Remarks by David Dodge
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Co-operation and the Conduct of Economic Policy

Good afternoon, ladies and gentlemen. I am delighted to be here and to have the opportunity to speak at this conference.

The theme of this event is "Policy Coordination in an Integrated Global Economy." It seems as if the idea of policy coordination is making a comeback these days. This is probably because of the growing interconnectedness of the global economy and the series of shocks that have recently reverberated around the world. While globalization has affected different countries to varying degrees, it has brought many benefits to the world economy—including increased trade, broader sources of financing, and more rapid diffusion of technology. But globalization has also left countries more exposed to developments beyond their borders.

From a central bank perspective, globalization has made the conduct of monetary policy somewhat more challenging. In order to gauge the prospects for the domestic economy, it is more and more necessary for central bankers to take into account how their economy will be affected by events elsewhere. And of course, central bankers in very large economies must be cognizant of the effects that their actions may have on the global economy and, hence, on their own economy. Canada has had a very open economy for many years. So, not only is it in our interest to ensure that our domestic economic policies are the right ones, it is also in our interest that other countries pursue appropriate policies. As globalization continues, it will increasingly be in everybody's interest that all countries follow sound economic policies.

Given this growing integration of the world economy, it might appear that there is a need for closer international coordination of economic policies. Traditionally, talk of coordination has made people think of more formal arrangements, such as the Plaza and Louvre Accords of the 1980s. Not only did those agreements attempt to influence global exchange rates, they spelled out detailed prescriptions for individual countries in areas such as fiscal and monetary policy.

I will argue today that the scope for macroeconomic policy coordination is very limited, although it is vital for policy-makers to co-operate in the sharing of information and views on monetary and fiscal policy. But I will also argue that there are some areas where coordination is required, most particularly in establishing and maintaining rules and standards that will allow global financial markets to function well and global trade to expand.

The Right Economic Policies

Let me start with macroeconomic policies and information sharing. I'll begin with a question. If there is no international macroeconomic policy coordination, how can countries determine which policies they should choose to strengthen their domestic economies and thus contribute to global growth?

In answering that question, I would say that policy-makers should always look to their own economies first. Promoting policies that encourage sustainable growth and financial stability in their own domestic economy is the best contribution that national authorities can make to the growth and stability of the global economy.

But which policies are the right ones? The OECD, among other organizations, has been working on this question for decades. I can recall attending OECD meetings here in the 1980s, when a consensus began to take shape on a set of policies that would provide the strongest base for sustainable economic growth. These policies relate to four basic areas. First, monetary policy should be directed at keeping inflation low and stable. Second, fiscal policy should take a disciplined approach to the public purse. Third, structural policies should encourage economic flexibility. And fourth, countries should work towards trade liberalization. Let me take a few minutes to discuss these areas, beginning with monetary policy.

In Canada, as in many other countries, the goal of monetary policy is to maintain the public's confidence in the future value of money. We do so by working to keep inflation low, stable, and predictable. Over the years, the Bank of Canada, like many other central banks, has struggled to find the right anchor for its monetary policy—an anchor to guide its actions and to give the public a way to measure its performance.

Since 1991, our monetary policy anchor has been our system of explicit inflation targeting. Under this system, we aim for a 2 per cent annual rate of consumer price inflation over the medium term. This target is spelled out in a formal agreement between the Bank and the Government of Canada. But the Bank is solely responsible for the implementation of monetary policy.

It's important to note that we conduct our policy <u>symmetrically</u> around the 2 per cent target. We will lower interest rates to stimulate total demand when we see that the trend of inflation is threatening to fall below the target over the next 18 to 24 months. Similarly, we will raise interest rates to dampen demand when we see that the future trend of inflation is poised to rise above the target. In this way, monetary policy acts as the primary tool for stabilizing the economy.

Although inflation targeting has a relatively short history, the experience of many countries so far suggests that this approach brings with it important economic benefits. By smoothing the peaks and valleys of the economic cycle as a whole, inflation targeting helps the economy to achieve maximum sustainable growth over the medium term.

But if a central bank wants to have the monetary policy independence needed to pursue low and stable domestic inflation, then it has to be prepared to allow the external value of its currency to fluctuate. That independence, which is typically lost under a fixed exchange rate regime, has been a tremendous asset for Canada. Further, given the somewhat sticky nature of both wages and prices, a floating exchange rate can serve as an important economic stabilizer, helping to facilitate the adjustment to shocks and the resolution of global imbalances.

It is true that under a floating exchange rate regime, currencies can experience short-term volatility. This volatility can certainly be unnerving. However, in my view, central bankers ought to be extremely cautious about trying to smooth these fluctuations. It is extraordinarily difficult to judge whether sharp currency movements simply represent market “noise” or more fundamental forces. So, there is great potential for policy error when central bankers try to smooth currency volatility. Besides, businesses can take advantage of highly efficient hedging tools available in financial markets to help them deal with short-term currency movements.

Let me now turn to fiscal policy. A country should have a medium-term fiscal plan that is appropriate to its particular situation. Citizens and investors need to know that their government will not let debt levels get out of hand. When public debt is controlled, people can have confidence that their governments will not inflate the debt away, impose an overly onerous tax burden in the future, or simply repudiate the debt.

In attempting to keep levels of public debt under control, governments should be wary of using “discretionary” fiscal policy to stabilize the economy. Let me be clear that I am talking here about discretionary action and not the use of automatic stabilizers, such as unemployment insurance payments. For one thing, it is very difficult to get the timing of discretionary action correct. For another, as we know from bitter experience around the world, tightening fiscal policy is politically much more difficult than easing it. And so the use of discretionary fiscal policy as an economic stabilizer increases the chances of a country getting into an unsustainable debt situation. Further, the economic evidence suggests that in open economies under a floating exchange rate regime, monetary policy can be a much more effective stabilizer than discretionary fiscal policy.

In the 1990s, governments in Canada—both federal and provincial—struggled not only to eliminate budget deficits, but to run surpluses in order to bring down public debt-to-GDP ratios. Given Canada's demographics, with an aging population and a workforce that is likely to stop growing within 15 years or so, aiming to reduce the debt-to-GDP ratio is an entirely appropriate fiscal anchor. Of course, other countries may have different considerations that shape their medium-term fiscal plans.

The Importance of Information Sharing

So far, I have argued that formal coordination of macroeconomic policies is unlikely to lead to better economic outcomes than if all countries simply followed the right policies for their own circumstances. In addition, coordination risks amplifying the effects of a mistake in judgment about the state of the global economy. But co-operation in the form of information sharing does play an extremely important role in the development of macroeconomic policy.

Let me elaborate. Countries can put an appropriate policy framework in place; but, without accurate and reliable information on the state of other economies, it is difficult to determine what policy actions will deliver optimal results. The Canadian economy provides a clear example. Given Canada's dependence on international trade, the Bank of Canada needs to thoroughly understand the forces at work in the world economy in order to adopt the appropriate monetary policy stance at home. Otherwise, we risk misjudging the state of total demand in the domestic economy, and that can lead to policy errors.

The increasingly interconnected nature of the world economy means that policy-makers in all countries must have a thorough understanding of global economic and financial developments. It is fitting that we should be discussing this topic here, in this building, given the OECD's long history in economic co-operation.

How does this information sharing among countries take place? In addition to OECD meetings, central bankers gather at the Bank for International Settlements every two months. In fact, I will be headed to Basel for such a meeting in a couple of days. One of the most important features of these meetings is our systematic, detailed discussion of the world economic situation. These meetings, as well as the periodic meetings of the International Monetary Fund, the G-7 and G-20, and the Financial Stability Forum, are important opportunities for policy-makers. Not only can we hear directly from our counterparts, but we also have the chance to ask questions about their policies and prospects. And between these meetings, senior officials from finance ministries and central banks talk frequently to each other.

This kind of information sharing can also be useful in areas other than macroeconomic policy. I mentioned before that the OECD policy consensus includes the idea that countries should strive for economic flexibility through their structural policies. In particular, that means the creation and maintenance of effective and efficient labour and capital markets. Again, the sharing of information about experiences and best practices can be invaluable in helping authorities design policies and programs that are appropriate to their own economies. Information sharing can also help to reduce uncertainty and to promote economic security by demonstrating the most effective ways to strengthen the rule of law and reduce the risk of abuses. And information sharing is an important part of the effort to combat money laundering and terrorist financing—an effort led by the Financial Action Task Force here in Paris.

Where Coordination Can Be Helpful

So is there any scope for outright policy coordination in a global economy? As I said at the beginning, I would argue that, when it comes to international trade and finance, actual coordination is not only desirable, it is probably necessary to facilitate the expansion of commerce and to promote well-functioning global financial markets.

Let me explain, starting with international trade. A moment ago, I said that trade liberalization is a crucial part of an appropriate economic policy framework. But in order to have freer trade worldwide, countries need to come together to draw up and enforce a set of rules governing the exchange of goods and services. In this regard, Canada has been a consistent supporter of the World Trade Organization (WTO) and its earlier incarnations.

Unfortunately, in recent years, there has been insufficient international support for strengthening the global trade order, and talks on difficult sectors, such as agriculture, have floundered. Collectively, developed countries still have a considerable way to go in terms of reducing subsidies and liberalizing trade for a number of goods, including agricultural products. In my view, we have a responsibility to do this in order to promote growth in the most impoverished nations. That is why Canada has been pushing for an early resumption of the Doha round. And there are other sectors, such as financial services, where major effort is required. This effort must be made so that the global economy can benefit. It won't be easy; but, in the long run, it will be worth it.

International coordination is also important in efforts to establish a framework to allow financial markets to function efficiently. In recent years, this has been reflected in the drive towards greater transparency. Unless countries develop and implement a clear and coherent way of disseminating relevant information, global financial markets will be unable to function at peak efficiency. This applies to both the public and the private sectors. Following the Asian and Russian crises of 1997–98, the IMF and the World Bank launched the Financial Sector Assessment Program to identify strengths and weaknesses in national financial systems. This effort is backed by Reports on Observance of Standards and Codes, which are conducted by the IMF. These reports can bolster confidence by demonstrating to markets the level of commitment that countries have to boosting their transparency. Other efforts to improve transparency in the wake of Enron and similar scandals include initiatives to improve corporate reporting, accounting, and dissemination of financial market information.

These efforts to further domestic transparency will certainly be helpful on their own. But if we coordinate our efforts, we can spread the benefits of transparency and help global financial markets to operate more efficiently. This applies to the development of market codes of conduct, as well as to compliance and enforcement efforts. And it also applies to the development of accounting standards that are universally applicable. It is only through coordination that we will all get the full benefit of improved standards and codes.

Unlike macroeconomic policy, where the best collective outcome depends on each country following appropriate domestic policies, when it comes to international trade and global financial markets, the best collective outcome will require strong, coordinated efforts.

Conclusion

Let me sum up. As globalization continues, it may appear that there is a need for national authorities to coordinate their macroeconomic policies through formal agreements and arrangements. I have argued that this is not the case. I hope that I have convinced you that such coordination is unlikely to be helpful. But I hope that I have also convinced you that information sharing among countries remains extremely important. What is crucial is that national authorities pursue sound domestic policies, while being fully cognizant of what is happening elsewhere in the world. These policies include a well-anchored monetary policy focused on inflation control and a prudent fiscal policy conducted within an appropriate medium-term plan. Such policies should be supplemented by a set of structural policies that foster economic flexibility, as well as by policies that encourage openness to international trade. By strengthening their domestic economies while taking global developments into account, policy-makers will be helping to improve the world economy.

Where I think we do need coordination is in the establishment of frameworks that facilitate international commerce and strengthen the global financial system. We do need a coordinated international trade order, and the strengthening of that order remains a worthy goal for us all. We do need a coordinated, transparent framework to support and maintain effective and efficient global capital markets. And we do need to promote the coordination of accounting standards.

Finally, let me say that, as we take part in this conference here, at the home of the OECD, economic co-operation remains as important now as it was on the day that organization was founded. The sharing of information among national governments and regulatory bodies is absolutely essential. Co-operation helps policy-makers follow sound domestic economic policies appropriate to their own circumstances while being cognizant of the actions of others. That, in turn, should lead to better global economic performance.