# David Dodge: Global imbalances - Why worry? What to do?

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the New York Association for Business Economics, New York, 29 March 2006.

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Today, I am going to discuss global current account imbalances—why we should worry about them, and what we can do to encourage their resolution. I will talk about the need to develop an international monetary system that supports market-based solutions to global imbalances and removes existing impediments to these market-based solutions.

## Global imbalances

Before I discuss why we need to worry about global current account imbalances, let me first explain what I mean by "global imbalances." I am referring to the persistent and growing current account deficit in the United States, mirrored by large and growing current account surpluses elsewhere, especially in Asia. These imbalances reflect the financial flows associated with mismatches in savings and investment on a global scale. Since the late 1990s, many economies outside the United States have increased their net national savings. At the same time, the United States has further reduced its net national savings and has relied more heavily on foreign borrowing.

Geographical imbalances are not a bad thing *per se,* nor are the capital flows that they generate. Indeed, there should be a process that works through world markets to allow savers in one country to lend to borrowers in another. Such a process leads to higher global economic growth, since countries with surplus savings can invest them in countries that do not generate enough savings internally.

In an ideal world, markets for goods, services, and capital function efficiently. Funds flow from areas with excess savings to areas with excess investment opportunities. In this ideal world, domestic labour markets operate without any barriers to the movements of workers. And there are no restrictions on the trade of goods and services or on the flow of capital across borders.

Under these perfect circumstances, as economies evolve, we would expect to see shifts in the flows of savings into regions where investment opportunities are particularly strong and where markets are offering favourable returns. These flows would generate periods of current account surpluses or deficits, but these would not be a cause for worry, since adjustment mechanisms in the market would resolve them. And since our world economy is a closed one—Mars missions notwithstanding, we still don't export to other planets—we would see savings increase in one part of the world to offset increases in domestic demand elsewhere.

## Why worry?

In this ideal world where markets operate efficiently, without distorting policy interventions, imbalances can resolve themselves in a smooth and orderly manner. But we don't live in an ideal world. Domestic labour markets in Europe and Asia are not very flexible, and reallocation of labour resources is difficult. Domestic fiscal and social policies often stifle investment and encourage excessive savings in some parts of the world and overstimulate consumption in others. And there are still persistent impediments to the free flow of goods and services across borders.

Meanwhile, some domestic banking sectors and capital markets continue to operate under rigid and inefficient regulations. And some important economies, particularly in Asia, are maintaining undervalued exchange rates through exchange market interventions and capital controls. In the process, they are accumulating excessive reserves.

Because of these issues—inflexible labour markets, inappropriate fiscal policies, barriers to open trade, and dysfunctional capital markets—market-equilibrating mechanisms are not being allowed to work as they should. And so there are risks that these current account imbalances will persist until they are resolved in a disorderly way.

### What are the risks?

Let me spend a few minutes outlining these risks. The first risk is that private and public savings in the United States will rise and that spending will decline without a compensating increase in demand in the rest of the world. If that drop in U.S. demand is not matched by higher demand in other countries, the global economy could slide into a phase of very slow growth, perhaps punctuated by periods of outright recession. A second risk is that investors could dramatically reduce their exposure to the United States, which could cause major disruption in world financial markets. Instability in the financial sector could spill over into trade in goods and services, leading to an even more dramatic decline in demand and output. A third risk is that these events might also prompt governments to adopt wrong-headed protectionist measures, which would exacerbate the damage to the global economy.

Economic theory and history tell us that external indebtedness cannot keep growing indefinitely as a share of a country's GDP - even for a country like the United States with its reserve-currency status. There is no compelling reason to believe that historical and fundamental economic and financial constraints do not apply to the world economy today. There is no reason to believe that this time is different. There is every reason to believe that a market adjustment to these imbalances will take place.

If this adjustment is disorderly, it would affect the economy through a sudden drop in demand and prices and a resulting decline in economic output. It could also cause a painful correction in capital markets and exchange rates. In a worst case scenario, it could do both.

### What can we do?

That is why we worry about the risks from current account imbalances, and why the Bank of Canada has been focusing on the implications of these risks. Policy-makers around the world have a responsibility to facilitate adjustments in a way that keeps the global economy growing at potential and mitigates the impact of these risks. Our job is to provide a framework that helps market forces promote an orderly adjustment.

So what can we collectively do to help prevent a disorderly adjustment? What insurance can economic and financial policy-makers take against these risks?

I said earlier that the resolution of global imbalances will require market-based solutions. In many cases, building the right framework will involve eliminating some of the policies that inhibit markets from resolving these imbalances. This was the theme of the G-7 discussions at Boca Raton two years ago. Let me briefly look back at what we called for in our statement following those meetings. Then I'll review what progress has been made.

Central bankers and finance ministers emerged from the Boca Raton meetings with a list of policy initiatives that are key to addressing global current account imbalances. This list included five priorities: first, microeconomic policies that increase flexibility and raise productivity growth and employment; second, the development of well-functioning domestic capital and financial markets; third, resumption of the Doha round of multilateral trade negotiations; fourth, sound fiscal policies; and fifth, flexible exchange rates that reflect economic fundamentals and promote smooth adjustments.

To deal with global current account imbalances in an orderly and efficient way that supports continued growth, we have to make progress on all five of these policy fronts. It simply won't do for countries to pick one or two of these policy priorities and ignore the others. And we can't delude ourselves into thinking that economic imbalances will be resolved in an orderly way through exchange rate adjustments alone. Progress has to be extensive, international, and simultaneous.

Let's review our collective progress on these priorities in the two years since our meetings in Boca Raton. I'll start with domestic microeconomic policies. Domestic reform is important because if each country works to get its own house in order, we increase the odds of doing the same on an international scale.

In well-functioning domestic economies, savings flow across sectors and regions without much risk of disruption, because market-based mechanisms—such as changes in relative wages and prices—are allowed to work. Authorities everywhere need domestic policies that promote 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. If they are not, confidence is undermined: businesses hesitate to hire when labour market rules are restrictive,

and households lack the confidence to spend when unemployment rates are 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 over time, provided that macroeconomic policies can smooth demand in the short run.

Since Boca Raton, we have seen some efforts to increase flexibility in some regions, but progress has been minimal. This is understandable because, politically, measures to increase the flexibility of labour markets can be very difficult. But labour market rigidities, particularly in Europe and Japan, remain significant barriers to adjustment.

The second policy priority is the development of domestic capital and financial markets. The goal is to have markets that are not distorted by capital controls and other interventionist policies. It is important that Asian policy-makers let their domestic financial systems do their job.

We must acknowledge the difficulty and the time that this will take. And we should acknowledge that progress has been made in the banking and financial systems of several countries since the Asian crisis of 1997-98. But even with that progress, it will still be some time before markets in that region are functioning at their optimal efficiency. And it will be some time before households in Asia have sufficient and appropriate incentives to reduce savings and increase their consumption.

This is not just an Asian problem. Europe, too, has a long way to go before it can establish a single euro capital market, let alone one that is open beyond the boundaries of that region. And I note, with some dismay, the rising economic nationalism with respect to foreign direct investment, not just in Asia and Europe, but in the United States as well.

The third priority we outlined in Boca Raton was resumption of the Doha round of multilateral trade negotiations. It is critical that all countries work to protect and enhance the free flow of goods and services by pushing the Doha round 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 be vocal in resisting calls for protectionism. Yet, two years after Boca Raton, progress on trade appears to be stalled. Protectionism is a real and rising threat, and we see mounting restrictions on the flow of capital. Instead of more openness in trade and investment, we see signs of increasing insularity.

Our fourth priority was sound fiscal policy over the medium term. Countries should pursue policies that promote sustainable levels of household and government consumption and a low ratio of public debt to GDP. And while we didn't discuss monetary policy goals in the Boca Raton communiqué, we all recognize that prudent fiscal policy works best when it is combined with monetary policy that promotes low and stable inflation. Such policies give businesses and consumers confidence that the value of their money will not be eroded over time by high inflation or excessive rates of taxation. Sound fiscal and monetary policies are needed in the United States, Europe, and Japan to support investor and household confidence. Fiscal consolidation in the United States would also be helpful in resolving global imbalances.

The fifth priority is a policy of more flexible exchange rates that reflect economic fundamentals and promote smooth adjustments. Given the fact that labour markets are still fairly inflexible and that wages and prices are slow to absorb shocks, a floating exchange rate is an important adjustment mechanism for many economies, including Canada's. A market-based exchange rate can be a useful "shock absorber," helping the economy to react to external swings in demand more efficiently than a fixed exchange rate.

Some Asian economies have pursued an export-led growth strategy by fixing the value of their currencies to the U.S. dollar through persistent, sterilized, foreign exchange market intervention. This has resulted in an accumulation of excessive foreign exchange reserves and has exacerbated global imbalances.

In theory, there is nothing wrong with countries having fixed nominal exchange rates. But in practice, this leads to major problems, because real rates do have to adjust to external shocks. The first problem is that under a fixed rate regime, the economy must adjust to these shocks through sharp changes in domestic prices. This means that countries with current account surpluses should experience high rates of domestic credit expansion, leading to high inflation. But when authorities use sterilization policies to try to offset the domestic price effects of their foreign exchange intervention, they delay both domestic and global economic adjustment. Such intervention also provokes threats of protectionist measures, which could choke off the growth of international trade that has led to rising incomes worldwide. It was these kinds of "beggar-thy-neighbour" policies that we were seeking to

avoid 60 years ago, when developed countries came together for the United Nations Monetary and Financial Conference at Bretton Woods, New Hampshire.

Increasing exchange rate flexibility is perhaps the most important of the five policy priorities that I have outlined today. But as I said before, the orderly resolution of global imbalances will require progress on all five policy fronts. The reward for such reform is better access to a growing world market. The gains for the citizens of emerging-market countries are more flexible economies, higher real incomes, and better living standards.

## The international framework

These and other reforms to resolve global imbalances can be achieved more easily if we also reform the financial institutions that oversee the world economy. I mentioned the Bretton Woods conference 60 years ago that created an international monetary order to help repair the damage of the Great Depression and the Second World War. Today, we must get on with the job of building an international monetary order for the 21st century—one that encourages market-based solutions to global imbalances.

To achieve these solutions, we need a framework that can manage a world where open economies interact with economies whose markets are not yet allowed to operate freely. We must accommodate the fact that some systemically important economies, including China, still prefer the stability of a fixed or quasi-fixed exchange rate regime. We need rules that will allow market signals to come through and market forces to work during what could be a lengthy period of coexisting fixed and floating exchange rate systems.

To build that framework and develop these rules, we need an international table around which we can all gather, and an institution to manage the development and the continued success of that framework. That institution should be the International Monetary Fund, but an IMF that is revitalized and is more representative of the global economy in the 21st century. A renewed IMF could use its surveillance to be more forthright in terms of the policy outcomes that are implied by different regimes. It could and should be the umpire for the world economic order, unafraid to call out countries that aren't playing by the rules. It could provide the support for the market to work at peak efficiency, monitor risks, provide necessary early warnings, and help to correct vulnerabilities before they become crises. In short, a renewed IMF could help us move towards a well-functioning, market-based international financial system in which markets would provide incentives that would lead to an orderly resolution of global imbalances. I'll have more to say on this tomorrow in a lecture at Princeton University.

## Conclusion

Let me conclude. We are all part of the global economy. A major economic disruption, such as a disorderly resolution of global imbalances, will affect every country. Collective action is needed now to minimize the chances of such a disruption. Domestically, policy-makers need to promote well-functioning markets for goods, services, capital, and labour. Internationally, policy-makers need to develop a framework that allows an orderly, market-based unwinding of global imbalances.

It is not realistic to suggest that overnight we can build the ideal market that I described at the beginning of my remarks. We don't need to create a perfect world. But we do need to make progress—real progress on better-functioning financial markets, more flexible currency regimes, more open international trade, and better fiscal and structural policies. Each country and each region has its work to do. Now is the time for all of us to get on with the job.