Tiff Macklem: Global integration, monetary policy, and the international monetary system

Remarks by Mr Tiff Macklem, Deputy Governor of the Bank of Canada, to the Winnipeg CFA Society, Winnipeg, Manitoba, 21 June 2007.

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Good afternoon. It's a pleasure to be in Winnipeg, and it's an honour to join you as you celebrate the CFA Institute's sixtieth anniversary.

Today is the longest day of the year. But I don't want it to *feel* that long, so I'll get right to the point. I'd like to discuss two aspects of global integration – how it's affecting our economy, and why it underscores the need for a sound monetary framework, both at home and internationally.

Now, Manitoba – right in the middle of our vast country – might seem an odd place to talk about globalization. But this province, like the rest of Canada, is very much affected by global economic forces. Some businesses – particularly in the manufacturing sector – are facing fierce competition from new suppliers in emerging Asia. Other businesses are benefiting from strong foreign demand and high prices for commodities. Most of Manitoba's exports go to the United States, so it might be tempting to think that what really matters is North American demand. But the prices of many of Manitoba's exports – both commodities and manufactured goods – are set in world markets, and thus influenced by the demand for, and the production of, these goods in Asian and other emerging-market economies. So, Manitoba, and Canada as a whole, are very much a part of the integrated world economy.

I'll start by highlighting two key developments in the global economy and describe how they're affecting Manitoba and Canada. Then I'll discuss how monetary policy helps Canada to weather, and indeed to profit from, changes in the global economy. I'll wrap up by returning to the international stage and suggest that, in an increasingly integrated world economy, we all have a greater stake in a sound international monetary system.

Developments in the global economy

As trade barriers have come down, and as the costs of transportation and communication have diminished, international trade has grown and living standards have improved. Since 1970, trade as a share of GDP has risen from about 25 per cent to almost 45 per cent in industrialized countries. Over the same time period, trade in emerging-market economies has increased from less than 15 per cent of GDP to roughly 60 per cent.

Much of the recent growth in trade has come as large emerging-market economies, such as China and India, have been integrating into the world economy. With this integration has come a significant increase in the global demand for commodities, as well as rapid growth in the production of manufactured goods in Asia.

That brings me to the first of the global developments I'd like to mention – a marked rise in the prices of commodities relative to those of manufactured goods.

In the past five years, energy prices have risen by about 150 per cent, and non-energy commodity prices have increased by about 80 per cent. Over the same time period, the price of nickel – Manitoba's biggest commodity export – has risen by about 500 per cent, and the price of copper has increased by more than 300 per cent.

At the same time, the prices of many manufactured consumer goods, such as clothing, computers, entertainment equipment, and household appliances have decreased in many countries. In Canada, the prices of durable and semi-durable manufactured goods, excluding automobiles, have declined by about 1 to 2 per cent per year, on average, over the past five years (although more recently, prices for semi-durable goods have strengthened). Given its endowment of natural resources, Canada has benefited greatly from strong commodity prices. But, just as clearly, new competition from China and other emerging Asian economies is posing some tough challenges for Canadian manufacturers.

Global integration has also been affecting international savings and investment flows. Indeed, in the past dozen or so years, what is sometimes called "financial openness" has increased significantly. Since 1995, the stock of cross-border investment in advanced countries has grown from about 40 per

cent of GDP to more than 120 per cent of GDP, and emerging markets have seen a similar increase, albeit from a lower base.

This leads me to the second development I want to highlight.

In recent years, desired global saving appears to have increased relative to desired global investment, which has made credit abundant and relatively cheap. Federal Reserve Chairman Ben Bernanke has called this a global "saving glut." The International Monetary Fund has emphasized the weakness of global investment relative to global growth. But whether it's high saving or low investment, the net effect is that large pools of internationally mobile capital have been searching for seemingly scarce investment opportunities, putting downward pressure on long-term interest rates. As investors have searched for higher returns, risk spreads have narrowed, and interest in alternative investments and more innovative investment vehicles has expanded.

While there are several reasons for this abundance of global credit, global integration is almost certainly an important part of the story. Saving rates in Asia are relatively high and exceed the region's investment needs. In addition, with the sharp rise in the price of oil in recent years, a number of the major oil-exporting countries have seen a large increase in their saving that has outstripped the growth of their investment demand. With the integration of these economies into world markets, and with investors seeking international diversification, new pools of capital have been injected into the global financial system.

How is Canada faring?

How have these developments been affecting the Canadian economy? I'll discuss them in reverse order.

The implications of abundant global credit are readily apparent. Long-term interest rates in Canada have been low. Even with some back-up in yields in recent weeks, yields on 30-year Government of Canada bonds remain well below 5 per cent. The Canadian stock market has been buoyant, and risk spreads on corporate debt are near historical lows. Household credit and money growth have been strong, and cross-border investment flows have accelerated.

The rise in the prices of commodities relative to manufactured goods has reinforced many of these same effects. Since Canada is a net exporter of commodities and a net importer of manufactured goods, the rise in commodity prices has made Canada wealthier as a nation. The increased value of Canada's natural resource endowments is showing up in higher domestic stock market prices and increased cross-border investment flows. It has also been a major factor supporting robust consumption and investment growth in Canada. And of course it's showing up in a higher Canadian dollar.

In the past five years, the Canadian dollar has gained about 45 per cent against the U.S. dollar. This appreciation since 2002 reflects a combination of factors, the most important of which is the significant increase in commodity prices.

The other implication of the rise in the relative price of commodities is economic adjustment, by which I mean the reallocation of labour and capital from weaker sectors to stronger sectors. The manufacturing sector, faced with higher costs for energy and other inputs, new sources of competition from Asia, and a stronger Canadian dollar, is going through a difficult adjustment. Our own surveys suggest that most manufacturers are responding to these challenges by making changes in the way they do business. Part of this adjustment has involved reducing employment. In the past three years, employment in manufacturing has declined by about 250,000 jobs. At the same time, the primary and service sectors have been expanding capacity and employment in response to strong demand. Over the past three years, employment in these sectors has increased by about 900,000 jobs, more than offsetting the reduction in manufacturing employment.

Of course, this adjustment is not affecting all parts of the country in the same way. Growth in output, employment, and incomes has been fastest in Western Canada. Nevertheless, growth in Canada has been broad based. Strength in domestic demand has supported solid growth of output and employment right across the country. Manitoba is in the middle of Canada in more ways than one. It has a well-diversified economy that closely resembles the structure of the Canadian economy. And in the past three years, GDP in Manitoba has grown by an average of 2.8 per cent, very close to the national average.

Economic adjustment is always difficult, but it's necessary if we are to put capital and labour to work where they are most needed. This, in turn, helps to support rising living standards for Canadians. The main point here is that the Canadian economy has adjusted – and is continuing to adjust – to take advantage of our opportunities in an integrated global economy.

Now let me turn to the role played by monetary policy.

The role of monetary policy

The Bank of Canada Act directs the Bank to "promote the economic and financial welfare of Canada." What we've learned from experience is that the best contribution monetary policy can make to Canada's economic and financial welfare is to maintain low, stable, and predictable inflation.

Since 1991, Canada's monetary policy framework has consisted of two main elements – an inflation target and a flexible exchange rate. This framework has allowed Canada to pursue an independent monetary policy – a policy suited to our own circumstances. The two main elements work together and reinforce each other. The result has been low and stable inflation, with less volatility in output and employment.

Let me elaborate on each of these elements. First, the inflation target.

Since 1995, the target for inflation has been the 2 per cent midpoint of a 1 to 3 per cent inflation-control range. To keep inflation at 2 per cent, the Bank tries to keep a balance between the overall demand for and supply of goods and services in the Canadian economy. When overall demand and supply are in balance, the economy can operate at its full potential, and inflation is stable.

Inflation control contributes to better economic performance in several ways, but let me highlight two that are particularly relevant in the current context. First, when inflation is low and stable, relative price signals are clear and readily apparent, and this helps businesses and households to make sound economic decisions. Second, meeting the inflation target helps to anchor inflation expectations to the target which, in turn, helps to keep inflation low and the economy more stable.

In the 1970s, which was the last time Canada experienced a commodities boom on the scale of recent experience, monetary policy failed to anchor inflation expectations. So, when sharply higher oil prices pushed inflation up, workers and firms extrapolated this higher inflation forward, and prices and wages more broadly began to rise more quickly. The result was higher and more variable inflation, and a more painful economic adjustment.

The other element of our monetary policy framework is the flexible exchange rate. The flexible exchange rate helps the economy to absorb shocks. Just as the Manitoba Floodway absorbs some of the deluge of a spring flood, the floating dollar helps the economy to absorb shocks – especially external shocks that affect our economy differently than those of our major trading partners. The flexible exchange rate also supports economic adjustment because it is much easier to have changes in the relative price of Canadian goods and services come through movements in the exchange rate than to require all domestic prices and wages to adjust.

Now, I said that the inflation target and the flexible exchange rate work together to promote our economic well-being. What this means in concrete terms is that relative prices can change without spilling over into generalized inflation, and the economy can operate close to its potential. This means that labour and capital are allocated more efficiently, and resources that move out of contracting sectors are put to work in expanding sectors. And that's what we've been seeing in Canada. With unemployment at a 33-year low, it's clear that Canada has been going through this difficult process of adjustment with considerable success. Our job at the Bank of Canada is to continue to aim for 2 per cent inflation so that when *some* prices change, these are clearly relative price changes, and longer-run inflation expectations remain anchored at the 2 per cent target.

To summarize, our monetary policy framework has served us well in maintaining a domestic environment of growth and stability. Together with other domestic policies, it has helped Canada to adjust to some significant changes in the global economy.

But sound domestic policies are not sufficient to eliminate spillover effects from decisions and events on the other side of the world. And, while global integration creates new opportunities, it also poses certain risks. In particular, if other countries fail to pursue sound policies, we could see abrupt changes in global financial conditions, with harmful spillover effects in Canada and elsewhere. It is this possibility that points to the need for a global table where countries can come together and take

account of their economic and financial interdependence. A stable global economy is in everyone's interest.

The international dimension

This is where the International Monetary Fund (IMF) fits in. It is the institution best placed to fulfill this role. With 185 member countries, the IMF truly spans the globe. And with a large, well-trained and very professional staff, the IMF has the "human capital" to analyze the increasingly complex linkages among economies.

The IMF began operations 60 years ago – in fact, just as the predecessor of the CFA Institute came into being. The IMF's mandate was to promote international economic growth and financial stability. This mandate remains relevant today. But a great deal has changed since the IMF first opened its doors. The IMF was set up to oversee the global monetary system in an era of fixed exchange rates. Today, flexible exchange rates are the norm; private capital flows dwarf IMF resources; financial markets are much more sophisticated and vastly more interconnected; and major new players are integrating into the global economy. To be effective in this world, the IMF must change the way it pursues its mandate.

Recognizing this challenge, the IMF's managing director, Rodrigo de Rato, launched a strategic review of the Fund's role in 2004. The review covers a number of elements. The most critical is to decide exactly what the IMF should do to fulfill its mandate. I will focus my remaining comments on this issue.

To be effective in a much larger and more integrated global economy, the IMF needs to become a more proactive institution, focused on limiting negative spillovers and preventing financial crises. And this means that the IMF needs to strengthen its main crisis-prevention tool – surveillance of its member countries and of the global economy.

We need IMF surveillance to help member countries set sound policies, and to provide all members with the assurance that everyone is playing by the rules of the game. We need the IMF to evaluate the coherence of policy frameworks across countries, to assess the spillover effects of one country's policy choices on other countries, and to speak out when countries thwart adjustment to economic fundamentals to the detriment of other countries. And we need the IMF to be an effective global forum where members can come together to address international economic and financial issues.

The groundwork for improved surveillance has been laid. As announced by Mr. de Rato three days ago in Montréal, the Fund and its members have just completed a revision of the guiding framework for surveillance. This is the first significant revision of the surveillance framework in 30 years, and it is a major accomplishment. The next step is to implement this framework. This will require establishing and periodically updating clear priorities and responsibilities for surveillance. Implementing the revised framework will improve the quality, the candour, and the even-handedness of IMF surveillance.

Under the revised guiding framework, surveillance will focus on the four pillars of macroeconomic policy – exchange rate, monetary, fiscal, and financial policies – as they affect external stability. In implementing improved surveillance, it will be important to better integrate financial sector analysis and assessments into country reviews, and to take a broader, multi-country perspective. It is also very important that IMF surveillance be – and be seen to be – even-handed. This means that all members – not just those on fixed or managed exchange rates – should come equally under Fund surveillance. Improving Fund surveillance by applying best practices universally across its membership would benefit *all* members.

Conclusion

I promised at the outset not to take advantage of this being the longest day of the year. So, allow me to conclude with three key points.

First, adjusting to a changing world economy is difficult, but Canada is doing well by profiting from new opportunities and responding to new global realities. Our monetary policy framework is helping the Canadian economy to absorb external shocks and to adjust to changing circumstances.

Second, sound domestic policies are central to maximizing the benefits of globalization, while minimizing the risks. But as global markets grow and broaden, and countries become more

interconnected, we have an increasing stake in a sound international monetary system, and in an institution to support it.

Third, and finally, the IMF is best placed to be that institution. But to realize its potential, we need to modernize the way it pursues its mandate. A process of renewal is well under way, and it is important that the IMF and its members seize the opportunity to build an IMF for the 21st century.