David Dodge: Prospering in today's global economy – challenges for open economies such as Australia and Canada

Notes for a speech by Mr David Dodge, Governor of the Bank of Canada, to the Sydney Institute and the Canadian Australian Chamber of Commerce, Sydney, Australia, 6 November 2006.

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I'm very happy to be here in Sydney this evening to talk about our two economies, which have so many features in common: healthy growth, low unemployment, solid prospects for the future, and sound macroeconomic policies. But I'd also like to talk about our economies in the context of the wider global market in which we both trade. Further, I'll discuss just how essential it is to our economic well-being, and that of future generations, that we buttress the global institutions that are so vital to stable international trade and financial systems.

As major producers of commodities, both Canada and Australia rely heavily on international trade for our economic expansion, and we each rely extensively on global capital markets. So, what I would like to talk about first is how we see the global and Canadian economies unfolding and what we might expect to see in the future. Following that, I'll also talk about some of the policies that can best help countries like ours to deal with the challenges of today's global economy, looking at this from both a domestic and an international perspective.

Canada, Australia, and the global economy

In Canada, we're feeling pretty positive right now about our prospects, despite the fact that the pullback we are now seeing in the U.S. economy is larger, and has come faster, than we had expected.

That slowing has serious implications for global demand, of course, but it hits home particularly hard for us, since the United States is, by far, Canada's largest trading partner.

After several years of strong expansion, the U.S. economy is cooling down, restrained by a pullback in the housing sector and slowing demand for autos. After growing robustly in the first quarter of this year, U.S. growth slowed to 2.9 per cent in the second, and the advance estimate is that growth was just 1.6 per cent in the third quarter. The Bank of Canada now projects that U.S. economic growth will average 2 to 2 1/2 per cent in the last half of this year and the first half of 2007. Activity should then recover to above 3 per cent in the second half of next year and throughout 2008.

Slower U.S. growth has clearly caused Canadian GDP growth to fall short of expectations in the second and third quarters. After expanding at a 3.6 per cent annual rate in the first three months of this year, GDP growth slowed to only 2 per cent in the second quarter, and we expect a similar figure for the third quarter.

But it's important to think of this as a mild, and likely very short-lived, cyclical slowdown for Canada. With near-term weakness in the U.S. economy, net exports will likely exert a considerable drag on Canadian growth. However, consumer spending and business investment are expected to remain robust. Overall, we at the Bank of Canada project 2.8 per cent growth for real GDP in 2006, slowing to 2.5 per cent next year but coming back up to 2.8 per cent in 2008.

Core inflation is expected to move a bit above 2 per cent in the coming months but return to the 2 per cent target by the middle of 2007 and remain there through 2008. Total inflation will likely average about 1 1/2 per cent through the second quarter of 2007, before returning to the 2 per cent target and remaining there through to the end of 2008.

The main upside risk to the Canadian economy continues to relate to the momentum in household spending and housing prices. This momentum is linked to strong consumer credit growth. By increasing home equity and thus expanding the availability of collateral, the recent strong increases in house prices have contributed to robust growth in consumer credit. There is a risk that these linkages could be stronger than assumed or that house prices could continue to grow more rapidly than expected, resulting in higher-than-projected household spending and, hence, greater upward pressures on inflation.

The main downside risk to the Canadian economy relates to the possibility of a sharper slowdown in the housing sector in the United States and a broadening of the weakness in the housing sector to consumption and investment. A larger decline in domestic demand in the United States would lead to decreased demand for Canadian exports and broader weakness in the Canadian economy. This development would also lead to lower inflation.

The slower growth in the U.S. economy is a sharp reminder of just how important a role its powerful appetite plays in absorbing the exports of many countries and just how critical that strong U.S. demand has been to global economic growth.

Of course, the United States has been far from alone in absorbing goods and resources from around the world to feed its economic expansion. The extent of the strong worldwide demand, particularly the demand for commodities coming from the emerging powers of China and India, has fuelled Canadian and Australian growth and also has reminded us of just how closely intertwined countries have become.

Canada has traditionally been known for its net exports of non-energy commodities. Minerals and lumber continue to be important commodity exports for us. However, over the past decade, thanks to plentiful oil and gas reserves and sharply higher prices for oil and natural gas, we are now increasingly known for our energy riches. Similarly, Australia's reserves and exports of minerals, uranium, and coal are among the largest in the world, and demand for those commodities helps to shape the views of global markets about your country. As well, we're both major exporters of grains, traditionally among the top three in the world. As such, I can certainly understand and sympathize with your farmers who are suffering the effects of drought.

With such strong world demand and interest directed towards our commodities, it's perhaps a good time to pause for a moment and reflect on how we might try to strengthen the global trade and financial systems that we rely on so much. World commodity markets are subject to ups and downs. The movements in commodity prices and our exchange rates can pose serious economic challenges for firms and workers. In turn, central bankers and governments must design policies that allow businesses and workers to react rapidly to changing economic circumstances. The healthy, steady prosperity of our two economies is a testament to domestic policies that are working to encourage flexibility, and thus facilitate adjustment.

Policies to encourage flexibility

On the domestic front, it seems that both Canada and Australia have been on the right track - and we both have the economic record to demonstrate that! In terms of monetary policy, both the Bank of Canada and the Reserve Bank of Australia have embraced a policy of inflation targeting backed by a floating exchange rate. For over a decade, both the Reserve Bank of Australia and the Bank of Canada have concentrated on maintaining low and stable inflation.

Inflation targeting helps to preserve confidence in the future value of money and, in that way, anchors inflation expectations. This helps business in making appropriate investments, by maximizing the clarity of the signals that are sent by prices. Controlling inflation is also crucial to maintaining the confidence of markets at home and abroad.

Central banks pursue inflation targeting by adjusting interest rates with the goal of keeping total supply and demand in the economy in rough balance. By aiming to keep the economy running at or near full capacity, monetary policy can make it easier for resources to shift from sectors that are shrinking to sectors that are expanding.

This is particularly important in times such as these, when large swings in relative prices highlight the need for rapid adjustments in economic activity. And it's especially important for countries like Canada and Australia - open, trading nations that rely particularly heavily on the production and sale of commodities for their economic well-being.

Of course, a central bank that targets inflation must have a floating exchange rate. Experience has shown that for countries such as ours, exchange rate flexibility facilitates adjustments to shocks.

Both Canada and Australia have reasonably flexible economies, by which I mean they have the ability to quickly adjust to changing circumstances. And while we recognize that both countries have taken steps to improve flexibility in recent years, there is still much more to be done. In my own country, for example, we continue to grapple with the need to make labour markets more flexible and to foster competition. We also recognize the need to make financial markets as efficient as possible.

In the past decade, both Canada and Australia have followed very good fiscal policies. In Australia, this has been built on an earlier period of debt reduction, while in Canada, we are in the process of reducing debt to levels that will be sustainable in light of forthcoming demographic pressures that we, like so many other nations, will be facing.

But flexibility and good macroeconomic policy at home still aren't enough to guarantee our future prosperity: it's crucial to us all that we maintain a well-functioning international financial system, an issue to which I will now turn.

Promoting a stable, well-functioning international order

It seems very clear to me that it is absolutely in the best interests of Canada and Australia to promote freer trade and greater financial stability around the globe. With respect to trade, it is vital that the multilateral negotiations that began five years ago at Doha under the World Trade Organization be restarted and brought to a quick and successful end, and that we all work to continue to strengthen the WTO. The future prosperity of so many nations, in the developing world as well as the developed, depends on these crucial trade talks.

In terms of international financial issues, I think we can all recall quite clearly a fairly recent example of what can happen when the international financial order breaks down. The Asian financial crisis occurred almost a decade ago, yet who can forget how rapidly it swept around the globe; knocking down currencies, shaking up markets, spreading to other emerging-market economies, and throwing many into a tailspin. Demand for commodities contracted sharply during the Asian crisis, which eventually led to a dramatic decline in many world commodity prices. Some commodity prices hit lows not seen since the end of the Second World War, and that led to a sharp depreciation of our currencies.

Some progress has been made since then, including the establishment of bodies such as the Financial Stability Forum and the G-20. The G-20 brings together systemically significant industrial and emerging-market economies and, as you know, will be meeting in Melbourne later this month. I'm looking forward to this meeting, and I want to say how much I appreciate your country's strong support of this very important forum. Such a forum can provide emerging markets, in particular, with an opportunity to improve the quality of their macroeconomic policies and their regulation of financial systems. And I think it's fair to say that thanks to these and other efforts, the global financial system today is more robust than it was in the late 1990s.

But there is so much more that must be done. The Asian financial crisis reminds us of how closely connected economies have become, and of the vulnerabilities of open, trading nations like ours. We can best flourish when the rules of the game are clear and when everyone follows them in deed, as well as in word.

This is why the work of strengthening the International Monetary Fund is so important. Born 60 years ago at Bretton Woods, New Hampshire, the IMF was part of a movement to create an international order, whether in finances or trade, that would work to the benefit of member states. As economies become more integrated and new players have emerged on the global stage, the Fund's central purpose - to promote a well-functioning international monetary and financial order - is more relevant than ever. And it remains crucial to countries such as ours, which are heavily involved in global trade. Underlying this purpose is a basic premise: that the welfare of all our citizens is enhanced by a growing global economy, with rising standards of living and with realized gains from the exchange of goods and services across countries.

Canada's need for a well-functioning international financial order helps to explain why we have been working so hard to see real reforms to strengthen the IMF, and to shift everyone's focus back to the original goals of its founders. With the size of capital and trade flows in today's global economy, we need - now more than ever - a fortified IMF that is truly able to promote a well-functioning, market-based international financial system. By "well-functioning," I mean a financial system that is both efficient and stable, so that markets can do their job of allocating savings to investments through the pricing of capital, and of smoothing economic adjustments through movements in relative prices.

How should the IMF be reformed? Well, to solve global problems, we need to have everyone represented at one table and all participants fully engaged. But since 1997, the work of the IMF has suffered. Over the past number of years, many emerging-market economies have shifted some of their attention away from the centre of the global financial system, towards regional initiatives. This trend must be reversed. The fastest-growing parts of the world economy should have a growing voice at the IMF. At its recent meeting in Singapore, the Fund began the process of making itself appropriately representative of today's global economic reality.

But the importance of this step will be lost unless we can improve the Fund's effectiveness in promoting a framework that supports a well-functioning global economy. I believe the key to that improvement lies in a strengthened surveillance function.

So, how exactly should surveillance be strengthened? In my view, the IMF can play a pivotal role in mitigating serious global risks by serving, in the words of John Maynard Keynes, as a "ruthless truth teller." This expression is a wonderful turn of phrase, not only for its colourful language, but because it neatly encapsulates the critical objectives of effective IMF surveillance. The Fund's surveillance should determine the "truth" about the economic policies and circumstances of member countries, and then "tell" or communicate this truth transparently to all members and to the international community at large.

To determine the truth, the IMF must be focused on the right surveillance priorities; namely, the exchange rate, monetary, fiscal, and financial policies of member countries. Surveillance should focus on these areas alone, and on the potential spillover effects that these policies may have on other members. These are the priorities that reflect the reality of an increasingly integrated global economy.

This is not to say that there is one single prescription for macroeconomic and financial policies that all countries must rigorously follow. But what is important is that the particular policies chosen by a country must not hinder economic adjustment. The purpose of IMF surveillance must then be to determine whether the policies being followed by a country are coherent, and whether they have the potential to cause spillover effects in the rest of the world. Surveillance must not get bogged down in domestic microeconomic issues that have little or no bearing on the functioning of the global economy.

Once the Fund staff have done their best analysis of the truth, the Fund must communicate, or tell it, clearly and transparently. I understand that being told the truth can be difficult for national authorities. After all, I was one of those national authorities back in the 1990s who was on the receiving end of IMF criticism. While at that time, we in Canada did not enjoy hearing the truth about our deteriorating fiscal situation, the criticism did help provide the impetus for us to take some tough decisions.

Transparent truth telling also serves a very important function in that it allows markets to discriminate in the event of a global disruption. When investors have good, reliable information, they can make better decisions. This can help limit contagion and minimize the occasions when countries are sideswiped by the poor policy decisions of others. This is particularly important for emerging economies that do not have the wealth, income levels, or institutional capacity to withstand a serious shock.

While the meanings of "truth" and "tell" are fairly clear, what can be said about the word "ruthless"? What this means is that surveillance must be uncompromising and free from interference, political or otherwise. If the policies of any country - large or small - pose risks for spillovers or impede market-based adjustments in the global economy, the truth must be told. Market integration and leverage have magnified the potential impact of policy spillovers. While risk sharing has also increased, markets remain far from complete; more and more countries can now have systemic effects.

To sum up, we need to agree that the IMF should provide a candid assessment of policies that can create external instability or that can prevent adjustment to external imbalances. A more robust IMF can help to maintain the stability of the international financial system that is so important to our businesses and to our economies generally.

Conclusion

It's very clear that Australia and Canada have both benefited greatly from the strong global economic growth in recent years. But we can't take that growth for granted. I have discussed domestic policies that are especially important for open trading nations like ours: sustainable fiscal policies, a monetary policy based on inflation targeting, a flexible exchange rate, and flexible markets that can respond to changing economic circumstances. By following these prescriptions, both Australia and Canada should be well placed to cope with whatever developments come about in the global economy.

But we must also work hard to help shape that global economy. We need to do our utmost to ensure continued free trade in goods and services and to resist protectionism. And we must work together and with other countries to make the international financial system as efficient and effective as possible. An important part of that effort must be to modernize the IMF.

With a stronger international system and solid domestic policies, both Australians and Canadians can look forward to continued strong economic growth in the years ahead.