

## Mark Carney: The paradigm shifts – global imbalances, policy, and Latin America

Remarks by Mr Mark Carney, Governor of the Bank of Canada, at the Inter-American Development Bank, Calgary, 26 March 2011.

\* \* \*

### Introduction

Globalization is the opportunity and the challenge of our age. It has the potential to lift billions out of poverty, vastly expand economic prospects, and develop a more diverse and resilient global economy. However, globalization also brings stresses, so policy-makers will need both discipline and new frameworks to realise its promise.

The financial crisis has accelerated the shift in the world's economic centre of gravity. Emerging-market economies (EMEs) now account for almost three-quarters of global growth – up from just one-third at the turn of the millennium.

Although this paradigm shift to a multipolar world is fundamentally positive, it is also disruptive. Labour, capital and commodity markets are changing rapidly. The effective global labour supply quadrupled between 1980 and 2005 and may double again by 2050.<sup>1</sup> Cross-border capital flows have exploded, growing at a rate almost seven times the peak during the last wave of globalization.<sup>2</sup> Commodity markets are in the midst of a supercycle.

Large imbalances are a natural consequence of globalization. These imbalances can be good or bad. Good imbalances are the product of capital moving to where it can be best used, production being reoriented and expanded, and the economic cycle becoming more commodity intensive.

Bad imbalances arise when countries resist or misread the consequences of this shift of activity and demand from advanced to emerging economies.

Indeed, the response to such pressures will influence the resiliency of the globalization process itself. In the run-up to the crisis, poor policy choices reinforced vulnerabilities. Countries frustrated exchange rate adjustment, and the recipients of large capital inflows squandered them. Price stability was achieved, but financial stability was forfeited. The result was unbalanced, unsustainable growth, culminating in economic catastrophe.

It is not clear that the commitment to open markets will withstand a repeat of such mistakes. Today, I will concentrate on two current policy challenges for our region that could prove decisive:

- 1) maintaining price stability in the face of a major commodity shock, and
- 2) maximizing the return to large, volatile capital flows.

In each case, there is a risk that policy-makers downplay longer-term forces when setting short-term policy. As a consequence, destabilizing global imbalances could re-emerge and undermine the globalization process itself.

---

<sup>1</sup> Adjusted for the percentage of the population in the traded-goods sector. See M. Carney, "The Implications of Globalization for the Economy and Public Policy," speech delivered to the British Columbia Chamber of Commerce and the Business Council of British Columbia, Vancouver, British Columbia, 18 February 2008.

<sup>2</sup> Cross-border capital flows were roughly 20 per cent of global GDP before the crisis, compared with 3 per cent at the turn of the last century.

## Commodities

Major commodity exporters, including Canada and much of Latin America, are experiencing a large, positive terms-of-trade shock (see Appendix, Chart 1). Real prices for energy and metals have been well above their long-term averages for more than five years, and real food prices are now at their highest levels in twenty years (Chart 2).<sup>3</sup>

The question is whether such strength will persist.

From a policy perspective, it matters whether prices are being primarily driven by demand, supply or speculation. In general, supply shocks and speculative overshoots tend to be short lived and can be looked through. Demand shocks are different.

While there have been supply disruptions due to geopolitical unrest and natural disasters, and while speculative pressures have reinforced, on occasion, the direction of fundamentally driven price moves, the Bank's view is that a large, sustained increase in demand is the primary driver of this boom. The breadth and durability of the commodity rally underscores this conclusion.

This surge in demand is the result of rapid growth in the emerging world, particularly in Asia (Chart 3). With convergence still a long way off, the demand for commodities can be expected to remain robust for some time. Based on the experiences of Japan in the 1960s and Korea in the 1980s, emerging Asia's energy and metals intensities should gain momentum.<sup>4</sup>

Rapid urbanization underpins this growth. Since 1990, the number of people living in cities in China and India has risen by nearly 500 million, the equivalent of housing the entire population of Canada 15 times over (Chart 4). This process can be expected to continue for decades, since urbanization rates in China and India are currently 30 to 50 percentage points below those in Brazil, Mexico and Canada.

In parallel, a massive new middle class is being formed. The world's middle class is growing by 70 million people each year and will double to 40 per cent of the global population by the end of this decade.<sup>5</sup> The ramifications will be considerable for a wide range of commodities, through higher protein diets, refrigeration and travel. Whether it is cars, airports or meat, consumption and development levels in major emerging markets are currently fractions of those in advanced economies (Table 1).

Even though history teaches that all booms are finite, this one could go on for some time.

With the demand story intact, the profile of commodity prices will turn on supply. Time will tell whether new supply will be sufficient, and whether consumption converges at current Western levels or whether price signals and serious attempts at reducing carbon intensity will ultimately force a more sustainable equilibrium.

The fundamental issue is that the relationship between U.S. economic activity and commodity prices has changed, and that this is complicating the policy response for exporters and importers alike (Chart 5).

---

<sup>3</sup> In all, 18 of 23 commodities in the Bank of Canada's commodity index are above their long-term average.

<sup>4</sup> Current per capita income is between \$5,000–\$10,000 per capita for China, Thailand, and Malaysia. Commodity demand should continue to grow rapidly before slowing once income levels reach about \$15,000–\$20,000 per capita. See C. Cheung and S. Morin, "The Impact of Emerging Asia on Commodity Prices," Bank of Canada Working Paper 2007-55. Adding to the potential momentum is the fact that per capita income levels remain below \$5,000 in India, Indonesia and the Philippines.

<sup>5</sup> McKinsey & Company, "The Great Rebalancing," June 2010.

## Policy implications

All IDB member countries are currently facing some similar challenges, which are best addressed with an eye to these longer-term trends.

First, large and persistent changes in relative prices will encourage substantial structural adjustment in all of our economies. In past decades, commodity-price increases were often driven by strong growth in the G-3 economies. More recently, however, higher commodity prices have been generated, in large part, from strong growth in emerging markets, particularly in China (Chart 6). Consequently, commodity importers in our region have had to face the adverse implications of higher commodity prices, without the cushion of a demand boost from stronger growth in G-3 economies. Similarly, there is greater pressure on the manufacturing sectors of commodity exporters coming from the strength in their exchange rates, again in the absence of traditional demand from the G-3.

Adjustment is inevitable – and it will be substantial. In general, such changes should not be frustrated, but rather facilitated by policies that enhance economic flexibility.

Second, all countries need to maintain price stability in an environment where G-3 monetary policy cannot be expected to lead the global cycle. As I will discuss in a moment, a key mistake would be to let fears of capital inflows and exchange rate pressures dominate the imperative of domestic price stability.

It is paramount that monetary policy everywhere acts to ensure that inflation expectations remain in line with medium-term policy objectives. Everything else being equal, higher commodity prices usually necessitate higher policy interest rates. The degree of the policy response depends on many factors, including the reasons behind the price increases, the expected persistence of the shock, and whether a country is a net exporter. Policy-makers also need to weigh the importance of commodities in the consumption basket (Chart 7), the historic experience with price pass-through, and how well anchored are inflation expectations.

It bears consideration that the terms-of-trade shock could be even more disruptive. Most of us have become heavily reliant on manufactured goods and components from China (Table 2). For example, in Canada, partly as a consequence of Chinese trade, goods price inflation has run about 1 per cent for the past decade. However, with commodity prices rising sharply in China, second-round effects on manufactured goods pricing are possible, due to rising wages and input costs and, potentially, exchange rate appreciation. Finally, it has to be considered that the process of globalization, with its large-scale displacement, may actually reduce potential growth in advanced economies during the adjustment phase.<sup>6</sup>

Canada has learned through long experience that the role of the exchange rate is crucial. For commodity exporters, improvements in the terms of trade tend to put upward pressure on the exchange rate. When such movements in the nominal exchange rate are limited, wages and a range of other prices respond. This is a more disruptive form of adjustment that can have profound implications for employment, financial stability and competitiveness – the very objectives exchange rate management seeks to protect.

Recent experience suggests that many emerging economies are taking the real adjustment through higher domestic inflation (Chart 8), in part because of concerns over capital inflows.

To the extent that the nominal exchange rate responds, it helps offset the expansionary effect of the increase in investment, and gives price signals to the production sector for labour and capital to shift to the areas of higher return.

---

<sup>6</sup> L. Bini Smaghi, “The Challenges of Surveillance and Coordination,” speech delivered at the International Symposium of the Banque de France, Paris, 4 March 2011.

Capital flows will move to hasten that adjustment, which leads to the second policy challenge.

## Capital flows

Capital can be expected to flow, on a net basis, from advanced economies towards higher expected risk-adjusted returns in emerging-market economies. Such was the case during the last wave of globalization at the turn of the twentieth century when Canada, then an emerging economy, ran current account deficits averaging 7 per cent of GDP over three decades.

The scale of the potential reallocation today is significant. Investors from advanced economies are substantially overweight their home markets: advanced economies represent half of current global GDP, but their equity market capitalization is nearly three-quarters of the global capital market.<sup>7</sup> A reallocation of 5 per cent of advanced economy portfolios to emerging markets translates into a potential flow of \$2 trillion or \$400 billion to Latin America.<sup>8</sup> This is eight times current annual flows to Latin America.<sup>9</sup>

Paradoxically, despite these secular forces, emerging markets are currently net capital exporters (Chart 9). In effect, there is a large recycling of capital: private capital flows from advanced to emerging economies are being more than offset by official outflows.<sup>10</sup> Central banks now hold more than 40 per cent of U.S. Treasuries, which delays adjustment at home and abroad by muting price signals in both locations.

Two dynamics are particularly important. First, the expansion of gross capital flows has dwarfed that of net flows. For example, since the 1990s the increase in gross flows into and out of the United States has expanded three times more rapidly than the increase in net flows.<sup>11</sup> Emerging economies are having difficulties absorbing large private flows, while advanced economies have often misallocated the surge in yield-insensitive gross claims. In both cases, the scale of movements and the impact of any reversal have important ramifications for financial stability.

Second, in the face of stimulative G-3 monetary policy and limited nominal exchange rate appreciation by China, many emerging markets are trying to forestall capital inflows and delay necessary monetary tightening. This in turn is feeding domestic demand, which drives commodity prices up further and leads to more generalized overheating. Third-best policies, including capital controls under the trendy guise of macroprudential policy, are being pursued.

Arguably, Latin America is the region most affected by these pressures and, therefore, it has the greatest interest in durable solutions.

---

<sup>7</sup> Advanced economies represent half of current global GDP on a purchasing-power-parity basis. Advanced equity market capitalization should be somewhat overweight in its GDP representation, given the large exposure of global companies to emerging-market growth.

<sup>8</sup> These calculations assume that emerging-market investors hold only a fraction of existing market capitalization in advanced economies.

<sup>9</sup> The conundrum for EMEs is that the more they reform, the more they encourage these inflows.

<sup>10</sup> Supplemented by EME private diversification flows.

<sup>11</sup> J. Caruana, "Capital Flows to the Emerging Market Economies: A Perspective on Policy Challenges," speech delivered at the SEACEN Governors' Conference, Colombo, Sri Lanka, 24–26 February 2011.

## **G-20 initiatives**

Two related G-20 initiatives can help spring this trap: the Mutual Assessment Process (MAP) and the reform of the international monetary system.

The MAP process stresses countries' shared responsibility to ensure that their policies are consistent domestically and globally. This process will establish indicative guidelines and benchmarks to identify instances of external imbalances. Then, using these guidelines, G-20 members will undertake a mutual assessment of their monetary, exchange rate, fiscal, financial and structural policies.

The immediate focus is to identify short-term policy measures to address global imbalances. These will likely include:

- financial sector repair and reform;
- timely fiscal consolidation;
- structural reforms to enhance growth; and
- more market-determined exchange rates over time.

## **Transition to a new international monetary system**

The G-20's second imperative is the refounding of the international monetary system, which has degenerated into an increasingly dysfunctional hybrid of fixed and floating regimes.

There are two options for redress. The first is to enforce the current rules of the game – as codified in the articles of the International Monetary Fund (IMF) and World Trade Organization (WTO). While this is possible, enforcing behaviour through trade sanction is obviously extremely divisive and runs the risk of reversing the globalization process itself.

A more constructive approach – favoured by Canada – is to renew the rules of the game so that country actions are both predictable and mutually consistent. Given the scale of transition under way, in our view, it makes sense to agree to the long-term objective and then implement short-term measures consistent with a transition to it.

Our long-term objective should be a well-functioning international monetary system that delivers sufficient nominal stability in exchange rates and domestic prices, with timely adjustment to shocks and structural change.

All countries should accept their responsibilities for promoting an open, flexible and resilient system. This responsibility includes recognizing the spillovers between economies and financial systems and working to mitigate them. Fundamentally, it means adopting coherent macro policies and allowing real exchange rates to adjust to achieve external balance over time. Indeed, in a multipolar world of global capital and trade, all systemically important countries and common economic areas should move towards flexible market-based exchange rates.

These objectives will not be realised overnight. However, informal commitments to improve the functioning of the current system could be implemented to guide current policy while maintaining momentum towards the longer-term vision.

## **Short-term measures**

First, as Bob Zoellick has suggested, major advanced economies should reaffirm the G-7 norm for flexible exchange rates without intervention, unless special circumstances warrant

and the action is agreed.<sup>12</sup> The reality is that unilateral intervention seldom is effective without surrendering monetary sovereignty and control over domestic prices. By reaffirming this principle, advanced economies could set the stage for a broader accord among all systemically important economies.

Last week's concerted intervention by the G-7 provides an example of these principles in action. The circumstances were clearly exceptional: movements in the yen had become disorderly, volatility was excessive, and there were potential adverse implications for economic and financial stability. To address these problems and in response to a request of the Japanese authorities, the G-7 acted in concert in foreign exchange markets for the first time since 2000.

Second, the Bank believes there could be value in agreeing to an informal code of conduct for capital flows as a precursor to renewing the more formal Articles of Agreement of the IMF.<sup>13</sup> Certain guidelines – in the form of a notional checklist or decision tree – could prove useful to maximize the cost-benefit of capital controls, from both national and global perspectives.

Capital controls may be appropriate in certain circumstances. Sudden capital inflows raise legitimate concerns about currency overvaluation, overheating and, conversely, the consequences of sudden stops. This is especially true for countries with less-developed capital markets and weak institutional infrastructures, where the capacities to absorb and benefit from large inflows are limited.

However, we should all recognise that short-term expediency could take precedence, and eventually turn back the clock on an open, flexible system. This risk grows more tangible as emerging economies become more systemically important.

A Code of Conduct for Capital Flows could include the following four elements to guide countries during the transition to the long-term system:

1. *A clear objective* to promote a sustainable and effective flow of private capital between economies in order to facilitate economic growth and prosperity through the efficient allocation of resources, specialization in production, and diversification of risk.
2. *A decision framework* that recognizes that capital controls should not be the first option. They are a complement to, not a substitute for, macro and macroprudential policies. Consideration should always be given to adjusting monetary, exchange rate and fiscal policy, consistent with budgetary and inflation conditions.
3. *Principles* to guide the design of measures:
  - a) *Temporary*. Time-limiting measures recognize that capital controls create distortions, adverse market reactions and negative externalities, as well as the reality that, over time, controls are often evaded. This principle is also consistent with the positive longer-term fundamentals that are driving capital flows to emerging market economies.
  - b) *Targeted*. Measures should address specific vulnerabilities, such as Korea's restrictions on foreign exchange derivative contracts.

---

<sup>12</sup> R. Zoellick, "A Monetary Regime for a Multipolar World," *Financial Times*, 17 February 2011.

<sup>13</sup> Specifically, Articles IV and VIII should be clarified with respect to country responsibilities for exchange rate adjustment. The Fund's role in the surveillance of the capital account and members' obligations in the surveillance process could also be better specified and resourced.

- c) *Transparent*. An example is Chile's pre-announced buildup of foreign exchange reserves. Measures should be consistent with the principles and should be peer reviewed.
4. *Recognition of the responsibilities* of capital-exporting countries to monitor the risks run by host institutions with respect to currency mismatches, maturity transformation and leverage. The Financial Stability Board's current initiatives for both the formal and shadow banking sectors are central in these regards.

## **Conclusion**

The shift to a multipolar economy is having a profound impact on capital flows and a broad range of relative prices, including commodities.

Imbalances are the result of advanced and emerging economies not recognising this new paradigm. Some countries are postponing monetary tightening in the hope that old relationships reassert. Others are resisting capital inflows by misreading the secular for the cyclical. All appear to be underestimating the scale of what is happening.

Therein lies the risk of another crisis. Avoiding it requires leadership, purpose and legitimacy.

The G-20 is well suited to building global economic co-operation, as the response to the crisis demonstrated. Resolving global imbalances is a much more complicated challenge. Countries will need to draw on a sense of common analysis and shared destiny to strike what Mervyn King has termed a "Grand Bargain" across a host of policies.

The G-20 cannot, however, relaunch the global monetary system by itself. The G-20 can create momentum: it can take important interim steps; but ultimately, to be legitimate, a new system will require the concurrence of all IMF member countries. Thus, the perspectives of member countries of the Inter-American Development Bank (IDB) on the appropriate code of conduct for capital flows and on financial reforms are essential.

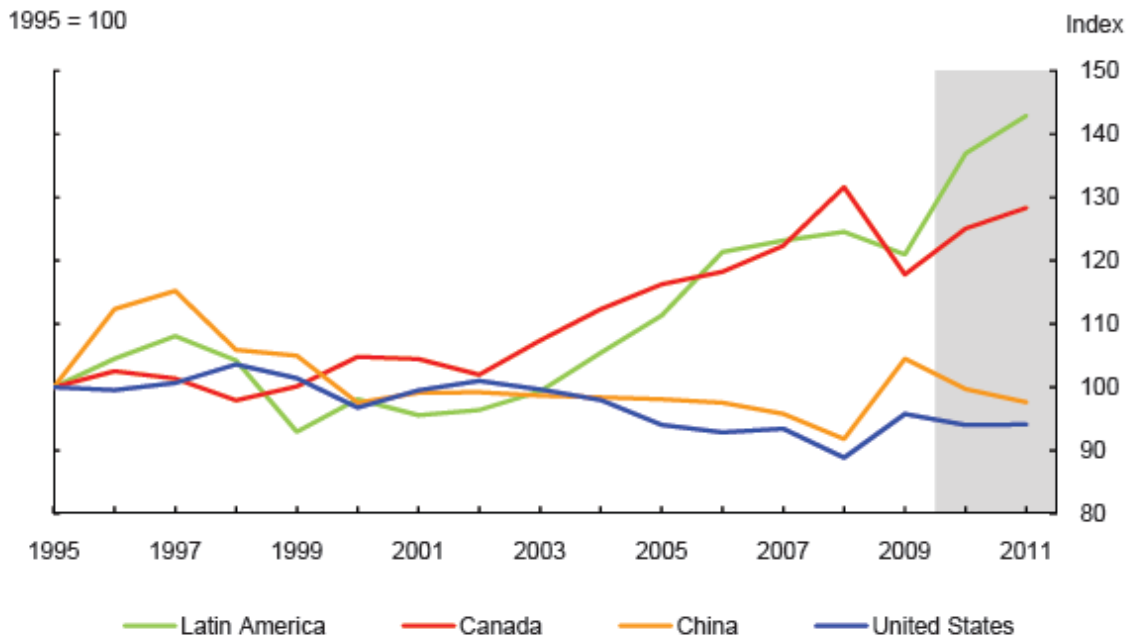
The stakes are very high. The current dynamics of commodity prices and capital flows create major risks to financial stability and sustainable growth across our region. When large economies with undervalued exchange rates keep their currencies from appreciating, others feel pressured to follow. Over time, macro policy becomes contorted: exchange rates more inflexible, monetary policy more hesitant, and economic controls more prevalent. The collective impact of this behaviour risks inflation and asset bubbles in emerging economies and, over time, subpar global growth.

Neither outcome is in the global interest. Neither is consistent with IDB principles.

IDB countries can help lead a co-operative approach by their example and influence. The transformation of Latin America during the past decade has been nothing short of remarkable. Greater reliance on policy frameworks, enhanced economic flexibility and decisive action have fed superior macroeconomic outcomes and economic resilience. During coming challenges, others would do well to draw on the lessons so evident in this room of the virtues of openness and sound domestic policies.

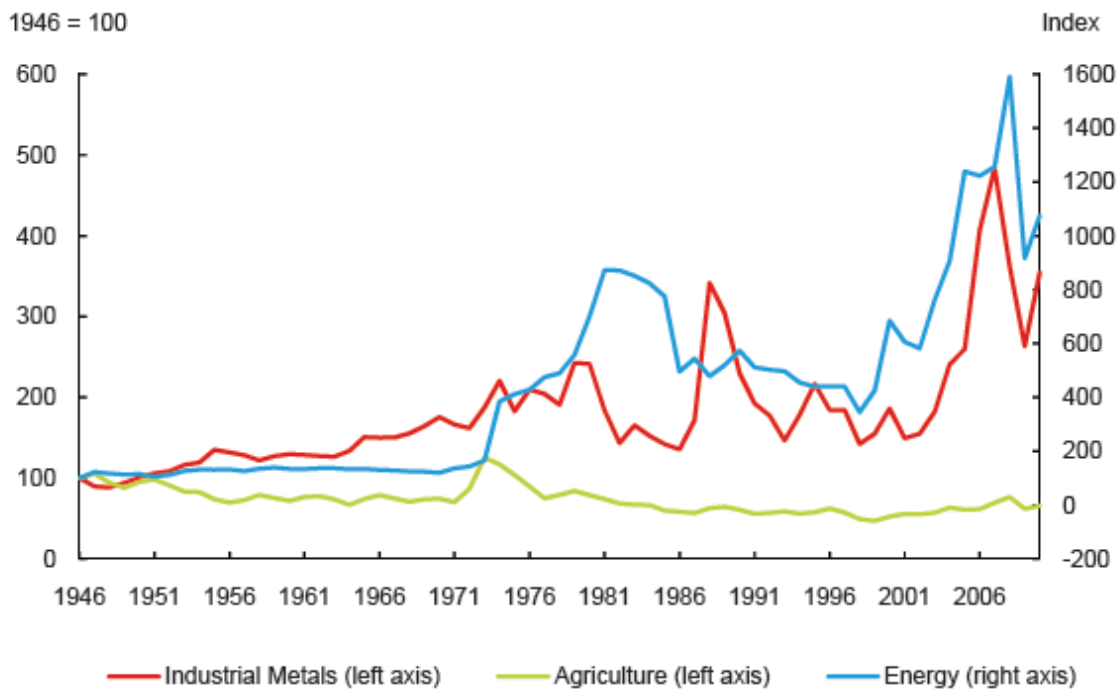
## Appendix

### Chart 1: Large Terms-of-Trade Shock for Commodity Exporters



Sources: Economist Intelligence Unit, International Monetary Fund World Economic Outlook October 2010

### Chart 2: Real Commodity Prices in the Post-War Period

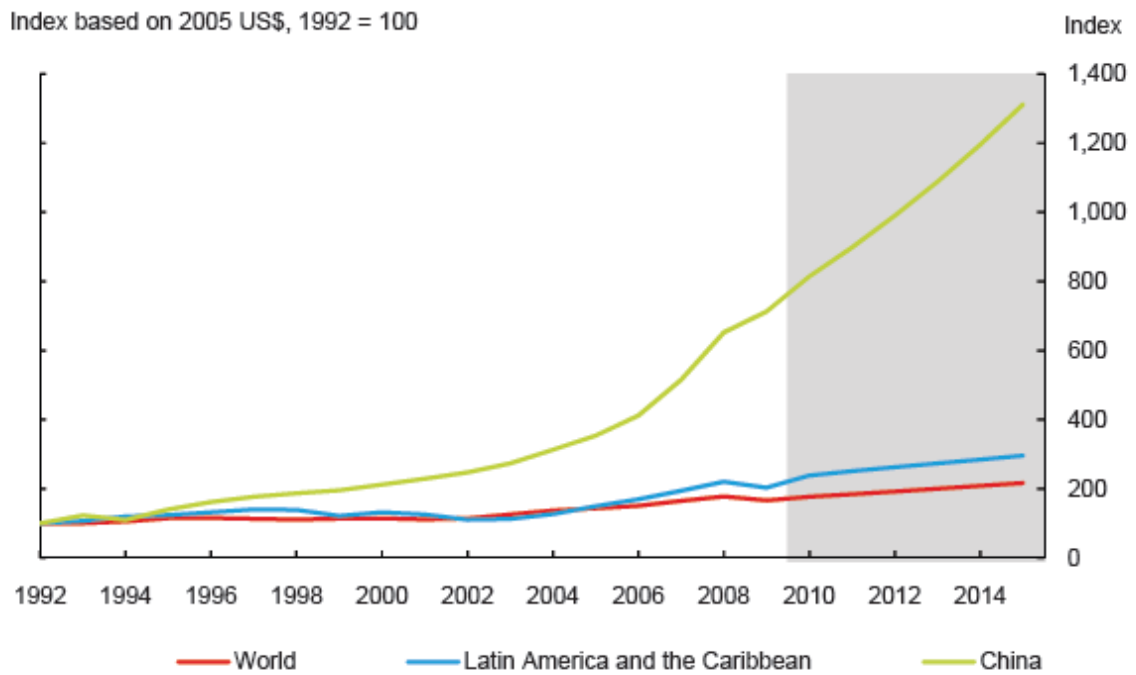


Source: Bank of Canada

Last observation: 2010

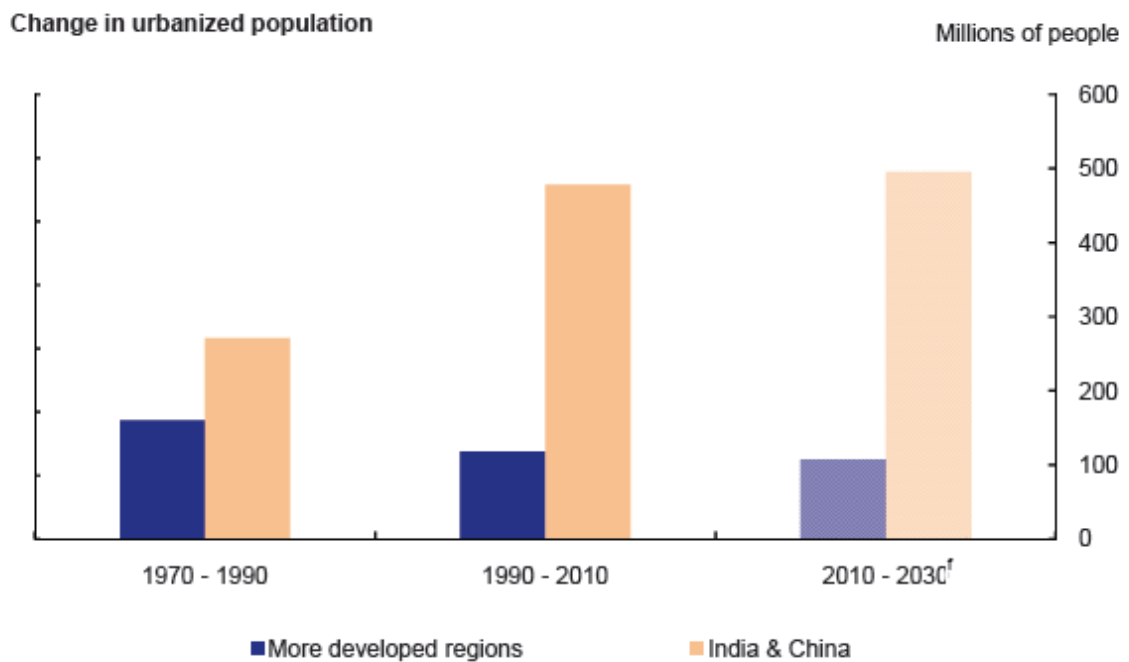


Chart 3: Real GDP in Selected Countries and Regions



Source: International Monetary Fund World Economic Outlook October 2010

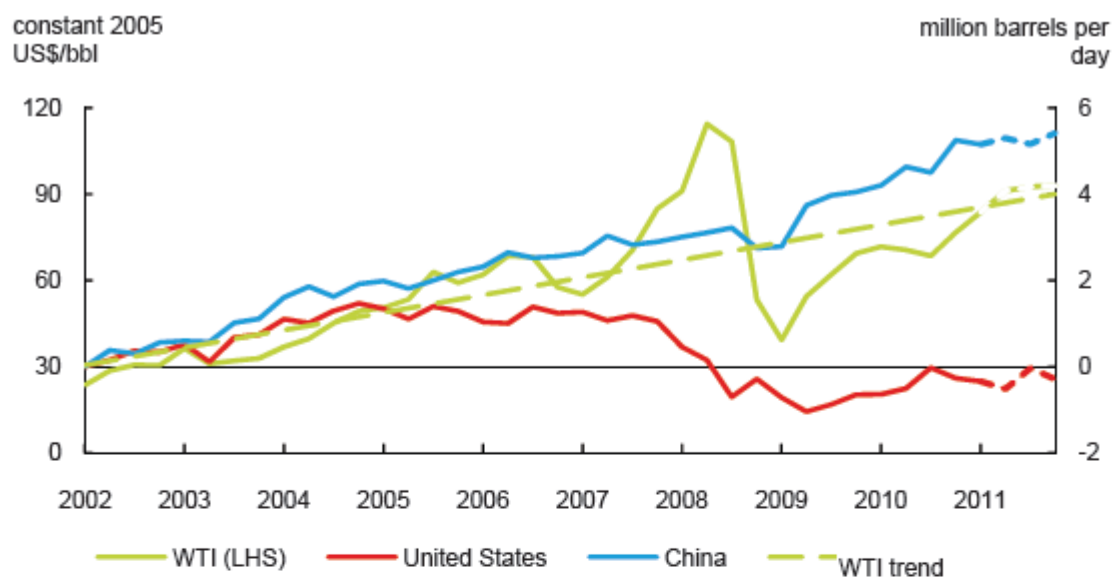
Chart 4: Increase in Urban Population



Note: <sup>f</sup>denotes forecast

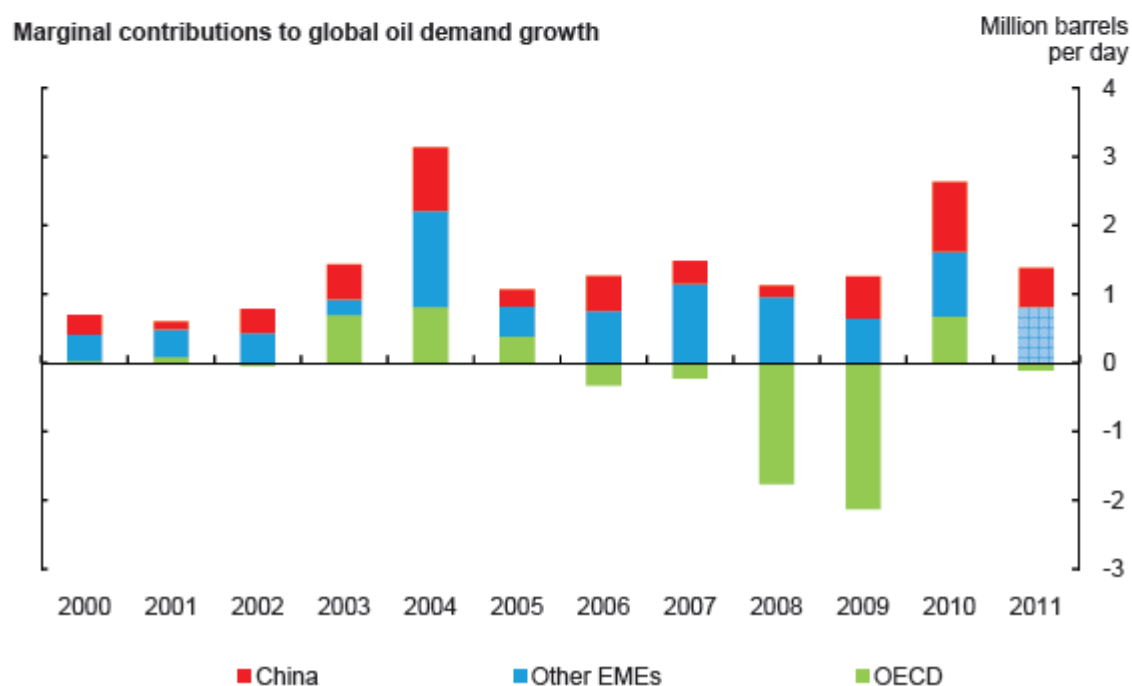
Source: United Nations World Urbanization Prospects

### Chart 5: Cumulative Marginal Oil Demand Since 2002



Source: International Energy Agency, International Monetary Fund World Economic Outlook 2010, US Bureau of Economic Analysis

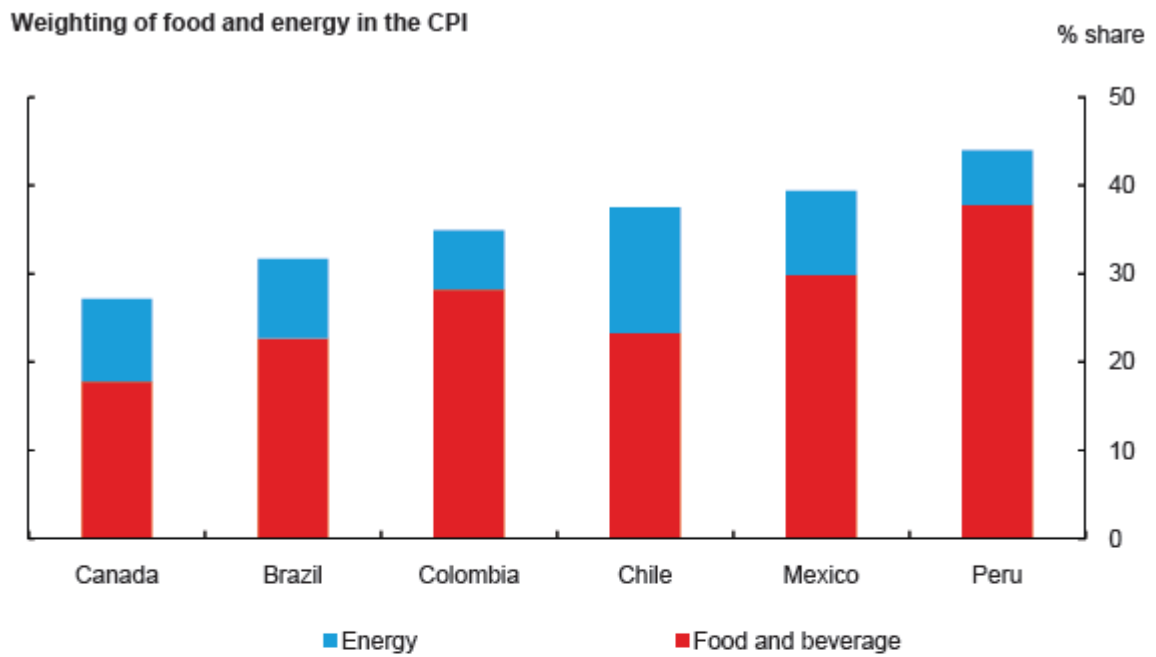
### Chart 6: EMEs Driving Global Oil Demand Growth



Source: International Energy Agency

Note: 2011 forecast

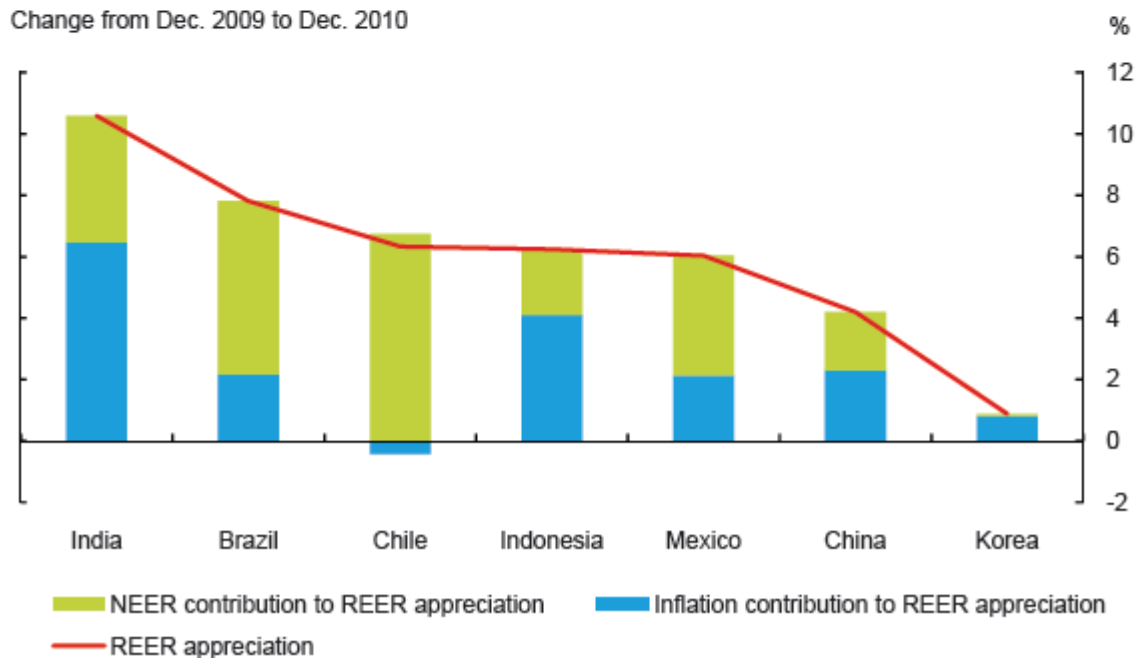
Chart 7: Consumer Price Index Weights



Sources: J.P. Morgan and Statistics Canada

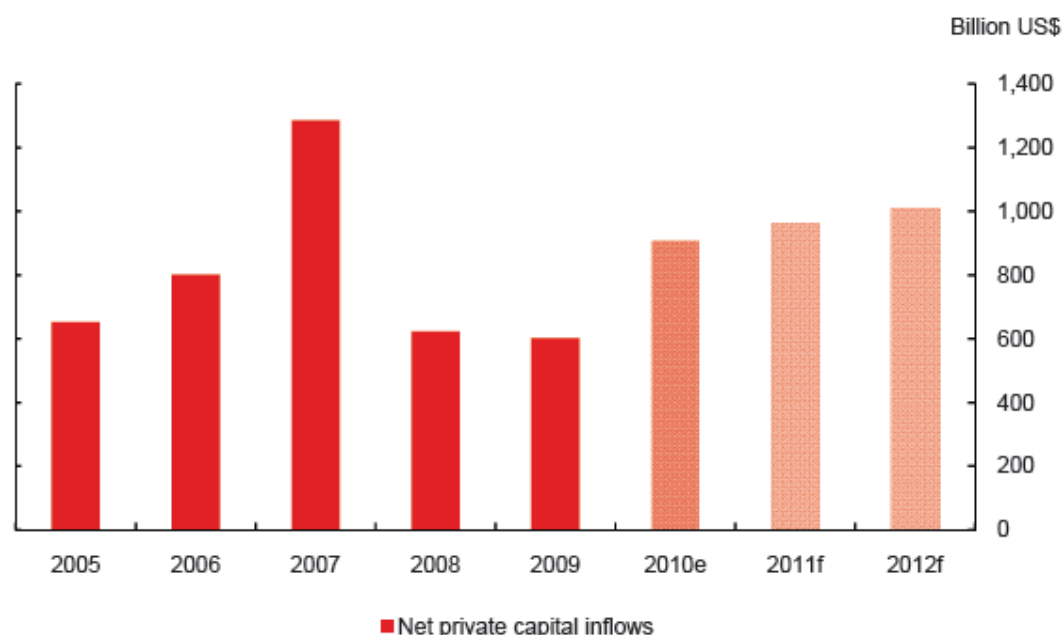
Last observation: January 2011

Chart 8: Components of Real Effective Exchange Rate Appreciation



Source: Bank for International Settlements

Chart 9: Emerging Market Private Capital Inflows



Note: e denotes estimate; f denotes forecast  
Source: Institute of International Finance

Table 1: Convergence is Still a Long Way Off

	Per Capita GDP (market exchange rate, USD)	Motor vehicles per 1000 people	Number of Airports
India	1,000	10	350
China	4,000	30	500
Brazil	10,000	200	4,050
Canada	46,000	600	1,400
United States	47,000	820	15,100

Source: International Monetary Fund World Economic Outlook 2010 (estimates), World Bank World Development Indicators 2010, Central Intelligence Agency Factbook 2010

Table 2: Per Cent of Imports from China

	Canada	Brazil	Chile	Colombia	Mexico
2000	3.2	2.2	5.7	3.0	1.6
2010	11.0	14.1	11.8*	13.5	13.9*

\*2009 data  
Source: UN Comtrade