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HOUSE OF COMMONS OF CANADA
35th PARLIAMENT, 1st SESSION

SPEECHES : GOVERNOR. =

EVIDENCE

Standing Committee
on

PUBLIC ACCOUNTS

Chairman: Richard Bélisle

Meeting No. 81

Tuesday, December 12, 1995

ORDER OF THE DAY:

Consideration of Chapter 9 of the October 1995 Report of the Auditor General of Canada (Information for Parliament - Deficits and Debt: Understanding the Choices)

WITNESSES:

Bank of Canada:

Tim E. Noël, Deputy Governor;

Vaughn O'Regan, Adviser;

Gordon G. Thiessen, Governor.

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EVIDENCE

[*Recorded by Electronic Apparatus*]

Tuesday, December 12, 1995

.1530

[*Translation*]

The Chairman: Pursuant to Standing Order 108(3)(d) we will proceed today with consideration of chapter 9 of the October 1995 Report of the Auditor General of Canada, more specifically Information for Parliament-Deficits and Debt: Understanding the Choices.

Our witnesses today are Mr. Thiessen, the Governor of the Bank of Canada, accompanied by Mr. Noël and Mr. O'Regan. I will give the floor first to Mr. Thiessen, who will make his opening statement. We will then proceed as usual and you may address your questions to our three witnesses.

.1535

Mr. Thiessen.

[*English*]

Mr. Gordon G. Thiessen (Governor, Bank of Canada): Thank you, Mr. Chairman. I would like to begin by saying that I found the Auditor General's statement on public deficits and debt to be a very good statement of the issues. It is only in dealing with the role of interest rates in the persistent accumulation of the public debt that I may have something to add for your consideration.

[*Translation*]

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 surpluses.

[*English*]

We at the Bank of Canada have commented, particularly over the last couple of years, on the need for all governments in Canada to put their fiscal positions onto a more sustainable track. At a minimum, this calls for actions to stop the ratio of public debt to gross domestic product 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.

[*Translation*]

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.

[*English*]

That 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 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 of the English version, 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.

Thinking about economic policies, for example, there were regulatory policies in the 1950s and the 1960s that imposed a ceiling on the interest rates that 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.

.1540

[*Translation*]

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 1970s 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.

[*English*]

However, the fiscal position of the government sector would have worsened from the 1970s onward even without the higher debt service costs. 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 concerns about fiscal debt and deficits.

A good indication of the size of 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 rate levels that are costly to Canada over time. High interest rates discourage investment in improved productivity that could help 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.

[*Translation*]

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 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.

[*English*]

Because of the 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 this was helpful in the period of political uncertainty during the referendum campaign.

.1545

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 that 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.

Thank you, Mr. Chairman. My colleagues and I are ready for your questions. //

[*Translation*]

The Chairman: Thank you, Mr. Thiessen. We will now proceed to the question period. We will begin, as usual, with Mr. Laurin.

Mr. Laurin, you have ten minutes.

Mr. Laurin (Joliette): Governor, given that our interest rates are influenced, as you were saying, by the credibility of the federal government, and that it also seems to be recognized by many people that not defining a long-term schedule for the reduction of the debt partially undermines this credibility, could you tell us what the impact on interest rates is of the fact that the government does not define a long-term schedule for the reduction of its debt?

If I may explain, Governor, this was also mentioned by Moody's rating firm when it lowered Canada's credit rating from AAA to AA1 on federal government bonds. The New York agency justified its