include not just Section 526 but the resolution by US mayors in July to support "federal legislation that prohibits government use of unconventional or synthetic fuels" derived from CO2-intensive sources such as oil sands or shales. It will require concerted and rapid effort by Canadian industry and governments, if we hope to shape, rather than adapt to, the changes that are coming.

As the financial rescue enters a new phase, the question is: 'Is any of this working?' As Treasury Secretary Hank Poulson has observed, the short answer is not nearly as much, or as fast, as hoped. The averages make that pessimism understandable. In his "The Trouble with Prosperity" (2006), financial analyst James Grant observed that the 22 American recessions from 1854 to 1948 averaged 21 months in duration, while all but three ran in excess of 10 months. The nine recessions from 1948 to 2006, observes Grant, had an average span of 11 months, and none lasted for more than 16 months.

Keynesian economics is again in fashion but the limits to economic stimuli were illustrated as recently as last spring when the cheques Americans received from the US government's last effort to start them shopping again, showed that more preferred to hold onto their money in the face of uncertain times. I once spent an afternoon with Milton Friedman at his apartment atop Nob Hill in San Francisco. His 'permanent-income hypothesis' says consumers consider their entire future, and not just their mood, when they shop. If expectations of lifetime earnings drop, so will their spending. Spending patterns this Christmas will be a good indication of the public mood.

The original Depression began as a sequence of crises moving from a banking crisis to an international trade crisis as governments' adopted beggar-thy-neighbour policies. We have learnt lessons from the Depression and we hope we will not repeat those mistakes. Governments are stimulating their economies, lowering rates and pouring liquidity into the financial system. Banks are lending, but they are under serious strain as they backstop a larger problem – the breakdown of securities markets. Notwithstanding the right noises at the recent G-20 and APEC meetings, progress on trade policy and the Doha Round is a question mark.

And in the rest of the world the financial structure is still shaking. Volatility in the markets seems likely to continue. Policy makers are scrambling to figure out how to get banks lending again. The banks' trust in one another needs to be restored but while their balance sheets remain enigmatic and the real cost of losses remain uncalculated, uncertainty will continue.

The financial models, as a chastened Alan Greenspan, the once-upon-a-time 'Oracle,' acknowledged before Congress, were "flawed." If we end up with prices falling and deflation over a prolonged period, then the whole process of debt burden will grow even more. This will continue to keep Ben Bernanke and central bank governors awake at night. We are not that far from a zero interest bank rate, deflation, and the Japanese scenario – the lost decade created by the excesses of real estate speculation.

Decoupling, the theory that emerging nations are weaning off American economic dependence and, thus, would weather a U.S. economic slump better than in the past, has proved to be a myth. The idea that the rest of the world could move away from the perfdies of 'anglo-saxon capitalism' lasted less than a fortnight as the world discovered that its financial system is interwoven in ways unimagined.

Growth rates have dropped everywhere. The economies of China, Russia, Brazil, and India cannot compensate for a recession that happens simultaneously in the United States, the European Union, and Japan because they constitute approximately two thirds of global GDP and their contraction would require an enormous explosion at home. The new economies still need the vast import market of the United States as an

engine of their own growth. They do not want to see the dollar fall through the floor and their own currencies appreciate and their export sector wiped out. Most of the global deficit next year will be accounted for by an enormous expansion in the US deficit because of the stimulus packages that could cumulatively approach several trillion dollars.

What if the Chinese decide, with their exports going nowhere, to focus on their own growth? What if instead of worrying about their exchange rate and accumulating American paper, they divert their resources to a domestic program that, to keep their own people employed, effectively builds a new 'Great Wall' around China?

A wider retreat into economic nationalism in reaction to the stresses of globalization is possible – a combination of nativism, populism and protectionism that you can watch each night on Lou Dobbs, with national variants. As the recent US National Intelligence Council report, *Global Trends 2025*, observes, the Western model of economic liberalism, democracy and secularism “which many assumed to be inevitable, may lose its lustre – at least in the medium term.”

For President-elect Obama, focusing on the relationship with China will be critical. As economic historian Niall Ferguson observes, the future will likely belong to that symbiotic relationship that he calls 'Chimerica.'

Yet for all their rapid growth, the Asian economies continue to be best at replicating rather than innovating. The United States continues to be the source of innovation in technology and management, and entrepreneurship in industry. The country continues to be built on risk, imagination and immigration. The election of Obama is another example of America's willingness to experiment, to learn, and to adapt, in the face of crisis.

These qualities remain the key to America's future. Never underestimate America's capacity to rebound and recuperate. Silicon Valley was seeded during the seventies, the last grim decade of recession. Creativity will continue in life sciences and technology. The next big thing may be just around the corner. One of the great advantages that the United States enjoys is that their best universities continue to attract the best in the world. They continue to be centres of imagination as well as economic stabilizers. The class of 2009 should be encouraged to see their graduate future in engineering rather than financial or legal services. But the key to future American success will be their commitment to their education system.

Economic growth in the United States, observes James Grant in *Foreign Affairs* (November/December 2008), is "almost, if not quite, irrepressible" and "no small source of strength in the U.S. economy is Americans' capacity for failure." Grant is optimistic. Arguing that Americans should learn from the Japanese experience, he writes that the US must take its lumps and "turn a deaf ear to suggestions to manipulate energy prices, prop up housing prices, suppress short selling in the stock market, or otherwise try to prolong boom-time errors."

The Harper Government's November Throne Speech promises a renewed commitment to reduce internal trade barriers by 2010 and establishing a common securities regulator, the latter likely with allowance for Quebec. Governments' spending will be aimed at boosting the economy. Expect to see tailored packages for the auto, aerospace,

fisheries, agriculture, mining and manufacturing sectors. Like elsewhere, deficit containment has been relegated to 'old think.'

Internationally, we can play a constructive role in the G-20 and other multilateral fora. But our first focus should be the development of a relationship with the incoming Obama Administration and the Democratic Congress.

The outcome of the debate on the auto industry will be an important indicator of congressional attitudes. The threat to 'dirty oil' needs to be addressed. We should coordinate infrastructure programs and use this practical opportunity for cooperation to improve our mutual competitiveness. The risks and opportunities in change underline, once more, the importance of first developing a coherent Canadian plan, an effective implementation schedule, accompanied by an ongoing advocacy effort in the United States, targeted regionally and sectorally, in Washington, and throughout the United States.

It will oblige a mirror effort in Canada - coordination from all levels of government, business and labour, and a dialogue with Canadians on why it is necessary. Premiers will have to make common cause with the prime minister to convince an increasingly anxious public that the status quo is not an option, and that compromise and cooperation, in order to advance Canadian interests, is not a 'sell-out' but rather 'change that we can believe in.'

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