

CHECK AGAINST DELIVERY

**Remarks by David Dodge
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The Evolution and Resolution of Global Imbalances

Good morning. I am happy to be back at Spruce Meadows, and to have the opportunity to join my friends, Governors Zhou and Noyer, at this roundtable discussion: “Changing Fortunes—World Monetary Policy.”

Our host, Ron Southern, has asked us to be at once “integrative, comprehensive, anticipatory, and apolitical.” This is a tall order, but I will do my best to oblige. Today, I will talk about two types of global economic imbalances. The first relates to the way that savings and investment are being distributed across countries in an increasingly uneven way. The second is the possibility that, over the next couple of decades, the global economy might face a protracted period in which desired savings exceed planned investment, partly because of demographic trends. If economic policy-makers do not take appropriate measures quickly enough, there is even a risk—albeit a small one—that the world economy could end up with the classic dilemma—first spelled out by John Maynard Keynes—of widespread demand deficiency and a persistent deflationary gap.

But before talking about this longer-term risk, let me focus on the savings-investment imbalances that currently exist across different regions of the global economy. The United States faces a large and growing current account deficit, which reflects an excess of investment spending relative to domestic savings. This is matched by growing current account surpluses in Asia, in oil-exporting nations, and in some other economies around the world.

Geographical imbalances are not necessarily a bad thing, nor are the large capital flows that they generate. Indeed, there should be a process that works through world financial markets to allow savers in one country to lend to borrowers in another. Such a process leads to higher global growth, since countries with surplus savings can invest them in countries that do not generate enough savings internally. However, when imbalances grow at an unsustainable pace, as appears to be the case at present, some form of correction must take place. If markets are allowed to operate without interference, imbalances can resolve themselves in a reasonably smooth manner. But in the absence of appropriately functioning market mechanisms, there is a greater risk that the

correction will be abrupt and disorderly. Beyond disruption to financial markets, a disorderly correction might also lead governments to adopt wrong-headed protectionist measures, which would then exacerbate the damage to the global economy.

But regardless of how these imbalances are resolved, it is clear that the resolution will require greater net national savings in the United States. Investment in the U.S. economy will need more financing from domestic sources—be it from the household, business, or government sectors—and less from foreign sources. This implies an increase in net U.S. exports and a decrease in net exports elsewhere in the world, as well as an increase in domestic demand in other countries.

Exchange rate movements have an important role to play in this regard, because they can help redirect international trade and investment flows. In this context, efforts by some countries to slow or prevent required adjustments by pegging exchange rates are, in the end, counterproductive. I know that Governors Zhou and Noyer fully understand that, by frustrating market mechanisms, such policies raise the risk of a much larger and more disorderly correction in the future, as well as an outbreak of protectionism.

But we should not look to exchange rate movements alone to resolve the existing global imbalances. Within the United States, higher interest rates can be expected to lead to increased savings. Authorities could also encourage greater national savings with a tighter fiscal policy. And they could implement structural reforms to encourage national savings through taxation, social security premiums, and other measures.

But if the United States alone were to act to resolve its imbalance by taking the steps I've just described, it would leave the global economy with much weaker aggregate demand. And so a number of other countries must focus on stimulating domestic demand. This task is made more urgent by the fact that the global economy is currently operating somewhat below capacity. The fact that inflationary pressures are absent globally is evidence of this.

So, how can we stimulate domestic demand outside the United States? Clearly, monetary authorities bear most of the responsibility for stabilizing domestic output in the short run and moving their own economies towards full production capacity. But monetary policy may not be as effective as it could be, if there are problems with an economy's structural or fiscal policies. Thus, the appropriate policy prescription depends on each country's circumstances. Structural reforms to remove market rigidities are important for most of us. Many need to improve or develop their financial system so that savings can be more effectively channeled into investment and households can have improved access to credit. For some, the development of social safety nets

would be helpful, so citizens don't feel the need to hold excessive precautionary savings. And for a few, more stimulative fiscal policy would be helpful.

I'll have more to say about these policies in a few minutes, since they are also critical for the good performance of the global economy in the long run. But first, I want to discuss the second type of imbalance that I mentioned at the beginning: the challenges that will be posed by evolving economic and demographic realities. As I see it, if countries do not have the appropriate structural policies in place, there is a risk of a prolonged deficiency in global demand in the future. Let me now expand on this risk by highlighting two trends that will be important over the next decade or two.

First, we can expect that Asia's share of the world economy will continue to grow. For various reasons, Asian nations have traditionally had a higher rate of savings than other economies. And so, all other things being equal, we can expect that global desired savings will rise. But all other things are not equal. The second trend that we can expect is higher desired savings in most OECD economies as the baby-boom generation prepares for retirement. Taken together, these two trends can certainly be expected to lead to a higher level of global desired savings. So it is critical for policy-makers to act now, so there can be an increase in demand and investment to compensate for the increase in desired savings.

How policy-makers handle the events of the next 10 to 20 years will be critical in preparing the global economy for the period from roughly 2020 on, when the proportion of the working-age population will start to decline in many countries. Canada will likely be in this position within 15 years. While demographic trends in the United States will likely be less challenging, in many OECD countries, the old-age dependency ratio is poised to rise sharply. According to a study by the European Commission, by 2025 the European Union will go from a ratio of roughly four working-age persons for every senior citizen to a ratio of 3 to 1. Indeed, without radical changes in fertility rates, life expectancies, or migration patterns, populations in many parts of the world will start declining, even as the world's total population continues to climb. According to the United Nations, the population of the EU could start to decline by 2025, with China expected to follow by 2050. Indeed, just this year, Japan reported a drop in its male population, and the number of deaths in that country began to exceed the number of births.

But for most OECD countries, the era of declining labour forces and population is still at least a couple of decades away. Before we get there, we will first go through a period when desired savings are likely to rise. Workers in many countries can be expected to try to increase their savings for retirement. This can be accomplished for a short period through rising prices of assets, such as houses. But over the next couple of decades, this increased saving will have to come out of current income, and this means slower growth in consumer

spending. At the same time, governments—faced with the need to prepare for future increases in public spending on an aging population—will also have to slow the rate of increase in current spending.

To deal with this expected slower growth in domestic demand, we would typically expect monetary policy in an open economy to encourage or “crowd in” foreign demand with higher exports. But the world as a whole is one large closed economy—we can’t export to another planet! If savings increase in one part of the world, offsetting increases in domestic demand will be needed elsewhere to keep global demand in line with global supply.

So, since we can’t export to another planet, what can policy-makers do to support the three remaining components of demand—private consumption, government spending, and investment?

In terms of investment, a key point to remember is that investment requires an expectation that future profits will more than compensate for the cost of capital. Of course, changes in financial conditions play an important role in spurring investment, since real interest rates should decline to the point where desired investment matches desired savings. But, if the desire to save is too strong, and if it is spread throughout the global economy, it could happen that real interest rates would not be able to fall sufficiently to match desired savings with investment. With global inflation and interest rates already low, it could be argued that, when the expected increase in desired savings materializes, there will be a risk that global nominal interest rates would hit zero before real interest rates had fallen sufficiently to restore the balance between desired investment and savings.

Let me stress that this is not a prediction on my part. I am only saying that, if there is no increase in global demand to offset the expected increase in desired savings, it may be difficult for monetary policy to effectively fulfill its role as the main short-run economic stabilizer in the years ahead.

So, what should policy-makers be doing now to help us avoid a Keynesian deflationary gap in the future? As it turns out, most of the policy prescriptions that I spoke about earlier in the context of the resolution of today’s imbalances would also address potential problems further ahead. Let me now return to those policies and talk about them in a bit more detail.

First, one might look to governments to provide an expansionary fiscal policy. In a few economies, there is clearly room for fiscal policy to become more stimulative in order to boost investment and demand. Certainly, the economies of emerging Asia have the scope to support demand with fiscal policy. But in North America, Europe, and Japan the scope for fiscal policy to spur demand appears to be very limited, given current debt levels in most of these countries and the increasing demands that aging populations will place on

the government sector. The strain on the public purse to meet the needs of our aging populations will be enormous. The situation will be more serious in those countries that have not yet taken steps to ensure that their public pension systems will be able to handle the retirement of the baby-boom generation. Unless the ratios of public debt-to-GDP are reduced before this strain is felt, governments in many countries will face the difficult task of reducing services or raising taxes, or both.

In any event, public debt in some countries may have already become so large that additional fiscal stimulus might actually be counterproductive. Households, anxious about future tax liabilities or the viability of public pensions, might cut back on consumption. This could offset the positive effects of the easier policy stance. But if there is any scope at all for effective fiscal action, I would argue that the emphasis should be on improving the economic infrastructure in a way that can support the production capacity of the economy while, at the same time, helping to meet rising social needs as the working population begins to decline. This might include additional money for education and training, which by adding to human capital, would help maintain the production capacity of the world economy.

But if there is one thing that all governments can do to stimulate demand, it is to have appropriate structural policies, and I stress the word "appropriate." Structural policies that promote economic flexibility are important in all circumstances. We all need to take steps to improve the flexibility of our labour markets and, in particular, to make sure that older workers who want to remain in the workforce are not discouraged from doing so. We also need to recognize that well-functioning credit markets are extremely important, so that households can borrow against future income, and businesses are able to make investments for the future.

The improvement of labour and financial market policies is particularly important in Europe. In emerging Asia, improving income-security policies is essential in order to reduce the need for households to build up large amounts of precautionary savings. As well, stronger, more efficient domestic financial systems could go a long way towards raising confidence and promoting increased spending. By effectively pooling resources, stronger financial institutions and markets in Asia would help individuals become less risk-averse. Households would be more readily able to borrow against future income, and businesses would have more appropriate access to credit in order to finance investments.

In closing, let me stress a few key points. I'm not saying that a disorderly correction to global imbalances is certain to happen. Nor am I saying that the global economy is inevitably headed for a deflationary shortfall in demand. What I am saying is that, as prudent policy-makers, we must not rely on

good fortune to help us muddle through. We need to get going on these policy issues now, before it is too late to take remedial action.

In particular, we need to make sure that our structural policies encourage maximum economic flexibility and that they do not impede investment and growth. We need to make sure that we will have the fiscal flexibility to handle the demographic challenges of the future. And we must continue to conduct monetary policy with the aim of keeping inflation low, stable, and predictable, to maximize the chances that our economies will operate at full capacity. We must act now to meet the challenges of today, and of the future, for the benefit of all our citizens.