

The UNIVERSITY of WESTERN ONTARIO

ECONOMICS STUDENTS' ASSOCIATION

Paul Martin Speaker Series Transcript

November 26, 2008

Ladies and gentlemen, the first thing I want to say is that it is with a reasonable amount of nervousness that I approach this podium today. I have been in this room before. As the Dean mentioned to you, I am a graduate of the University of Toronto. And I can remember coming here on many an occasion, watching the University of Toronto play the Mustangs in basketball. To be perfectly honest, I can not remember the University of Toronto ever winning. But I hope to do a little better with you here today.

Let me simply say, we are to have, as I understand it, I wide range of discussion. The purpose of this is not that I will beguile you with a lengthy speech, but that hopefully we can have a dialogue between us. And discuss the many issues that there are to discuss.

In my, what I now call, euphemistically, my post-political career, I spend most of my time on three issues. One of them is Africa. The other one, as the Dean mentioned, is the plight of Canada's aboriginal people. And the third is the whole question of the global economic architecture, and what needs to be done about it. Obviously, within this context, you would place the current financial crisis.

I was asked to open, and make my remarks specifically, given this is the Western Economics Students' Association, primarily on the financial crisis and what ought to be done about it. But I would hope that, as well, if you are so willing. We can open up the discussion, because almost all of the issues that the world faces today ultimately have an impact on Canada's economy, and the economy of most of our neighbours. So let me get in right off the bat, if I can find some water, let me begin right away with the current financial crisis.

Let me make a few points that will serve as the basis of our discussion. The first point is that financial crises are not the exception. They are the rule. In the nine years that I was finance minister, we had five financial crises. We had the Mexican peso crisis, which almost derailed my most important budget, followed by the Asian crisis. That was followed by September the 11th, which was obviously a huge human tragedy, but also brought about paralysis of the economic system. And then followed a succession that I would simply merge into two: the Russian default on its debt, the Argentine default on its debt, and the Brazilian devaluation.

Now, the point that I would make, is that governments should expect the unexpected Governments should understand that in the globally interdependent world that we live in, financial

crises are the norm. And they should be prepared for them. One of the difficulties that I had, it's somewhat ironic to say as finance minister, is that at the beginning nobody believed that we would eliminate the deficit. But once we had eliminated it, we started running up surpluses. For which we were criticized. But those surpluses were not by accident. We knew full well, that as a small market country of only 33 million people, in a world increasingly of only mega-giants, that there were going to be other financial crises, and we were in danger of being sideswiped. The only way we could handle that, is that if in fact we ran up surpluses that would give us the margin to be able to spend as we needed to spend, without going back into deficit.

The second point that I would make, is that the cause of most financial crises, is the flipside of the strength of most of the markets. First of all, there's no doubt that if you look at the world today, that the free market system – this is a bit of a euphemism in it self – the free market system is the essentially, and by far, the best economic system that we have been able to come up with. It has beaten the command economy. It has beaten socialism. Hands down. However, the free market system that we have is not a Darwinian market system. It is not simply Laissez-Faire. It is one that understands the necessity of the government supporting a wide range of social programs to sustain it. And there are many kinds of market systems. The so-called social market system of China, which is far more decentralized than people think, to what is becoming the increasingly socialist market system of the United States. Now, the reason that the market system works so well, is that the market system gives greater vent, greater opportunity for innovation.

(Microphone falls off)

There you go. I knew Western would do it to me.

(Laughs)

The market system essentially gives full vent to innovation. It gives full vent to entrepreneurial imagination which no bureaucratic system could ever do. On the other hand, that free, the freedom to innovate, that freedom to basically decide your own future regardless of what a bureaucracy might say providing you can raise the money in the capital markets in which to do it. Is also the basic reason why there is weakness, and why we have these financial crises. The problem is that innovation is inevitably taken a bridge too far, or a door is opened and when people go through it, they abuse the fact that the opening is there.

The best example I can give you is that the fundamental cause of the financial crisis of the banking system in the United States. When I left business in 1988 to go to parliament, I was at the cutting edge of what were then the cutting edge financial instruments. All of these derivatives, credit swap defaults. All of these new financial instruments that effectively got us into so much trouble, in 1988, these made a lot of sense. When I came out of government, and sat down and saw what had happened to them. I, who was at the cutting edge of them 20 years ago, I could not understand most of those financial instruments. In fact, most of the people in the US banking system who were selling them or were buying them did not understand. You began to understand what happens when the market system goes too far,

and that is the reason why I believe these financial crises are inevitable. Why there is a cycle in the market system: there is an introduction of a new idea, and then the idea is taken too far and it causes a crisis.

Now, the third point that I would make to you. Is that the worst crises that occur, are those that occur in the banking system. The reason for that is pretty simple: credit. Bank credit. Institutional credit. Lending, is the oil that makes the economic machine work. You can buy a house, if you can get a mortgage. You can expand your plant, if you can borrow the money to do it. If you can't, you're not going to buy your house; you're not going to expand your plant, which is happening now. But credit, in turn, depends on one very great intangible. And that is trust and it is confidence. You will lend me money if you are confident that I will pay you back. You will lend me money if you are confident that my business will do well enough to pay you back. If that trust and confidence doesn't exist, then there is no way that the market system is going to work.

When I was finance minister, as some of you may know, I turned down the bank mergers. To take you back, the history of banking since the 1950s has been a major battle between the financial centres of the world as to who in fact was going to be the world's banking centre. At the beginning Paris tried and failed, Frankfurt tried and failed, Tokyo tried and partially succeeded in Asia – but the great battle was between London and New York. And both countries deregulated their banks enormously in order to attract financial capital and the movers and shakers of the financial world to their country. Canada was never going to be the banking centre. My biggest concern was the safety of our banks. We had six banks, and of those six banks, we could not afford to lose one. The Americans have 9,000 banks. We didn't think they'd lose as many as they have, but we figured they could far easily absorb these kinds of things. That's why we didn't deregulate. We understood how important a sound banking system was to the ability of our industries to be able to compete.

Now, if you look at every crisis that has come along, in virtually every case, you will find what I've said. There's been a banking failure one way or another and that crisis was inevitable if you took a look at the internal workings of the country. Now the difference, between this crisis and the others, is that the other crises, the other ones, the 1997 Asian crisis, was the failure of the banking system because of a flood of hot money from outside, in countries like Thailand, Indonesia and Malaysia. The failure of this crisis, and the reason it is by far the worst we've had since at least 1945, is also the failure of the banking system arising because money is coming inside into the banks and it creates a bubble. And that bubble then leads to huge bubbles around the world, but the difference is, that when Thailand goes down its one thing, when Indonesia goes down is another. But when the United States goes down, it takes the world with it. And that's what we are in fact facing now.

Now, what should be done? Well, first thing is, do not allow protectionism to take hold. That's the reason that the recession of the 1920s and 1930s became the depression. The second thing is, you need a buyer of last resort. Alan Greenspan, who in my opinion is one of the great Federal Reserve chairmen, is being very criticised, because in fact what he did was, brought down interest rates and created huge amounts of liquidity in the U.S. system. The fact is that

the people borrowing then created a housing bubble, and many of the problems we have today come from that period. But the reason that Alan Greenspan did that was because after the Asian crisis, there was nobody who was prepared to buy, nobody could move. There was only one person in the whole world who was going to be the consumer of last resort, and that consumer was the American consumer, who was indebted up to his or her eyeballs. What he did was basically loosen the monetary purse – and they borrowed. They essentially stopped the Asian crisis – and lead to a lot of problems subsequently, but that happens to be the unfortunate consequence. You need a buyer of last resort. Well that buyer of last resort in the United States no longer exist. Because no one will lend to him, and even if they did he couldn't afford it.

That's why what you're seeing today, and you might have seen it the other day from Paul Krugman who won the Nobel Prize for Economics this year, has essentially said the only answer is to spend like a flood. The only answer to the situation in which we find ourselves today, is to spend enormously. That's why at the G20 meeting in Washington that took place a week ago, all the major economies agreed that they would spend between 0.5 and 2% of their economies. Now, I've got to tell you, and most of you are in one way or another economics students, that's why what you are now seeing today – if you had put it on last year's exam, you professors would have failed you – the fact is, they are now doing the exact opposite of all economic theory. And they are doing it because of the state within which the economy is in. Let me just explain this to you.

Why shouldn't you overspend, why shouldn't there be excess liquidity – why shouldn't central banks just bring interest rates all the way down? It's because of inflation. Because if you do that you're going to have galloping inflation. But there is one thing worse than galloping inflation. And that is deflation. Because what governments can do if you have galloping inflation is stop it. Governments can step in and stop an economy in its tracks. That's what Paul Volcker did in 1981 when interest rates reached 22%. But what governments can't do, is make you borrow or make you go buy something when what you really want to do is keep your money and try to protect it. You can't change that. And we're now in a situation, having told people to save and save and save, what government's are now telling you to do is spend and spend and spend. And the reason is that if we get into a deflationary period, and the last ten years in Japan is a classic example of it, is that it will be impossible for governments to get you out of it.

Now the last thing, that should be done, and on this I'll close – my father, who was a politician, always said “if you're going on too long, tell them you'll close. They'll believe you, and you can go on forever.”

(Laughs)

The last thing that has to be done is to get everybody around the table. By everybody, I mean the world. We did three things – I was G7 Finance Minister during the Asian Crisis – we did three things, most of which were Canadian initiatives by the way, that were very good but that came up lacking. One, we set up the Financial Sector Assessment Program. Essentially, the problem that we really have is that bank regulation is essentially done country by country, and

there is a really great shortage of great bank regulators. But the fact that it's done country by country, means there's a lot of political pressure. So we established a program whereby three countries would be named to take a look at the banking regulation of the other countries. You do a peer review of all of the various banks so that, for the sake of discussion, we would look at the Brits, they would look at the French and they would look at us. Canada, because it was our idea, had the first peer review. But one country that has never had a peer review, and refused to do it, was the United States – on the ground that you don't have to look at us. I have no doubt that had that review been done of the U.S. banking system over the last four or five years, we would not be in the mess we are now.

The second thing that was done, we created the financial stability forum. The financial stability forum is a group of people who get together, central bankers, finance ministers and officials – but not regulators, well some regulators, but to try and figure out what's going on beyond regulation. Because the other thing that's going on in the market system is that if you establish regulation here, they'll find their way around it in two years. So, you've got to get one step ahead of them. At this meeting, the G7 finance ministers basically took up the financial stability of the seven G7 countries and one or two Europeans. We in Canada said you need to bring in China, India, Brazil, South Africa and Mexico. That was turned down. Now remember this, that was ten years ago, and the general view of the financial community at that time – except for Canada and one other country – was that the world economic capacity would be run by seven countries, of which only one was Asian – Japan, and that the great emerging economies were only specs on the horizon and didn't count. Now, but at the same meeting, Canada suggested that an alternative to the G7 be created, called the G20 finance ministers, on the grounds that you could not exclude the great emerging economies. And therefore, the G20 finance minister was created, and when I became Prime Minister, I said you have got to, at the leader's level, create a G20. The G7 has had it, the architecture of the world's economic system is as dead as a dodo, it is like a museum, they are vestiges of past that is long since gone. But we did not succeed until two weeks ago when George Bush accepted to have a G20 meeting on the leader's level. I had gone and met with every G8 and every G20 country and every one accepted, except for the United States. Fortunately, the one silver lining in this current financial crisis is the absolute necessity of having the Chinese, the Indians and the Brazilians at the table.

I'm going to give you one last example of the sheer elegance of the West, and why it is so important that the G20 succeeds – and it remains to be seen if it will succeed, and we may get into this if you want to talk about it. I went to two G8 summits, one was in Georgia and the other in Glen Eagles in Scotland, the one you may remember, the one in Glen Eagles, Scotland was when the London bombings took place. Now I want you to picture, in terms of a global economy, where China now has an economy bigger than any European economy, India is close, and within the not too distant future, in fact China's economy will be larger than that of the United States. They are the largest single holder of U.S. debt, and they are now, according to Hank Paulson, the U.S. Secretary Treasurer who basically asked them three weeks ago, the only people who can stimulate their economy sufficiently – who can make the

world in fact begin to move. I want you to picture this meet. Glen Eagles, Scotland, we G8 leaders go into the meet. We go in at 9:00, the purpose of our meeting at 9:00 is our lunch meeting with the G5, China, India, Mexico, South Africa, and who did I forget, somebody, anyway. Shows you. (Laughs) And what was happening? Our meeting is taking place, we've invited the president of China, the Prime Minister of India to come across the globe to come to Glen Eagles, but they're not invited to the whole meeting. They're invited for lunch, and when lunch is over they're dismissed. I'm sitting in there, and I'm looking at Berlusconi, and I look at myself and I'm going we're dismissing the President of China, and the Prime Minister of India, because they're economies, which are five times bigger than us, are not significant enough to talk to us about the state of the world. And then, so I raise it at the meeting. "These guys are out there, for heaven's sake, you don't want to create a G5 there – a G8 here and a G5 there – what do you think they're doing in that corridor? They're in the process of creating that G5, our arrogance is going to do it." And what happened, we made a commitment. The summit that was going to follow that, in Germany, and the one that was going to follow that in Japan, they would be invited as full members. And they were not. And so they walk out, and basically said, we will not co-operate with you, we will not co-operate with you if you think we are going to come and see you as beggars with beggar's bowl. And then they went into the Doha round, and why did the Doha round of negotiations fail? Because when the United States and the G8 countries said here is our position, Indian and China lead the opposition. I believe that there is an opportunity now, with the G20 having been called, for the first time, for us to put together a global steering committee of all the great global powers of the world. And also, by the way, the great countries of poverty in the world – for the first time the world of reality would be represented. If I was asked, what is the single most important thing that can be done to get us out of this mess, it is going to be to recognize that we are one common humanity, divided perhaps into economic entities called countries, but the time has come for us to work together. And on that, I turn the conversation over to you.

For more media on Paul Martin's visit to the Western Economics Students' Association, including an audio version of this speech and hour-long question & answer period, please visit WesternESA.com