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Reflections on the International Economic and Monetary Order

Today, I want to talk about an issue that is central to the prospects for the world economy—the management of large, global economic imbalances that have become the subject of increasing concern among market participants and policy-makers around the world. I am referring, of course, to the persistent and growing current account deficit in the United States that is mirrored by large current account surpluses elsewhere, especially in Asia.

Up to now, world capital markets have been managing these imbalances in a reasonably smooth way. In the short term, it is reasonable to expect that they will continue to do so. But over the medium term, imbalances of this magnitude are not sustainable. At some point, they will have to be resolved. Why? For one thing, a country's external indebtedness cannot keep growing indefinitely as a share of its GDP. Eventually, investors will begin to balk at increasing their exposure to that country, even if it is a reserve-currency country, such as the United States. For another thing, the buildup of foreign exchange reserves by Asian countries will, eventually, feed into domestic monetary expansion and lead to higher inflation. These imbalances will ultimately be resolved, either in an orderly, or in an abrupt, disorderly way. The question is, are current economic policies and today's international monetary order likely to facilitate an orderly resolution of the imbalances? If not, what changes are needed to reduce the risk of an abrupt, disorderly adjustment?

The Origins of Global Imbalances

Before we discuss solutions and prescriptions, let me talk briefly about the nature and origins of the current global imbalances. In essence, these imbalances reflect the international financial flows associated with saving-investment mismatches. Specifically, over the past decade or so, we have seen many countries outside the United States increase their saving by a very large amount, while at the same time, the United States has reduced its saving and has become increasingly reliant on foreign borrowing.

The origins of the increased saving outside the United States are many and varied. Following the Asian crisis of 1997-98, many countries in that region built up large foreign exchange reserves to guard against having to rely on international assistance in any future crisis. Even countries that avoided the worst effects of the Asian crisis—China, for example—increased their net savings by building up reserves. But more importantly, policies to encourage export-led growth in many Asian economies have exacerbated the situation. Some countries have actively tried to prevent an appreciation of their currencies by intervening in the foreign exchange market.

In doing so, not only are they increasing the imbalances, they are also seen by some to be securing an unfair trade advantage and shifting the burden of global adjustment onto others.

Of course, savings have also increased outside Asia. In Germany, for example, two factors have led to a large increase in saving in recent years: the conclusion of the reconstruction effort following the 1989 reunification and efforts to fix the German public pension system. Certain oil-exporting countries, including Russia, have also started to generate large net savings. And some developing economies, such as Brazil, have moved from being rather large net borrowers to being net savers today.

Inside the United States, there has been a sharp decrease in national saving. The high expected returns in equity markets in the late 1990s led to large capital flows into the United States. The significant capital gains—first on equities in the late 1990s and then on housing in this decade—led to a net decline in household saving out of current income. Furthermore, the low interest rates after 2001, and importantly, the shift in the U.S. fiscal position after 2000, have contributed to growing net dissaving in the United States. As a result, the U.S. current account deficit—which represents the amount of net dissaving going on in the United States—now stands at about 6 per cent of GDP.

Why Global Imbalances Are a Problem

So you might ask, why should policy-makers worry about the resolution of these imbalances? After all, 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 supports higher global growth, since countries with surplus savings can invest them in countries that do not save enough internally.

Within national borders, regional savings-investment imbalances emerge all the time. And we don't normally worry about them because there are effective market-based mechanisms in place that work to resolve them. Relative wages and prices change, as do relative returns on capital. This causes a movement in the real exchange rate between regions, which then provides an equilibrating mechanism. The ability of labour to move within a country helps to promote an orderly adjustment process.

But there are reasons to worry about imbalances in a global context. To begin with, market-based means of resolving international imbalances are somewhat less effective and potentially more disruptive. This is because there is less labour mobility across international borders, and so larger movements in relative wages and prices are needed in order for them to act as an equilibrating mechanism. Further, certain national and international policies, as well as interventions in the foreign exchange market, have been inhibiting the necessary relative wage and price movements. Indeed, some of these policies are making the situation worse. And so the concern is that the longer these imbalances remain unresolved, the greater the chances that the ultimate resolution will be disorderly. Equally troubling, there is a greater chance of protectionist measures that can seriously damage the global economy.

Policy Impediments to Resolving Imbalances

Let's look a bit more closely at some of the key impediments to the resolution of imbalances. Some of these impediments are national policies, while others relate to the international monetary order. Let me talk about national policies first. Many of these impediments have been identified in discussions at the G-7 over the past couple of years.

It is clear that, to date, there has not been enough progress on structural reforms. This lack of progress is somewhat frustrating, given that there is a reasonable consensus on what should be done domestically in all countries. First, microeconomic policies should allow markets for both goods and labour to function as well as possible and with a maximum degree of flexibility. Almost every country, including Canada, talks a good line about this, but action has been rather slow everywhere. Second, strong policies must encourage the creation and maintenance of a sound financial system that can efficiently allocate domestic and foreign savings. Progress here, although slow, is taking place. The work of the Financial Stability Forum, and the contributions in this area from the Bank for International Settlements, have been helpful. But much remains to be done. Third, all countries must pursue fiscal policies aimed at producing a sustainable public debt-to-GDP ratio. Where structural fiscal balance is absent, it should be achieved; where it is present, it should be maintained. There are some real problems on this front in the United States, in Europe, in Japan, and in some developing countries.

A multiple-front approach like this, that works to remove the impediments arising from existing national policies, would certainly go a long way towards allowing market-based mechanisms to resolve global imbalances in an orderly way. However, I doubt that this approach by itself would do the whole job, if real exchange rates are not allowed to adjust in a timely manner.

Movements in real exchange rates can come from changes in nominal exchange rates, changes in relative wages and prices, or a combination of the two. But when the nominal exchange rate is fixed, the only way to bring about adjustments in the real exchange rate is through large movements in relative wages and prices. Theoretically, this is feasible—but only if wages and prices are highly flexible both upwards and downwards. But this high degree of flexibility is practically non-existent. And so, when exchange rates are fixed, global economic adjustment can still take place, but it comes at a high cost—through shrinking output and rising unemployment in countries with current account deficits and through very high inflation in countries with current account surpluses.

While this adjustment is costly, it does work, provided countries that are fixing their currencies through foreign exchange intervention are not offsetting the monetary consequences of this by "sterilizing" the intervention. This is an important point. When intervention is sterilized, this temporarily prevents the movements in wages and prices needed to bring about the necessary economic adjustment. In these cases, adjustment is postponed—in both surplus and deficit countries. But the adjustment and its costs are only delayed, they are not avoided. Indeed, the costs typically end up being larger than they would otherwise be, precisely because they have been delayed The only way to truly minimize the costs of adjustment is to allow nominal exchange rates to move around.

The ability of a flexible exchange rate to help with economic adjustment was a major factor behind Canada's decision to float its currency in 1950. By the end of the 1990s, most industrialized economies and a number of emerging-market economies had done the same. Other economies, particularly in Asia, have opted for a fixed exchange rate regime. However, some of these countries, by sterilizing their foreign exchange intervention, have rejected the adjustment mechanisms that should go along with such a regime. By sterilizing, not only are they accumulating even larger foreign exchange reserves, more importantly, they are undermining the efficiency of their own domestic economies and interfering with the resolution of imbalances.

So there are impediments in Europe, the United States, and Asia that are all getting in the way of a timely and orderly resolution. Because of this, global imbalances are growing, and this is increasing the risk of a disorderly correction at some point down the road. In addition, the longer the adjustment is delayed, the greater the risk that industrialized nations will take protectionist measures against emerging-market economies that are perceived as not playing by the rules.

The Rules of the Game

So, what are the policy prescriptions that hold the greatest probability of bringing about an orderly resolution of the imbalances? Put simply, what should be the "rules of the game?" I've already spoken about the consensus that exists on the need for action domestically. What I want to do now is talk about what would be helpful on the international front.

To begin with, we certainly need to preserve and increase the potential for goods and services to move freely across national borders. This means further enhancement of the rules of free trade through the Doha round and a strengthening of the World Trade Organization (WTO) to ensure proper compliance with the rules. This effort, as you know, is going on rather more slowly than we would have hoped three years ago, and my sense is that the prospects for substantial improvement are not as good as we thought they might be. However, keep in mind that the last round took 10 years to complete. So, it is important to keep moving forward and to support the WTO in its enforcement of proper compliance with the rules.

Of course, free trade needs the support of well-functioning capital markets, as well as exchange rate regimes that allow market-equilibrating forces to play a greater role in the adjustment process. Just as the WTO provides critical support for trade, there is also a need for an effective organization to support the international monetary system. Under Bretton Woods, this role was given to the International Monetary Fund (IMF). But world financial conditions have evolved dramatically, while in many respects, the IMF remains the same institution that was created in 1944 for an era of fixed exchange rates.

To be clear, the basic mandate of the Fund—the promotion of an international order that fosters economic growth and investment—remains relevant and important. And the Fund's main responsibilities—surveillance, lending, and helping member nations to develop their financial infrastructure and efficient product and labour markets—are the right ones. But the IMF could, and should, be doing its job more effectively. The IMF must evolve to take account of today's realities.

Essentially, change is needed in four areas. First, we must recognize that the Fund has little direct ability to affect the policies of non-borrowing members. Consequently, its ability to influence discussions of important global issues, such as external imbalances, hinges on the quality of its economic and financial surveillance, its advice, and its ability to communicate its message. The IMF should focus its surveillance on systemic issues that can affect global financial stability—an area where the Fund's particular expertise gives it a strong comparative advantage over other institutions. This surveillance must be seen to be independent of national authorities—and independent of the IMF’s lending activities. The Fund's analytic and surveillance functions must be strengthened and must not be subservient to its lending function.

Second, in a world of freely flowing private capital, we must rely on market-based mechanisms to resolve financial crises, if and when they occur. While the Fund has a continuing role to play in providing liquidity assistance to members in financial distress, there are limits to such assistance—the IMF does not, cannot, and should not have endless reserves.

Third, to help guide market expectations regarding the scale of official assistance, we must be very clear that extraordinary Fund lending is just that—extraordinary. If market players cannot judge whether or not the Fund will intervene, and at what amount, they are unable to make appropriate credit decisions. Without clarity on the rules governing access to Fund resources, we leave ourselves open to delays in resolving crises and to moral hazard. These rules must also be as free as possible from political considerations and must allow funds to be used for liquidity assistance only. The provision of additional loans to insolvent countries helps neither the borrower nor other creditors. In this regard, the Fund must improve its ability to distinguish between cases of illiquidity and insolvency.

Finally, and very importantly, the IMF must be more effective in its role as a forum where global economic issues are discussed and solutions are found. The Fund should be considered as <u>the</u> place where national authorities can gather around the same table for a frank exchange about policy issues common to all. The Fund must be imbued with the same co-operative spirit seen at the OECD during the 1960s and 1970s as it helped to build a liberal economic order and framework for freer trade.

But it's difficult to discuss problems and find solutions if key players don't feel that they are adequately represented. There is a crucial need to build an <u>international</u> financial institution that is seen as meeting the needs of all members. A good start would be to re-examine the representation of Asian and other emerging-market economies, and the implications for their quotas and voting power on the IMF’s Board.

A larger stake by Asian members in the IMF also implies greater responsibility on their part for the success of the Fund as guardian of the international monetary and financial systems. Indeed, by taking greater responsibility, Asian nations would affirm their commitment to the Fund’s important objectives. Moreover, by being able to draw more on the strengths of the Asian economies, the IMF would be in a better position to do its job properly.

Conclusion

I truly hope that such an institution—one that makes progress in these four areas—will emerge from the strategic review of the IMF that is currently underway. The creation of a global institution for the twenty-first century is tremendously important, not just for Canada, but for all nations.

If we can get it right, a more effective IMF would be helpful in the worldwide effort to resolve global imbalances in an orderly way. But a global institution can't do it all by itself. Policy-makers around the world need to make sure that they are part of the solution and not part of the problem. All countries must recognize that it is doubly important to pursue the sound domestic policies that I mentioned—the promotion of flexible markets, the creation and maintenance of a sound financial system, and the pursuit of sound fiscal and monetary policies. Clearly, following these policies is in each country's own domestic interest. But the benefits would flow beyond national borders. If we all follow appropriate policies, then market mechanisms can defuse the danger posed by global imbalances. And that is an outcome that is in everyone's interest.