

David Dodge: Canada's experiences of the past few decades

Speech by Mr David Dodge, Governor of the Bank of Canada, to the Spruce Meadows Roundtable, Spruce Meadows, Alberta, 5 September 2003.

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Thanks to my colleagues from around the world for giving such a comprehensive review of the vital issues facing the global economy. One of the hazards of speaking last in these kinds of sessions is that those who speak before you may cover all the interesting territory, leaving you with the unenviable task of trying to tie everything together.

In this case, however, going last is not so bad. That's because, in order to tie together the issues discussed so far, we need to take a global view of the economy. And as far as Canada is concerned, taking a global view has always been important. Of course, every country is affected to some extent by what happens in the world economy. But Canada, with its very open economy, has a particular need to keep an eye on the changing fortunes of the international scene.

Canada's reliance on foreign trade has required us to be active internationalists for decades. Louis Rasminsky, who went on to become Governor of the Bank of Canada, was one of Canada's delegates at the Bretton Woods Conference that led to the creation of the International Monetary Fund (IMF) and the World Bank. Rasminsky played an important role, formal and informal, at the talks. Not only was he the Chair of the drafting committee, he was also the peacemaker between the British delegation, led by John Maynard Keynes, and the U.S. delegation, led by Treasury Secretary Harry Dexter White. In the months leading up to Bretton Woods, it was Rasminsky who kept the two key delegations talking. Without his work, both as a skilled drafter and as a go-between, it's entirely possible that the talks at Bretton Woods could have ended in failure.

Canada was also present at the 1947 Havana Conference, where we pushed for the establishment of an international trade organization. This was meant to be a body parallel to the IMF, designed to establish and monitor a set of global trade rules. We didn't get quite what we wanted, but the result was still certainly positive: the birth of the General Agreement on Tariffs and Trade (GATT). In 1995, nearly five decades later, we were more successful, as we pushed the effort to turn the GATT into the World Trade Organization (WTO). So Canada's credentials as a supporter of institutions designed to promote free trade and a sound international financial system are well established.

Of course, much has changed in the global economy during the more than half-century since those institutions were founded. Of profound significance, transportation and communications have become very much cheaper and faster today than they were after World War II. Because of this, the potential economic gains from increased international trade and finance are now much greater than ever before. At the same time, individual countries are more vulnerable to economic and financial shocks originating outside their borders. So the need for a coherent international financial system is also much greater today. And our international institutions must evolve to take all of this into account.

To help us maximize the potential gains from increased trade, and to minimize the risks stemming from greater interdependence, we need to encourage trust, domestically and internationally. Let me explain what I mean. When I use the word trust, I am talking about the understanding that can develop when people recognize that everyone benefits when everyone plays by the rules. In this atmosphere, the rules that govern behaviour reinforce people's actions and help them choose to "do the right thing." This kind of trust allows for what game theorists call "positive-sum outcomes," where progress can come through "win-win" situations. It also allows national economies, as well as the global economy, to be strengthened.

This kind of trust begins at home. What all of us as national public policy-makers must do, and must be seen to be doing, is work to maintain and increase trust. We need to put in place the right incentives so that, in general, people will do the right thing. To be sure, the need to enforce sanctions when people do the wrong thing is critical. But when people can operate in an atmosphere of trust, they can spend less energy keeping tabs on others, and can concentrate on more productive activities.

We have seen over the past decades that trust is important to a well-functioning financial system. And a well-functioning financial system is necessary if we are to have an appropriate allocation of savings, which is a fundamental element of solid economic growth.

I would argue that five lessons can be drawn from our experiences since the time of the Bretton Woods and Havana agreements. All of them underscore the importance of trust.

The first lesson we have learned is the critical importance of having a robust legal framework. When a country has the appropriate legal structures, it creates a sense of certainty. Citizens, investors, and corporations have the security of knowing that contracts will be honoured, and that those who break the rules will be caught and punished. The protection of property rights and a tradition of contract law are prime examples of these structures.

Certainly, in recent years, we have all recognized the importance of a robust legal framework as we have watched countries in Eastern Europe, Latin America, and Asia struggle to make the transition to a market economy. But we in North America have also learned over the past two years, in a rather painful way, that issues of corporate governance are extremely important as well. So when we think of legal structures, we should now also think about high standards for accounting, transparency in corporate reporting, and adequate enforcement of the rules.

The second lesson we have learned is that our fiscal policies must always be based on prudence. When public debts are allowed to mount unabated, the trust of investors and citizens can vanish quickly. In its place comes fear that the debt will either be inflated away, or that a future government may default. Since the late 1990s, Canada has seen the benefits that can come from fiscal prudence. Putting our fiscal house in order has helped to establish credibility for our macroeconomic framework. And once fiscal credibility is established and a country has a low public debt-to-GDP ratio, the “automatic stabilizers” - which kick in to increase government spending to cushion the impact of difficult economic times - can operate without undermining the trust of citizens and investors.

The third lesson we have all learned is the importance of being open to trade. When a country opens its industries and markets to international trade, this may force painful short-term adjustments in some sectors. But at the same time, the country gains from ongoing competitive pressures which act to spur productivity improvements and raise living standards. In the end, the country as a whole is better off. But what is equally important is that those countries that have opened up to international trade play by the rules. Otherwise, we run the risk of falling into destructive “lose-lose” situations, where countries don’t trust each other and resort to unilateral actions that escalate trade disputes.

Fourth, we have learned the importance of a central bank that promotes trust in the value of money, free from political interference. When a central bank delivers an environment of low, stable, and predictable inflation, the public, and especially middle- and lower-income groups, can feel more confident that their savings and purchasing power will not be eroded by high inflation. And all borrowers can be more confident that the burden of their debt will not be increased through deflation. Low inflation also helps to win the public’s trust in the functioning of a market economy. As former Bank of Canada Governor Gerald Bouey put it, “inflation melts the glue that holds free societies together.” In Canada, we focus on inflation in a *symmetric* way. In doing so, we aim to avoid inflation while also minimizing the risks of deflation. Such an approach brings important economic benefits. But it also assures creditors that the value of their investment will not be eaten away over time. And it assures debtors that the burden of their debt will not increase in the future because of deflation.

The fifth lesson has to do with capital flows and exchange rates. Open markets and the free flow of capital can greatly accelerate development. But, as I noted before, open markets and capital flows can make individual countries vulnerable to shocks that originate elsewhere. So there is a need for countries to have a mechanism in place that helps their economies adjust to shocks. Recent experience has taught us how important it is to have this kind of adjustment mechanism in place and, in particular, how a floating exchange rate can play this role.

I know that not everyone here would agree that the floating exchange rate is the best adjustment mechanism for every country. Based on Canada’s long experience with a floating currency, I can certainly say that it has served us well. But I’m sure that we can all at least agree that there will always be shocks, that such shocks will have different effects on national economies, and that flexible exchange rates can help to facilitate the necessary adjustments. This lesson was clearly brought home during the Asian crisis of 1997-98. Many Asian countries, but also countries like Canada that are particularly vulnerable to sharp fluctuations in commodity prices, made relatively quick adjustments to a difficult situation through the floating exchange rate mechanism.

How does this relate to trust? Through the need to trust in market forces, I would say. When exchange rates float and capital moves freely, investors can trust that market forces are being allowed to do their job. There is an assurance that when shocks arise, countries will not be shielding their economy from

market forces through restrictive trade practices, arbitrary controls on capital flows, or fixed exchange rates.

So those are some of the key lessons we can draw from our experiences of the past few decades. In Canada, we have tried to apply these lessons to our own economic situation. And I would argue that doing so has helped us handle economic shocks better recently than in the past. Now, if we apply the principle of trust that is behind those lessons to our international financial institutions, we can get some idea of how these institutions might evolve to better work for the global economy. Game theorists will tell you that the best results come when the players see each other's behaviour and learn from it. Put simply, actions speak louder than words.

We have already seen the GATT evolve into the WTO, which establishes the ground rules for international trade and calls to account those countries that are not playing by the rules. Such an institution is essential if we are to reduce the frequency of "lose-lose" trade disputes I mentioned earlier. But for the WTO to go further, as it should, it is clear that progress needs to be made in the areas of greatest interest to the poorer nations. After all, the current round of talks is supposed to be the "Development Round." So it is incumbent on us in the developed world to "do the right thing," and overcome domestic political difficulties to open our markets in areas such as agriculture and textiles.

Recently, we have seen the IMF take steps to strengthen its surveillance function. These steps should be supported. Countries should strive to meet the highest standards for data dissemination and should welcome assessments of their economies and financial systems. Only when all the players have complete trust in the numbers - whether they are part of a nation's economic statistics or a firm's balance sheet - will investments be made most efficiently and effectively.

The IMF's other role, for which it is perhaps better known, is as provider of emergency liquidity. By the end of the 1990s, the Fund had increasingly found itself providing financial assistance many times in excess of a country's quota, in situations where sustainability, not a lack of liquidity, appeared to be the real issue. This is problematic, for a number of reasons. Perhaps most importantly, when debtors or creditors presume that there will be large official bailouts, there is the possibility of "moral hazard." This is a case where policy-makers have not provided the incentives for debtors and creditors to do the right thing.

In recent years, the Bank of Canada and the Bank of England worked together to develop a "middle-ground" approach to crisis resolution. This approach, which was detailed in a joint paper published in 2001, was designed to provide the right incentives for debtors and creditors. It contained three basic elements. First, "presumptive limits" to official assistance, which would be known in advance. Secondly, the possibility of exceptional official lending, but only in the unlikely event that a crisis threatened global financial stability. Third, orderly standstills or temporary suspensions of debt-service payments to give distressed debtors some time to take steps, including debt rescheduling, to address their problems.

Since that time, the G-7 finance ministers and central bank governors have adopted much of this approach in the context of their Action Plan for crisis prevention and resolution. What is important now is that we support that Plan and enforce the rules that have been put in place. If we ignore the rules that have been established, we risk losing the trust that we are trying so hard to build.

To conclude, I hope that I have been able to illustrate the importance of trust. By strengthening this trust, we can make the global financial system work better. And by doing so, we can deal with the changing fortunes of the world economy and find a more efficient means of financing world growth.