Remarks by David Dodge,
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at the International Symposium of the Banque de France
Paris, France
4 November 2005

Thank you, Mr. Chairman. My remarks today will focus on how countries and economies can best weather economic shocks and imbalances, and seize the opportunities that globalization brings.

As globalization intensifies, more and more regions are realizing the benefits of open trade and capital account liberalization. But with increased globalization also comes increased exposure to shocks originating outside each country's borders. Open economies will always be buffeted by shocks from abroad. But increased globalization of the financial system also means that imbalances can build and persist for long periods. Provided that market mechanisms are allowed to work, these imbalances will be self-correcting over time. However, when policies are followed that prevent market mechanisms from bringing about a smooth adjustment, the risk of a disorderly correction grows.

Experience has taught us that in this environment where shocks are common and where imbalances may build, the key to surviving—and thriving—is to be flexible. And flexibility comes from markets that work. Our domestic markets for goods, services, labour, and capital all need to allocate resources efficiently. We need to establish frameworks that let our markets and our economies function as efficiently as possible. In this way, we can increase living standards over time for citizens in all countries.

Of course, it is easy for us as economists and central bankers to say this. But it is much less easy to build the political consensus that lets governments put in place and maintain the policies that give our economies the flexibility to adjust. Part of our job as central bankers is to provide the analysis that helps to achieve that consensus.

Let me briefly outline what I believe are the five critical elements that create an environment of economic flexibility.

Monetary policy

The first critical element is monetary policy. Experience around the world has taught us that the best contribution that monetary policy can make to the flexibility and enduring health of an economy is to anchor long-term inflation expectations. In Canada, we target inflation at the 2 per cent midpoint of a 1 to 3 per cent range—a system that we believe has been effective as a macroeconomic stabilizer. But whether or not a central bank adopts explicit inflation targets, keeping inflation low is the best means that we have as central bankers to facilitate sustainable growth in output and employment.

Flexible Exchange Rates

A second critical element of flexibility, and an important part of any monetary policy approach, is the exchange rate regime chosen. For Canada, since our focus is on a target for domestic inflation, this, of necessity, means a floating exchange rate—a regime with which we have had more experience than almost any other country. Our floating exchange rate acts as a shock absorber, sending important price signals to businesses and consumers, and helping our economy adjust to swings in world demand and prices. Of course, real exchange rates will always adjust to reflect changing economic circumstances. But having this adjustment take place through movements in the nominal exchange rate is quicker and less painful than through general inflation or deflation. That is why efforts by some countries to slow or prevent required adjustments in their economy by pegging exchange rates may, in the end, be counterproductive.

Fiscal Policy

The third element of macroeconomic policy that is important for promoting sustained growth and flexibility is prudent fiscal policy. While needs will vary depending on circumstances, government budgets should be sustainable, with a view to achieving longer-run budget balance. Persistent deficits undermine confidence in the ability of governments to meet their obligations. They increase borrowing costs, and can place undue strain on the financial sector that may be forced to finance these deficits.

In a few economies, there may be room for fiscal policy to become more stimulative in order to boost investment and demand. Some emerging-market economies in Asia with low public-debt-to-GDP ratios 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. Unless the ratios of public debt to GDP are reduced before the strain of an aging population is felt, governments in many countries will face the difficult task of reducing services or raising taxes, or both.

Within the context of prudent fiscal policy, 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.

Structural Policies

This leads me to a fourth element that is critical to flexibility: and that is, appropriate microeconomic structural policies, and I stress the word "appropriate." We all need to take steps to improve the flexibility of our labour markets. Long-term demographic trends demand, for example, that we find ways to allow older workers to remain in the workforce, if they wish to do so. The G-7 finance ministers have been saying these things since their meetings in Boca Raton, Florida in February 2004, but much remains to be done. For some countries, the development of social safety nets, such as better public pension and health care plans, would be helpful, so that citizens would not feel the need to hold excessive precautionary savings.

While we as central bankers recognize the critical importance of building efficient markets for goods, services, and labour, the policies to achieve these goals are not the purview of central banks. However, improving the efficiency of financial markets does lie within our purview, and it is the fifth critical element to promoting flexibility. So I will conclude with a few words on this subject.

Efficient Financial Markets

I know that all of us in this room recognize that efficient domestic financial systems can go a long way to enhancing an economy's flexibility. Well-functioning markets are critical for the appropriate allocation of capital for investment. They are equally critical for households, allowing younger members of society to borrow against future earnings and older individuals to save for their retirement. And, of course, efficient domestic markets interact effectively with international markets.

The financial crises of the past decade in emerging-market economies have taught us that a resilient national financial system requires three things: a well-developed system of prudential regulation; policies that encourage competition between financial market players; and oversight of market conduct that enhances transparency and efficiency.

Prudential regulation, in its broadest sense, works to get banks and other financial institutions to recognize, and make provisions for, the risks they are taking. It also works at the systemic level, so that authorities can gather information, align incentives, and take appropriate corrective measures to head off threats to systemic stability.

The goal of effective competition policy is to promote maximum efficiency and innovation in financial markets. Within the scope of our powers as central bankers, it is important that we do what we can to enhance competition between institutions—both domestic and foreign—in our markets.

Finally, we have learned through bitter experience that transparency is a general prerequisite for well-functioning debt and equity markets. Appropriate oversight of market conduct is essential. As central bankers, we need to encourage regulators to take appropriate—and I emphasize the word 'appropriate,' not 'over-zealous'—actions in this regard.

In all cases, the focus should be on continuously striving to improve the efficiency of the financial system. This is a challenge that we in Canada also face, as we review the structure of our banking system and the efficacy of our capital markets.

Conclusion

Over the course of this conference, we have heard some cogent and useful ideas. Throughout the rest of these proceedings, I know we'll hear more. Some of the world's best economic minds are focused on the implications of, and policy responses to, globalization.

As we struggle to understand and to adjust to our changing world, it is important to remember that our past failures are usually the result of our inability—or unwillingness—to get the basics right. As Voltaire said, "il faut cultiver notre jardin" with sound monetary, fiscal, and structural policies, and with well-functioning financial markets. If we get the domestic fundamentals right, we all stand a better chance of managing sudden swings in capital flows and the inevitable shocks that will remain a reality in our globalized economy.