David Dodge: Making global economic institutions work – what the world needs now

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Chicago Council on Global Affairs, Chicago, 21 May 2007.

*   *   *

It is certainly an honour and a privilege to be able to address the Chicago Council on Global Affairs. For 85 years, the Council has promoted the idea that the United States should take a leading role in addressing global challenges. And it has done so consistently through the years, even during times when isolationism was more fashionable.

Sixty years ago, just a few months after the Council celebrated its 25th anniversary, Secretary of State George Marshall delivered his famous commencement address at Harvard in which he outlined what would become known as the Marshall Plan. To those who asked why the United States should take such a pre-eminent role in rebuilding war-torn Europe, Marshall said: "It is logical that the United States should do whatever it is able to do to assist in the return of normal economic health in the world, without which there can be no political stability and no assured peace."[1] That sentiment remains absolutely true today.

But the Marshall Plan was not the only major event of 1947. That year also marked the opening of the United Nations Conference on Trade and Employment in Havana, Cuba – the first step in the creation of a rules-based multilateral trading system. It is fitting that we should mark the 60th anniversary of these events, not just to commemorate their happening, but to celebrate the economic progress that they made possible – progress that has lifted millions of people out of poverty and, to repeat Marshall's words, "without which there can be no political stability and no assured peace."

The postwar reconstruction of Europe and the development of a rules-based multilateral trading system came a couple of years after the United Nations conference at Bretton Woods, New Hampshire that led to the creation of the International Monetary Fund (IMF) and the World Bank. These institutions were joined in 1948 by the Organisation for European Economic Co-operation (OEEC), which was formed to administer aid under the Marshall Plan. The OEEC eventually evolved into the Organisation for Economic Co-operation and Development (OECD), which has been an extremely useful venue where economic and financial authorities can gather and discuss how best to promote strong economies through liberalized markets, freer trade, and sound macroeconomic policies.

These institutions provided a framework that helped the so-called "first world" nations establish a market-based trade and financial order. And with this order in place, the economies of the first world nations – including the United States – thrived. In fact, they flourished so much that, over the years, a growing number of countries have seen the desirability of becoming part of this increasingly global order. This expansion, which continues today, is certainly a welcome development. It holds out the prospect of spreading growth and prosperity to millions more. This process is also very much in our own interest in the United States and Canada, since it will allow us to develop larger markets, leading to greater innovation and efficiency, along with increased productivity and incomes. Of course, it's important to recognize that this process implies adjustments for our own economies and for our citizens, and that these adjustments are often difficult and painful. But, in the end, there are always clear net gains to be realized from the expansion of trade.

However, today's market-based, global trade and financial order faces two main challenges. In my opinion, we need to deal with them with some urgency. First, there remain significant imbalances in global savings and investment, and all of us should be doing what we can to maximize the chances that these imbalances can be unwound in a smooth and gradual way. By and large, this means promoting policies that allow market-based adjustments to take place. Second, to facilitate market-based adjustments, we need to strengthen the institutions that support the global trade and financial order. So, today, I will talk about what needs to be done to help facilitate the orderly resolution of

1 *The Department of State Bulletin*, XVI, No. 415 (15 June 1947) pp. 1159-1160.

global imbalances and, in particular, discuss what needs to be done within our global economic institutions to help in this effort.

The risks posed by global imbalances

Let me begin by talking about global imbalances. The word "global" is the key to seeing both the nature of the problem and the path to its solution. There is no single cause of these imbalances. In China and many other Asian countries, we have seen very high levels of net savings. This is partly because, in the absence of social safety nets, households accumulate large amounts of precautionary savings. And it is partly because of the lack of a well-developed financial system that these savings are not being allocated efficiently. As well, the absence of market-based mechanisms within these economies – including the lack of a flexible exchange rate – impedes domestic economic adjustment. In addition to this, we have seen many oil-exporting countries record large trade surpluses, as the price of crude oil has risen. So, many Asian and oil-exporting countries are experiencing high levels of desired savings relative to desired investment.

The U.S. economy is in the reverse situation. Over the past few years, the United States has become a large net borrower, as government deficits rose and household savings fell. As a result, we have seen lower desired savings relative to desired investment in the United States. In the future, these global imbalances will have to be corrected through an increase of net savings in the United States and a reduction of net savings in Asia and in the oil-exporting countries.

But, given the recent behaviour of international financial markets, and based on recent commentary, one might start to think that global imbalances are no longer something to be concerned about. And it is true that we are seeing some positive indicators. Domestic demand has picked up in Europe and Asia, and has slowed somewhat in the United States. Oil prices appear to have stabilized, and the U.S. dollar has depreciated on a trade-weighted basis, helping to encourage U.S. exports and discourage imports. The U.S. current account deficit has shown signs of stabilizing. And China has taken some steps towards increasing household demand and building more market-based adjustment mechanisms. These steps include the introduction of some exchange rate flexibility, which can help increase China's real income and domestic demand. All of these developments are helpful in terms of resolving imbalances.

However, I worry that it is far too early to start discounting the threat posed by the persistence of global imbalances. There are a couple of risks that embody this threat. One is the risk of rising protectionism. We have already seen troubling signs. Some lawmakers are proposing tariffs or quotas on imports from some Asian countries in response to the perception that these countries are manipulating their exchange rates. The other risk is that financial markets could lose confidence that policy-makers worldwide will continue to take appropriate actions. Such a loss of confidence could lead to a sharp swing in market sentiment and an abrupt, and costly, resolution of imbalances.

So how can we best encourage an orderly resolution of imbalances? The first point to be made is that a global problem requires a global solution. Those who point the finger only at the United States, calling only for a reversal of its fiscal and current account deficits, are missing the point, as are those who say that the problem would go away if China would just let its currency appreciate more rapidly.

The world as a whole is a closed economy. This means that large swings in demand in one place need to be offset by compensating swings in other places. So, if the United States were to dramatically increase its net savings to suddenly wipe out its fiscal and current account deficits, the global economy would likely head rapidly into recession unless other economies took immediate steps to reduce their net savings by increasing their domestic demand.

The other point to make is that the key to a smooth and orderly resolution of imbalances lies in letting market-based adjustment mechanisms work. After all, savings-investment imbalances occur all the time between regions in a single country, such as Canada or the United States. But these imbalances don't tend to cause problems, because market mechanisms help to resolve them. Relative wages and prices change, as do relative returns on capital. And labour moves within a country to promote an orderly adjustment process.

Over time, authorities in many countries have come to understand that they need to make market-based adjustment mechanisms work. Their role in promoting market-based adjustments is to implement a coherent framework of macroeconomic policies, supported by a safe and sound financial system. From a central banker's point of view, our best contribution to this effort is to deliver monetary policy focused on providing low and stable inflation, supported by a floating exchange rate. Given the consensus on this point in terms of *domestic* economies, it seems clear to me that we can promote a smooth resolution of imbalances by removing impediments to market-based adjustments in the *global* economy. And this is where our global economic institutions come in.

Making global institutions work

I spoke earlier about the birth of the Bretton Woods institutions following World War II. The success of the Bretton Woods conference was due in no small part to the commitment shown by the American delegation and Harry Dexter White. Along with the leader of the British delegation, John Maynard Keynes, White was instrumental in setting out the original goals of the IMF. Under the Articles of Agreement, the Fund is charged with promoting international monetary co-operation by providing the machinery for consultation and collaboration on international monetary problems, and is tasked with facilitating the expansion and balanced growth of international trade. In short, the Fund was designed to be an institution where national authorities could work out the "rules of the game" for the international economy.

Thanks in part to this U.S. leadership, the world thus had an institution dedicated to promoting a market-based international financial order and to avoiding the protectionist, "beggar-thy-neighbour" policies that so hobbled the world economy in the 1930s. Delegates at Bretton Woods were ultimately able to see how their own country's interest was clearly wrapped up in a collective interest. Treasury Secretary Henry Morgenthau referred to the conference as the end of economic nationalism.

While the world and its economy have undergone revolutionary change in the past 60 years, we still need institutions where authorities from the key nations in the global economy can work out the rules of the game for economic policies. At Bretton Woods, it sufficed to have the allied nations around the table. But today, there are a number of different players who need to be present if we are to successfully remove impediments to market-based adjustments in the global economy. We need to make sure that these new players are at the table. But at the same time, we very much need the United States to show the same leadership that it did at Bretton Woods 60 years ago.

Where should we concentrate our efforts? I mentioned the OECD at the beginning of my remarks. This institution has been enormously helpful over the years. Indeed, I can recall attending OECD meetings in the 1970s and 1980s, when national authorities developed a consensus on the policies that would provide the strongest base for sustainable economic growth. These included monetary policy directed at keeping inflation low and stable, a disciplined fiscal policy, structural policies that encourage economic flexibility, and a framework for trade liberalization.

But while the OECD continues to provide excellent analysis, particularly in terms of structural policies, it is not yet a truly global table. Indeed, there are only two economic tables with a fully global representation: the World Trade Organization (WTO) to deal with trade issues, and the IMF to deal with macroeconomic and financial stability issues.

My comments on the WTO will be very brief. I mentioned increased protectionism as a key risk stemming from the persistence of global imbalances. This risk is heightened by the lack of progress at the Doha round of trade talks. It is essential for *all* countries to see the common interest in reducing trade barriers, and to work multilaterally through the WTO to accomplish this. Large emerging-market economies need to play their part. But so does the G-7. This means we need to be willing to talk seriously about agricultural issues. I know that, politically, this is a hard sell here in the heartland of America, as it is in many parts of Canada. But the global economy needs leadership in order to restart these talks, bring them to a successful conclusion, and reduce the threat of protectionism.

Let me now turn to the IMF. It has become quite common these days to question the relevance of this institution. Some people say that the IMF should be scrapped, because countries now have ready access to private capital flows in global markets and no longer need to borrow from the Fund. Indeed, those countries that have IMF loans are scrambling to repay them as quickly as possible.

But this viewpoint ignores the Fund's original mandate to promote international monetary co-operation by providing the machinery for consultation and collaboration on international monetary problems. The question then becomes, How can the IMF best fulfill this role today? I would argue that, given the Fund's structure, its worldwide perspective, and its considerable expertise, there are important ways for the Fund to do this. It can improve its surveillance function and, in doing so, it can more effectively engage the national authorities of all countries.

What do I mean by "improving surveillance?" To answer that question, it's best to have some context. In earlier decades, the Fund would have a dialogue with individual member countries about whether that country was following policies consistent with a fixed exchange rate regime and, under certain circumstances, the appropriateness of the fixed rate itself. But following the collapse of the Bretton Woods system in the early 1970s, surveillance naturally moved away from a narrow focus on exchange rates. For countries that were borrowers – or potential borrowers – from the Fund, discussion focused mainly on the conditions that a country would need to meet in order to access IMF funding. It certainly had little to do with the policies needed to enhance stability and to facilitate domestic and global adjustment.

It is clear that today there is a need to refocus surveillance on policies that enhance domestic economic stability, and thereby, support global stability. Surveillance should be confined to a country's exchange rate, monetary, fiscal, and financial policies, and to the question of whether or not the policy choices are coherent, and thus consistent with maintaining external stability. If these policies are inappropriate, or not coherent, they can damage not only one's own domestic economy, but they can also have spillover effects abroad.

When Keynes talked about the IMF, he sometimes said that it should engage in "ruthless truth telling."[2] Indeed, the Fund's surveillance activities must be applied with an even hand and must deal objectively, accurately, and honestly with the key macroeconomic policies of *all* countries. Of course, it isn't always easy to be on the receiving end of this surveillance. I know, because I was one of the national authorities back in the 1990s who heard IMF criticism directed his way. At that time, we in Canada did not enjoy hearing the truth about our deteriorating fiscal situation, but the criticism did help to provide the impetus for us to take some tough decisions. All countries should be subject to this ruthless truth telling, and we in the G-7 must show leadership by demonstrating our willingness to listen to the truth about ourselves.

In conducting surveillance, there is a complication that must be kept in mind. The goal must be to promote the sound policies that I mentioned earlier, so that market-based adjustments are not impeded. But some of the key emerging-market economies that are systemically important do not yet have sound financial systems in place to handle some of these necessary policies. Here, I am talking about policies such as full capital account liberalization or completely flexible exchange rate regimes. Let me be clear: it is crucial that these countries put in place sound financial systems as quickly as possible, so that they can move to adopt a coherent policy framework. But, to the extent that countries are making substantial progress, and are committed to further progress as rapidly as possible, those of us with well-developed financial markets will have to have some tolerance while these transitions are occurring.

The final point that I will make about surveillance may well be the most important. The Fund must step up its efforts to extend surveillance beyond bilateral discussions. Because of its global perspective, the Fund is the natural institution for conducting multilateral surveillance on issues that threaten global financial stability, and where responsibility for action is shared among many countries. It is the natural institution where national authorities can work with expert staff to assess spillover effects of domestic policies. And it would be tremendously helpful to the global economy if the Fund were to return to its original role of serving as a table for discussion. It is very important that the national authorities responsible for the implementation of macroeconomic and financial policies talk to each other around a table where all systemically important economies are represented. Along with strengthening its surveillance function, having the Fund serve as a global table is the other important way that it can fulfill its original mandate of supporting the global economy and promoting international financial stability.

Of course, there's more to IMF reform than improving surveillance and increasing the engagement of national authorities. Systemically important emerging-market economies will need a greater voice at the table over time. This is important for the Fund's legitimacy. And it is absolutely essential that improvements be made in the governance structure of the Fund, that the role of the Executive Board be re-examined, and that the accountability of the Managing Director and Fund staff to the Governors of the Fund be strengthened. But those issues could serve as topics for another entire speech.

---

2 Quoted by M. King, "Reform of the International Monetary Fund." Speech to Indian Council for Research on International Economic Relations, New Delhi, India (20 February 2006).

Conclusion

There will be some who will conclude that I am wildly optimistic to think that there is any potential for success in either the multilateral trade talks or in substantially transforming the IMF. But what better place for optimism than Chicago, where crowds have packed Wrigley Field, season after season, waiting almost a century for the Cubs to win the World Series again?

The owners of the Cubs invested a lot of money this past winter, trying to fulfill the optimists' vision of a World Series. But the vision I outlined today doesn't need money. What it needs is leadership; leadership from all of us in the G-7 and, in particular, from the country whose efforts 60 years ago helped to establish the global economy that we know today. It is imperative to drive for a multilateral trade deal, through the WTO, to counter the protectionist threat; and to promote a multilateral approach, through the IMF, to resolve global imbalances. An IMF that is strengthened along the lines that I spoke of today would be enormously helpful in this regard.

I am grateful for the opportunity to present these ideas to you today; ideas that should fit with the Chicago Council's philosophy. By keeping a common goal in mind, we can remove the impediments to market-based adjustments and be successful in our efforts to defuse the danger of global imbalances. In so doing, we can continue to promote the market-based, global trade and financial order necessary for continued global economic growth, for our continuing prosperity, and for the world stability that Marshall spoke of 60 years ago.