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Mr. James Rajotte

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● (0900)

[*English*]

The Chair (Mr. James Rajotte (Edmonton—Leduc, CPC)): I call to order the 17th meeting of the Standing Committee on Finance. Our orders today are pursuant to Standing Order 108(2), the study on measures to enhance credit availability and the stability of the Canadian financial system.

We have four distinguished guests with us here this morning. From TD Bank Financial Group, we have Mr. Don Drummond. From the Conference Board of Canada, we have Mr. Glen Hodgson. From the C.D. Howe Institute, we have Mr. Finn Poschmann. Finally, from the Canadian Federation of Independent Business, we have Mr. Ted Mallett.

Gentlemen, we thank you very much for being with us here this morning. Let's start in that order of organization. We have allocated about five minutes for an opening statement, if you could try to stick to that as best as possible, and then we'll do questions from members.

Mr. Drummond, we'll begin with you.

Mr. Don Drummond (Senior Vice-President and Chief Economist, TD Bank Financial Group): I thank you very much. Good morning to everybody.

I submitted beforehand a set of charts and tables on credit. I think I see it in front of everybody. I won't go through those one by one but just make some overview remarks about them. One of the reasons I did them was to try to put the discussion of credit in a broader context. Quite often the discussion is solely on what banks are doing, but of course, traditionally there's a variety of other sources of credit available.

The first thing that's obvious from those charts is that bank credit is growing quite strongly. In fact, unlike in previous recessions when the economy has weakened, credit from the banks has not slowed down, and for both households and businesses it is growing at a double-digit range. This will likely soften, and since I sent those charts out to you, we've had one more month of data that show the double-digit pace of growth of bank lending to business has dropped into the very high single digits—slightly below 10%. In previous cycles this has always been the pattern, that as economies weaken, particularly when nominal GDP is weakened, you've seen the demand for lending from the banks soften up.

On the household side, the lending continues to go from the banks at a double-digit range. The lines of credit are growing particularly strongly, at more than a 20% annual pace, but we've seen traditional household loans, credit cards, and mortgages also growing very strongly.

Just putting it in a broader context, the main source of funds for companies is typically retained earnings. Retained earnings have held up quite well in Canada until recently. In fact, if you look at 2002 through 2006, you'll see that retained earnings in Canada were extraordinarily strong and there wasn't actually a large demand for bank lending during that period because companies were funding it internally. Of course, it softened towards the end of 2008, and we expect that to get hit quite hard in 2009, not only by the real economy being weak but also by the drop in commodity and other prices.

In terms of the total market financing, there has been an increase in the reliance upon external funding, and I'll go through some of those sources. Share and bond issuances were reasonably strong in Canada, although they did decline from 2007. As I mentioned before, we had the largest increase ever in Canada's history in bank lending in 2008. That certainly did fill some of the gap left by some of the other sources of funding, but it was not the complete source.

I've also included for you some pieces of data on credit from the United States. The thing that's remarkable in the United States is that despite what we typically read in the newspapers, the bank lending in the United States is continuing to grow as all the other sources of credit have virtually disappeared. So once again, in 2008 there were actually negative issuances of shares. In other words, companies bought back more shares than they issued. There were virtually no issuances of corporate bonds. There was very little trade credit, and there was a virtual disappearance of the other sources, the shadow banking system—if you will, the non-banks, the hedge funds, the subsidiaries of companies that were in the financial arm. In the United States, we really did see that the banks were the only game in town, and while they did increase their lending, clearly that didn't fill the gap left by other sources and we did have a problem of credit.

I gave you a couple of charts as well on the cost of credit. This has been a major issue over the last couple of years. I've split that into two: the short-term cost and the medium-term cost.

Regarding the short term, there is good news. We have had a restoration of something approximating normalcy in the short-term end of corporate markets. Commercial paper rate is operating again. The cost of borrowing in the very short term, up to about 90 days, has come down quite a lot. It blew up in the wake of the Lehman Brothers failure, and it's been coming down steadily, quite a bit in the last two months in particular. The spreads are still not as low as they were prior to the summer of 2007, but that part of the market, the very short term, is working reasonably well. The last auction from the Bank of Canada providing 28-day funding was not fully subscribed from the banks. I think one of the reasons was that they were able to go to the market and get funding for that duration themselves.

The remaining problem continues to be at the medium and longer terms. The spreads on medium-term bonds in the corporate market are extraordinarily high. We really have to condition ourselves to not think about monetary policy in the traditional fashion. We tend to look at the central bank rate and think that's what's happening to all interest rates, and that is not the case. We have quite low mortgage rates, very low Government of Canada bond rates, very low U.S. government treasury rates, but the corporate bond spreads are extraordinarily high. Back prior to the summer of 2007, on average a Canadian bank could have raised five-year funding at 50 basis points above the Government of Canada rate. Our own bank was substantially below that. Until about a month ago, a Canadian bank would have faced a 300 basis point spread to raise five-year funding. So they went from less than 50 basis points to about 300 basis points. That's crept in a bit recently, but not very much.

● (0905)

So we still have a credit market that's gummed up on that medium to longer term on the corporate side. Hopefully the announcements of Geithner in the United States and hopefully what we might see in Canada in terms of quantitative easiness that gets into corporate bond markets will bring down that spread, but I think it's the last remaining piece of this puzzle. We need to see some improvement on that before we can have some confidence of a return to normalcy in credit and some economic growth.

Thank you.

The Chair: Thank you very much, Mr. Drummond.

We'll go to Mr. Hodgson, please.

Mr. Glen Hodgson (Vice-President and Chief Economist, Conference Board of Canada): Thank you, Mr. Chair.

I'm going to do something a bit different. I want to touch on four points in about five minutes. The first one is on what the U.S. is doing, because it's an interesting case study on the biggest credit crisis I think the world has ever faced. The second one is comparing where we are. The third point will consider the fact that I think our system is now in a state of healing. A lot of the data that Don just gave you is evidence that we're now on the right path. It's a question, really, of what more could be done to accelerate the healing. Finally, I want to talk just for a minute about the existing state instruments, like BDC and EDC, and frankly, how lucky we are to have them as a backstop for our financial system.

On the U.S., I think the number is up to $10 trillion now of policy intervention. When you add up all the action—the TARP program, the fact that the Bush government got $700 billion from Congress last fall, that he injected a quarter of a trillion dollars into the banking system—we've now seen the kind of action that Don's just referred to, with government stepping in to particular credit markets, building a program to buy back distressed assets.

So it's an incredible degree of intervention we're seeing in the United States. The evidence is hardly clear as to whether it's working yet, but the U.S. has more or less played all its cards. I think quantitative easing is the final card, trying to fight off deflation and having really improved conditions in long bond markets at the same time. The cards are all in. I'm confident that they're going to work, but it's going to take time. I think we're going to watch all of this year, frankly, before we see any semblance of normalcy return to the U.S. financial markets.

Compare that to what we've seen happen in Canada. I think government policy to this point has been very effective and it has been very well constructed. I think, for the most part, governments have done what they had to do in terms of offering to buy back mortgages, for example, and the various programs to try to restore credit conditions in credit markets. The bottom line is that we haven't seen a dime of taxpayer money go into banks in terms of equity because we haven't had the same sort of crisis.

So we're obviously in far better shape than almost anybody in the industrial world, and therefore I assume we're going to see a return to more normal conditions in Canada much sooner than we do in almost any other industrial country. But again, it's going to take time.

So we're now in a healing mode. The fact that we had all the chartered banks report profits in Q4, the fact that they're operating in the black.... Having to put provisions aside against old bad assets and the declining credit conditions is obviously very important. It's going to probably hurt their bottom line going forward, but we're in a situation where our system can work in the black.

It's really about the banks right now rebuilding their balance sheets and having healing, and dealing with the fact, as Don mentioned, that the non-banks and foreign banks have more or less retreated from our market. The evidence of that is pretty clear.

So what else could be done? I thought about that as I gave advice to the government in the budget context, and I hadn't had a chance to appear before you before, but it's really hard for me to come up with a magic solution at this point. There's no magic wand; there clearly is no silver bullet. The fact that we're getting evidence now that the full mortgage buyback program is not going to get taken up, I think, is a real sign of healing going on in markets. I don't know what cards, frankly, the government has left to play except within the assets that you own.

Here's where I'll wrap up. I think we're very lucky to have organizations like Export Development Canada, BDC, Farm Credit, and CCC as real key players within our financial system. I know there has been debate for a long time about privatization, about whether they're taking too big a market share, but aren't we lucky to have such strong institutions as a backstop for the commercial banks and for the private financial system right now? They're players through the market cycle. They have the skills, they have the knowledge, they have the balance sheet, frankly, to step up right now and fill gaps.

I had a chance to appear before the Senate committee earlier this week on the EDC legislation. I hope that when it comes back to the House it gets passed as quickly as possible, because it's time to take time away from management. Management should not have to think about the rules of operation. They should really have the chance now to use that insured capital they've been given, and the expanded mandate, and really try to accelerate the healing of our financial system right now.

I'll stop there, Mr. Chair. Thank you.

● (0910)

The Chair: Thank you, Mr. Hodgson.

We'll go to Mr. Poschmann, please, next.

Mr. Finn Poschmann (Vice-President, Research, C.D. Howe Institute): Thank you, Mr. Chairman.

Thanks to the committee for inviting me. I think this is my first visit to the committee in 2009. It's a delight to be back to see familiar faces and some new ones as well.

I want to start with some observations on financial market performance, turn to what the government and the Bank of Canada have been doing to respond to recent issues, and look at some specific measures introduced in the 2009 federal budget.

I won't rehearse events, as I'm sure financial market history since summer 2007 is well known to this committee. Suffice it to say that since mid-2007, doubts about the quality of assets underlying a broad range of securities and the financial derivatives layered thereon drove a meltdown in trust among financial institutions. That meltdown was so profound that banks that had earlier engaged in short-term lending to each other, at interest rate spreads in the single or very low double digits relative to risk-free lending, either ceased to do so or provided liquidity to their neighbours only at rates otherwise unknown in recent financial history.

This rocketing up of risk assessments of counterparty risk between financial institutions partly reflected a contraction of financial liquidity. It became clear through late 2007 into 2008 that there was more to the story than liquidity. After all, governments and central banks across the western world, including Canada, had been providing liquidity to the system by the trillion, when you added it all up. However, the risk spreads since fall 2008 were in the triple digits. We should add very quickly that they're down near normal levels in Canada, although the volume of lending that's going on isn't so high.

It became clearer that the counterparty risk I described was a more persistent problem than Iiquidity. Governments in Canada began to pay more attention to improving the quality of assets on financial institutions' balance sheets, hence the United States' troubled asset relief program as originally conceived in fall 2008, and the insured mortgage purchase program that has been operative in Canada for some months now.

Budget 2009 significantly expanded the capital available to the Canadian government to buy National Housing Act mortgage-backed securities from financial institutions. The mortgages underlying those securities were already contingent liabilities, from the point of view of the government's books and the federal taxpayer, so our risk exposure changed little while the program offered marginal improvements in the quality of domestic institutions' balance sheets. It seems to be working reasonably well. Glen just pointed out that there has been less take-up in recent weeks, which perhaps suggests that the program has partly run its course. So far so good.

In Canada, notwithstanding numerous contrary anecdotes, bank lending overall has continued to grow, not shrink. There was some flat-lining in late 2008, but the fact remains that overall bank lending in Canada is up in the past year, not down. However, we can't ignore the existence of significant financial market troubles. Most obviously, the collapse of several securities and derivatives markets, as well as much hedge fund activity, has crushed numerous non-bank financial intermediation channels. Don mentioned this. As a result, the broad supply of credit to the Canadian economy, like that elsewhere, has come under severe pressure. For example, at the end of 2008 the asset-backed securities market in Canada was about four-sevenths the size it was at the end of the previous year.

Governments have launched new measures that aim beyond the financial institution marketplace that regularly engages with the Bank of Canada. The key Canadian exhibit is the Canadian secured credit facility, CSCF, outlined in budget 2009. This is intended to jump-start the moribund vehicle and equipment lease and loan marketplace. The program is not yet fully formed. Yesterday the C. D. Howe Institute released a brief on the potential shape of the program, which will be run by BDC.

Our brief was written by Alexandre Laurin, who is well known to many members of this committee, and it makes a few simple points.

First, if the government is committed to restoring the lease and loan market to something like its recent form, a long job is ahead. It will almost certainly be necessary to commit more than the $12 billion contemplated in the budget.

The second point is that if the program is to succeed it must become active fairly quickly—certainly before summer this year. To the extent possible, it should take advantage of existing securitization channels.

● (0915)

Having said that, we can't forget that there are risks involved. No doubt the Canadian ABS marketplace has been hurt by contagion from other types of securities and other markets, and that has chased off investors. Perhaps the rollout of the new program will make the market perform better and bring back retail and commercial investors, as well as improve the financing available to auto and equipment dealers.

We should not for a moment forget there's a reason why investors left the marketplace. While we acknowledge that no Canadian AAA-rated ABS has failed to this point, markets remain unsettled by potential increases in default rates among underlying loans and leases, as well as declining residual values on vehicle leases. These worries can't and shouldn't be wished away.

To sum up, partway through an extraordinarily difficult economic period some things appear to be working better on their own. Others, such as mortgage markets, appear to be improving with little help from government actions to improve the balance sheets of mortgage lenders in particular.

Other parts of the financial marketplace have been performing far less well, hence actions in Canada and the U.S. to jump-start securitization markets. I'm hesitant to say this is a bad idea, but I must immediately add that one of the lessons we learned from 2007 is that we can spread risk around but we can't make it go away. Efforts to entice investors back to the securitization marketplace by lifting risk from that market—as we've seen in the U.S. and may yet see in Canada—inevitably park risk at taxpayers' doorsteps. That is something on which parliamentarians should be keeping a very close eye.

I think my time is up. I thank you for your time.

The Chair: Thank you, Mr. Poschmann.

We'll go to Mr. Mallett, please.

Mr. Ted Mallett (Chief Economist and Vice-President, Research, Canadian Federation of Independent Business): Thank you, Mr. Chairman. Thank you for inviting us to present to you today.

CFIB represents 105,000 small and mid-sized business owners. It's a sector that accounts for a major share of GDP, roughly 45%, and certainly a large amount of demand for operational capital financing. It's an area that we have been monitoring for decades, both on the financing and the economic performance sides.

Historically we have conducted studies, say on a three-year rolling basis, on bank financing. On the economy side, we've been running a quarterly barometer since the year 2000. Before that, we ran it on an annual basis, back to 1987. We have a huge amount of context, through good times and bad, in terms of how small businesses are responding to tough economic times.

Yesterday we released our “Business Barometer”. You have it in front of you. There's something there for both the optimists and the pessimists. The pessimists will see that clearly we're in a trough. Our index level is 87.3. Compared to 1988, when we first started doing this kind of measure, clearly it's in the category of negative economic growth. The good news is that it's really no different from what we found in December. The view that the economy has not continued to decelerate over the past three months is perhaps positive news, if you can take it in that context.

You see, in figure 2, that there are still businesses out there that are very successful. It's clearly not as large a number as we have seen in previous years, but it's important to recognize that there are pockets of strength and growth. One should never develop policy, whether it's financial, banking, or sales policy, on the assumption that every business is actually suffering, when in fact many of them are still doing well.

You'll see that GDP does track our numbers very closely. We're in the plans of developing a monthly barometer for the economy, and we're looking at combining that with some financial indicators as well. So we are moving forward on looking at where business financing demand and economic performance are with respect to small firms.

There clearly is a retrenchment going on within our membership. We see it in the numbers. One of the most obvious is at the back of the report, looking at capital expenditure plans. That is a figure that has really never changed since we started asking this form of question. We didn't think it was ever going to change, except that in the past six months a roughly 20% reduction in capital expenditure plans has been noticed. Clearly, there's something going on there.

We have also noticed that pricing and wage increase plans have basically stopped dead. The median price increase and median wage increase is roughly zero or 0.5% at this point. Where we were concerned about inflationary pressures in mid-2007, those pressures are clearly gone from the system.

Turning to the financing side, you'll also see a chart summary. This is from our new monthly foray into looking at the demand side of things. Roughly 50% to 55% of our members say they are underfinanced. Because these numbers are so new, we don't have the numbers to compare with what happens during better economic times. But comparing that with other surveys, we think we'd normally expect roughly 20% under better economic conditions.

We also track what their state is: are they borrowing money right now? There's a bit of good news and bad news there too. Roughly a third of our members don't borrow; they don't have any outstanding loans, which means they are highly conservative in their approaches to business. It means they're also less at risk to these kinds of shocks to the economy.

The other side of the coin is that they are not levered to grow as quickly when the economy does pick up. The small business sector, at least when they're presenting this kind of outlook, shows a high degree of stability, which is a good thing in this context, but the huge growth opportunity is not there.

● (0920)

We also get a sense of where total lending is. Don and a number of others said there is greater outstanding financing out there. We have asked our members why this is the case. Typically, most businesses say the reason they have increased their level of debt—largely through outstanding lines of credit—is that their cashflow has slowed down. They have higher expenditures or lower revenues, and their revolving lines of credit have increased somewhat as a result. That is perhaps the major reason why small business credit has increased, at least in the short term or the past little while.

We have a number of recommendations. They are the same as they've always been. Information on credit and borrowing is absolutely vital in this kind of environment. We need to ensure that we have competitive choice and multiple levels of lending or borrowing opportunities for small firms. And we need to ensure that financial institutions, whether banks or credit unions or others, really have the skills to properly assess the level of risk in the small and mid-sized business markets.

Those are the sorts of things we've have always been recommending in the past number of decades.

Thank you.

● (0925)

The Chair: Thank you, Mr. Mallett, for your presentation.

We'll start with Mr. McCallum. You have seven minutes.

Hon. John McCallum (Markham—Unionville, Lib.): Thank you, Mr. Chair.

Welcome to you all.

My apologies for being slightly late. What happened was that my colleague Mr. Mulcair and I were led to the wrong building by our friend the parliamentary secretary over there.

Some hon. members: Oh, oh!

An hon. member: Our former friend.

Hon. John McCallum: Not maliciously, I might add.

There is an element of humour in this meeting, because the government was pushing for you gentlemen to be included in the same session as the Parliamentary Budget Officer, on the assumption that you would offer a measure of protection for the government from his projections. But I believe—and this is a question for Mr. Drummond—that whereas the Parliamentary Budget Officer projected a two-year deficit of $73 billion, or $9 billion higher than the government's projection, TD Bank is projecting $82 billion, or $18 billion higher than the government.

I'd also ask you to confirm whether it's correct, based on my look at the charts, and partly on consensus projections—and maybe some personal input from the Parliamentary Budget Officer—that real GDP will fall by about 2% in the year 2009, and nominal GDP by about 4%, with the unemployment rate averaging about 8.4%. This is what the Parliamentary Budget Officer is projecting.

So am I right in thinking that on all four counts the TD forecast is more pessimistic?

Mr. Don Drummond: Yes, that's true. Actually, if you had invited both Glen and I to appear, you wouldn't have gone anywhere, because he's at the top of forecast pile and I'm at the bottom. So we would have just cancelled each other out, and you would have been right back where the parliamentary budgetary officer was.

There is a huge range of uncertainty. And yes, for some time we've been at the bottom of the pile of forecasters. And I must say it's been a good space to be in. In fact, we haven't been low enough; everybody, including us, until this point, has had to keep revising their forecasts down.

We're somewhat weaker than the consensus on the real side. Our biggest distinction has been on the price side, if you will, largely because of lower commodity prices. I'm not quite sure if everybody else has figured out how the low commodity prices feed into our export prices, which depress incomes in Canada. It's a particularly important variable. Government revenues don't depend only on real GDP. It has always amazed me when we talk about the economy solely through the prism of real GDP, which depends on nominal income. And so does the banking world. In fact, there has traditionally been an almost perfect relationship between changes in nominal GDP and bank lending, with about a six-month lag. And that six- month lag is exactly what Ted has talked about: your income first goes down, and you start by drawing on lines of credit, and then you weaken somewhat later—

Hon. John McCallum: Okay, thanks.

Some hon. members: Oh, oh!

Mr. Don Drummond: I was trying to get back to—

An hon. member: It's like trying to stop Niagara Falls.

Some hon. members: Oh, oh!

Hon. John McCallum: So the conclusion I draw from this is that if TD Bank is on the optimistic side and the Conference Board is on the pessimistic side—or the other way around—the Parliamentary Budget Officer is right in the middle, sweetly reasonable. Thank you for that.

Let me now turn to credit, and this is really to Don Drummond and Finn Poschmann.

I certainly agree 100% with the government's move of viability to $12 billion in the auto leasing, and I think it's approximately another $12 billion in lending authorized by BDC and EDC. Where I get extraordinarily frustrated and my usually laid-back self gets frustrated with the head of BDC is when he comes and displays zero sense of urgency. To me, the priority is to get that money out in 2009 because the problem is now, and not in 2010 or 2011 or 2012. I think both BDC and the car leasing facility....

Finn Poschmann said that yesterday he came up with the potential shape of it. How long will it take before it actually happens? It could have happened some weeks or months ago and people today would be buying more cars. Business is crying out for those loans from BDC, and the head of BDC was not even able to tell me anything about when any money would get out the door.

So I have a double question to both. I'll begin with Finn Poschmann. First, do you agree that there is a sense of urgency in getting this money out the door? And second, if you do, do you have confidence that this money can move quickly? We certainly haven't been told anything that would inspire such confidence.

● (0930)

The Chair: Can you each take about a minute to answer?

Mr. Finn Poschmann: Sure, I'll go very quickly.

The lease and loan financing industry, and the auto sector, and the vehicle sector certainly perceive a sense of urgency in seeing financing move quickly. Absolutely they do. From the point of view of designing and running a program, however, there are just a few things that you have to get right.

One of the issues is that we're talking about government buying securities from the marketplace of a form that doesn't actually exist yet. So it is possible that the government could use existing channels of securitization; however, if we want credit-enhanced products, as described in the budget, and if we want them to provide adequate taxpayer protection, it's going to take just a little bit of time to design and bring those securities to market. The sector can do it, and the program will roll out, as I understand, in the very near future. I also understand it would be quite reasonable to look for a rollout in June of this year.

The Chair: Mr. Drummond.

Mr. Don Drummond: I can't answer very definitively regarding BDC, because we have not had a long history of collaborative arrangements with BDC, unlike EDC. EDC is a very close partner of ours; in fact, of all the banks, TD does the most business with EDC. It's been a wonderful partnership, and I really have a sense of confidence that if a loan proposition is made to us with which we're uncomfortable, we will be able to involve EDC and make an arrangement that will allow them to go forward. We've had nothing but excellent exchanges with them previous to the budget, but particularly with the recapitalization and the possibilities afterwards.

I'm hopeful we can get some kind of an arrangement with BDC, but we just haven't had that track record historically with them.

The Chair: You have time for one question.

Hon. John McCallum: I had zero complaints about EDC. I was focusing entirely on BDC, so it sounds like both of you are agnostic or noncommittal on that subject.

Mr. Finn Poschmann: Mr. Chairman, that would be a reasonable characterization.

There is just one point I want to add, and it's a very important point. It's that the program won't succeed if consumers and businesses don't return to the loan and lease vehicle marketplace. If they don't come back, the program won't work. This is one issue for which the government can provide a program, but it's the market that has to look after what happens next.

The Chair: Thank you, Mr. McCallum.

Monsieur Laforest.

[*Translation*]

Mr. Jean-Yves Laforest (Saint-Maurice—Champlain, BQ): Thank you, Mr. Chairman.

Good morning, everyone.

Mr. Drummond, your organization, the TD Bank Financial Group, was one of the few financial institutions in Canada and Quebec that did not venture heavily into asset-backed commercial paper, ABCP. It's often said that an important quality in an economist is his ability to see the future.

Could you tell us what you saw in your crystal ball before deciding not to go that route?

Mr. Don Drummond: That's a question I have a great deal of difficulty answering because it was so simple for me. At that moment in Canada, other entities were buying a lot of asset-backed commercial paper. There was a premium of approximately 17 basis points, but there was a lot of risk, some of which, I thought, was unknown. I imagined that, with a 100- or 200-basis point premium in that market, it would be possible to set aside some risk capital, but it was 17 basis points. It was entirely obvious to us. I wonder how the others came to a different conclusion.

The same was true of mortgages in the United States. We decided that high-risk mortgage loans were not a market we had any interest in getting involved in. We did not want to buy mortgages in Canada or grant any at the banks we owned in the United States. Once again, that was entirely clear in my view. We started to be concerned about that market in 2005. We noted that no deposits were being made against those mortgages and people, families, were unable to make the payments. I thought at the time that there was no value in that market and that it was a disaster. All that was very clear to us at that time, and I wonder why the others did not see the same thing. It's impossible for me to answer that, but you should put the question to the others.

● (0935)

Mr. Jean-Yves Laforest: That answers my question quite well. One might wonder, since it was so clear to you, whether other interests were at stake. Of course, it's not you that I should ask that question. One may well wonder whether other interests or other reasons led the other institutions to go into that market. Among others, I'm talking about the Caisse de dépôt et placement du Québec, which bought a disproportionate number of those assets, considering the assets and size of that institution. The deputy governor of the Bank of Canada said that his organization issued a number of warnings on the subject in 2005.

Is that one of the factors that convinced you these were toxic, high-risk securities?

Mr. Don Drummond: That's a question on which I recently had the opportunity to give Alan Greenspan an interview in Toronto. The United States studied high-risk mortgage loans starting in 2000 and resumed that study in 2002. However, no regulations were implemented. When I asked why, I was told that the high-risk mortgage loan market in the United States was not in difficulty prior to 2005 and that they had decided to let the matter pass. I didn't like that answer, and I still wonder why they didn't impose any regulations when they saw that the market was in difficulty.

Mr. Jean-Yves Laforest: In Canada, do you think one institution in particular, the Bank of Canada or an oversight organization, should have issued more warnings?

Mr. Don Drummond: The problem is that DBRS is the only agency that evaluates these products. And their rating was quite positive. In the context of my bank's activities, I never use that as an excuse. We have more people analyzing risk than DBRS and all the other corporations combined. I think the same is true for the others. In fact, the risk was unknown. In the case of non-bank asset-backed commercial paper, these were packages of car loans, mortgages and so on, but we never really knew what there was in that box. In my opinion, when you don't know the content of a box, you don't touch it.

Mr. Jean-Yves Laforest: When the risk is unknown, you don't dive in.

Mr. Don Drummond: In my view, you have the choice of not touching it or charging an extremely high premium and setting capital aside. In this case, however, the premium was near zero.

Mr. Jean-Yves Laforest: We're talking about basic prudence here.

Mr. Don Drummond: Exactly.

Mr. Jean-Yves Laforest: Mr. Poschmann, I've learned that you submitted a document in English only, and I find it unfortunate that you didn't have it translated. We could have followed your remarks better.

You said that Canada began drawing attention to asset quality. That implies that attention was not previously being paid. Is that correct?

Mr. Finn Poschmann: Perhaps. Thank you.

[*English*]

I have to apologize. We released our brief only yesterday, and we did not have time to translate it.

Is the implication of government measures to improve the quality of assets on the balance sheets of financial institutions necessarily that those financial institutions did not do a good job of assessing the risks underlying those assets on their balance sheet? It's a good question. It's one that we don't actually have to try to answer. We can observe the risk spreads on interbank lending among financial institutions. These had soared to very high levels, first in mid-summer 2007 and then again in September and October 2008. We suspect the reason for that was lack of trust among the institutions about the quality of those assets.

● (0940)

[*Translation*]

Mr. Jean-Yves Laforest: I'd like to clarify one point.

The Chair: Mr. Laforest.

Mr. Jean-Yves Laforest: When you say that Canada began to pay attention to asset quality, who are you talking about? Who was not previously paying attention?

[*English*]

Mr. Finn Poschmann: The insured mortgage purchase program is intended to lift mortgages from financial institutions' balance sheets. That's run by Canada's treasury. What we're doing is substituting Government of Canada securities on the banks' books for mortgage-backed securities, which were already insured by the Government of Canada on those books. The risks implicit in these were fairly well understood. The reason for doing this, however, was to create improvements on the margin of the amount of certainty that other institutions, both in Canada and abroad, feel about the quality of the balance sheets of Canadian institutions.

[*Translation*]

The Chair: Mr. Laforest.

Mr. Jean-Yves Laforest: So that means that they are in fact doing something now that they previously did poorly.

The Chair: Thank you, Mr. Laforest.

Mr. Dechert.

[*English*]

Mr. Bob Dechert (Mississauga—Erindale, CPC): Thank you, gentlemen, for your presentations this morning.

There's an event happening in Ontario today that we haven't talked about. I think we all know the Ontario budget is due to be released later today, and there's been a lot of speculation in the media about possible harmonization of the provincial sales tax with the GST. I was wondering if some of you might comment on that.

I note that in my city of Mississauga, the president and CEO of the Mississauga Board of Trade said in a recent press release, “Harmonization of the Ontario sales tax with the GST will lead to a stronger economy with higher real wages, a higher standard of living, higher productivity, lower business costs, and increased investment”.

I also know that a number of members on this panel have extensively studied the issue, including Mr. Poschmann, who I believe released a report just last week. Mr. Poschmann, you advocated harmonization and noted that “Ontario workers, employers, and consumers, not to mention the rest of Canada, would benefit from an Ontario government decision to implement sales tax reform and to do so without hesitation. The province sorely needs near-term and long-term boosts to its growth and investment outlook, which sales tax reform, with appropriate policy fine-tuning, can deliver.” You went on to say that “putting an end to Ontario's archaic retail sales tax and adopting a value-added tax like the GST would sharply lower the effective tax rate on new business investment and offer the province a much-needed economic boost”.

I wonder if you could give us a short summary of your views on harmonization and also compare it with the past experiences of other provinces that in the 1990s harmonized their provincial sales taxes with GST.

Mr. Finn Poschmann: Thank you, Mr. Chairman, for that question.

It's an intriguing measure to contemplate in the current circumstances, because when we look at financial market turmoil and economic turmoil, tax reform, especially sales tax reform, isn't obviously the first thing a lot of us would reach for. However, we're presented with a fascinating opportunity for change in Ontario. The Ontario government to this point, I think it would be fair to say, has not been roundly applauded for its economic management. Seizing the moment for change in Ontario would be a terrific thing. Here's why: retail sales taxes are dumb taxes because they stack up costs of business, they raise cost to consumers, they raise the cost of new business investment in plant equipment and processes and that slows down investment, slows down wage growth, and boosts the cost of our exports. So it harms our competitiveness in international markets.

The opportunity for reform, in particular value-added tax reform, the cost that businesses are forced to build into their price of products, is simply stripped out by way of the credit invoice system. That means there's a sharp reduction in the effective tax rate on your business investment, and that tends to drive growth in investment and then wages and productivity.

What happened in 1997 when the eastern provinces harmonized at a slightly lower rate than they were taxing before is just a terrific example. The prices of some things that hadn't been taxed before under the provincial tax went up. Other things stayed the same and some other prices went down. Overall the broad price level in the eastern provinces dropped by roughly the amount of the decline in the net tax rate. So the competitive markets delivered a very quick pass-through of the lower tax on consumer prices.

Even better was the boost to investment. You have to do some fancy footwork to strip out the economic growth that was already happening in the eastern economies. Oil and gas were taking off in the mid- to late 1990s. When you adjust for all that, you still find there is a pop in investment per capita of better than 10% post-reform. That's a huge shock. It's a long-lasting positive shock and it's been a tremendous boost to the provincial economies. It lowers costs for businesses because they only have one set of sales taxes to comply with. It lowers costs for governments too. So there are wins on all sides—wins for consumers, wins for business, wins for federal and provincial governments, and that's why we encourage reform. That's why I'm delighted and hopeful that Ontario's budget today will put forward a sales tax reform program.

● (0945)

Mr. Bob Dechert: It sounds as if this could be a much-needed shot in the arm for the Ontario economy and the Canadian economy. Thank you for your comments.

Do any of the other gentlemen wish to comment? Mr. Mallett.

Mr. Ted Mallett: The CFIB has had a lot of experience in GST. We were there for the implementation back in 1990. We did a lot of research in the European countries on what they did right and what they did wrong.

Certainly a lot went wrong with the implementation of the GST. Small businesses supported the notion of the value-added tax as much more efficient than the old manufacturing sales tax. One of the non-negotiables from our perspective was keeping the base as simple and as much the same as possible. Of course we don't know what the announcement is for later today, but it sounds as if they are talking about a separate base in Ontario compared to the rest of Canada. We feel that's probably a very bad move in that respect and probably a slippery slope for other provinces, because if they do harmonize it will create their own tax bases and then you're losing a lot of the benefits of harmonization by each province choosing what to tax and what not to tax. The costs of compliance for small firms in collecting the tax is one of the highest of all the tax systems. So that's a very large concern.

Of course we also have lots of members on the other side, currently in the non-tax categories of restaurant food and fuel delivery, all those sorts of elements that are quite concerned about the tax.

On balance, in theory it's one of these things we want to see, but we think some implementation problems may come up as a result of today's announcement.

The Chair: Mr. Hodgson, please, very briefly.

Mr. Glen Hodgson: We put out a brief in the spring calling for harmonization of sales taxes built largely on the good work that the C.D. Howe Institute has done, because we agreed with all that analysis. I think one of the big challenges to this point has been the revenue shock that Ontario's going to experience. Estimates are between $0.5 billion to $1 billion of lost revenue, particularly if you add on something like the GST credit for low income. Presumably there's going to be assistance from the federal government in the rollout. I know that has been a big part of the dialogue for the last two years, and frankly it was a debate about numbers and whether the number was enough.

I too am hopeful we're going to see an announcement today dealing with some of Ted's issues. I hope we'll see a transition period toward a normalization of the base, so we have a common base but also federal assistance to allow the transition to take place.

The Chair: Thank you.

Go ahead, Monsieur Mulcair.

[*Translation*]

Mr. Thomas Mulcair (Outremont, NDP): Thank you, Mr. Chairman.

In my turn, I'm taking the liberty of saying a word to Mr. Poschmann. I did hear his excuses a little earlier, but he knows as well as I do that the document in question is only six pages long. If you look at the header, you see it reads: “C.D. Howe Institute, l'Institut C.D. Howe, celebrating, *nous célébrons* 50 years, *ans*”. That's the only bilingual thing in this entire six-page document. In addition, the text was written by a certain Alexandre Laurin. It would not have been very difficult for an institution of your size to have six pages translated, particularly since the clerk explained to you that, out of respect for the two official languages, it is prohibited in our committee to distribute this document, but you did so yourself. I think there is a real problem of respect for the two official languages at the C.D. Howe Institute, and I want to tell you that. It's not that I don't accept the apology you offered earlier, but I myself translated for many years—I was responsible for translating the laws in Manitoba—and I must tell you that it takes very little time to translate six pages. Out of respect for this committee, its members and the two official languages of this country, I believe very seriously that the C.D. Howe Institute could do better than that.

Mr. Hodgson, I wanted to go back to one of your remarks that was very interesting. You just made it incidentally, but I'm beginning to think some attention should be drawn to it. You said that you're not convinced that we're not making mistakes. If I may paraphrase, you said that a lot of solutions had been suggested.This is a bit complicated. An amount of $1,000 billion, which is called a “trillion” in English, and a “billion” in French. In the United States, they've reached $10 trillion in expenditures, to put it in terms that everyone will understand more easily. If I understood correctly, in your presentation, you expressed the fear that we might be doing things today that will cause us other problems later. It's like in stations: one train may conceal another. You try to cross the track and you get hit.

May I ask you to elaborate on your thinking on that subject?

● (0950)

[*English*]

Mr. Glen Hodgson: Mr. Mulcair, thank you very much for the question.

Frankly, we are in a grand experiment right now. None of us has ever seen this before. That's part of the reason Don and I have such huge challenges with the economic forecast right now. By the way, ours will be out in two weeks. It's going to be darker. Unfortunately, Mr. McCallum, the average is probably going down over the course of the next few weeks.

But it's a grand experiment. It's almost learning by doing. Perhaps I'll relate a little story. Early in my career I had a chance at the federal Department of Finance to work on the Latin American debt crisis. It took the world four years to understand that when countries can't afford to pay, you have to be prepared to reduce principal. It took us four years to reach that point.

Mr. Thomas Mulcair: If countries can't afford to pay, you have to be prepared to...?

Mr. Glen Hodgson: You have to be prepared to reduce principal, to actually mark down the face value of the loans, because if people can only afford to pay 80¢ on the dollar, there is no point in pursuing them for two decades trying to get 100¢ back. It just won't work. You can reduce interest rates, but their stock and debt is really the critical issue.

I see the same sort of learning by doing process happening right now on a global basis with respect to the financial crisis. Look at where Mr. Paulson came from in the course of one month. In September he went from complete belief that you should allow institutions to fail to stepping up and recapitalizing the banks. He had a total reversal of attitude in the space of one month.

The same sort of thing, the learning by doing, is happening over the course of this year. What I see the U.S. government doing, frankly, is almost experimenting. They try something; if it works, they go on. If it doesn't work, they try something else.

Clearly, there are going to be responses. Things we can't anticipate perfectly are going to happen. For example, if the asset-stripping program that Secretary Geithner has announced goes forward with $1 of private capital for every $5 of public capital, it's an extraordinary ratio. Almost all the risk is still being taken by the private sector, but the private capital is needed to set the price of the distressed assets in the markets.

Negative things are going to follow that. For example, suddenly banks will have to mark up all those assets. They may actually need more capital, so you may see some major money being sent to banks in the United States, requiring even further state capital injections, which may have consequences down the road. That's the kind of thing I was talking about.

I think we're on the right path. I think governments learn by doing, starting with the equity injections, which is something the academics tell us is almost always the bottom line in a financial crisis. Governments step up and recapitalize banks. That's been done. We're now looking at taking the bad assets off the banks' balance sheets in the United States, but we really don't know what the end state is. We think we know the direction the train is moving, but we could well be sideswiped by—

Mr. Thomas Mulcair: We know that Canada's banks don't have the same bad assets—toxic assets—as the American banks. Mr. Drummond made a good description of that. We have nothing close to it. Yet your description of asset-backed commercial paper.... Having practised commercial law for a long time, I'm always amused by the fact that you can draft reams of documents like this and charge your appropriate hourly rate and nobody's actually going to read the darn things. I have a feeling there was a little bit of that going on with ABCPs. As you said, it was bundled, but nobody was actually saying, “Well, what's this?”

I spoke with Stephen Jarislowsky about that and I asked him if he had invested in ABCPs. He wasn't being falsely modest, just being himself, and he said, “No, I didn't touch them. I didn't understand them.”

So how come all the smart people in the banks bought them?

Mr. Don Drummond: Because they wanted a 17-basis-point higher return. I assume they didn't do what I would have thought was appropriate risk management. But we know, through the work of Purdy Crawford and others, it took them more than a year to penetrate into that box to figure out what was in that box. So it wasn't that they could have got into the box if they'd put in another hour and paid that hourly rate. It took a big committee and a lot of lawyers a year to figure it out. And even then there were elements of what was backing those that were still not known.

● (0955)

The Chair: Thank you, Mr. Mulcair.

Mr. McKay, please.

Hon. John McKay (Scarborough—Guildwood, Lib.): It's remarkable, Chair, how regardless of what the economic conditions are, the bankers and the lawyers seem to end up with the money in their pockets.

I just want to keep track of this ever-escalating deficit. The government's on the wildly optimistic side of 74. The Parliamentary Budget Officer was at 73 yesterday. Mr. Drummond, I take it you're projecting about 82, and Mr. Hodgson is about to change his position to being possibly even worse than Mr. Drummond's. Is that a fair synopsis of where the government's projections are at this point, where the deficit is at this point?

Mr. Glen Hodgson: Well, why don't I speak to our forecast, what's happening right now?

I have 32 guys back at the shop who model everything in the country, and we do our forecasts on a quarterly cycle. What we're seeing happen right now in the economy is a very sharp impact on investment. We're now heading into a period where Canada could have a worse quarter than the United States by a lot. I won't put a number on it, but certainly a contraction of more than 5% in the first quarter is going to be in our forecast. That naturally will lead us to mark down our growth forecast for the whole year.

Like Don, I don't know whether we're in deflation or not. We see a little bit of inflation, so there could be nominal income growth in the economy. But certainly, having the economy contract by, let's say, about 2% over the course of this year—we'll finalize the number in the next 10 days—is going to have an impact on government revenues and will make the deficit a little bit deeper.

Now, of course, we can afford it. All the writing I did over the course of the last two months has been to explain to Canadians the fact that having a debt-to-GDP ratio at 30% means you can provide stimulus for, let's say, two years. That's quite affordable going forward. The challenge will be when we get back to growth. Are we going to get back to balanced budgets fast enough? That's the challenge this committee is going to grapple with two to three years down the road.

Hon. John McKay: I want to go to another question with respect to this shift in credit. Yes, it's right to say that the banks are issuing more credit. It's also correct to say that the non-bank actors have left the shop; therefore, the banks have moved in and arguably creamed the good stuff and left the taxpayer—in the form of BDC, EDC, and the rest—with less than optimum credit. A lot of us are hearing, including from CFIB folks, that the banks and other financial institutions, such as Visa and MasterCard, are really starting to crank up the cost of credit. So you see credit actually constricting.

I want to get a response to that from both Mr. Drummond, representing the banks, and Mr. Mallett, representing the consumers of credit. Are we getting into a situation where credit is becoming more expensive for many of your folks?

Maybe we'll lead with Mr. Mallett and then go to Mr. Drummond.

Mr. Ted Mallett: I'll start with the latest comment. Our work on credit card issues has to do not with the cost of credit on credit cards, but with respect to transaction costs—what the business has to pay to accept cardholder payment for their goods and services. That's really the focus of our work on that area.

What we're tracking is the interest rate you're paying on your largest loan or line of credit, and we're noticing a slight uptick in the cost of credit. We think the average loan amount is around two and three-quarter points above prime. Thirteen per cent of our members are paying six points above prime or more.

Hon. John McKay: Yes, I looked at your chart. It's quite shocking.

Mr. Ted Mallett: A lot of that is BDC, a lot of that is credit unions, and a lot of that is the specialty asset financing companies. Now, they are small players in the small-business market. BDC traditionally represents about 3% of our members' activities. Our latest survey shows about 6%. So there seems to be an increase in their work with our members, but it's still by no means a major portion.

As for the specialty asset finance companies, I believe—I don't have the numbers in front of me—that still fewer than 10% of our members use those. So roughly two-thirds of our members are using one of the traditional Canadian domestic banks, 3% are using a foreign bank, and about 15% are using a credit union.

● (1000)

Hon. John McKay: Can we get a comment from Mr. Drummond?

The Chair: We're out of time. Mr. McKay wanted Mr. Drummond to speak briefly to this question.

Mr. Don Drummond: First, let me just say that I object to your characterization that EDC and BDC are being left with the questionable loans and the banks are creaming off the crop. In fact, if you look at the portfolio of BDC in particular, you will find that these are not the questionable loans; they're in the prime loan territory. In EDC it's not a question of our taking the good ones and their taking the poor ones. We've been a partnership in all these loans. So I really don't think this characterization is what's going on in the Canadian credit market.

I'll come back to the point you raised on the cost of credit. A Canadian bank that wants to raise five-year funding would face Government of Canada plus 300 basis points. Two years ago, you would have gotten a commercial real estate mortgage from a Canadian bank at probably the Government of Canada rate plus 175. How can you do that right now? Their cost is plus 300, so of course the cost of credit has gone up. Prime has gone down to 250. The banks' cost of funds has not gone down in parallel with prime, so of course the pricing has become an issue.

There's an access to credit issue, not from the banks but, as you say, from the non-banks. But absolutely, there's a pricing of credit issue, and that is because the costs faced, because of the difficulties in the corporate bond market, have not gone down commensurately.

The Chair: Thank you, Mr. Drummond.

Thank you, Mr. McKay.

Monsieur Carrier, *s'il vous plaît*.

[*Translation*]

Mr. Robert Carrier (Alfred-Pellan, BQ): Thank you, Mr. Chairman.

Good morning, gentlemen.

I listened carefully to your presentations. What emerges from them is that access to credit seems to be under control. Mr. Hodgson mentioned that BDC and EDC are doing a good job in that respect. You're responding to the demand for credit.

In a release last Monday, I believe, the Toronto-Dominion Bank predicts an even bigger deficit in 2011, $81 billion, which represents $18 billion more than that forecast by the present government. That shows that you are more pessimistic about the country's future economic performance.

You seem to be responding to demand, but you're not saying a lot about the immediate future. In the medium and long terms, will you still be able to meet that demand? Should additional measures be taken to stimulate the economy and to enable you to continue meeting the demand for credit? Currently, you can easily meet demand. If people are highly pessimistic, they won't even dare apply for credit. That's not necessarily indicative of a good economic situation.

Mr. Drummond, you said that you had many experts forecasting economic performance; so I'm speaking to you first. Is the present economic plan adequate? Will you still be able to meet demand for credit?

Mr. Don Drummond: My forecasts are spread over three periods. We'll have more difficulty in 2009, but there will be an economic recovery in 2010 and 2011. Then we'll have to wait a number of years to solve the problems that have been caused during the current period. The United States is forecasting a deficit of more than $2 trillion next year and more than $1 trillion for a number of years. Their debt burden relative to gross domestic product will exceed 40%. It may take a number of years to correct that situation. Cuts will have to be made to spending and so on. Banks, especially in the United States and Western Europe, will need to replenish the capital they have lost during this period.

There will be economic growth, but the rate will be depressed as a result of these factors. Instead of 3% from 2011 to 2015, for example, the growth rate may be 2% to 2.5%. I don't think the answer in Canada is to add more tax measures. I am very much concerned. I nevertheless anticipate a deficit of approximately $40 billion. There will be an economic recovery in Canada, the United States and the world, both as regards demand from the United States for Canada's products and in the price of natural resources in Canada.

This is one of the major differences between Glen and me concerning revenue and taxation. I think Canadian resource prices will remain quite low for the next two years because global growth rate is very low; there's no demand for those products.

● (1005)

Mr. Robert Carrier: Thank you.

I have one minute left. I'd like to speak to the Canadian Federation of Independent Business.

In the folders you submitted to us, we see that certain economic sectors are more pessimistic about the future. These are direct consumer businesses, such as the first furniture store and a truck dealership.

What tax measures could the government take to increase the confidence of these businesses that don't foresee a brilliant future?

[*English*]

The Chair: Please be brief, Mr. Mallett.

Mr. Ted Mallett: Yes.

Thank you for the question.

A demand for loans is certainly very important for ensuring that the economy can bounce back as effectively as possible. The measures that we tend to agree to mostly are really making sure that there's good information in the marketplace, making sure that lenders have appropriate knowledge of what sector performance is. One of the problems we have been tracking is that....

The availability of credit is a huge concern for our members. We are noticing that existing banking relationships are being supported. We haven't found, to date, a large case of where financial institutions have decided just to cut off financing to large swaths of the economy. We did notice that in 1990. We believe that's what made the 1990 recession worse than it should have been. Lots of healthy companies were being cut off at the knees by financial institutions: “You're a restaurant; you're in the forestry business; you're in the auto sector—we're going to cut your line of credit in half.”

We have not seen that. To a large degree, we're starting to get a number of questions about that from some of our members. It's something that we really have to watch in the next couple of months.

The Chair: Thank you.

We'll go to Mr. Menzies, please.

Mr. Ted Menzies (Macleod, CPC): Thank you, Mr. Chair.

Thank you, gentlemen, for coming.

I stand by my suggestion that it is good to bring financial experts after or with the Parliamentary Budget Officer. I stand by that. I think it is very helpful to get a broad brush from you folks, who are dealing with it every day.

Once again, thank you for coming, and thank you to Mr. McCallum for agreeing to my great suggestion.

I wanted to follow up on where I was going with Mr. Page yesterday, but some of my colleagues have brought up the non-bank asset-backed commercial paper. We saw some of the worst outcomes of the lack of what I would suggest is common securities regulation in this country at the caisses in Quebec. Yet Quebec seems to be the major push-back—albeit my home province of Alberta is still struggling with the issue.

Can I have your comments, very quickly? I think you're probably all on the record on this. I'm not going to ask you to suggest whether or not the asset-backed commercial paper debacle would have been prevented, but is there a potential that a common securities regulator may help prevent something such as this in the future?

That's to whoever wants to answer.

It looks like all four of you are ready to answer.

Voices: Oh, oh!

Mr. Ted Menzies: Go ahead, Mr. Poschmann.

Mr. Finn Poschmann: I'll take that one, thank you, if I may, Mr. Chairman.

A common securities regulator would be very helpful for the securities-issuing business and for its clients, because you have better clarity of regulation, better clarity of enforcement mechanisms, and better international cooperation, which is important to free trade in securities, which is I think is an appropriate goal for policy.

However, the notion that a single regulator or a national regulator would necessarily ward off types of trouble such as we saw in the ABCP market, I think, is probably attaching a few hopes too many to the program. Similar failures happened in other markets where there were single regulators. The U.K. has a financial services authority that is an über-regulator, and I would not hold out the U.K. marketplace as an example of success for regulation of financial services in the past two years.

I point out also that with respect to ABC in particular, you had failures on the part of the issuers to understand what they were issuing; you had failures on the part of distributors to understand what they were distributing; you had failures on the part of the overseers to understand what they were regulating; and you had failures on the part of buyers to understand what it was they were buying. So there were plenty of things going on there, in that market, that didn't function very well.

One of the key issues, I think, is that those managerial incentives, those risk management incentives, do need addressing, but I wouldn't like to see them being addressed using a top-down mode from a Canadian regulator or a federal regulator.

● (1010)

Mr. Ted Menzies: Does anybody else want to comment on that?

Mr. Don Drummond: I'm happy at the drop of a hat to give a sales pitch for a single securities regulator, but I don't want to pretend that it would have stopped that problem.

Mr. Ted Menzies: No, and that's not what I'm asking.

Mr. Don Drummond: I do applaud the approach proposed in the Hockin document. I must admit—I'll be transparent—I have baggage. One of my jobs in the late 1990s was to try to get a common securities regulator. Obviously—it goes without saying—I failed miserably. We're still at it. But at the end of that endeavour, I came to the conclusion that we should get Ontario and a couple of other provinces, and then just do it with the parties that are willing.

Look at Quebec and the harmonized GST. It's not a part of the official tax base, and it's virtually the same. Quebec is not in the personal income tax collection agreement, and its base is virtually the same. I think we've also been fussed around about the necessity of getting everybody in. If we have a critical mass, I think we'll get what we need out of it. And I think the Hockin report put us on the right path towards that.

The Chair: Okay, there's about 30 seconds, if someone else wants to comment.

Mr. Hodgson.

Mr. Glen Hodgson: We've been on the record for a long time calling for a single regulator. I think Finn has made the case: it's all about efficiency—improving efficiency, information flow—but it wouldn't have solved the problem. It wouldn't have prevented the problem from happening, unless they suddenly had better foresight than everybody else in the world.

Mr. Ted Menzies: Am I out of time?

The Chair: You have 10 seconds, if you need a quick yes or no.

Mr. Ted Menzies: Thank you, sir. I agree with the common securities regulator.

Thank you, Mr. Chair.

The Chair: Thank you, Mr. Menzies.

Mr. Pacetti, please.

Mr. Massimo Pacetti (Saint-Léonard—Saint-Michel, Lib.): Thank you, Mr. Chair.

Thank you to the witnesses. It's always interesting to have a panel of economists before us.

One of the troubling items I'd like to bring up is something I'm seeing of late, which is the deficit. It's acceptable that governments go into deficit all of a sudden, but we're throwing around billions like they're millions. The government, just a couple of months ago, forecast a $64 billion deficit in the next two years. We had Mr. Page yesterday, who put it at $73 billion.

Mr. Drummond, I think you're at—what?—$82 billion now. Is that correct?

Mr. Don Drummond: Yes.

Mr. Massimo Pacetti: Is there a reason you're at $82 billion and the Parliamentary Budget Officer is at $73 billion?

Mr. Don Drummond: This question has come up a lot of times. Can I just take one minute and maybe explain how the government and the Parliamentary Budget Officer do this? I think there's some confusion around that.

Mr. Massimo Pacetti: That's what I'm asking you.

Mr. Don Drummond: Yes, but I think I just said that the government, of course, starts off by taking the average of the private sector forecast. To their credit, on January 27 they didn't believe the private sector forecast, and they actually lowered the forecast for the key factors of a nominal GDP. The Parliamentary Budget Officer is updating that by the revised average of the private sector forecast. And there's a huge range within that. As we indicated, we're at the bottom of the range. Glen, by coincidence, is at the top of that range.

Mr. Massimo Pacetti: I understand that, but is it based on growth?

Mr. Don Drummond: I came up with the $83 billion number by taking everything in the budget as a given and substituting in my economic assumptions for the budget economic assumptions. I didn't redo anything else. It's just purely my more pessimistic take on the economy.

Mr. Massimo Pacetti: Okay.

And Mr. Hodgson, how did you get your number?

Mr. Glen Hodgson: Our forecast is very much driven by an economic model that we run four times a year. We run it every quarter. So we ran it in September, in the middle of the financial crisis. We actually did the reforecasting two weeks later.

Mr. Massimo Pacetti: But your number is probably going to be closer to the $90 billion?

Mr. Glen Hodgson: Ninety? Frankly, I can't give you a number because our forecast is not done yet, and of course the forecast is critical for revenue growth for government, assuming that spending is as planned. But it's really all the impact to the revenue side of the slowdown that we're seeing right now in investment across the country.

● (1015)

Mr. Massimo Pacetti: The revenue growth is dependent on the economic growth, is it not?

Mr. Glen Hodgson: Absolutely.

Mr. Massimo Pacetti: So if you feel that economic growth is not going to increase but actually decrease, and it's at the bottom end, then the revenue growth of the government is going to decrease, meaning a bigger deficit.

Mr. Glen Hodgson: That's right.

Mr. Massimo Pacetti: Okay. So—

Mr. Don Drummond: I'm sorry, but not the way you're postulating it: a lower deficit than the Conference Board would have forecast previously, but their forecast was way above the average before.

I don't know what he's going to lower it to, but you can't imply, as I think you just did, that their forecast of the deficit is going to be higher than the government's. They're higher than mine.

Mr. Massimo Pacetti: I didn't imply anything. You just—

Mr. Don Drummond: You don't just add—

Mr. Massimo Pacetti: Whoa, Mr. Drummond. I didn't imply anything. He said that the economic forecast was going to be even worse, and that meant worse than yours, okay? So we're going to see who has the worst of the worst, but I still think the government deficit is way understated. I think we're headed for a little bit more trouble than anticipated.

But having said that, and seeing how the forecasters or economists have done such a great job, I'm going to give you guys the benefit of the doubt, since we've been hearing that very little money has actually been spent to date. Let's assume this money's going to get spent, whether it's going to be in the next six months or the next twelve months. What happens if the money gets spent correctly? What happens if the money does not get spent correctly? I'll decide what I feel about whether the money will get spent correctly or not from the latest budget, but I want to know what will happen with either outcome.

Mr. Glen Hodgson: Parliament just approved the budget for next year, which starts in about 10 days' time.

Mr. Massimo Pacetti: Yes, I know that. What I'm saying is, let's assume the money is going to be spent, whether that's in six months or twelve months. After the money gets spent, what will happen?

Mr. Glen Hodgson: It'll provide stimulus to the economy.

Mr. Massimo Pacetti: Will it provide jobs? Will revenues increase for government?

Mr. Glen Hodgson: Of course. That's the whole point behind a stimulus package. You're adding stimulus of between 1.5% to 2% of GDP, and—

Mr. Massimo Pacetti: Okay. What happens if the money doesn't get spent properly?

Mr. Glen Hodgson: Well, the stimulus won't be as great. That's a very simple arithmetic exercise.

We think the government is going to be challenged, frankly, in regard to getting the machinery in place to ensure, for example, that the infrastructure spending happens by summer or early fall. Whether it's $12 billion or $20 billion, when you add the provinces in, it's a challenge to get that new money out the door. We all know that's a challenge.

For example, I spent years of my career grappling with federal and provincial regulators, trying to get them to approve projects faster. You have to go through that whole project identification and approval cycle, and letting contracts and all of that has to happen. That's the challenge a lot of us have had with infrastructure spending, in that notionally it's the right thing to do, because you have very high domestic content and you have a lot of stimulus through it, but actually finding useful things to spend it on is not easy. So that—

Mr. Massimo Pacetti: That's exactly my point.

Mr. Drummond, do you have a feeling?

The Chair: Very quickly, Mr. Drummond.

Mr. Don Drummond: We had estimates in the January 27 budget of what the economic impact would be. In our forecast, we've embedded two differences. First, we don't have the overall impact as large. Secondly, we have the timing quite a bit different. We have much less impact in 2009 and more in 2010.

That's just based on the natural history of this, particularly, as Glen mentioned, on the infrastructure, and particularly for some of the infrastructure, for very good reasons. It's tripartite finance with provinces and municipalities, and it's just not going to start tomorrow. There are lags to that. It's not a criticism of government or the fault of government; that's just the reality. So as for a fair bit of the stimulus that was in the budget referring to 2009, I don't believe it will come until 2010, but it will come, and it's part of the reason we do forecast a return and an economic return to growth in 2010.

Mr. Massimo Pacetti: So what happens if there's—

The Chair: I'm sorry, Mr. Pacetti. We're over time here.

Mr. Massimo Pacetti: Thank you.

The Chair: Thank you.

We'll go now to Mr. Kramp, please.

Mr. Daryl Kramp (Prince Edward—Hastings, CPC): Thank you, Chair.

Welcome, gentlemen, to your imperfect world.

Voices: Oh, oh!

Mr. Daryl Kramp: In the world of science, of course, things can be exact, but in the forecasting business it certainly is abstract, because you're dealing with that little thing called humanity, and I've never met anything quite as unpredictable as that yet.

As a matter of fact, we seem to have this changing world and these uncharted waters, and I think everybody recognizes that. Of course, we had the PBO here yesterday, who essentially, in the course of a few weeks, has junked even his original forecast. So certainly—and I will quote one of Mr. Drummond's statements—this has been a humbling experience.

Knowing that, my concern, of course, is how we as a government react to this. Do we react every time there is a movement? Do we revise an entire economic plan on a daily basis? How do you react in an intelligent, capable fashion when a lot of the factors, quite frankly, are beyond our control, whether it's the Obama administration or others?

Knowing the fact that we have a deficit that could be $60 billion or $70 billion, or $80 billion by some estimates, over a period of time.... Obviously, everybody would prefer the lower proportion of that, but is it a fair statement to say that at least we have the financial capacity—you've mentioned the debt-to-GDP ratio—to move forward with a plan? Knowing that we have the financial capacity to deal with that and that we can at least move on a path that has a solid sense of direction, we can rationalize.

Would that be a fair comment, Mr. Hodgson?

● (1020)

Mr. Glen Hodgson: That's an interesting question.

First of all, I think we should be thankful as a country that we did the right thing, resolving our deficit problems back in the mid-1990s. What's really striking to me is the fact that not just the federal government but virtually everybody across the country got their act together. We got debt ratios under control, we paid down debt, and that's part of the reason Canada is in a special place, I would argue. We're actually able to provide more stimulus relative to our economy than almost everybody, except maybe the U.S. In Britain you're getting push-back now from the Bank of England, encouraging the government not to stimulate a second round, because they're worried about this talk of debt and the huge borrowing requirements that the British government has going to the market right now.

How do you respond to the current circumstances? Well, I think you start with a plan, and I see a plan. You have a plan that's going to roll forward. Clearly it will have to be adjusted and adapted as we go along. I don't think you react to every incident. Understand that growth could be much darker this year, and revenues will be impacted, and the deficit will be deeper. But the good news story, for me, is that as a country we can afford it.

I would be more challenging probably two years from now, when we come back and see growth restored, and then ask questions about whether the path to get back to balance is aggressive enough. But I'm going to save that for 18 months.

Mr. Daryl Kramp: Thank you.

We can be optimists, we can be pessimists, we can be realists. The one thing that does disturb me—and this is certainly not a slam against our media friends—is that in some cases there appears to be a race to be the bad news bearers. Quite honestly, when you take a look at some of the information per se that is out there, we all know that media coverage certainly does influence consumer confidence. Excessively negative coverage, quite simply, is going to drive down that confidence. It becomes a self-fulfilling prophecy to some particular extent. I mentioned this the other day.

We all recognize that the numbers are bad. I think there isn't a Canadian or a parliamentarian or an economist who doesn't recognize the straits we're in. But do you feel at some particular point that we're simply ramping up this downside risk without taking into account the positive possibilities and realities that we do have?

I'll leave that open to whoever would like to comment.

Mr. Don Drummond: I don't buy the line of argument that the media is distorting it. The news is terrible, and there's no way around it. In fact, for every example you could put to me where you think the media has exaggerated the downside, I could point to a counter-example.

Mr. Daryl Kramp: Okay.

Mr. Don Drummond: We have had, in the last week, four increases in key variables in the U.S. housing market. I pick the U.S. housing market as an example because that's one of the criteria we need in Canada. We need the U.S. housing market to get back. We've had an increase in housing starts, resale, new homes, and the prices, and the media has jumped all over this, and it's phenomenal. Housing starts in the United States went up 22% from January to February. It blared on all the front pages how positive this was. They are at one-third the level they were a year ago. They're abysmally low. The only reason they went up is because they couldn't go any lower than they were in January. I could have spun that story in a totally different fashion. Look how low it is! Aren't we depressed at how low they were?

They've talked about Geithner's plan and they talked about the toxic assets. That's the second key condition. We have to get these toxic assets separated from the U.S. banks' books so they can lend it. There is a very good chance that plan won't work, yet it was given very charitable treatment by the media. The markets reacted up 6% to 8% around the world on that basis. I could have come and written a story on that thing: look, we're not even going to know until May; we know there's enough incentive for people to buy; we don't have any idea whether there's enough incentive on the bankers' side; this could fall flat. You didn't find a lot of people taking that stance. So I find it on both sides.

I myself am getting messages frequently pretending I'm single-handedly pulling down the economy because I have a negative forecast. The day I got that, it was released that the capacity utilization rate in Canada for the fourth quarter was the lowest number in the history of this country. What are you going to say?

It comes back a little bit to the aspect of that commercial paper. Do you see it the way it is in reality, or do you just sugar-coat it and end up with problems? If I'm in Ted's world and the capacity utilization number is really low, I want to know that and I want to do something about the management of my business so I don't get caught with unintended inventories. If you just put the blinders on, then you're not going to get anywhere.

● (1025)

The Chair: Thank you.

Thank you, Mr. Kramp.

Mr. Daryl Kramp: Thank you.

The Chair: We'll go to Mr. McCallum again, please.

Hon. John McCallum: Thank you, Mr. Chair.

At the risk of belabouring the point, I'd like to ask Don to comment.

Can you clarify what is your understanding for the next two years? What is the government's estimate of the deficit? What is your estimate of the deficit?

Mr. Don Drummond: The government's estimate is simple. They haven't publicly changed it since January 27.

Hon. John McCallum: I mean, what is the number?

Mr. Don Drummond: We all know that. Was $37 billion the hit? I can't remember precisely the number. We have as our cumulative total just slightly under $40 billion for the fiscal year 2009, and $41 billion, slightly over. The only difference between the two is that I substituted our current economic assumptions for the economic assumptions that were underlined in the budget. That's not a full-fledged different view on the budget, and I haven't assumed any different revenue or expenditure or relationships or different programs. It's simply on the basis of economic assumption.

Hon. John McCallum: So if you look at the dollar value of the government's assumption over two years and ignore—

Mr. Don Drummond: Well, ours is $18 billion higher than theirs.

Hon. John McCallum: Right.

Mr. Don Drummond: This is roughly a difference of $9 billion in each of those years. Basically, that's taking the level of nominal GDP difference and multiplying it by the 15% average tax rate. Revenues divided by GDP is roughly 15%. So on average government taxed 15% of nominal income. I looked at the sensitivity of employment insurance, and my higher unemployment rate adds about $1 billion. So that's our number.

Hon. John McCallum: Thank you.

It's great to get clarity, Ted. We like clarity, like the Clarity Act.

Voices: Oh, oh!

Hon. John McCallum: Mr. Hodgson, after that little disruption, again for the sake of clarity, for 2009, can you tell us approximately what your assumption is on real GDP?

An hon. member: Revised.

Hon. John McCallum: In your revised forecast.

Mr. Glen Hodgson: We're marking it down right now. It'll be much closer to 2%.

Hon. John McCallum: I beg your pardon?

Mr. Glen Hodgson: It'll be closer to a 2% contraction of the real economy than our previous forecast suggested, simply because we're looking at the investment numbers across the economy and you're seeing a rout in investment plans. I think Ted confirmed that bottom-up analysis from your members. You're seeing people really pulling back on their investment intentions.

Hon. John McCallum: So you're converging on Don Drummond, in a sense?

A voice: He's still not low enough.

Hon. John McCallum: Can you give us the order of magnitude of your two-year deficit? We have the government at $64 billion; we have TD Bank at $82 billion; we have the Parliamentary Budget Officer at $73 billion. Can you tell us where in that range you would like to find yourself—not necessarily to the closest billion?

Mr. Glen Hodgson: I can't even tell you to the billion. We use very different tools to get there. Don gave you a pretty nice snapshot of how they do it. We actually crank up our model and do the national forecast. We then do a separate fiscal forecast. We use a model-based forecast. As a portable think tank, we can't do that for free, unfortunately. Part of the reason we have a contractual relationship with the Department of Finance is that we give them this advice on a regular basis. At one point, going back two or three years, we actually had a similar relationship with this committee. So I can't give you a single number, but based on the logic that Don walked you through, it's clearly going to be a deeper deficit over the next two years.

Hon. John McCallum: Thank you.

[*Translation*]

The Chair: Mr. Bernier, please.

Hon. Maxime Bernier (Beauce, CPC): Thank you, Mr. Chairman.

I agree with you: the crisis we are currently experiencing in Canada did indeed originate in the United States. However, I would like to ask you a question concerning a witness we heard from last Monday. That witness targeted the persons responsible for the current economic crisis. He said that those responsible for the crisis that we are currently experiencing around the world were the American politicians, both Democrats and Republicans. I will explain his argument and I would like to hear your comment on what he said.

He said that, in the early 2000s, American politicians had a very noble objective of enabling all Americans to have access to home ownership. In so doing, they asked Fannie Mae and Freddie Mac to guarantee mortgage loans that Americans otherwise would have been unable to obtain as they were unable to make a downpayment or were simply unable to get a mortgage loan in the private sector. By asking Fannie Mae and Freddie Mac to guarantee high-risk mortgage loans, they led the banks and the private sector to agree to do the same as they were, since they were sharing the risk. The crisis originated in the early 2000s, and we have seen that those loans were securitized and bought by certain international financial institutions. As a result, the financial crisis was transformed into an economic crisis. In his view, the nasty capitalists aren't at the origin of the crisis; it's the fault of American politicians instead.

I'd like to know what you think of that.

● (1030)

[*English*]

Mr. Finn Poschmann: If I may, Mr. Chairman, I believe everything the member reported is roughly correct, except the history is longer. If you go back to the Community Reinvestment Act in the United States, we have a much longer history going back to the beginning of the 1990s, and even earlier in different incarnations, where Congress and legislators pushed mortgage lenders to put money back into low-income communities specifically because they thought banks weren't lending as much as they should to people near the edge of creditworthiness. The pressure emerged from Congress, from the House financial services committee in particular, and also from the White House, and in 1998 President Clinton pushed hard on Fannie Mae and Freddie Mac to broaden their lending activities. And what Franklin Raines said at the time was that too many homeowners were just a notch below creditworthiness and they wanted to reach out to them with our lending programs.

And guess what? He was right, they were just a notch below creditworthiness, but that we didn't know for sure until very recently.

The program, yes, it was broadly expanded by President Bush, who carried on with the mandate of extending home ownership to low-income communities. Lots of indicators show what you saw: ownership at the bottom end of the price range, at the entry-level price range, boost up relative to other income ranges over this particular period, and you saw debt accumulation among those households build up at an unusual rate in response to the incentives created by the mortgage lenders.

The Chair: There's about a minute left.

Mr. Drummond.

[*Translation*]

Mr. Don Drummond: I agree that the government has its share of responsibility, but it's too simple to limit oneself to that. I also blame the people responsible for regulation.

As I said, I don't agree with Alan Greenspan when he says that high-risk mortgages were acceptable in 2000 and 2001. There were such obvious problems that there would have been grounds for changing the regulations in 2005 and 2006. I also blame investors. Why did they buy batches of high-risk mortgages when returns were so low, with risk both high and absolutely unknown? I have no sympathy for them. They made a serious mistake. Perhaps the government can correct that mistake, but they are adults; they used risk analysts who could have led them to make a different decision.

I also blame the population of the United States. Why did a family in California or Florida take out a $400,000 mortgage to buy a house worth $400,000 without making any downpayment? The banks that granted the mortgage did not even request proof of their income. After granting the mortgage, they did the checks and found that these people who had reported an income of $100,000 had none. They had not even had a job in the previous six months. Should we have sympathy for them? Should we just blame the government? No. A society can't rely solely on regulation and think that the government is always responsible for everything. Yes, the government had its share of responsibility. It made a mistake by encouraging too many people to take out mortgages without making downpayments. They made a mistake in the area of regulation, but everyone made a mistake: the people who granted the mortgages, the investors who made the mortgages and the public, citizens who took out the mortgages.

The Chair: Thank you, Mr. Bernier.

Mr. Mulcair.

Mr. Thomas Mulcair: Mr. Chairman, I would like to continue asking questions of Mr. Drummond, who is on a roll here.

Today in the United States, they're going to propose another raft of measures, they say, to provide a better framework for the situation. I am taking the liberty of suggesting that certain things that were done in the wake of the Enron scandal regarding accounting rules—because walls had to be built—were part of the problem.

Earlier it was said that mark-to-market was one of the challenges. Certain things that were done in response to the very real crisis will cause real problems for us in the longer term. For example, currently they're talking—and I'm going to say it literally—about $10 trillion in the United States, somewhat like what happened during the Vietnam War. The only way to repay the debt from the Vietnam War was through heavy inflation in the 1970s. The war ended in 1975 and there was heavy inflation in the late 1970s and early 1980s.

Aren't we running a real risk of inflation by printing $10 billion? Réal Caouette and Camil Samson—I apologize for citing Mr. Bernier's heroes—are no doubt looking at this with big smiles on their faces. *Newsweek* recently published the following headline: “We are all socialists now.” I would dare say that we are all social creditors now. Aren't there any other challenges, other problems that are concealed with that orientation?

● (1035)

Mr. Don Drummond: As I said earlier in response to a question, I believe that the challenges are enormous in the medium term. In view of the burden of their debt, the United States will have to do what Canada did in 1995 and 1996. However, I doubt it's capable of doing so. At that time, it was the Liberals who did it in Canada, and they had a very strong majority. In the United States, considerable importance is attached to the voice of minorities. I really doubt that, to reduce the growth rate... Even the growth rate influences the level of spending in the United States. The banks need to accumulate capital, not only in the short term, but also to replace the capital provided by the government. They have to replace the entire system of shadow banking, which has disappeared. I don't think it's returned in force in the United States. That's a responsibility of the banks; they would be capable of doing it.

Next, it must never be forgotten that the real problem with the global economy stems from the fact that the United States was spending too much when the savings rates in other countries were very high. We are in exactly the same situation. In the United States, it's the government that's spending too much, not consumers.

At first, we thought that a slowdown in U.S. economic growth would be beneficial, that it would lower [*Inaudible - Editor*]. We saw that kind of thing in the private economy, but we simply saw that consumer spending was being replaced by government spending. We're in exactly the same situation; we're seeing the same trend in the world, probably worse. I'm sure that—

Mr. Thomas Mulcair: Do you think there will be inflationary pressures in the medium term, over a five- to 10-year horizon, let's say?

Mr. Don Drummond: That's a risk, but it would be a mistake by the central banks. Everyone talks about the basic expansion of money in the United States. They can control that in a few months, if they want. The risk is keeping interest rates too low for too long, as Alan Greenspan did. That was a serious mistake on his part. Personally, I think that it will make the same mistake. I firmly believe that the inflation rate will still be 2% in two or three years. The problem is more fiscal than monetary.

Mr. Thomas Mulcair: Since today's subject is access to credit and the stability of Canada's financial system, I'll take the liberty of asking one final question on that subject.

Certain chartered banks—not yours—currently want a mortgage market at a rate of 2% or 2.5%. That's not unusual in Montreal.

The Mouvement Desjardins' rate is now below 2%, 1.5%. I don't entirely agree with you that interest rates won't stay at that level for a long time. The 1.5% rate at Desjardins isn't a fixed rate, but a variable rate. It's like a game on a computer screen: someone sends you something and it moves every time you try to click on it. Try to fix that mortgage at 1.5% for five years and they'll start talking to you about 5%, 6% or 7%.

As soon as rates start to rise, shouldn't someone assess what's happening with those mortgages? We're creating demand. People still think they can pay by the month, not the total value. Shouldn't that be subject to greater oversight?

Mr. Don Drummond: There are remarkable situations on both sides. The Bank of Canada rate is 0.5% and mortgages are extremely low. In addition, bank margins are extremely low, probably the lowest ever seen. The banks will be trying to restore their margins to normal levels. I'm convinced we'll see an economic recovery, but we'll have to wait until early next year.

The Federal Reserve, the Bank of Canada and the Bank of England will raise interest rates quickly, but they won't be 10%. The Bank of Canada's normal rate is probably between 3.5% and 4.5%. Those interest rates will have to go into effect as soon as possible. I don't think they will before mid-2010; they'll wait for the economy to recover. I'm worried about inflation, but, to avoid that problem, they'll have to start raising interest rates as soon as the economy is stronger.

● (1040)

[*English*]

The Chair: *Merci.*

I have Ms. Hall Findlay. I'm advised that I have to get the consent of the committee because there are four members. Do I have the consent of the committee for Ms. Hall Findlay to ask a question?

Some hon. members: Agreed.

The Chair: Ms. Hall Findlay, please.

Ms. Martha Hall Findlay (Willowdale, Lib.): Thank you, Mr. Chair, and thank you very much, colleagues, for your gentlemanly behaviour today.

I have a quick question for Mr. Hodgson. You mentioned earlier that you have revised forecasts in terms of GDP—although not published yet—and you mentioned some contraction, some numbers. Because of the bit of confusion in the discussion we've had so far, can you repeat for me what your forecasts are now for the next number of quarters in terms of GDP?

Mr. Glen Hodgson: That's a painful exercise, but I'll go through it.

We saw the economy contracting. The forecast we did just before Christmas—we do it on a quarterly cycle, when the national accounts come down, which is when we run the model—saw a contraction of about 0.5% for the country for the year, with growth returning in the third quarter and strengthening in the fourth quarter. The profile will be more or less the same, but it's going to be down a notch. So you're going to see a really bad first quarter. I think there's a consensus among everybody who does forecasts. Some have talked about a contraction of 9%. I think that's too high, but you're going to see a 5% or 6% contraction.

Ms. Martha Hall Findlay: That will be for the first quarter.

Mr. Glen Hodgson: Yes, that is for the first quarter, even though, again, we're getting a little bit of good news as we go along.

You simply look at all the other factors. The thing that troubles us the most right now is the contraction we're seeing in investment, whether it's through polling or whether it's through the kind of information Ted has. Actually, looking at investment intentions or at the numbers we're seeing as we get the data down, there are very sharp contractions in manufacturing in southern Ontario and Quebec, and particularly in the oil sands. In Alberta right now there's a real recoiling of investment intentions related to oil sands expansion—for the upgraders, for example. People are simply cancelling things. It is probably based on the belief that oil is going to go to $35 a barrel and stay there.

Ms. Martha Hall Findlay: So overall, what do you think those contractions...?

Mr. Glen Hodgson: I think there's actually been a step up on a global basis in oil prices, and we're going to see oil back at maybe $60 a barrel.

Ms. Martha Hall Findlay: But generally over the next two, three, or four quarters, do you see contractions?

Mr. Glen Hodgson: Yes, certainly in the first two quarters of this year. There will be a sharp contraction in Q1 and certainly a contraction again, but not quite as sharp, in Q2. Then we get into an area of debate about whether there's going to be enough fiscal stimulus, because infrastructure spending will start in earnest in Q3, which is summer and into the early fall. We certainly expect that the economy will be growing again by Q4. At that point, we're sort of half back towards a more normal state. That will take most of 2010. Our 2010 forecast will probably be in the mid-2% range—so growth of about 2.5% in 2010—and the economy will not really be getting back to potential and beyond, as it normally does, until 2011.

Ms. Martha Hall Findlay: I think from what you said, you see Q2 and Q3 as contracting still.

Mr. Glen Hodgson: Q2 is certainly within the forecast. Q3 is an area of debate inside the shop right now, looking at a whole variety of what people would see as extraneous factors, such as inventories. Are they going to go up or down? And how quickly will people start responding to the investment recoil and start building investment plans out again?

Ms. Martha Hall Findlay: Thank you.

I have a question for Mr. Mallett. In figure 7 on your chart, which is the interest rate you're paying on the largest loan currently outstanding, clearly the line at the bottom, the prime plus 6% or greater, leaps off the page. Historically, how does that relate to what we've seen in the past? On a one-look basis, that jumps off the page. Is that significantly different, however, from what we've seen in the past?

● (1045)

Mr. Ted Mallett: We've never asked this question in this particular way. We've known that an awful lot of our members use high-interest-rate kinds of instruments. Many small businesses use credit cards to finance their businesses, and of course that number would be off the page, over there on Glen's side.

We do look at who's offering these types of loans and who's demanding them, and it's typically, again, BDC kinds of loans. Credit unions are more likely to be in that category, as well as the specialty asset companies. It's not typical of the domestic banking industry. There are a few people who say that there are domestic bank customers paying those kinds of rates.

What we're noticing, though, is that this time around there's a lot more flexibility in where the interest rates are. There seems to be more pricing for risk in the market now, whereas in 1990 generally the notion was that if you didn't qualify for a prime-plus-2% mortgage or loan or line of credit, you weren't allowed to get any financing. This time around, there's some discussion that someone is moving to prime-plus-3% or prime-plus-4% but is at least still getting a loan. Our members were complaining 20 years ago that, boy, they would have loved to have the chance to pay prime-plus-3% for a loan, but their bank wouldn't let them do that. They were saying that they wouldn't lend them any more.

We haven't seen that to date, and really our role is to measure.... I mean, we're not in the forecasting business. We've often thought that maybe we should be, but forecasting the future with imperfect current information isn't great. So what we try to do is provide current information to help Glen and Don and others do their jobs better. What we're noticing is a bit more reliance on price for risk in the financing area and less concern that financial institutions are cutting off loans to people just because they're in a certain sector. We've noticed a couple of comments from members along those lines, and we're going to be monitoring that over the next couple of months to see if it gets worse. We'll certainly let any policy-makers know about what kinds of changes and adjustments we see.

Ms. Martha Hall Findlay: Thank you both.

And thank you again, colleagues.

The Chair: Thank you.

Monsieur Laforest, s'il vous plaît.

[*Translation*]

Mr. Jean-Yves Laforest: Thank you, Mr. Chairman.

Thank you. Mr. Menzies would no doubt have liked to have a different answer, but you answered that a single securities commission wouldn't be entirely effective, with regard, among other things, to the purchase of commercial paper in Quebec. From what I understand, you came out in favour of a single securities commission, but for other reasons. You no doubt know as well that there is virtual unanimity on this issue in Quebec. For reasons of constitutional jurisdiction, among other things, the Government of Quebec is opposed to the idea. Whatever the case may be, that didn't prevent the massive purchase of commercial paper, particularly by the Caisse de dépôt et placement. Based on Mr. Drummond's remarks, one might well believe that that was more the result of a lack of clear-sightedness, prudence, on the part of officials and investors. It is also possible that other interests were at stake. We don't yet know the reason, but we hope to discover it.

Mr. Drummond, you said earlier that, at that point, it was entirely clear in your mind that buying asset-backed commercial paper was really too risky and that you naturally avoided, as it were, venturing into that. However, did you share your view of the situation, which you found obvious? When the attraction to commercial paper appeared, did TD Bank warn its clients, generally speaking? Did it explain to them why it was not touching those products?

Mr. Don Drummond: We wrote a lot about the situation regarding mortgage loans in the United States, but we wrote nothing about the situation involving commercial paper in Canada. After all, we compete with the other institutions. We didn't give them our information. I can tell you, however, that not only did our bank not buy commercial paper, it also did not include any in its mutual funds. At least we shared the benefits of having avoided that market with our customers—but not necessarily with those of other banks, as I mentioned.

● (1050)

Mr. Jean-Yves Laforest: You say in your document that “TD Economics provides analysis of economic performance and the implications for investors.” Since that was a highly fashionable product, you no doubt said or wrote something on the subject.

Mr. Don Drummond: No, and as I've already said, I don't think it's the responsibility of a private bank to provide that kind of service. If we want to establish a system of governance, I think that responsibility should be assigned to a rating agency or an organization responsible for regulating securities, but not to a bank.

Mr. Jean-Yves Laforest: Mr. Poschmann?

[*English*]

Mr. Finn Poschmann: *Oui. Merci.*

Very quickly—

The Chair: We're going to have to check how long the bells will ring. It's an unscheduled vote, just to let the witnesses and the members know. We're going to check about the length of the bells.

I'm sorry, Monsieur Laforest.

Mr. Finn Poschmann: Thank you.

In 2002, DBRS, the bond rating service, published a positive assessment of non-bank-backed ABCP in the Canadian market. At the same time, Standard & Poor's, another rating agency, refused to rate them. They issued a document that explained exactly what their concerns were with the quality of the product. It was for exactly those reasons the product eventually failed.

So there was competing information available in the marketplace. It was not acted on, for an interesting set of reasons involving incentives on the part of buyers, distributors, and rating agencies as well.

[*Translation*]

Mr. Jean-Yves Laforest: Thank you very much.

[*English*]

The Chair: *Merci.*

The bells are ringing for 29 minutes, I'm told.

As the chair, I'm going to take the next Conservative spot and I want to ask about a couple of issues.

First, Mr. Drummond, you raised the shadow banking sector in your response to another colleague's question. On Tuesday we had a witness before the committee who said that one of the issues was the fact that this sector is not regulated enough in Canada. He certainly said it's a bigger problem in other countries like the United States, but in Canada we ought to look at greater regulation of things like hedge funds, derivatives, and asset-backed commercial paper was an example of that.

Mr. Drummond, perhaps you want to start, and if anyone else wants to comment, they may. Does that sector need to be better regulated in Canada?

Mr. Don Drummond: Absolutely, but Canada can't do it alone. It has to be done in an international context. I think that's an inevitable result of the discussions that are going to be held on April 2 by the G20, and held within each country. The regulation in the United States is so fragmented relative to what we have, but there's a whole host of it. In fact, probably almost half of the credit that was provided in the United States in 2007 was being provided by non-regulated entities. That proportion wouldn't be nearly that high in Canada. But absolutely the spectrum of coverage of the regulators has to be expanded.

The Chair: Mr. Hodgson, do you want to comment?

Mr. Glen Hodgson: We just published a paper done by two outside authors, an academic and a former banker, looking at global financial regulation. The premise is, as I'm seeing now in the media, that we have to think about the global requirements but really act on a local basis. I'll give you one of the ideas in the paper.

In future securitization, for example, as you bundle things together and sell them into the market, we would propose that the originator be required to hold a portion of that for their own book. That will change the behaviour fundamentally. If you have to hold the risk to term yourself, you're going to take a lot more responsibility for what you're underwriting and for doing ongoing risk evaluation and keeping in touch with what the risk is.

That's on our website, and I will certainly commit it to the committee.

The Chair: Thank you very much for that.

The second issue I want to address is the whole issue of forecasting. It's a very important issue. I think you mentioned this as well, Mr. Drummond.

The budget 2009 forecast was actually more bleak, conservative, or whatever you want to say, than the private sector forecast. There was some contingency built in there, but as all of you have mentioned, the forecasts have gotten much worse since then. That's been in the last six months, certainly since last August, and all the forecasts have got worse almost every quarter. That obviously has a tremendous impact.

Putting on your hat now as a former Department of Finance official, what is a prudent course of action for the government to take? The government doesn't want to be way more bleak and negative than the private sector forecast. You want to be as close as you can to where the economy is going, but if you misjudge it, then it affects all your variables in terms of revenues, in terms of deficit projections.

What's a prudent course of action here? It's a very fluid situation, and forecasting is a very tough thing. It's very frustrating as a government to be in that situation of trying to guess where we're going, but at the same time not being overly bleak so that we affect consumer confidence and we then make the situation worse.

I know that's a tough question, but it's a tough issue we're wrestling with.

● (1055)

Mr. Don Drummond: It's a tough question, but it's one I have a lot of experience with. I started in the Department of Finance in 1977, and that debate has been going on every single minute since then.

The Chair: Well, I need you to solve it for me here today.

Mr. Don Drummond: Invariably, every new Minister of Finance wants you to put out something positive, because you don't want to depress markets. With over 30 years of experience, I've come to see that the only way is to do the best forecast you possibly can, and whether that's viewed as pessimistic or realistic, that's the way you go.

The history of the making of this budget follows a tradition that Paul Martin started in 1994. The normal procedure is to base it on the average of the private sector forecast, so as is usual, a month before the fall update, the Department of Finance did a survey of the private sector forecasts.

I'll refer to nominal GDP because that's the key economic variable. The average of the private sector forecast was 1.9% growth in 2009. At that moment I was sitting with a decline of 3.2%. Just to give you an element of what we're talking about, the difference between my forecast and the average would have been $15 billion on the federal deficit, so it was a huge range of uncertainty. I was aghast. I thought that 1.9% was totally inappropriate as the basis of a budget.

During the course of the discussions it was agreed that the update assumptions would be held open for another week to see if anybody wanted to lower any forecasts, and indeed, if you look in the fall update, instead of the 1.9%, it was 0.8%.

Then when Finance came in mid-January to do their last survey, the average nominal GDP forecast in the private sector was a decline of 1.5%, and again I didn't believe that. I didn't have the impression that officials at the Department of Finance believed that, and I was urging them.... You know, you're not locked into this pattern of using the average of the private sector. In fact, in one of the budgets that Ralph Goodale did, they broke that mould as well: when they were troubled by the average in the private sector, they adjusted it.

I said, “Do that. Do your own. Knock it down; otherwise, you're just going to have to come and revise it and you're going to look silly on the budget forecast.” To their credit, instead of using that average of a decline of 1.5%, they used 2.6%. It still wasn't down as low as mine, and my current forecast for the decline in nominal GDP is 4.5%, which is why I have this $18 billion higher deficit.

I think Finance and the minister and the budget did the right thing in January by not getting locked into this pattern of using the average of the private sector. I just wish they had gone with a number that was even lower.

The Chair: Okay, thank you. Time is up.

Go ahead, Mr. Hodgson, very briefly.

Mr. Glen Hodgson: I had one other thought. You're supposed to forecast on your anticipated revenues and expenses, but there is also the matter of how you actually budget. One of the points I've made to the minister and to the department on a number of occasions is that we have to build margins into our budgeting process. At one point we had a $3 billion contingency fund. I continue to see around $5 billion, which is still a very small share of the national budget. The federal budget is now to about $225 billion; how much of a slush factor do you want to build in to ensure you've got some *marge de manoeuvre*? It's what good companies do. It's what good organizations do. For me, it's part of good budget planning going forward.

The Chair: Okay, thank you.

Mr. McKay, you have one minute.

Hon. John McKay: I want to question Mr. Hodgson's optimism in the light of two hours of conversation in which we seemed to be going down and down and down.

The issue here is that the government has put a stimulus package of just under 2% into the budget. I am taking their figures. We now really appear to be going down a great deal, so I question your optimism on the usefulness or the efficacy of the fiscal stimulus at the size the government has projected in its budget. Is it fair to say that the government should substantially increase the stimulus package in order to have any impact on the economy?

● (1100)

The Chair: Go ahead, Mr. Hodgson, very briefly.

Mr. Glen Hodgson: I think there's a real difference between how much you do and what you do. For example, I advised a different composition of action. I would like to have seen more that dealt with displaced workers and more put into the employment insurance system. If I had a chance right now, frankly, I would reinvent employment insurance to shorten the waiting period and increase the coverage ratio and things like that, knowing that a lot of it leaks into imports. People don't save that; they're going to go out and spend it.

I say that because I would like to see the stimulus happen sooner. The $12 billion infrastructure spending is going to happen in the second half of this year. Don thinks it might even drift into 2010. How much you do is maybe not as important as what you do, and the composition really does matter.

The Chair: Thank you.

I want to thank all of you for being here this morning. This has been a fascinating discussion, a fascinating two-hour session. Thank you all. You're certainly welcome to come back at any time. If there's any further information, please submit it to the clerk or to me, and we'll distribute it to all the members.

The meeting is adjourned.

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