TD Securities

2012 Global Economic Outlook

A discussion on macroeconomic issues featuring:

Ed Clark, Group President and CEO, TD Bank Group and David Dodge, Senior Advisor, Bennett Jones
Moderated by Frank McKenna, Deputy Chair, TD Bank Group

BOB DORRANCE
Group Head, Wholesale Banking, TD Bank Group and Chairman, CEO & President, TD Securities

In late December, TD Securities hosted an event for corporate and financial industry executives that brought together Ed Clark, Group President and CEO, TD Bank Group, and David Dodge, Senior Advisor, Bennett Jones and former Governor of the Bank of Canada. The topic of discussion was current macroeconomic issues and the future outlook for global economies. Frank McKenna, Deputy Chair, TD Bank Group moderated the discussion, while sharing his own perspective as a former Premier and Ambassador to the United States.

Having learned very hard lessons in the '90s, Canadians weathered the recent

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economic storms relatively well. However, we live in an interdependent world and therefore are not immune to the challenges of our global partners.

The problems are great and the solutions are many, but what our panel concluded is that leadership is needed. Not just from politicians but from the business community and public at large. This may be the silver lining in the gathering clouds. There is a very real opportunity to shape the world we want.

The following is a transcript of this candid and thoughtful discussion. We hope you enjoy it.

Bob Dorrance

E.Clark
D.Dodge
F.McKenna
Event Transcript

December 15, 2011

"...it isn't so surprising that by the time we got to 2007 that these imbalances had got to the point where something was going to give...what gave, of course, was the global financial system."

– Dodge

FM: At the real macro level, the global level, we just seem to be lurching from crisis to crisis. The entire world is transfixed with what's gone on with the debt ceiling in the United States and then with Europe, and it just seems to go on and on and on for some period of time. We had a warning from the president of the IMF that we are staring into the abyss of a great depression. So my question to you is how did we get to this place and what are the forces that have got us here and how are we going to get out?

DD: I think we understand the forces pretty well that have been pushing us, certainly since the end of the 1990s. We've had a world which has been building up imbalances. We've had a bloc (Germany in the case of Europe, China in the case of the US) that have essentially been vendor financing. In Germany's case, vendor financing the periphery states of Europe. As with any vendor financing scheme, at some point you've got to make sure that the people you're selling stuff to can pay you back or, indeed, you've got to do something that allows them to earn money to pay you back.

And we've had these debates. These debates have been going on now for a long time, either in terms of exchange rate changes, in terms of trade patterns and so on, but we really did very little about it all through the first decade of this century. And so it isn't so surprising that by the time we got to 2007 that these imbalances had got to the point where something was going to give.

We didn't know what it was going to give. Personally, I thought at the time it was going to be the US dollar that gave. But in the end, something was going to give and what gave, of course, was the global financial system. And that provided, in a very bad and unfortunate way, some correction for a period of time. But we're right back in the stew now.

The Europeans are having their debate as to how they're going to manage this. That debate has got pushed a little under the carpet for the moment between China and the United States on how they're going to manage it. And in the end, if the creditors get their way, we are going to end with a global depression—or a global lack of demand. So in some ways, we've got exactly the same problems that the world, as it then was, had in 1930 or at the end of the 1880s: how to manage this rebalancing. And that's what we're really engaged in except nobody really wants to talk about it. Why? Because it's politically difficult at home in every one of these areas because it implies structural change, and structural change is difficult.

FM: Let's get into specific challenges now. The United States—Ed, you obviously are involved as a major investor there but also as a student of US politics. How serious is the debt situation in the United States? We've gone through some drama at different points, but how serious is it and what is the map towards a solution of their specific problem?

EC: I do think, while there are similarities between Europe, Germany versus Greece, and, as David says, the United States and China—I think that's fundamentally correct—I do think the problems around Europe are dramatically more complex to find a solution because you really have a euro zone that was either incorrectly constructed at the beginning or you don't know how to deconstruct it now. So I think the United States has huge competitive advantages that it has a single government, and maybe at the moment what appears to be a dysfunctional single government, but it does have a single government. And it has an economy that has enormous resilience.

And so to me, the issue in the United States is that I think—and I think this is true across the world—how to solve this problem is you have those things that you think you have to do in the short run and those things you have to do in the long run. The US problem is fundamentally a long-run problem, and fundamentally they have a society where you have a different view of whether we're taxing too little or spending too much, or which combination. But what you can't do is essentially have a reserve currency and have a cooperative partner in China and the whole emerging market, and not make a decision. You could actually just borrow the money and you can spend too much and tax too little and get away with it. And that game is over. And the markets eventually—even though in the moment it doesn't look like they care—will care.

"...the United States...has moved to a world of ...increasing polarization of the politics, so the very issue that has to be solved is the hardest issue for them to solve." **– Clark**

And so I think what the United States has to do is to get that long-term solution in place. The problem is that has become now the essence of the ideological debate, and the United States, as you [Frank] know better than I, has moved to a world of, over time, increasing polarization of the politics, so the very issue that has to be solved is the hardest issue for them to solve. And there's a risk, I think, that in fact you then back up what appears to be an easier go around to short-term austerity measures, to throw some meat to the market and say, "See? We're doing anything," even though that's not the issue. And, indeed, you have to keep the engine of growth going in the short run if you have any hope to solve the long-run problem. But what the market really wants you to do is keep the economy growing now but clearly put in irrevocable measures to solve the long-term problem. What you have to do is be a believer that Americans in the end will get there. It's just going to be very painful until we get there.

FM: And so that's very painful, and that's a single country. Europe—the euro zone and Europe writ large, the number of countries, number of languages, number of cultures, number of two-speed, three-speed economies in Europe. So, David, how does Europe get to this point? How do they fix their problem?

DD: I agree with Ed that the US problem is fundamentally a long-term problem and fundamentally easier to solve. And you have political bifurcation in Washington. The trouble in Europe is you've got 27 political pushes and pulls here, and you have a decision making mechanism which is broken more fundamentally than the US decision making mechanism. But if you ask what needs to be done first of all, you need the peripheral economies to take the structural steps that Germany took with some very real pain to make their economy more productive, to concentrate on getting unit costs down, getting productivity up.

But this has not been the case in Italy. This has not been the case in France. In fact, France has taken a step backwards in that regard. And it has not been the case in Spain. So you really need that structural change, and that is very hard because internally, in each of those countries, that creates winners and losers. And so the domestic governments have to deal with the winners and losers internally even though in aggregate the countries would do a lot better.

And remember, in getting debt-to-GDP ratios down, it's not just the question of getting the debt down, the numerator, but it's getting the denominator up. And that has not really been the essence of the debate, and that's kind of unfortunate.

Is it soluble in Europe? I guess all I can say is that the nearer you get to hanging at dawn, the more imperative it is that you come together and take the steps. And I'm

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– Dodge

not as pessimistic as I think many observers are that this can't be brought together certainly in the case of the four major states of continental Europe. The UK is a little bit of a different story.

FM: Ed, let's talk specifically about European banks because the banks are in an extraordinary position of being overleveraged to the sovereign debt of Europe and, at this stage, undercapitalized. Goldman Sachs wrote: "Based on what's going on in Europe, the United States is going to lose a full 1% of their GDP in the next year." There're not many points of GDP to take away. So this is not a contagion that will stay in Europe, obviously. The rest of the world will all be involved in their problem. What is the solution for the banks in Europe?

EC: I think the thing that keeps us up at night is, is there going to be a political accident here where you will actually lose control? And will there be a run on a bank or a run on a country? And to a certain extent, if you look at the deposits of many of the peripheral country banks, and there is a run going on those banks.

I think European officials are saying, "We are going to stop the tail risk event." You know, the economists, I thought, had a great expression that—Merkel's view is you do "just enough just in time." And the market looks at that and say, "Too little, too late." And both of those are the correct views, but, I mean, her view is you never do more than you have to because the only way you cause the regimes to change the way you want them to do is you only do just enough at the last moment to save the tail risk event.

So I do think the ECB, while it may not be standing up and saying, "We are going to be the lender of last resort to countries," is saying, "We will be the lender of last resort to banks. We will not allow a bank to fail." And I think this new program which they've announced of lending money for three years is an important move to say—as long as they have the stomach for what they're going to get—is that "We will essentially fund our European banks."

DD: We'll not allow a bank to become illiquid.

EC: Exactly. It's not our job to solve the solvency problem. It's our job to solve the liquidity problem. And so I think that's a big step. I think the European banks have made a huge tactical error. I think when the crisis happened they did not go and recapitalize the way they should have, and so they were short before they got into this, and then when, in fact, your sovereign credits start to have to be marked down—because you're running a country, they kind of expect that you could use your own government's bills, treasury bills, and count them for par. But they clearly delayed, and so you just look at the average big European bank is down 40%, 50%. So the cost to the shareholders of recapitalizing today is dramatically more than it would have been if they'd just done it even a year ago. So this—just enough, just in time—for them has been a disastrous strategy.

I think in the end what they have to do is—the ECB says, "You'll not have a liquidity run." The banks have got to stand up and say, "We're solvent and we have taken our write-downs." And then I think you start to then back it into "Okay, we've got one more complicated problem." Because I'm sympathetic to political leaders. You know, the example I use in the United States when I'm talking about this: Can you imagine the reception from Rick Perry if you said, "You know, California's had a lot of good-living times here in the last 20 years. They can't pay their debt. So why doesn't Texas bail out California?" That would be a pretty short conversation. That's what Germany's being asked to do. That's got to be a long conversation.

FM: So you had mentioned the denominator and numerator thing, and it just leads me to a question because we've talked about the political issues in the euro zone and the United States and trying to find a fix, but isn't it also fair to say that economists are deeply divided on solutions? And there are economists who think we should be stimulating more aggressively and then there are economists who think we shouldn't be doing anything. There are some people who think we should be stimulating in the short term and cutting in the long term, some people who think the stimulus should only be tax reductions, others who think it should be expenditures. Do you have a view, David, having been through exactly this, as to what the right recipe would be, or is it a different recipe for every situation?

DD: Well, first of all, we are talking about the long term in Europe as well as the United States, and I would say, in a different way, in China. But in order to be credible in the long term, you've got to be credible now. That's the lesson I think we learned in Canada in the 1980s.

And that's why we had to do what we did in the 1990s. So the peripheral states have got to start to move now but they've really got to deal with their longer-term problems, whether those are pension issues, whether those are structural issues in terms of regulation and so on, or whether they're trade issues, they've got to deal with those. But they've got to do enough in the short term to be credible.

"But in order to be credible in the long term, you've got to be credible now. That's the lesson I think we learned in Canada in the 1980s...But the other side of it is that the Germans and the Finns and the Dutch have got to be willing to provide a little demand domestically themselves." **– Dodge**

But the other side of it is that the Germans and the Finns and the Dutch have got to be willing to provide a little demand domestically themselves. They have squeezed their workers quite a bit, so there is really room for them domestically to actually increase the wages, to work on the demand side. Because if the only actions that are being taken is to contract demand, then everything goes down. That's the sort of thing that Madame Lagarde was referring to, and I think that is a very real danger.

And I think even some of the most libertarian economists would understand that you've got to do that. Now, you may disagree whether you do it on the tax side or whether you do it on the expenditure side. But in the end, as an employer, as a corporation, you're not going to make an investment if you can't sell the product down the line, no matter how low interest rates are. And so the demand has got to come, and that means that those countries that are in creditor positions and in relatively good shape have to be willing to expand their domestic demand as the others, the traditional debtors, contract theirs. And if they're not willing to do that, then indeed you do get the downward spiral.

The other comment I would make—Ed, I completely agree with you there—if I have a worry about Europe is that I think they will solve the tail risk problem. They will not let the world collapse. I think they will avoid the political accident. But they will be deeply mired in a recession.

And therefore these problems will just keep accumulating because they can't get themselves out of that trap, and that's where I probably lean to say in the end, if you can't bust up the euro and start all over again, if that's too catastrophic, then unfortunately the answer is going to be you're going to have to do the equivalent, which is to have the ECB print the money, and devalue the whole currency. Germans are going to have to pay the price of some inflation in order to finally solve this problem.

But I think the part that's missing here is that Keynes said two things, not one thing. Keynes said, "Yes, it's all about demand," but two, "It's all about restoring business confidence." And I think that's the part that is the most worrisome thing here, is we are living in a world where, from a business person's point of view, we're unusually vulnerable to political acts. Public policy turns out now to be the determinant of success at the very time where the politics appears around the world to be pretty dysfunctional. And so you're sitting there saying, "How do you be confident?" In the United States, when you step back and think that it was seriously proposed that the reserve currency of the world should default, no wonder people lost confidence.

My reading of US business now is that they've kind of got themselves settled away with a view, "You know what? This isn't going to cure itself quickly. But nor does it really turn out to matter that much because we're in this unique position that we're the reserve currency. It's not as if our rates are backing up. If anything, the world crisis has kept them artificially low. And so we're just going to have to let these guys go on." And so what they're doing is they're actually back borrowing money, investing, but in a scenario that's 2% to 3% growth, not any faster. And so they lack confidence to do anything that's bolder than that, and that's partly because they don't see the United States quickly getting its act together. And then secondly, what's going on in Europe weighs heavily on major corporations in the United States.

"…what we have to solve is how many dollars of stimulus you do now, how much you do later on,…'How do we get people's confidence back that we have a political process that can resolve issues?'" **– Dodge**

And so to me, what we have to solve is how many dollars of stimulus you do now, how much you do later on, and stuff like that, but we also have to figure, "How do we get people's confidence back that we have a political process that can resolve issues?" And if we don't have that, that's a very difficult situation.

FM: And we're not going to have that for the next year in the United States.

DD: No, I don't believe so.

FM: It's pretty well game over until the election. Two quick other questions.

DD: The more interesting question, though, is will we have it after 2012?

FM: That is an interesting question. So two quick questions. They may not be quick answers. Income inequality: Increasingly being discussed at the political level in the United States because the gap continues to widen out, but we're not immune from it in Canada and it's also become a major subject of discussion in Canada. Is this a solvable problem, and how do you solve it?

DD: That's an extraordinarily difficult issue, but I think we have to be careful what terminology we use. What's happened is that labour's share of national income is down about five points from its sort of long-term average. It's down about ten points from its peak. And so it's really been a big redistribution from labour to capital over this period. And it's bad in the US. It's terrible in China. In China only 38% of national income accrues to labour. In the end, somebody's got to take the products and the services you produce off your hands; otherwise business can't make any money. And if indeed you've got a smaller and smaller fraction of the income that's going to people that actually consume, then indeed we do have really quite a serious problem. And it's not one that is amenable to easy fixes. This is not just a tax-and-redistribute issue. It's come about in part because we've had major technological change, which has been favourable to capital, and in part because we've expanded from national to regional to global markets. As you do that, inevitably you drive down the share of income that is going to the workers in the mature markets.

And so this is actually a pretty fundamental question as to how, in fact, in the mature economies we're going to get some more income flowing to workers, to people who actually consume the products and services that businesses produce. And Frank, to this one, there is not an easy answer, but it goes a long way to creating the Occupy Movement. The bulk of the population is quite right that they're getting a smaller share of the pie. And so somehow we're going to have to try and deal with it. In part it may mean that return-to-capital has got to go down. That's one way …

EC: Be careful about that, David. (Laughs) Be careful about that.

DD: But we have to be honest about how this accrues. Because if you think about it, we're all aiming for 20% ROE at a time when that's almost 20% real.

EC: Right.

DD: Whereas historically we were looking at sort of 14% - 15%, when 5% of that was inflation.

So we actually are taking a much bigger slice of national income now in profit and interest. In China it's a different story. It's the government that's taking this big slice, and their problem and the problem of the next State Council is going to be how to move some of that back to the Chinese workers so that they can buy some of the products of Chinese corporations, that the American and the European consumers won't be able to. These are huge structural issues, but it's really important to understand fundamentally what has to happen to solve the aggregate demand problem.

FM: So, Ed, another specific issue, I guess, bringing this whole thing back to Canada, is the issue of household debt and the Statistics Canada report this week was nothing short of alarming. A lot of people saying—not saying; I guess empirically demonstrating that we're worse off than the United States and perhaps even Europe in that regard. You were quoted with a specific measure on mortgages and there was another article from somebody saying the banks should take some responsibility here more than they've taken of dealing with this problem. So here's your opportunity.

EC: What I said was that you really have your classic public policy dilemma. You know what the answer is—where you're trying to get to, and then the question is—for the government is "Is the delicacy of the economy, fragility of the economy, such that I can't afford to go to that structural solution now because I'm worried already that the economy is slowing down too much?"

But I think—you know, my own view tends to lean to say it always seems like a bad time to do the right thing, and that if you think you can get away with it, getting this problem solved before it gets too big to manage is the right thing to and so I think reducing the amortization from 30 to 25 years. We also believe strongly that we ought to have a qualifying rate for fixed-rate mortgages too, because if we ever get a rebound in interest rates, we could find people have borrowed money assuming that forever we're going

"...it always seems like a bad time to do the right thing...[but] getting this problem solved before it gets too big to manage is the right thing..."

– Clark

to be in a low interest rates environment. But it's a very difficult issue. I think in the end we should try to get ahead of it as a public policy matter.

DD: Can I add to this Ed? This is a really interesting one. The one real fight I had as Governor with the government was when, in 2006, they lifted those ceilings just at the wrong time. And in fact, if you think about it, monetary policy has its biggest impact on the household sector through housing. And so it's very important that the other instrument you have—the quantitative control instrument that you have through the terms on which CMHC will provide mortgage insurance—that you use that judiciously along with the monetary policy. And at the moment, we need low rates for lots of reasons, but not for housing. And so the right thing is to balance that off low interest rates with tighter rules, just as it was the right thing to not loosen the rules back in 2006. But this is a very judicious balancing act, and unfortunately it's the Bank of Canada, on one side that does the monetary policy, and Canada Mortgage and the Department of Finance on the other side that does the regulation. And that really does require much closer policy co-ordination between the three parties.

EC: Just to address the other sort of implication, "Well, what about the banks?" The reality is it's not like we don't offer 25-year amortization mortgages or 20-year amortization mortgages. People can pick their amortization periods. But if you offer them a choice, overwhelmingly they will choose the longer period, and so the question is would one bank say, "Well, I don't care what you want; we're going to only offer 20-year amortization mortgages," while everyone else offers 30-year amortization? We know what would happen—TD would no longer be issuing mortgages and everyone will go across the street. That's what the public has said by the way they act.

What's interesting is the difference today between the

United States and Canada. And so it shows where the consumer's head is.

In the United States, where they have interest deductibility—so you've got a 4%, 30-year mortgage and you get to deduct that interest against your income tax—half our consumers are choosing a 15-year amortization, which says when you go through and these cycles blow you up, then the consumer goes into the net worth restoration mode, and that's what makes the recovery so difficult, that once you're there, then all these fiscal stimulus tools go away from you because the consumer says, "I've got to look after me and I am going to restore my own personal balance sheet." And so that's what we don't want to go into, is where we get that collapse and then we have to dig our way out of it.

FM: The front row?

Audience: From what I understand, some of the countries like Italy and Spain that are having problems right now have about half of their debt that's short term and it's in United States treasuries, which are at very low rates, and next year they have to renew them, about 50% of them. And I wonder how Angela Merkel is ever going to, you know, sell that to the German people. I have a second one and I've got to think about it for a minute …

DD: Italy carries a high debt load, most of which is actually financed domestically and is actually financed through the vehicle of their domestic banks. And so from a national point of view, Italy Inc., so to speak, Italy doesn't really have that big a problem. It's actually a high-saving nation. The savings has been redistributed from households and small businesses to the government, and so in a very peculiar way, Italy's problem would be quite manageable at normal rates. The trouble is nobody has had any confidence in the Berlusconi government, and we don't know yet whether Monti is going to be able to do any different. But Italy has a much smaller deficit than Germany does although it has a higher debt load.

Spain is a different story, but what we've got now is a government in Spain in which people, for the moment, have a degree of confidence. So if you look at that last Spanish auction, it went really, very, very well. So this is not unmanageable if indeed, as Ed said earlier, you can get some degree of confidence in the management of these major European states.

Greece is *sui generis.*

Audience: The other is, I think it's obvious that some of the French banks, the bigger ones like SocGen and Credit Agricole, have lots of problems. You've got a parallel in the United States. You've got a Lehman Brothers situation where you let Dexia go bankrupt and now the Europeans are saying, "We're going to help out any bank that gets in trouble." I don't make much sense out of that kind of thing.

EC: Well, as I said earlier, I think first off, which the ECB has done, is say they will not run out of money. It may be that essentially the ECB funds them, but they will not run out of money. And so then I think what you're trying to find are solutions where you say, "Either we improve the value of the assets by getting a credible solution on the sovereign side," so the degree of write-down that they're required to take on those assets is less, or you have government step up and say, "We're going to run a TARP-type program," to essentially say, "We're going to put the money in there to make sure that they can afford to take those write-downs if bad things happen."

The trouble is it's the circularity of, "Is the Italian government or the Spanish government or the French government going to go in and start recapitalizing their banks? And what does that do to their own balance sheets as countries, and therefore do they actually make the problem worse?" And trying to figure out how to cut through that is, I think, the core of the issue they're trying to work their way through.

DD: We do have to remember that the European banks, by and large—and this includes the German banks—were running leverage ratios which were absolutely unacceptable by any standard for a very long period of time.

"...the problem today is there is no partner for the IMF to play the role which the IMF could certainly play in this circumstance, but they can't do it alone." **– Dodge**

EC: Right.

Audience: I was wondering if you could think back to the LDC crisis of the 1980s and talk about what parallels you see; useful lessons for the current circumstances from that episode. And I guess one of the things that I think about from that period of time is, you know, we knew for a long time, many years, that there was a big problem, and yet it actually wasn't such a bad time for the stock market.

DD: Let me make two points. First of all, we didn't have the accounting vigilantes back in the early 1980s. I mean, every major American bank by today's standards was bust. We never admitted it through the period, and indeed we allowed the banks to work their way out in part because we had a nice, steep yield curve and banks could earn their way out.

The second issue, if you think of it from the public's side: We had the United States which was willing to put up a pile of dough alongside the IMF to make the system work. As Ed and I were discussing earlier, the problem today is there is no partner for the IMF to play the role which the IMF could certainly play in this circumstance, but they can't do it alone. And the United States I'm not sure is unable but it's certainly unwilling to step up. The Chinese claim that they are only a small country and that they're not a major global player (Laughter) and so it's not up to them to do anything. So the IMF can't do it. And, you know, quite frankly, however much we used to complain about American leadership (and sometimes they drove things down our throats here in Canada that we didn't really like very much), that leadership was fundamentally important in the original LDC debt crisis of the '80s. It was absolutely critical in solving what could have been a major problem in Brazil. The Americans were willing to step up and then everybody came along. We don't have that anymore. So there are two issues: Get rid of the accountants, number one, (Laughter) and second, revive the US as a player in the international arena.

EC: Well, now, you've just said we're going to lower returns on equity and now we're going to get rid of all the accountants. There's not going to be much left by the time you're finished. (Laughter)

So David and I were talking about this earlier. To me, what it shows is the two sort of things that are going on is: one is this cumulative effect of the United States essentially dining out on its reserve currency, and so not making the hard choices because the easy choice was always available, but at the same time gradually eroding its economic power, and then that crisis itself helps to then create this degree of polarization as to what the solution is, and so now you have a political logjam. And I don't think you can underestimate the destabilizing effect on the world of no longer having a single dominant economic power. And we as a world—you know, it's all very nice to say, "Well, now we've got an equal world and there's multi poles in this world," but that's a very complicated world to solve. And if you think about, what happened in the US crisis and to counter, the difference with Europe is Hank Paulson could go to Congress. They turned him down and he went back in Congress and said, "I'm not leaving until you say yes," whereas nobody can play that role in Europe today and no one's playing that role in the world, and that's the role the

United States would always end up walking in and saying, "I don't care whether you like it anymore; we're the most powerful nation in the world and you're going to do exactly what we say." That's a big missing ingredient right now.

Audience: So can we get the conversation back to Canada? Because frankly, whatever will happen in Europe—the European and other global leaders will decide and we can influence; whatever happens in China will eventually be down to Chinese management. And I worry that we're far too sanguine about our own position here in Canada. You touched on one of the subjects, which is mortgages and low interest rates. But we keep thinking, "Well, the population seems to be immune to the issues that are raised," and it seems to be that people are only thinking there's one transmission mechanism of our high consumer debt, which is eventual high rates. But we've got a gathering storm coming from Europe. It might be mild if the deleveraging is dealt with measurably. It could be an ugly storm. And we're not preparing ourselves for it.

And so the biggest transmission mechanism is unemployment. If we get a global recession and the banks are facing unemployment amongst their customers, that would be as good a transmission mechanism as you're going to get. But we have a bifurcated economy. We have an overstretched consumer and we have an underinvested corporate sector. So I've got questions for all three of you. What do we do in a low-interest rate environment to get the consumer to understand this and to start saving when there's no incentive for them to save as well as deleverage? How do we get a corporate world in a low-interest rate environment that's scared to invest and improve our productivity to offset the risk of a recession coming? And Frank, you're not alone here, so how do we get the politicians to start being brave and start elevating some of these issues to a political debate so Canadians are presented with it as a choice and not a disaster?

EC: I think we should start with Frank, don't you, David? (Laughter)

"...I don't think you can underestimate the destabilizing effect on the world of no longer having a single dominant economic power...that's a very complicated world to solve." **– Clark**

DD: Yes, so do I. We have a consensus. (Laughter)

FM: Well, I don't think there's a good answer to that. Almost invariably you need a burning platform before politicians have the political will to act. And we could blame the politicians; it's fair game. But we also have to not just blame the leaders but the followers because, generally speaking, the electorate throw us out of office when we're too brave unless we've really created the environment for tough decisions to be made. An electorate properly prepared, properly informed will support very difficult medicine.

I don't think Canadians now necessarily feel there's a burning platform in this country. I don't think they see it in terms of productivity, it's the old boiling-the-frog syndrome. I don't think people feel like they're being boiled on productivity. I don't think people on household debt feel particularly alarmed. And so we're trying to create

"An electorate properly prepared, properly informed will support very difficult medicine."
– McKenna

solutions to problems that people haven't defined as being problems. So I think our political leadership, to start with, have to prepare us for the solution by articulating better the problem. It may be that we get so infected from the contagion spreading elsewhere that we have the burning platform that will create that politician environment in Canada.

"...we are going to have to work here in Ontario not just on the government side but we, as citizens, as employers...to get our unit cost down" **– Dodge**

DD: I said the outrageous thing during the Ontario election campaign that all three parties were lying to the public, and, I mean, we really haven't prepared people for what is out there. The burning platform is right here in Central Canada. I've spent a lot of time out West, and that platform is not burning. It may be burning in a different way because we're all scrambling for labour and trying to make the thing work out there, but we have a burning platform here in Ontario. We've got a unit cost problem that is very severe and we will not be bailed out by a low dollar as we were for a number of years, during that terrible period in the 1990s.

We crowded in a pile of world demand. So this is a totally different ballgame. It's a much tougher ballgame. But I think here in Ontario we've got a unit cost problem. It's a unit cost problem for government certainly, but it's a unit cost problem for industry. And why is it that we in this province somehow feel that we are just so different than the people in Cleveland or the people in Buffalo or the people in Detroit. We are not—we are part of that industrial zone and we have priced ourselves out of the market in that industrial zone. So we are going to have to work here in Ontario not just on the government side but we, as citizens, as employers, are going to have to get our unit cost down either through miraculous productivity increases (which we've failed to deliver for the last 20 years) or we're going to have to have wage freezes or cuts not just in the public sector but across the board.

So we have a very difficult issue in Ontario. It's going to be, hard for us in Ontario. There are some major structural changes that we've got to undergo just like the Italians and the Spanish have to undergo major structural changes.

EC: So the only thing I would add to that is that—David will disagree with me on this—I'm not quite as pessimistic in the sense that I do believe that Europe is already in a recession.

DD: It is.

EC: But I haven't yet given up. I do think there're signs that the United States has, as I said, kind of got themselves used to "Okay, you know, this is what our world's going to look like." I think the thing that the United States suffered from was that Americans are quite impatient and the idea that it would take longer than 18 months to just get the whole economy back together just was a staggering notion to them and just equilibrated them. But now I think they sort of say, "Okay, so now you're going to grow at 2% to 3%, maybe even 3.5% and we're going to have very slow reductions in unemployment rate. I'm going to build 600,000 houses a year when I need 1.2M, and I'm going to gradually burn my way through this inventory because I can't come up with any government program to speed this up, and I just have to work my way through." And so I think there are signs that business leaders are getting

"I think the big question mark is how fast China slows down. I think if China keeps on going, there's a chance that the United States may slow down a little...but it won't tip the United States into a recession."

– Clark

back there. I think the big question mark is how fast China slows down. I think if China keeps on going, there's a chance that the United States may slow down a little bit from what you might have had absent in Europe, but it won't tip the United States into a recession.

And if it doesn't, then I think Canada will kind of trundle along here, which then goes then to David's point—and I think all three of us are on the same ground, first off, if it turns out to be worse, what Canadian politicians have to understand is they cannot change that world. And so trying to stimulate Canada out of that is to drop a peanut in the ocean, and it's a wasted peanut. You should keep that peanut for yourself.

And so the bigger issue is—the longer-term issue that Canada is going to face, like every country in the world, is the aging of its population, a slowdown in government revenues at the very time that government expenditure demands are going up, and if you can't tackle issues like health care, you're doomed. And so in the end, we have to find a way to have a conversation to say, "We all believe in universal health care. We all want to maintain the system. We will not maintain the system without reform. What's the nature of the reform that the population will accept as fair?" And it may well be a system that says, "Sorry, David. You're too rich to get free health care. Everyone below you may get it but you're not going to get it anymore because we can't afford to give away health care to people that can pay for it themselves." I don't know what the answer is but we have got to get that conversation going or we're going to dig ourselves a deeper and deeper hole.

Audience: Mr. Dodge and Mr. Clark, just to build on this theme of the impact on Canada and stimulating our economy and looking ahead, and we're talking about whether it's through tax policy or otherwise to stimulate investment or demand, is it important to also take this opportunity to think about, even more strategically and in a focused way, of what areas of demand and investment do we want to focus on, or is all demand—whether it's TVs and houses and other things—equal, looking ahead in the 21st century?

DD: Go ahead.

EC: Well, I think governments have almost a perfect record of picking the wrong areas to focus, and I guess I'm strongly in the camp of what governments do is create frameworks and let the market figure it out. And when governments go beyond that, as I say, it's almost 100% perfect track record of picking yesterday's industries rather than where it goes. It doesn't mean that you don't have framework policies in the sense of supporting things like research. You know, clearly, to go back to health care, if I worry about anything, it's that we're going to starve

"...if I worry about anything, it's that we're going to starve education to pay for health care...'What's the key to having high growth? Is having a highly educated population'." **– Clark**

education to pay for health care. And I do think you look around the world and say, "What's the key to having high growth? Is having a highly educated population." And I think there're lots of reforms that we need in our universities. It's not obvious that we're getting bang for buck out of our universities, and there's a lot more we could do there. But I think when governments start to pick sectors, it's almost always assured that that's not the sector you'd want to invest in.

DD: Yes. And when governments try to run universities, it's exactly the same problem.

EC: Yes.

DD: I absolutely agree with Ed. Industrial policy doesn't work. What governments can do is they can provide the framework and they can provide the infrastructure or at least the underpinnings of that infrastructure.

EC: Or a great thing, which they did was the HST decision. That was a politically courageous decision to provide a framework for manufacturing exports that put Ontario in first place around the world.

DD: Right.

FM: Anybody else? We have time for one more.

Audience: Imagine you're Mario Draghi. Given your experience, what do you ultimately do to stop what's happening in Europe?

DD: Well, I think Ed expressed it pretty well, and I think Mario would absolutely agree that what the role of a central bank is to provide liquidity for banks. That's really important. The problem is this circularity issue that the banks don't have that safe asset to hold. And, you know, the ECB is not a central bank like other central banks, and I think it's quite important to understand that. Because when the Fed acted in 2007 and 2008, when the Bank of Canada acted, when the Bank of England acted, we acted as an agent of the government. The government was there because the taxpayer in the end was going to absorb losses if indeed we made mistakes.

Mario doesn't have that. Jean-Claude didn't have that at the ECB. He was operating on his own balance sheet under a statute which actually said he couldn't do what the Bank of Canada, the Fed, and the Bank of England did. So I think we have to remember there are very real limitations, and that's why I think, (like Jean-Claude before him) Mario is insisting that there be an inter-governmental compact so that in fact he can legitimately go out and blow up his balance sheet by buying European bonds. But short of that inter-governmental compact, short of some bigger, more grandiose EFSF or whatever, he really can't do it. We think of the ECB as a central bank but it's not quite a central bank like others.

EC: So I think he's kind of teased us to a certain extent with what his willingness to do is on your latter point, because I think the opening there is that if he believes that they've got the regime in place that will ensure that governments will do the changes that they have to do, he is free to say, "But the effect of those is to slow down overall growth."

DD: Right.

EC: "And therefore I can go out and be very vigorous about stimulating the economy through a low-interest rate policy"—a.k.a. print money—"and I can be buying bonds, and I might as well buy Italian bonds or Spanish bonds if I'm going to be buying bonds," and through the back door, in a sense, do what he's refusing to do or can't do legally in the front door.

I think he occasionally sends out a message: "I am prepared to do that." And then as soon as the market gets a little excited that he's going to do that, he then pulls back and says, "No, I'm not." And my own reading—but I'm not an insider on this—is that he's also having to carefully manage his relationship with Germany. And so he really wants to say to the market, "I get it. I'll do it. But you can't put me in the position that if I'm doing through the back door what I can't do through the front door, you want me to

admit that I'm doing it through the back door," because then he loses Germany and he won't be able to do it through the back door. And so he's got a careful political dance of saying, "Of course it's obvious," and I thought the fact that, you know,

"…Europe can't solve its problem without growth."
– Clark

within 24 hours he cut interest rates when he first came in was a pretty strong signal that he gets that Europe can't solve its problem without growth.

DD: Yeah.

EC: And he's got to find language, I think, in the sense of all this about restoring confidence. If he says, "Well, I'm not going to bail the governments out but I am going to bail the economy out"; if he could get a little bit more forceful in saying that, I think the market will get what he's telegraphing.

FM: And clearly they want to keep their hands on the throat of Greece and Italy and Spain so that there's no relenting on that fiscal record.

EC: Right. And, you know, if you think about it, they only got to oust Berlusconi by letting the rates go to 7%.

And so if the ECB had come in and held those rates down, Italy would still have the same prime minister.

FM: In fact, I think they've turned over every prime minister. If you look at it, Portugal's lost theirs, Greece, Spain …

EC: And to David's earlier point, it is remarkable you could say objectively, "Spain is in worse shape than Italy." But the market sees the government as more prepared to do the tough thing than Italy.

DD: Right.

EC: And, you know, so Spain is trading with significantly better rates than Italy is. And so I do think you have to keep having these market signals. If you said, "What failed here?" in both cases we have massive market failure that, you know, people were willing to lend money to Greece because it was denominated in euros as if that was like lending it to Germany. And yet, on the surface, well, who was in their credit departments? I mean, it's pretty obvious that was a ridiculous decision to make. And the United States has been able to borrow money because of the reserve currency where there's no signal that said, "This is crazy. If you were any other country in the world, the United States would have been stopped by the markets." And so I don't think the market could step back and be, so proud of its role here because it essentially tolerated intolerable behaviour and is now outraged. And that's what I think leads people like Merkel and Draghi to say, "I've got to get market discipline back in here somehow."

DD: Yeah. And Mario is an Italian. And probably understands better than Jean-Claude did the difficulties

of actually making this work because he had to confront Italian governments. But I have tremendous respect for both of them.

In the end Mario will try to move his board—and it's not him, remember; it's his board—to actually do the right thing. I am not Pollyannaish about this, but I kind of think that the Europeans actually will get through it, but it's a 51/49 proposition. And if they don't, the 49 is really quite bad, and that's why I think that the 51 probably in the end will win.

EC: Yeah, and I think the difficulty is—that most people have is the 51 doesn't feel so good either.

DD: Well, it doesn't feel so good in the short run. Regardless, right?

EC: Right. And that's what I think we've got to get ready for, is that the 51 doesn't feel perfect.

FM: So it's taken us an hour to get here, but we have an astonishing show of optimism at the end. (Laughter)

This has been extraordinary for me to watch two people so well versed in these international issues discussing them and have so many people take of their precious time and come out late in the afternoon and listen. So I want to thank everybody for doing that, for participating, for being part of it all. And David and Ed, I want to thank you for giving so generously of your time and being so candid in your views. Thank you.

Transcript has been edited and condensed

E.Clark
F.McKenna
D.Dodge
Biography

ED CLARK
Group President and CEO,
TD Bank Group

Ed Clark was appointed President and Chief Executive Officer of TD Bank Group on December 20, 2002. Prior to this appointment, he was President and Chief Operating Officer, a role he held since July 2000.

Following TD's acquisition of Canada Trust Financial Services in February of 2000, Ed joined TD Bank Group as Chairman and Chief Executive Officer of TD Canada Trust. In this role he oversaw the successful integration of the TD and Canada Trust banking operations. Before joining TD, Ed was President and Chief Executive Officer of Canada Trust Financial Services.

In 1985, he joined Merrill Lynch, and three years later was appointed Chairman and Chief Executive Officer of Morgan Financial Corporation, a position he held until he joined Canada Trust Financial Services Inc. in 1991. From 1974 to 1984, Ed held a number of senior positions in the federal government.

Ed graduated from the University of Toronto in 1969 with a Bachelor of Arts degree. He earned his Master's degree and Doctorate in Economics from Harvard University in 1971 and 1974 respectively. Ed has also received honorary degrees from Mount Allison University and Queen's University.

Ed serves as Chairman of the Board of TD Bank N.A. and its subsidiary banks, and also serves as Vice-Chairman of the Board of TD Ameritrade Holding Corporation. He is a member of the Board of Directors of the C.D. Howe Institute, a member of the Chair's Advisory Council for Habitat for Humanity Toronto, and provides support to Woodgreen Community Services, an organization that delivers programs to build sustainable communities in the Toronto area.

Ed's strong business and community leadership continue to be widely recognized. He is an appointed Member of the Order of Canada – one of the country's highest distinctions – for his "contributions to Canada's banking and financial industry, and for his voluntary and philanthropic endeavours". Ed has also been named the Ivey Business Leader of the Year by the Richard Ivey School of Business at the University of Western Ontario, and Canada's Outstanding CEO of the Year by The Caldwell Partners. A proponent of workplace diversity, Ed has been honoured with the Egale's Leadership Award in support of LGBT (Lesbian Gay Bisexual Transgender) communities, and the inaugural Catalyst Canada Honour, as a champion of women in Canadian business. In addition to his business accolades, the Clark family received the Outstanding Philanthropists award from the Association of Fundraising Professionals, Greater Toronto Chapter for their personal contributions and ongoing charitable work.

Ed and his wife Fran make their home in Toronto. They have four children and six grandchildren.

FRANK MCKENNA
Deputy Chair
TD Bank Group

Frank McKenna was appointed Deputy Chair of TD Bank Group on May 1, 2006. He is responsible for supporting the Bank in its customer acquisition strategy, particularly in the area of Wholesale and Commercial Banking.

Frank has held numerous leadership positions in both the public and private sector. For a decade (1987–1997) he was Premier of New Brunswick, having earned three consecutive majority governments, including the historic victory in 1987 of all 58 seats in the legislature. The McKenna government significantly improved the province's standard of living and quality of life. Among its accomplishments, it balanced budgets, pioneered e-government services, attracted innovative industry clusters and improved educational outcomes. Frank also played a central role on the national stage, where among other initiatives, became a lead advocate for the Canada-US Free Trade Agreement.

Prime Minister Martin nominated Frank as Canadian Ambassador to the United States of America in 2005, where he was charged to navigate contentious bilateral issues related to trade and security. In 2006, Frank resigned this position upon change of national government.

In the private sector, Frank is in wide demand as a corporate director. Currently he is the Chairman of Brookfield Asset Management and is on the board of Canadian Natural Resources. He has also been Chairman of the Board of CanWest Global and served on the Boards of Noranda, Shoppers Drug Mart and General Motors.

Frank is a graduate of St. Francis Xavier University as well as Queen's University, where he completed his post-graduate degree in political science and the University of New Brunswick Law School. He was appointed to the Order of Canada in 2008 and is the recipient of eight honourary doctorates.

Frank and his wife Julie have three grown children and seven grandchildren.

DAVID DODGE
Senior Advisor

David Dodge advises clients on the national and international economic developments and their effect on businesses in Canada and abroad.

During his academic career, he taught economics at Queen's University; at the School of Advanced International Studies, Johns Hopkins University; at the Faculty of Commerce at the University of British Columbia; and at Simon Fraser University. He also served as Director of the International Economics Program of the Institute for Research on Public Policy.

During a distinguished career in the federal public service, Mr. Dodge held senior positions in the Central Mortgage and Housing Corporation, the Anti-Inflation Board, and the Department of Employment and Immigration. After serving in a number of increasingly senior positions at the Department of Finance, including that of G-7 Deputy, he was Deputy Minister of Finance from 1992 to 1997. In that role, he served as a member of the Bank of Canada's Board of Directors.

In 1998 he was appointed Deputy Minister of Health, a position he held until his appointment as Governor of the Bank of Canada.

Mr. Dodge, appointed Governor of the Bank of Canada, effective 1 February 2001 for a term of seven years, retired on 31 January 2008.

Mr. Dodge is currently Chancellor of Queen's University. He is a member of the board of directors of Canadian Utilities Limited, the C.D. Howe Institute, the Canadian Institute for Advanced Research and the Bank of Nova Scotia. Also, he co-chairs the Global Market Monitoring Group of the International Institute of Finance and is a member of the International Advisory Council for the Central Bank of the U.A.E. In 2009, he was elected a fellow of the Royal Society of Canada.

Bennett Jones

2012 GLOBAL ECONOMIC OUTLOOK

A DISCUSSION ON MACROECONOMIC ISSUES