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CHECK AGAINST DELIVERY

Rebalancing the Global Economy

The theme of this conference—"Adapting to a New World Order"—suggests that it is clear how global commerce and finance will be reorganized in the wake of the current crisis. However, the outcome is far from preordained. How we manage the rebalancing of the global economy could profoundly influence how open, equitable, and prosperous the New World Order will be.

Globalized product, capital, and labour markets[1] lie at the heart of the New World Order to which we should aspire. However, the next wave of globalization needs to be more firmly grounded and its participants more responsible. In recent years, a belief in the power of markets has not always been accompanied by a commitment to build resilient markets. Moreover, at times, policy-makers and the private sector did not live up to their responsibilities.

In my talk today, I will outline an agenda to redress these failings in order to build a more responsible, more resilient globalization. But first I want to highlight the current challenges that stem from several key imbalances. Across economies, demand must rotate from deficit to surplus countries. Within our economies, major stock adjustments in inventories, labour, and capital will be required. Excessive levels of private debt must also be reduced. To offset the resulting shortfall in private demand, public demand must increase. The role of public demand is to bridge a gap. To do so successfully, it must be temporary, credible, and accompanied by measures to relaunch an open, resilient, and responsible global economy.

The (Newly) Old World Order

It was not that long ago that we basked in the seemingly effortless prosperity of globalization. During the past quarter century, steady advances in transportation, communication, and information technologies, underpinned by the widespread adoption of liberal economic policies, shrank the globe and expanded its economy. Never in history has economic integration involved so many people, such a variety of goods, and so much capital.[2]

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[1] The globalization of labour markets is due mainly to information technology, which facilitates the global outsourcing of services, including medical and financial services.
[2] The effective global labour supply quadrupled between 1980 and 2005. Merchandise exports grew to 20 per cent of global GDP, more than twice the level reached at the height of the last great wave of globalization a century ago.

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The pace and breadth of globalization were made possible in part by the onset of global supply-chain management.[3] In effect, technology and globalization facilitated a more widespread application of two of the most powerful forces in economics: division of labour and comparative advantage. National economies became tightly linked, with demand in one country driving production and inventory cycles across several countries. From a price perspective, the net result was steady downward pressure on the prices of manufactured goods and steady upward pressure on commodity prices.[4] [5]

The global capital market was similarly transformed during this period. Cross-border capital flows reached 15 per cent of global GDP, five times the rate at the beginning of the 20th century. By and large, these flows facilitated the diversification of risk, the transfer of technology, and the acceleration of global growth. At the same time, global markets became more interdependent. The actions of others mattered more, particularly during times of stress.

Globalization lifted hundreds of millions of people out of poverty and created the potential for hundreds of millions more to share their destiny. For Canada, it contributed to the second-longest expansion in our nation's history—a period characterized by rising real incomes, surging employment, and low, stable, and predictable inflation.

In recent years, however, the global economy has become increasingly unbalanced. The process of rebalancing will profoundly affect the medium-term outlook for the global economy.

Rotation of Domestic Demand from Deficit to Surplus Countries

We are now experiencing the inevitable correction of global imbalances. These were characterized by misaligned relative prices, underdeveloped financial sectors, and excess savings in emerging markets. These were matched by rapid credit expansion, asset-price booms, and negative savings in many Western economies. These trends were encouraged by policies such as inflexible exchange rates and an overreliance on export-led growth in Asia and, in the United States, the promotion of unsustainable household spending in response to the bursting of the tech bubble. These measures collectively contributed to a low and stable interest rate environment, which fed enormous risk taking and leverage across markets and currencies.

These imbalances were most evident in current accounts. In a reversal of usual trends, emerging markets ran surpluses, and developed countries ran deficits. Poor countries in effect lent to rich ones. In 2006, the American deficit reached almost 7 per cent of GDP and the Chinese surplus more than 10 per cent. The net foreign liabilities of the world's most developed economy and the net foreign assets of its largest emerging market were both on explosive paths.

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[3] Advances in information technologies, specialized production processes, and reduced communication and transportation costs all led to a whole new range of goods and services becoming tradable. For example, over the past 30 years, the share of imports as a percentage of manufacturing production has tripled.

[4] For Canada, the combination of lower prices for imports of manufactured goods and higher prices for our commodity exports drove an improvement in our terms of trade, which bolstered real disposable income per capita by about 8.5 per cent in the five years leading to 2008.

[5] The rise in commodity prices was due to the rapid increase of manufacturing in emerging markets, where production is relatively more commodity intensive.

That which could not go on forever eventually and brutally stopped. When the cavalier "search for yield" was replaced by a desperate "rush for shelter," leverage was viciously unwound across markets, sharply increasing risk premia around the world. In the real economy, the Bank expects that the U.S. current account deficit this year will fall by almost two-thirds from its peak. China's surplus will also narrow, although less dramatically (partly reflecting the offset from a sharp fall in commodity prices).

The unwinding of global imbalances has highlighted the fundamental interconnectedness of the global economy. Virtually every financial asset on the planet was significantly re-priced as the crisis intensified. The reverberations of contracting U.S. consumer demand spread rapidly via global supply chains, and a global inventory glut developed virtually overnight. A 3 per cent decline in U.S. consumption of goods over the past six months fed a 20 per cent fall in Asian industrial production. A relationship that had been symbiotic became virulent.

The recent narrowing of global current account imbalances reflects a collapse in demand, which is hardly desirable. A sustainable rebalancing of domestic demand from deficit countries, such as the United States and the United Kingdom, toward surplus countries, such as China and Germany, will take some time—and this will likely dampen the pace of global growth.

Reduction of Debt, and the Reallocation of Labour and Capital

The second important correction in this period of transition to the "New World Order" will be characterized by significant stock adjustments in the financial and real sectors of major industrialized economies.

A key lesson of Japan's lost decade is that an economy will not grow until the excesses that built up during the bubble have been removed.[6] In Japan, these included commercial real estate, physical capital, and a highly leveraged corporate sector. Financial imbalances and losses from a deteriorating economy quickly overwhelmed the capital buffers of the Japanese banking sector. The resulting negative feedback loop between the real and financial economies took nearly a decade to break.

There are some striking parallels in the United States. Earlier this decade, there was substantial misallocation of investment (much of which was financed from abroad) into private real estate. In addition, key industries such as autos invested in capital stock that became increasingly misaligned with prospective demand. There are also important differences. Unlike Japan, excess debt in the United States is concentrated in the household and financial sectors, and the deleveraging of the financial sector was a trigger rather than the result of the recession.

With U.S. banks now raising significant capital to cushion their losses, the negative feedback loop between the financial and real economies has been slowed, though not yet reversed. More capital will be required globally; the toxic assets in core banks still need to be addressed; and a host of vital financial markets, such as private-label securitization,

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[6] See "Way Out of Economic and Financial Crisis: Lessons and Policy Actions," Masaaki Shirakawa, Governor of the Bank of Japan, Speech at Japan Society, New York. 23 April 2009.

must be relaunched. As a result, stabilization of the global financial system remains a precondition for a sustainable recovery, both globally and in Canada.

This process of financial stock adjustment is mirrored by an adjustment process on the real supply side of the economy. In the last quarter of 2008, it became clear that levels of inventories, employment, and capital were not commensurate with the level of global demand. Each, in turn, fell roughly in the sequence one would expect, given relative adjustment costs: first, inventories; next, employment, which is quasi-fixed; and last, capital, as investment fell below the rate of replacement.

Although global demand and trade levels appear to be approaching bottom, and inventory and labour adjustments have already been substantial, there is still more to come. Unemployment will likely rise further across the G-7, with the sharpest increases still to come in those economies with the least-flexible labour markets. Uncertainty over the employment outlook will weigh on consumption in most major economies for some time. The capital stock adjustment process will take longer, and global investment growth is likely to remain negative well into 2010. This will serve as a significant drag on global growth and can be expected to reduce potential growth in most major economies.

Declining investment and stagnant consumption will mean that private demand, excluding that generated by tax stimulus, will remain weak until the middle of 2010. In the United States, China, and Japan, growth will likely be positive in the third quarter of 2009, but largely owing to massive fiscal expenditures and tax cuts. Self-sustaining private demand in most major economic areas is not yet imminent.

The G-20 strategy is to enact extraordinary fiscal stimulus to offset financial headwinds and to bridge the gap until the end of the stock adjustment process and the restoration of private demand. Its success depends on three interrelated factors: the scale of the private savings response; the magnitude, duration, and credibility of the fiscal response itself; and the eventual rebalancing of risk between the public and private sectors. Let me address each of these factors in turn.

The Evolution of Private and Public Savings

One of the biggest imponderables is the outlook for household savings rates. In the run-up to the crisis, households increasingly "saved" through capital appreciation rather than from current income. A decline of roughly 30 per cent in U.S. wealth has caused household savings rates to rise sharply from nearly zero between 2005 and 2008 to 4 per cent in the first quarter of 2009. The new equilibrium of household savings will depend on multiple factors, including wealth effects, risk aversion, the evolution of the financial system, and crucially, the credibility of fiscal policy itself.

The surge in private savings is being offset by a rise in public dissaving. The world is well on its way to spending an average of 2 per cent of GDP in discretionary fiscal measures. Simultaneous fiscal action means that spillovers across countries offset each other to some degree, thereby limiting net leakage and maximizing the overall impact. In addition, the current global concentration on infrastructure spending provides some support for commodity prices.

But there are limits to everything, including fiscal policy. Across the G-7 this year, the average deficit will be 12 per cent of GDP. Global public borrowing requirements will be two times greater than last year. Compounding effects and the need to avoid an abrupt withdrawal of fiscal stimulus will mean that average public debt levels in many major economies could increase to 110 per cent of GDP before stabilizing. The composition of global savings will need to change radically.

These dynamics could become self-defeating if the credibility of fiscal paths is called into question. A combination of substantial upward pressure on interest rates on investment or Ricardian effects[7] on consumption would retard the recovery. It is therefore paramount that fiscal policy frameworks retain credibility. This requires both effective current initiatives and realistic exit strategies. In this regard, Canada's experience of the 1990s with the steady overachievement of near-term targets on the road to fiscal balance is relevant.

Ultimately, a return to sustained growth in private sector demand that can accommodate desired private savings is essential. An open, global economy centred on private risk taking is the best prospect for this. But before that can be assured, much needs to be done, starting with an orderly retreat of the public sector.

Redistribution of Risk Between Public and Private Sectors

The financial panic required a bold response from the public sector. The loss of faith in the solvency of core banking institutions at times threatened the very functioning of the global financial system. While absolutely necessary, the response to the crisis has profoundly shifted risk from the private sector to the public sector. Since October, the G-7 has committed that no systemically important financial institutions will be allowed to fail. Across the world, bank financings have been guaranteed. With securitization markets still moribund, assets have been purchased and tail risks assumed by the public sector. Governments have even guaranteed warranties on certain car models. With these precedents, there will be further pressure for a host of new risk-sharing arrangements.[8]

We need to think carefully about where risks are best held as we emerge from this crisis. There are two considerations. First, risks that can be priced are best borne by the private sector, whereas uncertainties that have a wide and significant potential impact are best borne by the public sector. Second, risks are endogenous: Public policy and private decisions influence aggregate risk in the system. For example, the widespread private use of collateral to mitigate counterparty risk reduced credit risk but sharply increased liquidity risk. Similarly, the public sector's recent assumption of some risks creates moral hazard. If left unchecked, this will eventually promote private behaviours that will add overall risk to the system.

The expedient should not become permanent. Governments have assumed extraordinary tail risks *and* quite ordinary financial risks. They should decide whether to keep the

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[7] Ricardian equivalence refers to the theory that increases in government spending are largely offset by reductions in private consumption, reflecting future anticipated tax increases.
[8] See "(Nearly) nothing to fear but fear itself," Olivier Blanchard, Chief Economist, International Monetary Fund. Published in *The Economist*, 29 January 2009.

former or to effectively shut down the activities associated with them (for example, some aspects of securitization). They should return the latter to the private sector.

A Central Bank Agenda for Renewed Globalization

But how to do so, when animal spirits are so clearly moribund? Perceptions have changed. There is a better appreciation of the amorphous and endogenous nature of risk. There is also a welcome acknowledgement of uncertainty. Knowing that a black swan might be out there disciplines activity. Humility seldom goes before a fall. Unfortunately, a newly humbled private sector may only re-engage if it believes that the system is more resilient. To accomplish this, central banks, along with other public agencies, must promote both the necessary market infrastructure and responsible policy.

There are four priorities for renewed globalization.

First, transparency should be increased so that risk can be identified more effectively and priced more efficiently. The crisis laid bare important deficiencies such as the woefully inadequate disclosure on securitized products. The Bank of Canada used its collateral policy to improve the disclosure of asset-backed commercial paper (ABCP), creating a standard that should become commonplace. The current global initiative to transfer many over-the-counter derivatives onto clearing houses is motivated partially by the desire to promote standardization.

Second, core funding markets should be made more efficient and less susceptible to extreme price movements. The crisis was clearly exacerbated by the seizure of interbank and repo markets: Good collateral became unfinanceable overnight, firms failed, risk aversion skyrocketed, and the global economy plummeted. Promising avenues to break such (il)liquidity spirals include introducing clearing houses, standardizing products, implementing through-the-cycle margining, and ensuring more effective netting. As the ultimate provider of liquidity to the system, the Bank is thinking through whether to adapt its facilities to support continuous private liquidity creation.

Third, macroprudential regulations must be enacted to help smooth the credit cycle. A prominent example could be a new bank capital regime. It should be dynamic (with buffers and provisions moving through the cycle), simple (including Canadian-style leverage caps), and coherent (consistent with broader initiatives such as moving over-the-counter derivatives onto exchanges). Given where we are in the current crisis, it should also be Augustinian, that is, new requirements should be phased in over time to avoid deepening the recession because of procyclical deleveraging.

Fourth, all countries must accept their responsibilities for promoting an open, flexible, and resilient international monetary system. Responsibility means recognizing spillovers between economies and financial systems and working to mitigate those that could amplify adverse dynamics. It means submitting to peer review within the Financial Stability Board and external review by the International Monetary Fund. Fundamentally, it means adopting coherent macro policies and allowing real exchange rates to adjust to achieve external balance over time. This crisis was caused in part by failures to meet the same challenges that bedevilled the architects of the original Bretton Woods system. Given the current, deeply synchronous global recession, the costs of free riding should be obvious to all.

Conclusion

I would like to conclude with a few words on the impact of this rebalancing for Canada. It appears likely that the global economy is entering a period of lower potential growth. The substantial capital misallocation and financial excesses of the boom years will take years to work off. Rebuilding globalization will also take time. Recognizing the scale of the industrial restructuring and the lower investment over that period, the Bank has lowered its estimate for Canadian productivity and potential growth.

The shifting composition of global growth will also have important implications for Canada. The current pattern of U.S. activity, with its weakness in the housing and auto sectors, is proving particularly challenging for our businesses. We expect the U.S. recovery to be relatively subdued compared with historical experience, given the domestic rebalancing requirements in that economy.

More positively, the greater proportion of emerging-market growth in the overall growth of the global economy should create new opportunities, particularly by supporting commodity prices. Our research indicates that, even in the throes of the crisis, those emerging markets whose demand is most relevant to our exports are also generally the most resilient. These countries can be expected to make up an increasing proportion of global demand going forward.

Unfortunately, a smooth rotation of demand across economies is not assured. Overall, the orderly resolution of global imbalances remains an important risk to the outlook for growth and inflation in Canada. As we noted in our policy decision last week, the recent sharp increase in the value of the Canadian dollar, if it proves persistent, could fully offset recent positive developments in financial conditions, commodity prices, and confidence.

In the wake of a major shock to external demand and the financial crisis, the Bank has acted proactively and aggressively. We eased our policy rate to the lowest possible level—1/4 per cent—to support private demand and to achieve our 2 per cent inflation target. Conditional on the outlook for inflation, the Bank expects the policy rate to remain at its current level until the end of the second quarter of 2010 in order to achieve the inflation target. The Bank retains considerable additional flexibility, including unconventional measures, as outlined in the principles-based framework in our April *Monetary Policy Report*.

With our domestic and international partners, the Bank is working actively to build more resilient markets and to create an open, global financial system. Success is not assured. Setbacks in managing through the recession could undermine support for open economies. More broadly, without credible policy frameworks and robust market infrastructure, private risk taking may not return to the extent required. However, there is every reason that Canada should be among the first to implement the agenda that I have described today. Through such leadership, we can do our part to create a more responsible, resilient globalization.