David Dodge: International issues and the Canadian economy

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Canada-UK Chamber of Commerce, London, 28 June 2005.

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The international Monetary Order and the Canadian Economy

As business people with ties to Canada and the United Kingdom, you are keenly interested in the economic prospects of both countries. When we look closely at our economies, it is striking how much they have in common in terms of policies and outlook.

The United Kingdom may have roughly twice the population of Canada, but our economies share some very important characteristics. Both are relatively small compared with our respective neighbours—the euro zone and the United States. From a macroeconomic perspective, we both operate with an inflation-targeting regime, backed by a flexible currency. We have had a record of sound fiscal policy, certainly in comparison with our large neighbours. We are relatively open economies and depend greatly on international trade for economic growth. This means that global developments are central to our own domestic economic performance. So I will begin my remarks today by talking about international issues—particularly global economic imbalances—before discussing how the Canadian economy is adjusting to international events.

Global Imbalances-Origins and Solutions

When I say "global imbalances," I am referring to the persistent and growing current account deficit in the United States that is mirrored by large current account surpluses elsewhere, especially in Asia. While Canada and the United Kingdom have not contributed in a major way to the creation of these imbalances, we *will* be part of the solution, whatever that solution turns out to be. And given our dependence on international trade and global financial stability for economic growth, we both have a major stake in seeing that global imbalances are resolved in an orderly way.

These imbalances reflect the financial flows associated with mismatches in savings and investment on a global scale. Since the latter part of the 1990s, many economies outside the United States have increased their national savings by a very large amount for various reasons. At the same time, the United States has reduced its savings and has become increasingly reliant on foreign borrowing.

Why should we care about global imbalances? After all, isn't it a good thing that markets allow investors in Asia and elsewhere to fill the savings gap in the United States? In theory, yes. But there are three concerns with the current situation. First, these financial flows are not sustainable indefinitely, and there are risks that markets could adjust in an abrupt way. Second, it seems clear that the excess savings in Asia could be put to better use in Asia itself. And third, there is concern that imbalances are contributing to rising protectionist sentiment.

So how can we achieve an orderly resolution of these imbalances? Within domestic economies, savings flow across sectors and regions without much risk of disruption, because market-based mechanisms—such as changes in relative wages, prices, and returns on capital—are allowed to work. These market-based mechanisms should also be allowed to work internationally. Unfortunately, a number of inappropriate national policies are preventing these mechanisms from working effectively, and so imbalances are growing unchecked. We know that U.S. external indebtedness—even with that country's reserve-currency status—cannot keep growing indefinitely as a share of its GDP. Eventually, investors will balk at increasing their exposure to the United States. Should that occur suddenly, we could see economic growth plummet and world financial markets become disorderly, threatening global financial stability.

Global imbalances are a global problem, and we need to think about them collectively. There is no simple solution to these saving-investment mismatches. But we must deal with the fact that the amount that citizens and businesses in the euro zone and much of Asia currently want to save exceeds the amount that firms there want to invest. And with current policies, this situation may persist for some time. As well, most oil-exporting countries are now generating large net savings. At the same time, desired investment in the United States exceeds desired national savings by a considerable amount, although it is not certain that this situation will persist.

Thus, as we look out over the next decade or so, there is a risk that we will find ourselves in a situation of global excess supply. This could happen if policy-makers fail to take appropriate measures, and the risk will increase if policy-makers resort to protectionism. Should these risks materialize, the global economy would then be headed for a period of very slow growth, perhaps punctuated by periods of outright recession.

I hasten to add that this is *not* a prediction on my part. I am only saying that such an outcome would be the consequence of inappropriate policies in many economies. And this outcome would hurt us all—including Canada and the United Kingdom—even if in our own case we are following appropriate policies. So it is clearly in everyone's interest to discuss these issues, not only domestically, but most importantly in international forums, such as the International Monetary Fund, the G-7, and the G-20.

Ironically enough, the key to changing global savings and investment flows rests with each country doing what is right for itself. If all countries followed a framework of appropriate domestic policies, this would go a long way towards defusing the danger posed by global imbalances. These policies go well beyond the responsibilities of a central banker. But I am raising them because it is important that they be discussed more broadly. So let me take a few minutes to review some of these policies. I'll start with issues outside of central banking before turning to monetary policy.

Appropriate Policies Support Confidence

The way to ensure that global demand continues to grow over time is for all policy-makers to follow frameworks that give households the confidence to spend and businesses the confidence to invest. Let's look at how this applies to fiscal policy. There is a clear need for countries to pursue a fiscal policy aimed at producing a sustainable ratio of public debt to GDP. Such a policy gives businesses and consumers confidence that the value of their money will not be eroded over time, either by high inflation or by excessive rates of taxation. Where a sustainable public debt-to-GDP ratio is now absent, it should be achieved; where it is present, it should be maintained. Clearly, fiscal consolidation is in the best interest of the U.S. economy and would also be helpful in resolving global imbalances. More generally, sound fiscal policies help support investor and household confidence in all economies.

The second point is that authorities everywhere need to ensure that domestic policies are promoting well-functioning markets for goods, services, capital, and labour. In particular, labour markets need to be flexible enough to facilitate the movement of workers from sector to sector as the economy adjusts to events. This is especially true in the euro zone, where rigid labour markets have been undermining confidence. Businesses hesitate to hire when labour market rules are so restrictive, and households lack the confidence to spend when unemployment rates are so high. By promoting domestic flexibility, policy-makers everywhere could support confidence and boost growth. This would be good for national economies, and it would also help to resolve global imbalances.

There is also a need for policy-makers to recognize the positive role played by a well-functioning social safety net. Here, I am referring to unemployment insurance, public health care, and public pension systems. The benefits of a well-functioning safety net should not be underestimated. Consider the countries of emerging Asia, where such systems are lacking. Because there is no social safety net, citizens in those countries need very high levels of savings to mitigate the risk of job loss and illness, and to provide for the years after they leave the workforce. A well-functioning social safety net pools risk, so that citizens can have increased confidence about the future and reduce their need for precautionary savings. Boosting consumption in Asia would certainly help with the resolution of imbalances. Of course, the key to a well-functioning safety net is that it actually functions well. We have seen examples where safety nets become so unwieldy that they act as a hindrance, holding back prospects for growth. Certain Asian economies also face the particular challenge of ensuring that the benefits of increased growth and higher incomes are spread more widely throughout the economy. I'll return to this point in a moment.

Authorities everywhere also need to follow policies that help a country's financial system work well. This is critical if the financial system is to carry out its vital role of helping to match savings with productive investments. The financial system can also support confidence by giving households appropriate access to credit. So it is essential that emerging-market economies have sound and efficient banking systems. The Asian crisis of 1997-98 illustrated this point clearly. International institutions, such as the Financial Stability Forum, have been working on this issue. While a number of emerging-market economies still have some distance to go, I am happy to say that we have seen some progress in many countries over the past few years.

Finally, appropriate monetary policy is very important. It can help instill confidence among consumers and businesses alike. Canada's monetary policy is anchored by an inflation-targeting system—a system that has also been adopted by the Bank of England. The Bank of Canada aims to keep inflation at 2 per cent, the midpoint of a 1 to 3 per cent range. Under this regime, not only has inflation in Canada remained near the target in recent years, but inflation expectations are now anchored near 2 per cent. As a result, market signals can be sent and received more clearly, and Canadian businesses and consumers are more confident about the future value of their money.

A critical feature of our inflation-targeting system is that we operate *symmetrically* around our target. This means that we care just as much about inflation falling below target as we do about inflation rising above it. This symmetric approach helps keep the Canadian economy near its production potential, thus encouraging strong, sustained growth in output and employment. I'm not arguing that all countries should copy every detail of our inflation-targeting regime. But it is important that central banks follow policies that anchor inflation expectations and thus prevent a buildup of deflationary as well inflationary pressures.

As I mentioned before, both Canada and the United Kingdom operate with a flexible exchange rate. Much has been said recently about floating exchange rates in relation to certain Asian economies—China in particular—and global imbalances. The policies of some Asian economies to encourage export-led growth, including the fixing of their exchange rates to the U.S. dollar, have caused a buildup of large foreign exchange reserves, thus exacerbating global imbalances.

It's important to point out that, in theory, there is nothing wrong with countries having fixed exchange rates. But in practice, there is a major problem. Through "sterilization," certain Asian countries—including China—have been trying to offset the domestic price effects of their foreign exchange intervention. This is inhibiting economic adjustment.

At the Bank of Canada, we have argued that it is very much in China's own economic interest to float its currency. By having a flexible currency, China could gear its own monetary policy to its own domestic considerations. If the external value of the renminbi were allowed to rise, the global purchasing power of Chinese citizens would also rise. This, in turn, would help to spread the gains from integrating into the world trading order throughout Chinese society and would allow that country to boost its consumption, thus helping to resolve global imbalances. Floating exchange rates are not the whole answer to the problem of global imbalances, but they are an important part of the solution.

As I just said, when countries offset the effects of intervention, they delay domestic economic adjustment. They also delay global adjustment. Just as worrying, such intervention is provoking threats in certain political quarters of protectionist measures. Such wrong-headed measures could choke off the growth of international trade that has led to rising incomes worldwide.

And so it is very important that all countries work to protect and enhance the free flow of goods and services by pushing the Doha round of trade talks to a successful conclusion, and by strengthening the World Trade Organization to ensure proper compliance with the rules of trade. All of us need to support these efforts and to be vocal in resisting calls for protectionism.

In addition, it is critical that we get on with the job of building an international monetary order for the 21st century. A more effective International Monetary Fund (IMF) has a crucial role to play in this regard. This issue is extraordinarily important, and I spoke at length on this topic in a speech I gave last month in Montréal.

Current Economic Developments in Canada

Against that backdrop, what specific policies are needed to help the Canadian economy adjust to global developments? While imbalances pose risks ahead, recent economic growth in the global economy has been quite strong, led by the United States and China. This growth has increased the world prices of oil and of many other commodities that we produce in Canada. As a result, there has been a marked improvement in our terms of trade—that is, the ratio of the prices that we receive for our exports to the prices we pay for our imports. This improvement has helped to raise real incomes and stimulate domestic demand in Canada. We have also been importantly affected by the sharp appreciation of the Canadian dollar against the U.S. dollar over the past couple of years—an appreciation that has had a major impact in many sectors.

The Canadian economy has been adjusting to these economic forces. We have seen increased business investment spending in sectors that are benefiting from higher world prices. We are also seeing rising investment in sectors that are not very exposed to international trade, as such firms react to strong growth in domestic demand. And we've had very strong investment in housing. But in other sectors that are highly exposed to international trade, mainly goods-producing sectors, prices are either falling or rising very slowly. Firms in these industries are feeling the pressure of the higher Canadian dollar, and they are also facing increased competition from other regions of the world.

The good news is that many Canadian firms are making the necessary adjustments. Investment spending is being directed towards increased specialization, higher productivity, and lower costs. Since much of the productivity-enhancing machinery and equipment is priced in U.S. dollars, the stronger Canadian dollar has made it easier for firms to make investments. A growing number of firms are looking to cut costs by importing more inputs, particularly from Asia. Other firms are phasing out production lines with low profit margins.

Through its monetary policy, the Bank of Canada is helping these adjustments by keeping inflation low, stable, and predictable, and by aiming to keep the economy operating close to its production potential. With the recent sharp appreciation of the Canadian dollar, net exports have been acting as a drag on economic growth. So growth has been driven by domestic demand, supported by monetary stimulus. In our April *Monetary Policy Report*, we projected that final domestic demand would grow by almost 4 per cent in 2005. According to recently released data, it grew by more than expected during the first quarter of the year. So we continue to see evidence that strong domestic demand is offsetting the weakness in net exports.

On 14 July, we will publish our *Monetary Policy Report Update*, in which we will spell out our latest views on the Canadian economy. The Bank is now in the process of gathering and analyzing the full set of information on the global and the Canadian economies that will feed into our next interest rate decision, and into the *Update*.

On our last policy announcement date in May, we decided to keep the target for the overnight rate at 2 1/2 per cent. At that time, we indicated that global and Canadian economic developments had been unfolding broadly in line with our expectations and that our outlook for the Canadian economy through to the end of 2006 was unchanged from the one presented in our April *Monetary Policy Report*. The analysis in that *Report* is still relevant. So is our statement that, in line with this outlook for growth and inflation, a reduction of monetary stimulus—that is, an increase in our key policy interest rate—will be required over time.

Conclusion

Let me conclude. On the one hand, I'm bringing you a hopeful message: Canada's economy, backed by a sound policy framework, is adjusting to forces at work in the global economy. This adjustment is not painless, but it is taking place, leaving Canada well placed to thrive in the years ahead.

On the other hand, I want to leave you with a caution against complacency. We are all part of the global economy and, as such, we can do little to shield ourselves from a major economic disruption, such as a disorderly resolution of global imbalances. Collective action is needed now to minimize the chances of a major crisis down the road. The task won't be easy, but it is up to policy-makers—whether they gather at the Bank for International Settlements in Basel, at the IMF in Washington, or around the G-7 table at Gleneagles in a few days—to work towards an environment that will support sustained economic growth worldwide.