BANK OF CANADA

*Opening Statement by*
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*before the House of Commons*
*Standing Committee on Public Accounts*
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I would like to begin, Mr. Chairman, by saying that I found the Auditor General's chapter on public deficits and debt to be a good statement of the issues. It is only in dealing with the role of interest rates in the persistent accumulation of public debt that I may have something to add for your consideration.

The main issue that the Auditor General raises for discussion and resolution in this chapter is the appropriate level of federal public debt relative to the size of our economy. He points out the deterioration of the government's financial position over much of the past 20 years and the likely further accumulation of debt in the future unless the government runs substantial primary (or operating) surpluses.

We at the Bank of Canada have commented, particularly over the past couple of years, on the need for all governments in Canada to put their fiscal positions on to a more sustainable track. At a minimum, this calls for actions to stop the ratio of public debt to gross domestic product (GDP) from rising. Evidently, public debt ratios cannot continue to rise over long periods without encountering impossible pressures on debt service costs, deficits and debt financing. But if one begins with a low level of debt to GDP, a rising ratio can be sustained for some time, as we have seen. However, once very high debt levels are reached, just stabilizing the debt to GDP ratio may not be sufficient -- lower ratios may be needed.

Unfortunately, economic analysis on its own does not provide a simple answer on what is an appropriate debt to GDP ratio. We would probably all agree with the Auditor General that our society needs to sort out its views about acceptable levels of taxation and the size of government, and those views can influence the amount of debt our society can afford to carry. However, when you reach a high debt to GDP ratio, what is sustainable is also very much influenced by the willingness of investors in financial markets to hold your debt.

I do not mean to imply that financial markets might suddenly decide to stop lending to Canadian governments. What happens, as recent experience has shown, is that at very high levels of debt, there may be an increasing nervousness among lenders so that they would only continue to hold Canadian government debt at much higher interest rates.

This brings me to the matter of interest rates, and I would like to put their role in the debt and deficit problem in a broader context than the arithmetic calculations included in the Auditor General's Report. The main point that I want to make is that the interest rates in Canada are influenced by the economic policies we pursue, including the debt and deficit policies of governments. This is part of the explanation as to why, in the Auditor General's chart on page 11, interest rates were low relative to the growth of the economy before 1980 and higher subsequently. The other part of the explanation is an increase in international interest rates.

For example, regulatory policies in the 1950s and 1960s imposed a ceiling on the interest rates banks could charge as well as other restrictions on lending, which meant that governments were not subject to the same competition as now from private sector borrowers in obtaining funds. Beginning in 1967, many of these regulations were removed to give private sector borrowers, and especially households, better access to credit. With more competition among borrowers, an increased level of interest rates was needed to balance the supply and demand for credit. Thus, governments had to pay more to borrow when they began to allow their deficits to rise in the 1970s.

Inflation also had an impact on interest rate levels. When inflation first began to rise in the 1970s, many savers and lenders were caught by surprise. And for some time they believed that inflation was only temporary. Thus nominal interest rates were low relative to inflation and the growth of the economy, making debt-service costs easy for governments to carry, but at the expense of savers. However, from the late 1970's on, high inflation came to be expected. Because high inflation tends to be unpredictable, savers, investors and lenders came to demand interest rates high enough to cover expected inflation, plus an added premium for inflation uncertainty. This risk premium raised the interest rates faced by all borrowers and meant that debt-service costs of governments began to rise more rapidly than the growth of the economy.

However, the fiscal position of the government sector would have worsened from the mid-1970s onward, even without higher debt-service costs. And as I mentioned, once debt to GDP ratios reached high levels, investors became nervous about the capacity and willingness of governments to service their debts in the future. So even as our inflation rate has come down, our interest rates have remained relatively high. While inflation uncertainty probably remains a cause of risk premiums in our interest rates, those risk premiums are now related much more to a range of concerns about fiscal debt and deficits.

A good indication of the size of the risk premiums is provided by the interest rate differentials between Canada and the United States for medium- and longer-term maturities. These differentials are currently relatively wide, and they imply interest rates levels that are costly to Canada over time. High interest rates discourage investment in improved productivity that could help to raise Canadian living standards in the future. And to the extent that our debt is owed to foreigners, the present risk premiums in our interest rates raise the debt-service costs we pay abroad and make us poorer as a country.

Moreover, at our current debt levels, each time a piece of negative news comes along, such as higher international interest rates or political uncertainty in Canada, investors become even more worried about the capacity and willingness of Canadian governments to service their debts in the future. As a result, investors demand still higher risk premiums for holding our governments' debt, and interest costs, deficits and the accumulation of debt rise still further. In these circumstances, a government can potentially find itself in a vicious circle of rising interest rates and rising debt. These were the sorts of pressures the government encountered for a time following the rise in U.S. interest rates beginning in early 1994 and again early this year following the Mexican currency crisis.

Because of measures taken by the federal government and most provincial governments this year to address fiscal imbalances, some of the nervousness in financial markets about the fiscal situation has eased. I believe that this was helpful in the period of political uncertainty during the referendum campaign.

However, judging from the relatively wide spreads that persist today between Canadian and U.S. medium- and long-term interest rates, we remain vulnerable to any shocks which may come along that increase investors' worries about the capability of Canadian governments to keep on their fiscal track. What this suggests to me is that if we want to reduce our vulnerability to financial market volatility and to high interest costs, we need a debt to GDP ratio for Canadian governments in total that is lower than it is now.