David Dodge: The right policies for today's global economy

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Chile-Canada Chamber of Commerce, Santiago, Chile, 19 July 2006.

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Canada and Chile both rely heavily on international trade and foreign investment for economic growth, and are both major producers of commodities. Because we share these attributes, we also share a keen interest in the health of the global economy. So, what I would like to do this morning is talk about how the global economy has unfolded and what we can expect to see in the future. In doing so, I'll talk about some of the major forces at work in the global economy and the key challenges that they pose. Then, I'd like to discuss the policies that will best help countries like ours to deal with these challenges, from both a domestic and an international perspective.

The global economic context

Over the past few years, we have seen a strong expansion of the global economy. Indeed, the rate of expansion has exceeded the growth rate of global potential output. This strong growth has led to higher prices for many of the primary commodities that our two countries produce. In turn, this has meant an improvement in our terms of trade and rising national incomes.

This global growth has been rooted primarily in the economic strength of the United States and emerging Asia. In the U.S. economy, growth has come from strong household demand, while net national savings have been negative. But in emerging Asia, household demand has been weak, while net national savings have been very high. These forces have contributed to the global current account imbalances that are now such a concern. To be clear, when I say "global imbalances," I am referring to the large and persistent U.S. current account deficit, which is mirrored by current account surpluses in Asia and in many oil-exporting countries. These imbalances have grown to the point where the United States needs to attract 70 per cent of the world's capital flows to finance its current account deficit - clearly an unsustainable situation.

I'll have more to say about imbalances, and how they can be resolved, in just a moment. But first, I should mention another important consideration in today's global economic picture. Following events such as the Asian and Russian financial crises of the late 1990s and the bursting of the tech bubble earlier this decade, central banks around the world injected a lot of liquidity into the global economy. Clearly, this liquidity helped to encourage the strong growth of recent years. But now, central banks are in the process of removing some of it. The interest rate increases seen to date, and the prospects for more increases to come in some countries, have been associated with somewhat increased volatility in financial markets, as investors adjust their expectations about future growth.

This withdrawal of liquidity is completely appropriate, given that the global economy is now likely not too far away from the limits of its capacity. Thus, it seems very likely that global growth will slow to a more sustainable pace. Ideally, this would take place in a relatively smooth way. But there are a number of risks surrounding this scenario, and there is a possibility that global growth will slow more sharply than desired, to the detriment of our two economies. The most important risk has to do with the way global imbalances are ultimately resolved. There are a couple of concerns here. First, in order to reduce its current account deficit to sustainable levels, the U.S. economy needs to reduce its domestic demand. But as I mentioned, U.S. demand has been a key support for the global economy. So it is crucial that other major players boost their domestic demand to pick up the slack. Specifically, it is important that China and the economies of emerging Asia take steps to reduce their savings by strengthening household demand. It is also important that demand in Europe and Japan continue to strengthen, to help global economic growth smoothly "rotate" away from the United States without global demand slowing too much or too quickly.

It is crucial that financial markets remain confident that policy-makers are serious about putting the right policies in place to allow for an orderly resolution of imbalances. As long as they have this confidence, financial markets are likely to continue to function smoothly. But my main concern is that if we don't make more progress in implementing the right policies, then we run an increased risk of global financial instability. And such instability could then spill over into trade in goods and services, leading to a dramatic decline in global growth.

So, what are the right policies? This will be the subject of the rest of my remarks. Let me begin by looking at this question from the perspective of domestic policies before turning to international issues.

The right domestic policies

My counterpart at the *Banco Central de Chile*, Vittorio Corbo, spoke at a conference on central banks and global imbalances last month in Spain. In his remarks, Governor Corbo discussed the need to have the right domestic policies in place to help deal with the resolution of imbalances. These policies include structural reform, fiscal policy, and monetary policy. Let me say a few words about each of these.

Structural reform is a broad area with many priorities. But in general, we can say that policy-makers should aim to encourage efficiency and flexibility in their economies. This is particularly true in the financial sector, where it is vital that all countries work to strengthen their financial markets and institutions. The ultimate goal should be an efficient and stable financial system, so that scarce resources can be channelled into the most productive investments, and so that problems in the global economy are less likely to disrupt national economies. While both Canada and Chile have reasonably flexible economies, there is still much more to be done. In my own country, we continue to grapple with the need to make labour markets more flexible and to foster competition. We are also working to make financial markets as efficient as possible.

As regards fiscal policy, the key for macroeconomic policy is to focus on the sustainability of public debt over the medium term. Canada has run a budgetary surplus at the federal government level for nine consecutive years. Because of this record, the federal government's public debt-to-GDP ratio has fallen from a peak of over 70 per cent to about 35 per cent now, and is on track to reach just 25 per cent in 2013-14. In Chile, the government has had great success since 2000 with its structural surplus rule. This policy has proven to be an effective stabilizer throughout the business cycle and has helped the country maintain an enviable debt position.

A fiscal policy that delivers public debt sustainability is particularly useful in today's economic climate, because it gives governments the flexibility to respond to evolving circumstances. For Canada, this will become increasingly important given that we will be facing demographic pressures in the years ahead as our population ages.

In terms of monetary policy, both the Bank of Canada and the Banco Central de Chile were pioneers in adopting a policy of inflation targeting backed by a floating exchange rate. Both central banks agree that preserving confidence in the value of money is the best contribution that we can make to the economic and financial welfare of our countries. The inflation-targeting system has been enormously beneficial in providing an anchor for monetary policy. In both countries, the high and variable inflation rates of the 1980s have given way to low, stable, and predictable inflation, and inflation expectations are firmly anchored. We both approach the inflation target in a symmetrical way. This helps to smooth the ups and downs of the business cycle and, more generally, has led to stronger economic growth in the long term.

How does inflation targeting help in the context of today's global economy? First of all, by reducing uncertainty about the future value of money, a climate of low and stable inflation maximizes the clarity of signals that are sent by prices. This helps businesses to make appropriate investments. Further, central banks pursue inflation targeting by adjusting interest rates with the goal of keeping total supply and demand in the economy in rough balance. In doing so, monetary policy can make it easier for resources to shift from sector to sector. This is particularly important in times such as these, when large swings in relative prices highlight the need for rapid adjustments in economic activity. One of these relative prices is the exchange rate. A flexible exchange rate is very useful because it helps the economy adjust to shocks, especially external shocks that affect different economies in different ways. But large movements in the exchange rate can pose difficulties for particular sectors. And it can be harder for policy-makers to keep following the right policies when some important economies are seen to be circumventing what could be called "the rules of the game."

The right international policies

I'll come back to this point, and discuss the international financial system in just a moment. But first, let me say a few words about international trade.

Our reliance on international trade means that both Chile and Canada have a particular interest in promoting the free flow of goods and services. All countries should be working to push the Doha round of multilateral trade negotiations to a successful conclusion and to strengthen the World Trade Organization in order to ensure proper compliance with the rules of trade. And policy-makers need to be vocal in resisting calls for protectionism. Unfortunately, progress on trade appears to be stalled, and protectionism is a real and rising threat.

The calls for protectionist action are, perhaps, a natural by-product of today's globalized economy. As the world economy has developed, domestic firms have found themselves having to adjust to global forces much more quickly than in the past. With the globalization of markets has come intense competition in many sectors. Without question, this globalized economy has brought tremendous benefits to our citizens. But in the face of competition, policy-makers have heard calls to shield businesses or sectors from market forces. And in some cases, we have seen policies that try to prevent market-based economic adjustments, restrict foreign ownership in certain sectors, or restrict capital flows.

These policies may have short-term appeal, but, in the long run, they are counterproductive. Instead, governments need to adopt the right policies - those that will encourage free and open markets and facilitate market-based economic adjustments. Indeed, the strong growth seen in Canada and Chile is clear evidence of the benefits that come from opening our economies to global competition.

Central banks cannot do much directly to implement policies that encourage free and open markets and facilitate market-based economic adjustments. But central bankers do have a responsibility to advocate these policies. And we have a responsibility to work with each other in international settings to ensure that the world's financial system is conducive to the free flow of goods, services, and capital. We have a responsibility to ensure that systemically important countries are doing their part to support a well-functioning international financial system.

This is why we in Canada have been pushing hard for a renewal and modernization of the International Monetary Fund. Just as the WTO is charged with promoting free and fair trade in goods and services, so should the IMF be the international organization dedicated to promoting a well-functioning, market-based international financial system. We need an IMF where all members commit to playing by the rules of the game - a set of guidelines for policies that best support a market-based international financial system.

For the IMF to fulfill this role, we need to rekindle the spirit of internationalism that was evident 60 years ago when the Fund was first established. But it is difficult to build a shared sense of trust and responsibility if key players feel that they don't have an adequate voice. What Canada and others have been advocating is a multi-step approach to making the Fund more representative. First, at the annual meetings this year in Singapore, the Fund should move to grant an "ad hoc" increase in quota to the four key countries that are clearly underweight in terms of quota and voting power: China, South Korea, Mexico, and Turkey. Then, the Fund needs to move with some urgency to determine and implement a process for adjusting quotas in order to more systematically recognize the changing realities of the global economy.

But how would a more representative IMF go about promoting a well-functioning international monetary system? Let me mention three issues. The first is to have countries commit themselves to following the rules of the game. What does this commitment mean in concrete terms? It means that members should commit to establishing frameworks for their monetary, fiscal, exchange rate, and financial sector policies that are coherent, consistent with maintaining internal balance, and that support an efficient and stable market-based international financial system. Further, their policies should facilitate adjustment to shocks and should aim to mitigate negative spillovers to other economies.

I should be clear that following the rules of the game does not mean that a country must adhere to a narrow range of policy choices. The important principle is that all countries, whether they are OECD members or economies in transition, should share a commitment to a market-based international financial system. This means a commitment to strengthening domestic institutions and policy frameworks so that markets are allowed to work freely, and to eschewing policies that thwart market-based adjustments. This includes a commitment not to undertake sterilized foreign exchange intervention that impedes the adjustment of real exchange rates over the medium term.

The second issue is IMF surveillance. The Fund should conduct bilateral surveillance that would assess how well each member is living up to its commitments. But there is also a clear need for the

IMF to strengthen its *multilateral* surveillance of the global economy. The Fund is uniquely placed to perform this task. Essentially, multilateral surveillance should identify the key risks facing the global economy and the scope for policy actions - either by individual members or collectively - to mitigate these risks. If national policies are causing negative spillovers to other countries, this should be addressed through the surveillance process. And the Fund should be prepared to share its analysis of these spillovers with national authorities.

The third issue is that the IMF must be more effective in its role as a forum where national authorities come together to discuss global financial and economic issues. The Fund should be considered as *the* place where national authorities can gather around the same table for a frank exchange about common policy issues. The Fund must cultivate the same co-operative spirit seen at its inception and seen at the OECD in the 1960s and 1970s as that institution helped to build a liberal economic order and a framework for freer trade.

Canada has called for this modernization of the IMF because it is clearly in our interest that there be an effective institution to promote a market-based international financial order. I believe that such an institution is in Chile's interest as well.

Conclusion

Canada and Chile have benefited greatly from the strong global economic growth of recent years. But the global economy could suffer if policy actions are not taken to deal with global imbalances. In this context, I have spoken of domestic policies that are particularly important for countries such as ours: structural reforms to encourage economic efficiency and flexibility, a sustainable fiscal policy, and a monetary policy based on inflation targeting. By following these domestic policies, both Canada and Chile will be well placed to handle developments in the global economy, whatever those may be. But we also need to work together to shape that global economy. We need to support free trade in goods and services and to resist protectionism. And, as I said, we - together with other countries - need to make the international financial system as efficient and effective as possible. An important part of this effort will be to modernize the IMF. With strong domestic policy frameworks and a strengthened international financial system, Chileans and Canadians can look forward to continued strong economic growth in the years ahead.