FINANCIAL RESTRUCTURING: IMPLICATIONS OF RECENT CANADIAN MACROECONOMIC DEVELOPMENTS

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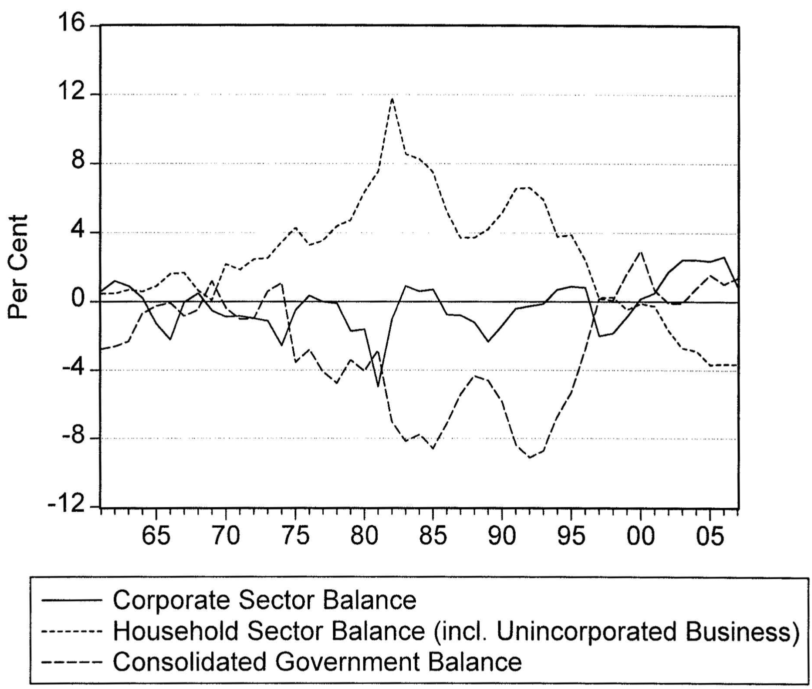
The Canadian economy experienced substantial economic restructuring in the closing decades of the twentieth century. This process, much of which was directed and legitimized by the hegemonic emergence of a neoliberal ideology, put its stamp on the economy and has largely defined its contemporary character. Behind this important transformation, one finds not only the forces of globalization, which many on the Canadian Left have traditionally identified,[1] but also the systemic forces underlying the longer term development of financial institutions and activities, on one hand, and the historically changing relationship between finance and capital accumulation, on the other. From this perspective, the late twentieth century economic transformations experienced not only by Canada, but also by other highly industrialized capitalist countries, involved a movement from an earlier Keynesian form of industrial capitalism, where finance was regulated (as under the Bretton Woods system during the early post-World War II period) and subordinated to productive industrial activity, to a predatory financial capitalism, where casino-type activities have become the norm — a process that is sometimes described as one of "financialization" with an almost complete decoupling of the financial sphere from commodity production.[2]

A growing volume of research is documenting the newly emergent structure: apprehending its internal tensions and immanent tendencies; investigating how these tensions and tendencies are likely to manifest themselves, and discerning their implications for concrete political strategies. One international strand of this research has drawn attention to the impact that this restructuring has had on the macroeconomic sectoral balances.[3] Utilizing flow-of-funds accounting identities that link these sectoral balances[4] and applying them to Canada, an examination of the sectoral interrelations and their changing net balances reveals a reconfigured macroeconomy in Canada as well. For example, as can be seen from Chart 1, the fiscal restructuring that helped generate the government surpluses since 1995 has, as its counterpart, a plummeting personal saving rate and increasing indebtedness of the household sector.[5] Furthermore, with the expiration of the twentieth century, the balance sheet of the corporate business sector also moved strongly and persistently into a surplus position. Thus abstracting for the moment from net foreign savings, the new century in Canada is marked by a virtually unprecedented stretch of public sector surpluses, private corporate surpluses, and household sector deficits.[6]

Chart 1: Net Lending/Borrowing by Major Sectors as a Percentage of GDP Canada, 1961–2007



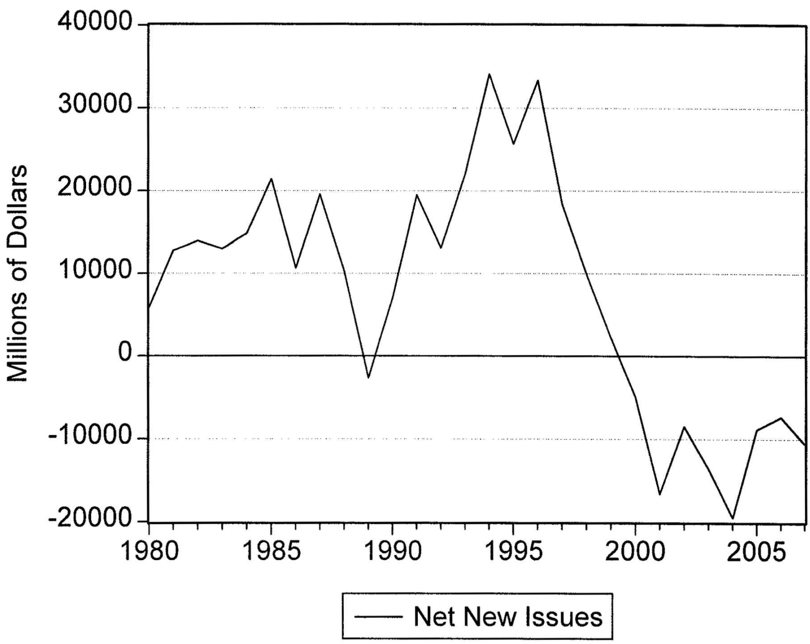
Source: Statistics Canada, Financial Flow Accounts, CANSIM II, Series V31751, V31786, V33360, and V498086.

This paper examines financial implications of this late twentieth century economic restructuring, and situates those developments within the larger context of the reconfigured sectoral balances of the Canadian economy. The structure of the paper is as follows. Section I identifies some financial implications of the fiscal revolution that secured the significant government surpluses, and the low inflation regime that accompanied this period. Section II considers financial implications of the restructuring of labour and product markets, and of the labour process itself. The implications are presented first from the perspective of firms (i.e., capital) and then from the perspective of households and workers (i.e., labour). Section III turns to the problems of adjustment, and argues that the instability incidental to the twenty-first century Canadian economy requires further restructuring. The conventional wisdom regarding fiscal and monetary policy is critically revisited. A brief conclusion follows.

The Fiscal Revolution, the Low Inflation Regime, and the Financial Crisis The fiscal revolution of the 1990s is reflected by a shift in the consolidated balances of all levels of government from decades of annual deficits to a new era of sustained surpluses. For instance, on a national accounting basis for the consolidated government sector, the budget deficit had reached a peak of almost $64 billion in 1992, while in the 2001 fiscal year, the budget surplus peaked at $28.6 billion. In each of the last four fiscal years, the consolidated government surplus has exceeded the $20 billion mark, with the balance for the year ending 31 March 2008 coming in at $28.1 billion.[7] For all levels of government, as well as for the federal government taken separately, the deficit-surplus Rubicon was crossed in 1997. The pre-1997 deficits were debt financed, and for the federal government this involved issuing government securities in domestic financial markets. This string of sustained deficits resulted in the accumulation of the net outstanding stock of government securities held by the private sector. By the end of 1996, Government of Canada securities funded federal debt of $464.6 billion.[8]

The annual net new issues of federal government bonds since 1980 are shown in Chart 2. Over time, positive levels of net new issues produced a growing pool of desirable, low risk securities available to (primarily domestic) private sector agents. As the chart indicates, in the aftermath of the fiscal revolution this net flow was reversed. Despite the continued accumulation of private sector wealth incidental to a growing economy with resurgent profitability, the availability of these preferred securities decreased, not just relatively, but absolutely. Wealth-holders were, and are, compelled to adjust their portfolios as higher risk alternatives are forcibly substituted for the shrinking stock of government bonds.

Chart 2: New Bond Issues of Federal Government, Canada 1980–2007



Source: Statistics Canada, CANSIM II Series V122305.

It should also be noted that this fiscal revolution occurred in a domestic, as well as international, macroeconomic environment of relatively low and stable inflation. Since the early 1990s, annual rates of increase in the Consumer Price Index (CPI) have remained consistently within the one to three percent target range of the Bank of Canada. Holders of multiyear bonds reaped handsome gains through the 1980s and early 1990s, as the transition from a high to a low inflation environment took place with inflation-adjusted (or "real") interest rates reaching at the time unprecedented historical levels. Since then, however, as the high interest bonds issued in an era of higher inflation mature, their latter-day replacements necessarily carry much more modest returns. Having been accustomed to high returns in the not-so-distant past, wealth holders and their representatives in the financial sector were especially eager to embrace other financial instruments and portfolio strategies that held some promise of enhanced returns.

Furthermore, the advent of a period of low and stable inflation induces financial investors to downplay significantly the possibility of renewed variability of inflation rates, and/or of a period of rising average inflation levels. Policymakers and central bankers in particular had for many years emphasized their commitment to getting inflation under control, and conventional macroeconomic theory had for decades allocated enormous intellectual resources to neoclassical models and theories that highlighted the importance and desirability of the commitment and credibility of central bankers to the achievement of low and stable inflation rates. This literature, taken as a whole, tended to imply that the only significant systemic risk facing financial agents in the macro economy was the risk associated with inflation. With inflation remaining stable at very low levels since the early 1990s, that risk was gone, and the risks that remained were those associated with individual firms or specific markets in the larger macro economy. These are individual or idiosyncratic risks, to which a measure of protection could be provided to individual investors based on conventional strategies of asset diversification. The creation of new financial instruments linked to the proliferation of financial derivatives are thus motivated and peddled as sophisticated means through which this idiosyncratic risk could be optimally carried. In short, after decades in which relatively large public sector deficits and relatively high and variable inflation rates dominated both public economic discourse and much of the macroeconomic research agenda, the start of the twenty-first century was readily interpreted as the dawn of a new era of macroeconomic stability.

The famous heterodox American economist, Hyman P. Minsky (1919–1996), had long argued that the roots of systemic financial instability normally take hold and find new breeding ground in a seemingly stable macroeconomic environment,[9] and developments over the last few years effectively underscore this very point. Specifically, the push to find new sources of pecuniary reward through financial innovations constantly tempts market agents to become more highly leveraged. With the deregulation of financial markets during the preceding decades, an appealing new source of pecuniary return was found in the market for financial derivatives. A derivative is simply a contract that is traded between two parties (with or without going through an intermediary or organized exchange market), representing a guess about the future value of a vast variety of assets, whether these are commodities, equities, bonds, foreign exchanges, and so on. While, in theory, a derivative (in, say, a futures market) could serve as hedge against risk, for instance, to a farmer who wishes to secure a value for his grain in the uncertain future, the proliferation of the market for derivatives in the hands of speculators could be a source of tremendous instability if traders trade with other speculators instead of hedgers.

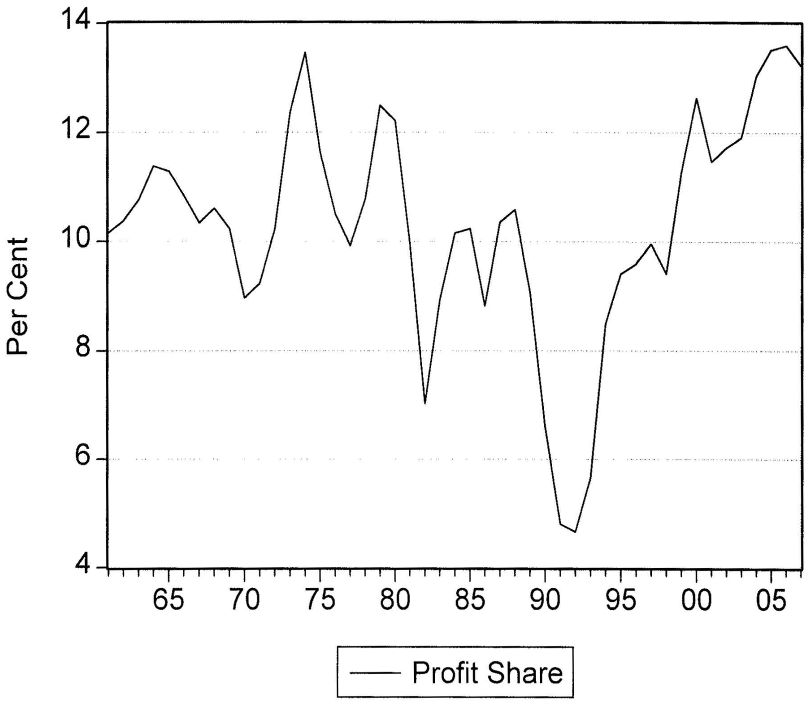
The speculative mania that exploded into the subprime crisis in the United States was not, as it was so widely decried in the media, primarily the result of the immoral behaviour of US mortgage dealers seeking quick commissions through "teaser" rates offered to all-too-willing households, many of whom would otherwise have had difficulty even qualifying for a mortgage. Undoubtedly, legal and ethical boundaries were transgressed by numerous players, ranging from mortgage vendors[10] to hedge fund managers,[11] and the phenomenon of rising real estate prices and the speculative mania that it fosters helps generate a fertile environment for the exercise of dubious practices. However, it is primarily the unwinding of the derivatives market in mortgages that has created the havoc and spread the contagion throughout the world and, not coincidentally, has also involved a good number of Canadian financial institutions. This is because these mortgage loans were "securitized" or repackaged into financial derivatives, the so-called "collateralized debt obligations," and sold to investment banks and other financial institutions worldwide. It is the fallout arising from the collapse of these highly leveraged derivatives that is causing turmoil in the financial markets. Indeed, a year after the subprime crisis began in the United States, the Federal Reserve vice-chairman, Donald Kohn, was still telling the US Senate Banking Committee (on 5 June 2008) that "the worst is yet to come"! The outcome that has affected financial markets internationally in varying degrees has led to a credit crunch by creating enormous uncertainties in the financial markets internationally, thereby making banks nowadays ever more reluctant to finance productive activities.[12]

An obvious manifestation of this crisis and the fears that it has generated in the financial markets is the high volatility of the financial returns on corporate securities in relation to central bank rates. Indeed, these financial market spreads have displayed some pretty wild gyrations not seen since 2001. If one looks at some indication of the increasing risk premiums as reflected, for instance, in the spread between the cost of interbank borrowing (the overnight rate) and the prime corporate paper rates (one to three months), these spreads fluctuated by very wide margins, as investors sought to realign their portfolios. From when the crisis began to show subtle signs in early 2007 to when it officially broke out in August 2007, these corporate financing rates grew and reached a historical peak of as much as 67 basis points above the Bank of Canada overnight rate.[13] On the other hand, by February 2008, as the US Federal Reserve's bailout of investment banks became imminent, the spreads had reached a low of 16 basis points below the Bank of Canada base rate — indicating how fearful and edgy the financial markets had become in Canada as a result of the emerging financial crisis in the United States. How these financial markets will eventually settle is still everyone's guess; however, much like a ship on a dark and stormy sea that may be headed towards an iceberg, at the time of writing (which is more than a year since the turmoil began to show subtle signs in early 2007), the full scale of the crisis has yet to be revealed.

Financial Implications of Labour and Product Market Restructuring

Implications for Capital and the Corporate Sector The massive economic restructuring unleashed upon the Canadian economy throughout the 1980s and the better part of the 1990s can be viewed as a victory for capital and, by the close of the century, the spoils accruing to the victor were becoming increasingly apparent. Before-tax corporate profits (in current dollars) reached \$110.8 billion in 1999, up from \$86.1 billion the year before. In 2000, profits surged yet again to the \$136 billion level, and then after a slight dip in 2001, continued their upward climb, recording an unprecedented \$203.2 billion for 2007.[14] As a percentage of GDP, the before-tax profit share is presently at a level that, by recent historical standards, is relatively high (see Chart 3). The profit rate,[15] considered historically, is showing even greater strength, as can be seen from Chart 4.

Chart 3: Share of Profit Out of Gross Domestic Product, Canada, 1961–2007



Source: Statistics Canada, CANSIMII Series V646928 and V498086.

Chart 4: Profit Rate of Canadian Business Sector, 1961–2007

Source: Statistics Canada, CANSIMII Series V646928 and V1408425.

The robust profitability of Canadian business has encouraged some real investment. Real gross fixed capital formation in the business sector increased 6.3% in 2003, 8.1% in 2004 and in 2005, and 7.0% in 2006, although the torrid pace slowed to 2.9% in 2007 and for the first quarter of 2008.[16] Nevertheless, this surge boosted real business investment as a percentage of GDP from the 15% to 17% range that characterized the 1990s to a 19% to 20% band in 2006 and 2007.[17] This is close to the peak investment/GDP ratios of 20.4% and 21.5% that were recorded in 1974 and 1981, respectively. But, unlike previous investment booms, this growth in overall investment went inordinately into housing and the oil and gas sector, while investment in the Canadian manufacturing sector remained somewhat anemic, especially after the high-tech collapse in 2001.

Even with this investment surge, however, the corporate sector balance has retained its surplus position with levels, as a percentage of GDP, not matched for half a century. Despite increasing levels of real investment, both absolutely and as a percentage of GDP, corporate demands for funds in capital markets have eased. Some corporations have taken advantage of this surplus position to reduce debt levels and pursue share buybacks. Placing these recent developments in the larger institutional context, it is important to recall the financial market liberalization of the 1990s. That liberalization, and the concurrent proliferation of new financial instruments, was understood to erode barriers, including transaction costs that hitherto had operated to constrain the access of agents to pools of finance. The easing of such constraints would be expected to result in a dramatic expansion of the range of financial instruments available, and in the quantities traded. The cost of finance would fall while accessibility increased, and the promise of efficiency gains would redound to the benefit of all.

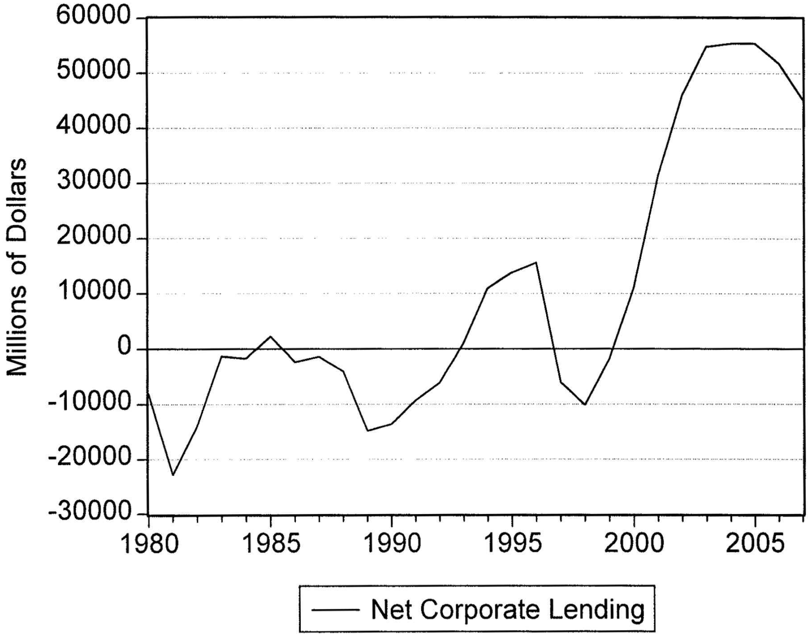
The latter half of that decade did indeed witness an expansion of financial activity. Gross new issues of corporate bonds increased dramatically, rising from $21.7 billion in 1994 to $59.2 billion in 1997 and a record $105.9 billion in 2001.[18] Gross new issues of common corporate stock soared to a cumulative total of $107.7 billion for the 1996–2000 five-year period.[19] In contrast, total new issues for the 1991–1995 period amounted to a more modest $71.4 billion of new common shares, and the 1986–1990 years had gross new issues of only $48.3 billion.

This expansion proved to be short-lived. With the emergence in the twenty-first century of sustained surpluses in the corporate sector, the number of gross new issues of corporate bonds and common stocks starts to level off, while the volume of retirements of both bonds and stocks increase markedly. Net new issues of corporate bonds have consequently fallen dramatically since their peak in 2001 (levels for 2007 are about 1/3 the value recorded for 2001). A similar reversal occurred for common stock from the late 1990s up to the end of 2006. Net new issues of common stock reached $20.5 billion in 1997, but were only $3.3 billion in 2005, and actually were negative (-$1.6 billion) in 2006. These net issues rebounded strongly in 2007 and the first quarter of 2008. It is, however, too early to discern whether or not this is a reversal of the trend, and recent evidence suggests that many of these new issues are coming from banks themselves, as they react to the liquidity crunch and face a market that is now reluctant to acquire various portfolios of loans that the banks would like to unload.[20]

Taken as a whole, the corporate need to issue debt and equity in order to finance business activity has abated sharply. Finance is still required for major undertakings involving mergers and acquisitions, and the strong corporate balance sheets in conjunction with a low interest rate regime have continued to fuel these exercises in increasing corporate concentration. However, a significant part of the corporate involvement in the neoliberal-induced expansion of financial activity has, in the twenty-first century, taken a quite different turn. The national savings rate, which fluctuated between a low of 0.5% and a high of 9% throughout the 1990s, has moved well above this range and has returned to levels experienced through the 1960s and 1970s. There is a difference, however. In the twenty-first century, it is the corporations that are generating most of the savings. They have become the net lenders, and, as shown in Chart 5, the magnitude of this net lending is substantial. Indeed, because of the significance of this corporate net lending, an important spillover of these growing corporate savings has now been flowing outside of Canada. This would partly explain why, for the first time in Canadian economic history, instead of being a net receiver of foreign investment, Canada since 1999 has become progressively a net exporter of capital, with growing investment and financial acquisition of foreign assets by Canadian corporations in the rest of the world.

Also, among other things, this repositioning of the players in financial markets implies that the simple circular flow diagrams that inhabit introductory economics textbooks will need to reverse the direction of the arrow of causation representing the flow of funds from lenders to borrowers via the interposition of financial "intermediaries." Now it is the firms that make funds available to households, not the other way round. The conventional story, where household savings finance business investment and capital accumulation, is turned on its head as the nonfinancial corporate sector has now become a net lender to the household sector. On the supply side, however, these corporate lenders place a considerable premium on liquidity.

Chart 5: Net Corporate Lending, Canada 1980–2007



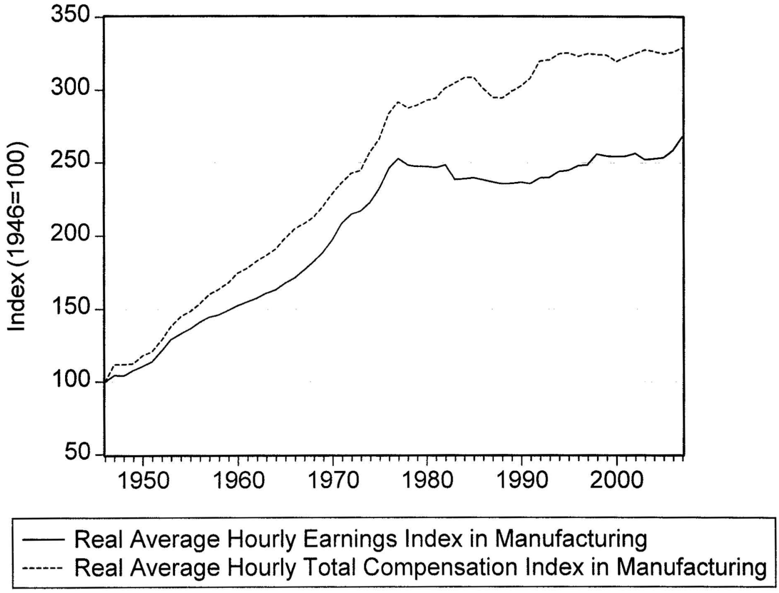
Source: Statistics Canada, CANSIMII Series V498513.

Opportunities and challenges in the business world demand flexibility on the part of corporate players, and part of this flexibility requires an ability to mobilize financial resources quickly. Thus, as lenders, short term loans and highly liquid markets are desired. These properties are not the properties sought by households seeking credit. The role of financial intermediaries involved producing financial instruments that could, often in financially creative ways, enable the demand by households for medium- and longer-term credit to be aligned with the short time horizons and high preference for liquidity of corporate savers. The incentive for financial innovation, and its measure of success, was understood to lie in this ability of financial institutions to attract and capture the pools of savings of the corporate world. As the next subsection indicates, there was little need to manufacture anything new on the demand side. That had already been generated.

Households and Labour The restructuring of the Canadian economy exacted a toll on labour. The multiple avenues through which this toll was levied have been well documented. They include the leaner and meaner workplace installed in both the public and private sectors; the restructuring of employment insurance; the decline of public services and the widespread use of various forms of user fees on members of the public seeking to avail themselves of those services; the use of unemployment as a weapon in the fight against inflation; and the increasing action by the state to regulate labour, such as business-friendly changes to labour legislation and the deployment of the coercive power of the state in industrial disputes, often in the form of back-to-work legislation and the selective abrogation of the right to strike.

The manifestation of this toll on labourers and their households and communities is anything but uniform, and varies across time and space. At the aggregate level, however, one outcome shows up in the form of wages and household incomes. Over the last decade, as real economic growth rates increased and as profits and profitability soared, the situation for workers was noticeably different. On some counts, there is some evidence of improvement. For example, aggregate participation rates have inched upwards while aggregate unemployment rates fell by a full three percentage points. In addition, the index of labour productivity rose to 116 in 2006 relative to a 1997 base of 100.[21] However, the growth of real wages has been miniscule. From 1997 to 2007, average hourly earnings increased a total of only six percent in real terms,[22] which works out to an increase of about one-half of one percent per year. Indeed, from our evidence displayed for the manufacturing sector alone in Chart 6, we see that, except for 2007, real wages have been relatively flat since the mid 1970s, when the long period of early postwar growth had come to an end. Furthermore, those workers in the lower half of the income distribution ladder received increases that averaged below this aggregate average. Substantial real increases were realized primarily for those positioned at the top of the earnings scale. For example, in the private sector, managers saw their real hourly earnings rise by 20.3% over the last decade. All other private sector employees, however, enjoyed an increase which, on average, worked out to only 4.6% for the entire 10-year period.[23]

Chart 6: Index of Trends in Real Wages and Real Total Labour Compensation in Canadian Manufacturing Industries, 1946–2007



Source: Statistics Canada, Employment, Earnings and Hours, 1965–1985; Man-hours and Hourly Earnings, 1945–1965; Historical Statistics of Canada, 1983; CANSIM II Tables 281-0022, 281-0030, 281-0033, 281-0039, 281-0008, 281-0009, 383-0001, and 383-0005.

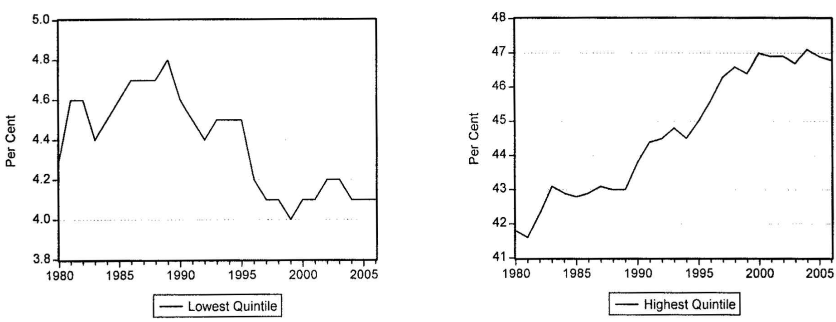
With the majority of individual workers facing sluggish real wage growth, one avenue to increasing household income would be an increase in hours worked. This, in fact, happened. The average work week for hourly employees averaged less than 31 hours in the first half of the 1990s. Beginning in 1997, it moved up to 31.5 hours and has averaged slightly above this mark through to 2007.[24] Some households composed of more than one person of working age may also have the option of increasing their total household labour by bringing more household members into the labour force. This has also occurred, and national labour force participation rates have increased from an average of 65% in the mid-1990s to an average of 67.4% for the years 2003 to 2007.[25]

Thus, despite very modest real wage growth, these supply-side labour market responses have helped sustain and augment the incomes of some

Canadian households. However, the recent rise in average market income[26] for households also reflects the property income earned by wealth holders, who are disproportionately situated on the upper ranges of the income distribution scale. Including all types of market income, average household income in 2002 constant dollars rose from $47,900 in 1995 to $57,900 in 2006,[27] an increase of 20.1%. Median household incomes, however, were lower (only $43,110 in 2006) and had increased only 15% over the same period.[28]

This growing gap between average and median household incomes is indicative of growing household inequality in Canada, and this inequality is being driven primarily by market-generated incomes. Despite some adjustment in their labour supply, the family incomes received by most working-class households are falling further behind those of wealthy, high-income households. As displayed in Chart 7, for the highest and lowest quintiles of income groups in Canada, the distribution of household income has been widening in recent decades. Between 1980 and 2006, only the top quintile of family units had their relative income share go up (from 42 to 47% of total household income). The other 80% have been increasingly receiving a smaller and smaller portion of the income pie, with some of the most substantial decline taking place during the mid 1990s after the "fiscal revolution," which saw substantial cutbacks in public sector jobs and employment insurance and welfare programs.

Chart 7: Percentage Income Shares of Lowest and Highest Quintiles, All Family Units, 1980–2006



Source: Statistics Canada, CANSIM II, Series V25731827 and V25731831.

Thus the majority of working-class households found themselves constrained by virtually stagnant real incomes, while their relative income levels were falling further behind those in the upper income cohorts. At the same time, households, including those in the lower and middle income brackets, continue to be assiduously targetted with the assistance of ever more sophisticated marketing techniques by corporations seeking sales of consumer goods and services. Meeting the irresistible pressure for sales in the context of a culture of consumerism with the virtually immovable level of real household income helped induce an adjustment of the saving and spending propensities of these households.

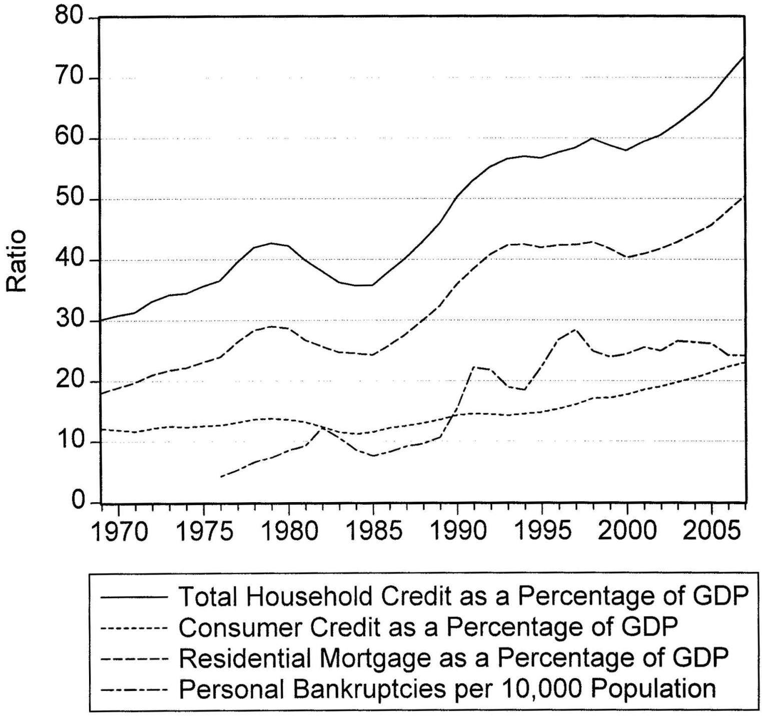
This adjustment was further encouraged by other macroeconomic factors. Falling unemployment rates and the receding memory of 1990–1991 — the last serious recession — helped reduce the expectation of the likelihood of major job losses and serious disruptions of employment, and consequently bolstered consumer confidence. Interest rates had already come down from the punitive rates of the 1980s, when a double digit prime lending rate was the norm. After a renewed rise in the late 1990s, interest rates once again resumed their downward trajectory, and the twenty-first century has consistently seen a prime lending rate below six percent. Finally, the equity market boom of the roaring 1990s — fuelled in part by financial deregulation, renewed corporate profitability, and increased advertising and marketing of equities through the media and various online sources — enhanced the nominal wealth of middle- and upper-income households who either directly held corporate shares, or who held them indirectly though pension funds. The Toronto Stock Exchange (TSX) price index gives an indication of the magnitude of this boom. Between 1995 and 2000, the index rose from 4,434 to 9,608, i.e., more than doubling over a period when the CPI increased by less than 10%. After the drop precipitated by the collapse of the dot.com boom in 2001, the TSX renewed its ascent, surpassing the precollapse peak in 2005 and moving beyond the 14,000 mark in May 2007.[29] Thus, an equity-based wealth effect enhanced the propensity to consume. The personal savings rate continued the decline that had started back in 1982. From that 1982 peak of 20.2%, this savings rate had fallen to seven percent by 1996, then slipped down to an unprecedented two percent in 2005, and has subsequently hovered around the three percent level on into 2008.[30]

With a personal savings rate for the entire household sector sitting at these low levels, it is easy to imagine many households taking on increasing amounts of debt. The seductive allure of consumer goods and the desire to maintain and increase both absolute and relative material standards of living provide the motivation; but the low interest rates and the eagerness of financial institutions to meet and, in fact, encourage and amplify this demand created the perfect storm for the expansion of household credit. Consumer (non mortgage) credit to households increased from $130 billion in 1996 to $203 billion in 2001 (an increase of 56% over five years). This expansion has not abated. Over the last five years (March 2003 to March 2008), consumer credit has in fact grown 65%. As of March 2008, this credit amounted to the sum of $377 billion.

A similar trend has developed with the household mortgages. Part of the increased spending has been on housing, and the environment of low interest rates and enhanced access to credit makes house-buying an increasingly attractive option for consumers. This has helped fuel an increase in housing prices,[31] which in turn has three further effects. First, since the home is, for many households, the primary form of wealth, an increase in housing prices reinforces the wealth effect, which tends to induce increased consumer spending. Secondly, rising house prices have generated an expectation of even higher prices in the future, thereby encouraging consumers to buy now, even if such a purchase requires significant debt financing. Finally, rising house prices increase the nominal value of consumers' equity. Lending institutions were increasingly prepared to recognize this equity and use it to secure the extension of additional credit, often by providing personal lines of credit, to the homeowner.

As a result, the value of mortgages extended to households increased along with the increase in consumer credit. Specifically, the value of mortgages grew 30% between March 1998 and March 2003 (from $388.4 billion to $504.5 billion), but then this mortgage activity intensified and expanded by another 60% over the next five years, reaching a value of $839.4 billion as of March 2008.[32] Total household credit outstanding

Chart 8: Evolution of Credit Ratios as Percentage Share of GDP and Personal Bankruptcies as a Proportion of Population, Canada, 1969–2007



Source: Statistics Canada, CANSIM II Series V6213, V36408, V36409, V36410, and V510005.

(consumer credit plus mortgages) stood, as of March 2008, at $1.2 trillion, and it is worth noting that, despite the outbreak of the credit crisis in August 2007, the rate of increase in total household credit for the March 2007 to March 2008 period was 12.3%, which surpassed the 10.4% rate of the previous 12 months.[33] Indeed, as displayed in Chart 8, household credit as a percentage of GDP has more than doubled since the early 1970s and households remained saddled with a huge debt load.[34]

Thus we have, in the aftermath of the restructuring of the late twentieth century, a macro economy where strong and sustained consumer spending is playing a major role in pushing demand and supporting growth in the

Canadian economy; but this process is increasingly underpinned by growing consumer debt, on the one hand, and stagnant real wages concomitant with increasing corporate profits on the other. The financial sector has moved quickly to exploit this situation, pushing ever increasing amounts of credit towards consumers while producing the financial instruments to attract and retain the pools of savings accumulating within the larger corporate sector. Systemic sustainability requires continued corporate profitability, corporate access to liquidity, and continued household solvency and confidence. The rapid accumulation of consumer debt, the worsening distribution of income among households, and the increases in profits in the face of stagnant real wages suggest, however, that this scenario is not sustainable over time. Further adjustment and restructuring would appear to lie ahead.

Instability and Adjustment Real gross domestic product declined during the first quarter of 2008 for the first time in five years and there are fears of a further plunge into recession — the yet unspoken "R" word that, in Canada, has not been pronounced, at least officially, since 1990. In the United States, weaker consumer spending, attributable in part to the unfolding credit crisis, has adversely affected the growth of demand in what is still Canada's largest export market. This, in conjunction with the soaring Canadian dollar, which has now established itself as a petro-currency internationally, suggests that, for Canada, the era of robust export growth is coming to a close. High commodity prices will continue to attract investment in selected resource industries and also on the attendant transportation infrastructure that such staple production demands but, beyond that, growing excess capacity[35] rather than heightened rates of fixed capital formation are emerging as the new defining face of the production activities of corporate Canada.

Business sector surpluses can continue to support merger and acquisition initiatives as well as outflows on the capital account. For Canadian households, however, the elastic extension of credit will — in the context of rising debt-income ratios, the sobering effect of the credit crisis on financial markets, and the erosion of consumer confidence — increasingly start to experience difficulties in sustaining past rates of expansion. Unlike the previous era when the Bank of Canada stimulated household spending by cutting interest rates, fears of accelerating inflation may prevent the Bank from cutting interest rates any further — not to mention the fact that the room to manoeuver by cutting interest rates is quite small at present. Indeed, nominal interest rates are relatively low when compared to the levels of the late 1970s and early 1980s and, as was experienced by the Bank of Japan during the 1990s, even with interest rates approaching the zero level this does not guarantee that households or firms are impelled to extend their borrowing. In this period of financial fragility, households would be more reluctant to go further into debt despite any further cuts in interest rates and banks would be more averse to a looser credit policy.

As a result, the Canadian economy appears to be facing more and more the spectre of stagflation, that is to say, upward pressures on the rate of inflation resulting from ever higher oil and commodity prices worldwide, coupled with declining production due to weakening demand both domestically and internationally. Just as in the mid-1970s when the first bout of stagflation brought real wages downward, the current stagflationary tendencies will make it more difficult for real wages not only to grow, but to remain at their present levels despite any gains in labour productivity. Canada's previous experience with stagflation led to public and corporate policies that attacked labour. In contrast to the 1970s, however, when Canadian households had experienced two decades of sustained real wage growth and enjoyed low debt-income ratios, the 2008 household sector finds itself in a much more fragile state. This time, the preceding 20 years were devoid of significant real wage growth, and high household indebtedness is now a reality. Consequently, a sharp decline in real wages may just be the *coup de grâce* that will significantly push down consumer spending in Canada and trigger serious financial problems as an increasing number of overly indebted households fall into bankruptcy.

In such a context, the federal government's commitment to a neoliberal policy agenda of persistent budget surpluses and declining public debt will become impossible without exacerbating the macroeconomic downturn. Hence, because of *force majeure,* governments will need to rely on a more activist fiscal policy of budget deficits. For the first time in more than a dozen years, the federal government will be forced to choose either strong doses of fiscal stimulus (and run budget deficits along Keynesian lines) or let the economy falter. This is the real choice facing Canadian policymakers today: to stay on course with budgetary austerity by pushing the economy further into stagnation or abandon neoliberal fiscal orthodoxy. Long-term stagnation can be prevented only if policymakers reject the principles of "sound finance."

Concluding Remarks We are told by the federal Finance Minister in his February 2008 budget, as well as by the new Governor of the Bank of Canada, that the economic "fundamentals" in Canada are strong in the face of fears of recession. To allay the fears, the minister proudly displays his financial trophy of persistent surpluses that will supposedly allow the Canadian economy to weather the storm. These accumulated surpluses — surpluses that are actually the accumulated social deficits that were imposed on vast numbers of Canadians, including many of the most vulnerable and disadvantaged — and the associated policies of fiscal austerity are themselves partly destabilizing financial markets. Thus the ultimate byproduct of the governments' deficit-fighting policies has been to increase household indebtedness and render financial markets ever more fragile (since the latter are losing an important element of stability and makeweight that federal debt previously constituted in these markets). Federal and provincial governments in Canada were able to slaughter the "deficit dragon" largely on the backs of households (and the municipalities), with overhanging federal and provincial public debt merely being transformed into exploding household (and municipal) debt — debt that is traded in increasingly turbulent and unstable financial markets internationally. It is only a pro-growth policy relying heavily on an activist fiscal policy, and perhaps based on a rigorous public investment policy,[36] that may turn things around. Much as during the "Golden Age" of the early post-World War II period, what is needed is growth that is sustained not by rising household indebtedness and stagnant real wages but by a virtuous cycle of rising real wages and productivity, propelled forward via expansionary fiscal policy. This may avoid an immediate and drastic bout of macroeconomic reckoning, help reverse the growing household deficits and public surpluses, and buy time to mobilize support for addressing distributional issues, on one hand, and the corporate sectoral surplus on the other.

Notes

1. See Ricardo Grinspun and Yasmine Shamsie, (eds.), *Whose Canada? Continental Integration, Fortress North America and the Corporate Agenda* (Montreal & Kingston: McGill-Queens University Press, 2007).
2. See Riccardo Bellofiore and Joseph Halevi, "A Minsky Moment? The Subprime Crisis and the 'New Capitalism,'" in C. Gnos and L.-P. Rochon, (eds.), *Credit, Money and Macroeconomic Policy. A Post-Keynesian Approach* (Cheltenham: Edward Elgar, forthcoming, 2008); Till van Treeck, "The Political Economy Debate on 'Financialisation' — A Macroeconomic Perspective," *Institut für Makroökonomie und Konjunktursforschung, Working Paper 01/2008* (Düsseldorf: Hans Böckler Foundation, 2008); the various contributions in Gerald Epstein, (ed.), *Financialization and the World Economy* (London: Edward Elgar, 2005); and, among many others, Greta R. Krippner, "The Financialization of the American Economy," *Socio-Economic Review* 3 (2005), pp. 175-200.
3. Some of the most important and innovative research has been carried out in the United States at the Levy Economics Institute. See, for example, Wynne Godley, Dimitri B. Papadimitriou, Greg Hannsgen, and Gennaro Zezza, "The U.S. Economy: Is There a Way Out of the Woods?" *Strategic Analysis* (Levy Economics Institute of Bard College, November 2007).
4. Following conventional national accounting and flow-of-funds analysis, net private sector savings, net public sector spending, and net foreign spending must all sum to zero when accounting for the aggregate net financial flows in an economy. A surplus (deficit) in one sector must necessarily be matched by a corresponding deficit (surplus) in the sum of all the other sectors of an economy.
5. Research by one author has shown that, based on flow-of-funds data spanning almost a half-century, the consolidated government balance in Canada essentially mirrors that of the household sector. See Mario Seccareccia, "Growing Household Indebtedness and the Plummeting Saving Rate in Canada: An Explanatory Note," *Economic and Labour Relations Review* 16/1 (July 2005), pp. 133–151.
6. This is the local macroeconomic context in which the ongoing financial turmoil plaguing the world economy has visited Canada. Indeed, this imbalance of the household and corporate sectors is very much a continental phenomenon. In the United States, a similar situation exists (i.e., household sector deficit, corporate sector surplus), but unlike Canada, the US government sector is running a massive negative balance. For the United States, this is offset to a considerable extent by its current account deficit (reflected in the positive net flow of foreign sector savings).
7. The data can be found in the Department of Finance, *Fiscal Reference Tables* (Ottawa: Department of Finance Canada, 2007), and from Statistics Canada's National Income Account Data Tables available on the Statistics Canada website <http://cansim2.statcan.ca/cgi-win/cnsmcgi.pgm> (accessed 27 June 2008). Also see Conference Board of Canada, "The 2008 Federal Budget: The End of Surplus," at <www.conference board.ca/budget/>.
8. Statistics Canada, CANSIM II series V37289.
9. See Hyman P. Minsky, *Stabilizing an Unstable Economy* (New Haven, CT: Yale University Press, 1986). For an early application of some of Minsky's ideas to the Canadian economy, see Mario Seccareccia, "Systemic Viability and Credit Crunches: An Examination of Recent Canadian Cyclical Fluctuations," *Journal of Economic Issues* 22/1 (1988), pp. 49–77; as well as a critique of an important aspect of Minsky's theory in Marc Lavoie and Mario Seccareccia, "Minsky's Financial Fragility Hypothesis: A Missing Macroeconomic Link?" in Riccardo Bellofiore and Piero Ferri, (eds.), *Financial Fragility and Investment in the Capitalist Economy: The Economic Legacy of Hyman Minsky* 2 (Cheltenham: Edward Elgar, 2001), pp. 76–96.

10. A recent newspaper article states that banks in the United States reported "nearly 53,000 cases of suspected mortgage fraud" in 2007 (up tenfold from 2001 and 2002), and that between March and mid-June 2008, more than "400 U.S. real estate industry players have been indicted." See Lara Jakes Jordan and Alan Zibel, "U.S. Indicts Hundreds of Industry Players in Mortgage-fraud Sweep," *The Globe and Mail* (20 June 2008).
11. On 19 June 2008, Ralph Cioffi and Matthew Tannin, late of Bears Stearns, were indicted "on conspiracy and securities and wire fraud charges" in what could be the first of "a wave of prosecutions" of Wall Street players "related to the meltdown in the housing market." See Tom Hays, "FBI Charges Pair in Subprime Debacle," *The Globe and Mail* (20 June 2008), p. B7.
12. Quoted in Glen Somerville and John Poirier, "Bank Woes Will Worsen, Kohn Warns," *Financial Post* (6 June 2008), p. FP7.
13. Statistics Canada, CANSIM II series V39050, V39072, V39073, and V39074.
14. Statistics Canada, CANSIM II series V646928.
15. The profit rate is calculated as the ratio of corporate profits to the value of the capital stock of the business sector. The figures used for the value of capital stock are the year-end price of the capital stock after allowing for geometrically calculated depreciation. Profits and the value of the capital stock are expressed in current prices.
16. Statistics Canada, CANSIM II series V1992052.
17. Statistics Canada, CANSIM II series V498927.
18. Statistics Canada, CANSIM II series V122270.
19. Statistics Canada, CANSIM II series V122276.
20. Allan Robinson, "Financing Deals Plummet 23% in First Quarter," *The Globe and Mail* (3 June 2008).
21. Statistics Canada, CANSIM II series V1409153.
22. René Morissette, "Earnings in the Last Decade," *Perspectives on Labour and Income* (February 2008), p. 13.
23. Morissette, "Earnings," p. 18.
24. Statistics Canada, CANSIM II series V1802965.
25. Statistics Canada, CANSIM II series V2461245.
26. Market income consists not only of labour income (i.e., wages, salaries, benefits) but also property income, such as profits, rents, dividends, and interest earnings.
27. Statistics Canada, CANSIM II series V1542413.
28. Statistics Canada, CANSIM II series V1554031.
29. Statistics Canada, CANSIM II series V122620.
30. Statistics Canada, CANSIM II series V498187.
31. As an indication of this trend, the new housing price index has increased from 114.1 at the beginning of 2003 to 158.4 as of March 2008, an increase of almost 40 percent in just over five years. The monthly data for the new housing price index is available from Statistics Canada, CANSIM II series V21148160.
32. Statistics Canada, CANSIM II series V122736.
33. Statistics Canada, CANSIM II series V36408.
34. See Raj K. Chawla, "Personal Debt," *Perspectives on Labour and Income* (January 2007), pp. 28–34.
35. Capacity utilization rates in the first quarter of 2008 had dropped to 79.8, which is the lowest level since 1992. Following the recession of 1991, capacity utilization rates through the first three quarters of 1992 rested at 78.6. See Statistics Canada, CANSIM II series V4331081.
36. Cf. Mario Seccareccia, "Keynesianism and Public Investment: A Left-Keynesian Perspective on the Role of Public Expenditures and Debt," *Studies in Political Economy* 46 (Spring 1995), pp. 43–78.