David Dodge: Promoting sound economic policies globally and locally

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Americas Society and the Council of the Americas, New York, 29 March 2007.

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It has been three years since I last had the opportunity to address the Council of the Americas. Since then, the global economy has continued to expand at a remarkable pace. Indeed, over the past five years, it has grown more than in any five-year period since the Second World War.

In my opinion, much of this performance can be credited to the increasingly widespread acceptance of the need for a liberalized worldwide financial and trade order. Many countries that once closed themselves to the outside world are now actively engaged in the global economy. Notable examples are China, India, and, within the Americas, Chile. Many states that twenty five years ago would have been considered "less-developed countries," or that were within the sphere of the former Soviet Union, are now experiencing the benefits of economic openness, and millions of people have been lifted out of extreme poverty.

In Canada and the United States, it is understood by many – although certainly not by all – that it is in our own interest, both economic and geopolitical, to increase the number of countries taking part in a liberalized financial and trade order. While there have been clear successes, particularly in Asia, there have also been clear disappointments. Within Latin America, there have perhaps been more disappointments than successes. And even in those Latin American countries that have taken real steps to join the global economy, anti-globalization sentiment remains quite strong.

So today, I want to talk about the factors that have led to either success or setback in our progress towards a liberalized global framework for trade and finance. Then, I want to talk about the particular challenges that we face in promoting active involvement in the global economy by countries throughout Latin America. I will confine my remarks to economics, although the challenges clearly extend well beyond this domain.

Developing a global policy framework

The best place to begin is with the aftermath of World War II. Delegates to the Monetary and Financial Conference at Bretton Woods, New Hampshire, began to create an economic order where trade could flourish, and postwar reconstruction could take place. Led by a strong contingent of American, British, and, if I may say so, Canadian representatives, the delegates set out to establish new international institutions. These would serve as tables around which policy-makers would gather to work out what could be called the "rules of the game" for a new financial and trade order.

Over time, policy-makers at these new institutions had some real success in developing the rules of the game for several important areas. Early on, there was the establishment of the International Monetary Fund (IMF), and the International Bank for Reconstruction and Development, which would become the World Bank. Later, the General Agreement on Tariffs and Trade was launched, which would ultimately become today's World Trade Organization (WTO). And over time, the Organisation for Economic Co-operation and Development (OECD) evolved to become a venue where financial authorities could gather and discuss how best to promote strong economies through liberalized markets, freer trade, and sound macroeconomic policies.

Initially, the rules of the game were meant to apply to many of the so-called "first world" nations, including the United States, Canada, Western Europe, Japan, Australia, and New Zealand. And for many years after the Second World War, the rules that had been developed served these countries reasonably well. Indeed, the global economic order was sufficiently successful that a number of other nations began to see how their economies and their citizens could benefit from taking part in it. And so, more nations began to adopt the policy frameworks needed to become engaged in an increasingly inter-connected global economy. I'll have more to say on this in a few minutes. But first, I want to discuss the struggles of policy-makers to keep the rules of the game relevant, given the changing nature of the global economy.

Updating the rules of the game

The need to keep the rules of the game updated is no surprise. After all, the world economy has changed tremendously over the past few decades. Enormous advances in transportation, communications, and information technology have led to widespread gains in productivity and massive changes in the structure of the world economy. While this has been going on, new economic powerhouses have emerged. In response to these developments, the rules of the game have evolved somewhat, as have the institutions supporting the global financial and trade order. But to be blunt, neither the rules nor the institutions have fully kept up with the times.

To illustrate my point, I'm going to say a few words about the IMF in particular. The Fund was critical in establishing some of the rules for monetary policy and exchange rates in the years immediately following the Second World War. But more recently, the IMF has been perceived by some countries as being irrelevant, and its activities have sparked resentment and outright hostility in other countries, including some in Latin America.

A major source of this hostility and perception of irrelevance is the fact that the Fund has not evolved in step with the global economy. And this lack of evolution contributed to the Fund's inability to prevent or even to mitigate international crises such as the Asian Crisis of 1997 and the Argentinean crisis in 2001. In the absence of global co-operation to update the rules of the game, and an effective IMF to support these rules, we have seen a drift towards regional initiatives. And rather than using the IMF to efficiently pool international reserves, countries such as China have set out to accumulate very high levels of reserves.

I have made several speeches in other places about the need to strengthen the surveillance function of the IMF, to improve its governance, and to make it more representative of today's global economy. I won't repeat those arguments here; if you are interested in the details of our recommendations for the IMF, I'd invite you to read the lecture I gave one year ago at Princeton University.

The point I want to make today is that strengthening the IMF could help some countries – including those in Latin America – to willingly support and engage with the Fund. And this would increase the chances that these countries would willingly engage in the global economy. Unfortunately, in recent years, the attention of Canada and the United States has focused mainly on Asia. We have worked hard to help the Asian economies integrate into the global economy and take their rightful place at the policy-makers' table. We've encouraged these countries to play by the rules of the game with respect to international trade, in particular, by supporting their accession to the WTO. But at the same time, we have become concerned that these nations, notably China, are not always following the rules of the game with respect to monetary and exchange rate issues. Rather than deal with this issue through a strengthened IMF, we in the G-7, including the United States, have often dealt with it on a country-by-country basis.

My contention is that all of us in the G-7, particularly the United States – which truly believes in a liberal financial and trade order – should lead the effort to strengthen multilateral institutions, such as the IMF. Not only would a stronger IMF be a more effective forum for dealing with the policy challenges now seen in Asia, it would also be more effective in encouraging the countries of Latin America to engage more fully in a liberalized financial and trade order.

Policy challenges in Central and South America

Because of our recent focus on Asia, we have, in many ways, neglected the need to promote economic progress and development in our own backyard. We need to pay equal attention to encouraging global economic involvement and promoting appropriate policies in our hemisphere, so that the countries of Latin America and their citizens can share the benefits of globalization.

But this is not a simple task. The challenges of Latin America differ from those in Asia and other regions. And the task is made more difficult because there is no table around which the economic policy-makers of this hemisphere regularly gather. There is the Organization of American States (OAS), but it deals mainly with political and strategic issues. There is CEMLA, but it deals with the limited range of issues common to the central bankers of the Americas. There is the Inter-American Development Bank, but it is more project-oriented than policy-oriented. And at the IMF, the countries of Latin America and the Caribbean island nations are divided among four executive directors. In short, we really do need a table around which all the economic policy-makers of the Americas can gather. Unfortunately, there is no OECD for the Americas.

If there were an OECD for the Americas, what would it do? Essentially, it could serve the same function as the original OECD did for Western Europe. It could be a forum where economic policy-makers would discuss how best to promote strong economies through sound monetary, financial, and fiscal policies, as well as how to promote liberalized markets and freer trade.

I do not know how such a table could be created, or how we could ensure that discussions would be as fruitful as the ones at the OECD. But creating such a table could be a very positive step, and I would be most interested in hearing your thoughts on this during our discussion period.

Monetary policy

Let me now take a few minutes to discuss some of the issues that could be dealt with at an OECD for the Americas. I'll begin with my subject area: monetary policy. The first point to make is that Latin America has to overcome a history of high inflation and, occasionally, hyperinflation. High inflation has not only held back economic development in Latin America, it has also had a devastating effect on its poorest citizens, who cannot shield themselves from its pernicious consequences. Inflation has exacerbated the problems of an already skewed income distribution.

Some countries have made substantial progress in getting inflation under control and keeping it under control. I am thinking here of Chile, Mexico, and more recently, Brazil. In these cases, central banks were given sufficient independence from government and tasked with controlling inflation, although I hasten to add that the independence of the Brazilian central bank has never been formally legislated. These central banks were then able to make progress by adopting an inflation-targeting framework, supported by a floating exchange rate.

In a Latin American setting, inflation targeting has been tremendously helpful in promoting macroeconomic stability, facilitating investment, and very importantly, aiding the most vulnerable members of society. Indeed, a low-inflation environment has allowed banks to offer credit to some households for the very first time – often a crucial first step in escaping poverty. I'll say more about the banking sector in a moment.

I should also mention that some smaller nations in the Caribbean and Central America have achieved low inflation, quite appropriately, by fixing their exchange rate to the U.S. dollar.

But while we can celebrate some monetary progress, we must also consider the country with the most troubled monetary policy history: Argentina. This is a country that has all the natural advantages needed to be one of the richest in the hemisphere. But Argentina has consistently failed to live up to its potential, and bad policy choices are largely to blame. The independence of Argentina's central bank has been repeatedly undermined, and unfortunately, the current policy path chosen by the government is once again leading to high inflation in that country. Of course, Argentina isn't alone in this regard.

Perhaps the most important thing that Canada and the United States can do is to demonstrate our support for those countries that have made the right policy choices. In this way, we can show the citizens and their governments that they are on the right path to development. That is why the Bank of Canada has worked closely with the *Banco Central de Chile*, the *Banco de México*, and the *Banco Central do Brasil*, to provide support and technical assistance as they implemented inflation targeting.

Financial system policy

Next, I'll say just a few words about financial system policy. Here, I'm referring to the rules governing banking and the financial sector, as well as policies to support sound clearing and settlement systems. This is an area that is often overlooked. A sound and stable banking sector is, of course, enormously helpful in encouraging investment, which leads to increased employment and economic activity. And, as I just mentioned, extending access to credit to a broader segment of the population is a critical step towards economic progress. With increased access to credit, the poorest members of society are enabled to break out of the poverty trap.

Progress in the financial sector area has been quite good in several countries for a number of years. Indeed, one could argue that there has been more progress in Latin America on financial system policies than there has been in Asia. The result has been that some commercial banks from the United States, Canada, and Europe, have expanded into the region. But it is important that we also encourage local financial institutions in Latin America. In the long run, having a sound and vibrant financial sector in place is in everybody's interest, even those financial institutions that would face increased competition in these markets.

Another point to be made here is that policies must be put in place to encourage the development of local capital markets across Latin America, beginning with government bond markets. It is through both capital markets and financial institutions that savings are efficiently turned into productive investments, stimulating economic growth and helping to alleviate unemployment and poverty.

Clearly, an OECD-like table, where policy-makers in Latin America can learn from each other, and from our experience in Canada and the United States, could be tremendously helpful in this area. It would be very beneficial to have a forum where economic policy-makers could gather to discuss issues and devise solutions to help strengthen financial sector policies across the Americas.

Fiscal policy

Now let me turn to fiscal policy. In many ways, this has been the Achilles heel of Latin American economic policy. There are very few examples of sound fiscal frameworks in the region, although I would point to Chile, which has adopted the prudent policy of sequestering the windfall gains realized from the sharp increase in the prices of its exports. Elsewhere, Mexico and Brazil have made some progress, although not as much as they might like to see. And even where there has been improvement, countries still lack an anchor for their fiscal policy, although I have to acknowledge that, more often than not, the problems are political rather than economic. That's no different from the situation in many of the OECD countries in the 1960s and 1970s. But what was helpful to the fiscal authorities of the OECD is that they received support from the analysis carried out at that institution, as well as from their colleagues around the OECD table.

This is another area where a regional table for the Americas would be a tremendous help. Fiscal authorities from the region could gather to exchange policy advice and develop strategies to deal with their situations. And civil servants could gather to share best practices with regard to tax and expenditure issues. We in Canada and the United States can offer advice. But, ultimately, fiscal policy in most of Latin America is a political problem, and it will be up to the people and governments of Latin America to solve it.

Trade policy

The final area I want to address is trade policy. We can all agree that more open trade is key to economic development. Canadians and Americans have clearly benefited from freer trade, and there is a reasonable degree of support for further trade liberalization. However, in Latin America, there is much greater resistance to freer trade, and much greater popular support for protectionist policies. Indeed, a number of countries have chosen to adopt trade policies that impede growth and jeopardize improvements in living standards.

But while governments in Canada and the United States generally favour and advocate freer trade, we don't always act on our own beliefs. And since we do a poor job in demonstrating our own willingness to live by the principles we espouse, it's not surprising that we in Canada and the United States have been unable to convince our neighbours in the Americas that the best way to raise incomes and lift people out of poverty is by taking on the challenges of free trade and global competition.

One way for us to do a better job is to work more diligently towards a resumption of the Doha Round of trade talks, and to show a greater willingness to open our own markets to products in which Latin American countries have a comparative advantage. I recognize that it is easy for me, as a central banker, to say that we need to confront our own protectionism. But this is a political problem that we in Canada and the United States have to solve.

These areas – monetary policy, financial sector policy, fiscal policy, and trade – are what I see as the four major economic policy challenges for Latin America. And these are four areas where it would be very helpful to have a forum for economic policy-makers in the Americas, a forum that could facilitate greater co-operation in the hemisphere. My remarks today reflect a long-standing tradition at the Bank of Canada of working with our central bank colleagues throughout the hemisphere. But beyond the Bank's collaboration in the region, Canada enjoys an enduring connection with the Americas. More Canadians now travel to Latin America and the Caribbean than to any other part of the world outside the United States. Canada joined the OAS and signed NAFTA in the early 1990s. Our involvement with the Americas has grown, encouraged by democratic transition, increased commercial and investment opportunities, and the movement of people. And Canada's engagement will continue to grow. In a speech last month, our Prime Minister noted that Canada "will seek to re-engage relationships throughout the Americas, with our partners in Mexico, the Caribbean, and Central and South America."

Conclusion

Ladies and gentlemen, allow me to conclude. The prosperity that we enjoy in Canada and the United States is a testament to the ability of free markets to generate wealth and raise living standards. We understand the gains that can come from building a strong global financial and trade order, backed by appropriate rules of the game. Other governments have worked hard to engage in this global order because they, too, understand the benefits that it can bring to their citizens.

We now face two challenges. First, we must think globally about how best to update the rules of the game to take into account the evolving nature of the global economy. Second, we must act locally, within our own hemisphere, to help our neighbours to see that integration into the global economy is in everyone's interest.

Neither of these tasks will be easy. They will require patience and persistence. And along the way, we will encounter governments that are more inclined to withdraw from the process than to engage with the global economy. But we can't let the difficulty dissuade us from our goal. To the delegates at Bretton Woods, the task of rebuilding the world's economy must have appeared daunting indeed. And there were times when the political will to see this task through appeared to be lacking. But eventually, a spirit of co-operation overcame the obstacles, and policy-makers gathered around tables at international institutions and built a liberalized financial and trade order – an order that has led to the prosperity we know today. It is time to rekindle that spirit of co-operation and to build a table for the Americas, so that the benefits of the global economy can be spread throughout our hemisphere.