David Dodge: Global imbalances and the Canadian economy

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Barbados International Business Association, Bridgetown, 6 February 2006.

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Canada and Barbados may not have much in common in terms of climate, but we both have very open economies. So we both rely on good economic performance globally for good performance domestically. Recently, the global economy has been delivering that performance, and is expected to record real growth of about 4 per cent or better through 2007. It would be nice to think that this solid growth could endure forever. However, we all know that the global economy is subject to a number of risks, and policy-makers in international forums spend a lot of time thinking about how best to handle those risks. Most recently, discussions have focused on two major issues that are partly related to the rise to prominence of China and other Asian economies. One is that world oil markets remain very tight, and a further increase in oil prices remains a possibility. The other issue relates to the global economic and financial imbalances that we now see, and the way in which they will be resolved. Today, I want to spend some time discussing these imbalances and how they might be resolved. Then I'll say a few words about the state of the Canadian economy before turning to you for questions and discussion.

Global imbalances - origins and solutions

I should start with a definition. When I say "global imbalances," I am referring to the large and persistent current account deficit in the United States that is mirrored by large current account surpluses elsewhere, especially in Asia and in many oil-exporting countries. Given that Canada and Barbados depend on international trade and global financial stability for economic growth, we both have a major stake in seeing that global imbalances are resolved in an orderly way.

There has been much written and spoken commentary on the causes of these imbalances. But at the Bank of Canada, we see them as reflecting the financial flows associated with mismatches in savings and investment within major regions of the global economy. Since the latter part of the 1990s, many economies outside the United States have, for various reasons, increased their national savings by a very large amount. At the same time, the United States has reduced its savings and has become increasingly reliant on foreign borrowing.

Is this a problem? So far, no. Global financial markets-in which many of you are involved-have done a good job of matching international savings flows with investment opportunities. International capital flows are the lifeblood of the global economy. However, the sheer size of these financial flows into the United States is not sustainable indefinitely. We know that U.S. external indebtedness-even with that country's reserve-currency status-cannot keep growing forever. This is especially so given that this borrowing is being used mainly to finance current consumption.

We also know that in many places outside the United States-particularly in Asia and in many oil-exporting countries-households currently want to save more than businesses want to invest. At the same time, desired national savings in the United States are not sufficient to meet desired investment, although it is not certain that this situation will persist. Eventually, domestic savings in the United States will have to increase. Should that occur suddenly, we could see global economic growth slow sharply, unless there was corresponding growth in domestic demand outside the United States. Such a slowdown in growth, in turn, raises the risk that policy-makers might resort to protectionism. In that event, a period of very slow growth could, perhaps, be punctuated by periods of outright recession.

I hasten to add that this is *not* a prediction on my part. I am only saying that such an outcome could be the consequence of inappropriate policies in many economies. And this outcome would hurt all countries, including those that are following appropriate policies.

Global imbalances are a global problem, and we need to think about them collectively. So how can we achieve their orderly resolution? Let me spend a few minutes talking about what is needed, both domestically and internationally, to help resolve the imbalances.

Appropriate domestic policies support confidence

One of the keys to changing the flows of global savings and investment is for each country to follow policies that have the best chance of achieving sustained growth in the medium term. The best way to ensure that global demand continues to grow over time is for policy-makers to provide an environment that gives households the confidence to spend and businesses the confidence to invest. If all countries were to follow appropriate domestic policies, this would go a long way towards defusing the danger posed by global imbalances.

Specifically, in terms of fiscal policy, there is a clear need for countries to focus on having a sustainable ratio of public debt to GDP. This would give confidence to businesses and consumers that the value of their money will not be eroded over time, either by high inflation or by excessive taxation. Where a sustainable public debt-to-GDP ratio is now absent, it should be achieved; where it is present, it should be maintained.

The second point is that authorities everywhere need to ensure that domestic policies are promoting well-functioning markets for goods, services, capital, and labour. In particular, labour markets need to be flexible enough to facilitate the movement of workers from sector to sector as the economy adjusts to events. By promoting domestic flexibility, policy-makers in all countries could support confidence and boost growth. This would be good for national economies, and it would also help to resolve global imbalances.

There is also a need for policy-makers to recognize the positive role played by a well-functioning social safety net. Here, I am referring to unemployment insurance, public health care, and public pension systems. Consider the countries of emerging Asia, where such systems are lacking. Citizens in those countries need very high levels of savings to mitigate the risk of job loss and illness, and to provide for the years after they leave the workforce. An effective and efficient social safety net pools risk, so that citizens can have increased confidence about the future and reduce their need for precautionary savings. I know that the Chinese authorities that we at the Bank deal with are well aware of the need to create a well-functioning social safety net.

Authorities everywhere also need to follow policies that help a country's financial system to work well. This is critical if the financial system is to carry out its vital role of helping to match savings with productive investments. The financial system can also support confidence by giving households and businesses appropriate access to credit. I know all of you in this room are well aware of the importance of a well-functioning financial system, so I don't need to belabour the point. But I would add that, in terms of supporting confidence, appropriate monetary policy is also critical. It is important that central banks follow policies that anchor inflation expectations and thus promote confidence in the future value of money.

A renewed international monetary order

Having spoken about what policy-makers can do domestically, let me now turn to international issues. Essentially, the global economy needs a commitment by all countries to a renewed international monetary order, and a willingness to play by accepted rules within this order.

Let me explain what I mean. Around the end of World War II, the developed countries came together and reached a series of agreements. They agreed to establish a monetary order based on fixed exchange rates, together with a process to realign exchange rates in the event of fundamental imbalances. Important institutions, such as the International Monetary Fund, the World Bank, and the General Agreement on Tariffs and Trade, were also established.

But since the 1970s, many economies have adopted flexible exchange rate regimes. In general, these regimes have been able to coexist with fixed exchange rate regimes, and to do so relatively well in a world of open capital markets. However, the success of this coexistence has depended on countries following "the rules of the game" appropriate to the exchange rate regime they have chosen.

What do I mean by "the rules of the game"? For countries with a flexible exchange rate, this means that authorities should actually let their currency float freely. And for countries with a fixed exchange rate, this means that authorities need to run appropriate policies in order for the fixed exchange rate to be sustainable. In particular, countries with a fixed exchange rate and a current account surplus should not "sterilize" the foreign exchange interventions required to fix the value of their currency. By "sterilize," I mean offsetting the effect of interventions on the domestic money supply.

Recently, problems have arisen from countries not playing by the rules of the game. Certain Asian economies have been stifling the inflationary effects of their interventions and, in the process, building up massive amounts of foreign reserves.

When countries offset the effects of intervention, they delay domestic economic adjustment. They also delay global adjustment. Just as worrying is the fact that such intervention is provoking threats of protectionist measures in certain political quarters. Such wrong-headed measures could choke off the growth of international trade that has led to rising incomes worldwide.

What is needed today is a renewal of the international monetary order and of the spirit of international co-operation that led to the original agreements. The global economy has changed enormously since the end of World War II. But the danger posed by global imbalances is a clear reminder that there is still a need for a coherent international monetary order-and a need for countries to play by the rules.

In this context, it is also very important that all countries work to protect and enhance the free flow of goods and services by finding a way to break the stalemate at the Doha round of trade talks and by strengthening the World Trade Organization. We all need to support these efforts and to be vocal in resisting calls for protectionism.

Current economic developments in Canada

Having set out this global context, let me now turn to how Canada fits into the picture. As I said at the outset, like Barbados, Canada has a very open economy, so how we deal with the current challenges is crucial to our economic health. We have been following policies that allow the Canadian economy to adjust to global developments. Let me say a few words here about my own area, which is monetary policy.

Canada's monetary policy consists of an inflation-targeting system, backed by a freely floating exchange rate. We aim to keep inflation at 2 per cent, the midpoint of a 1 to 3 per cent target range. Under this regime, not only has inflation in Canada remained near the target in recent years, but inflation expectations are now anchored near 2 per cent. As a result, market signals are sent and received more clearly, and Canadian businesses and consumers are more confident about the future value of their money.

A critical feature of our inflation-targeting system is that we operate *symmetrically* around our target. This means that we care just as much about inflation falling below target as we do about inflation rising above it. This symmetric approach helps keep the Canadian economy near its production potential, thus encouraging strong, sustained growth in output and employment.

Another feature of our monetary policy is that we aim to be transparent. At the Bank of Canada, we believe that monetary policy is more effective when people understand what we are doing and why we are doing it. We publish regular reports and updates about our monetary policy. In the most recent *Update*, published on 26 January, we noted that the Canadian economy continues to adjust to global developments and to the associated changes in relative prices.

As I said at the beginning, global economic growth is expected to remain robust-around 4 per cent this year and next. Against this backdrop, we continue to judge that the Canadian economy as a whole is currently operating at its production capacity. And we expect it to keep on growing roughly in line with its production potential through 2007. Specifically, we project annual average growth of 3.1 per cent this year and 2.9 per cent in 2007.

Total consumer price inflation, which was at 2.3 per cent in the fourth quarter of 2005, has been and will continue to be affected by changes in the prices of crude oil and natural gas. Assuming that energy prices evolve in line with the prices reflected in futures markets, we expect total inflation to return to the 2 per cent target by the first half of 2007. The same is true of core inflation which, in the closing months of 2005, was at 1.6 per cent.

With the Canadian economy operating at capacity and expected to grow at potential through the projection period, on 24 January we raised our policy interest rate by 25 basis points, bringing it to 3 1/2 per cent. And we indicated that, in line with our base-case projection and our current assessment of risks, some modest further increase in the policy interest rate would be needed to keep aggregate supply and demand in balance and inflation on target over the medium term.

It is important to keep in mind that there are, as always, both upside and downside risks to our projections. For 2006, these risks appear to be balanced. But through 2007 and beyond, the risks are tilted to the downside because, as I have said, the unwinding of global imbalances could involve a slowdown in world economic activity.

Conclusion

Let me conclude. Global imbalances are a global problem, and their resolution requires a global effort. Every country has a role to play in this effort. And while the specific policy measures will vary from country to country, there are common principles that policy-makers everywhere should follow. These include the adoption of appropriate fiscal policies, the promotion of well-functioning labour and product markets, the provision of a well-functioning social safety net, policies that allow for an efficient and sound financial system, and a monetary policy focused on low, stable, and predictable inflation. We also need a commitment by all countries to a renewed international monetary order and a willingness to play by the rules of the game.

This does not represent a new prescription for global economic health. But the need for urgent action has increased. Imbalances are persisting, and if they aren't resolved in an orderly way, we face the threat of great disruption. That is particularly true for countries with very open economies such as Canada and Barbados. An orderly resolution of imbalances is in all of our interests.