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Rebalancing the International Economic Order

Presentation to a conference hosted by the Peterson Institute for International Economics
"Currency Wars: Economic Realities, Institutional Responses, and the G-20 Agenda"
Washington, D.C.
2 April 2013

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Escaping the "prisoner's dilemma"

- Urgent need to rotate global demand
- Deleveraging required in advanced economies and greater reliance on external demand
- Less reliance on export-led growth required in emerging market economies and increased reliance on domestic demand
- Fundamental asymmetries in the existing system and the need for co-operative strategies (the G-20 Framework)

Estimating the benefits of co-operation and the costs of failure

Three illustrative scenarios drawn from model-based simulations:

1. The good solution

2. The bad solution

3. The ugly solution

Key elements of the good solution

The good solution involves four key elements:

1. Fiscal consolidation in most AEs
2. Household and bank deleveraging in many AEs
3. Structural reforms to promote growth in some AEs
4. Structural reforms and exchange rate adjustment in many EMEs [Charts 1, 2]

Heavy costs of delaying needed adjustment

The bad solution occurs when essential policies are delayed: [Chart 3]

1. Loss of US $6 trillion by 2015, equivalent to 8 per cent of global GDP [Chart 4]

2. Cumulative loss in global output of US $16 trillion in net present value (NPV) over the 2012-16 period

Doing half the job could be even worse

The ugly solution occurs if adjustment is asymmetric:

1. Much larger losses over the near term if AEs front-load fiscal consolidation without demand rotation [Chart 5]

2. NPV cumulative losses over the next five years equivalent to $17.6 trillion, 10 per cent higher than the "bad" solution

Exchange rate adjustment is an important part of the solution

Smaller, open economies caught in the middle

- Canada is a small open economy that plays by the rules [Chart 6]
- Pressures from those who break the rules are displaced onto more flexible currencies
- Effects of persistent large-scale intervention and capital controls differ substantively from those of quantitative easing
- They target exchange rates directly and lead to zero-sum outcomes

References

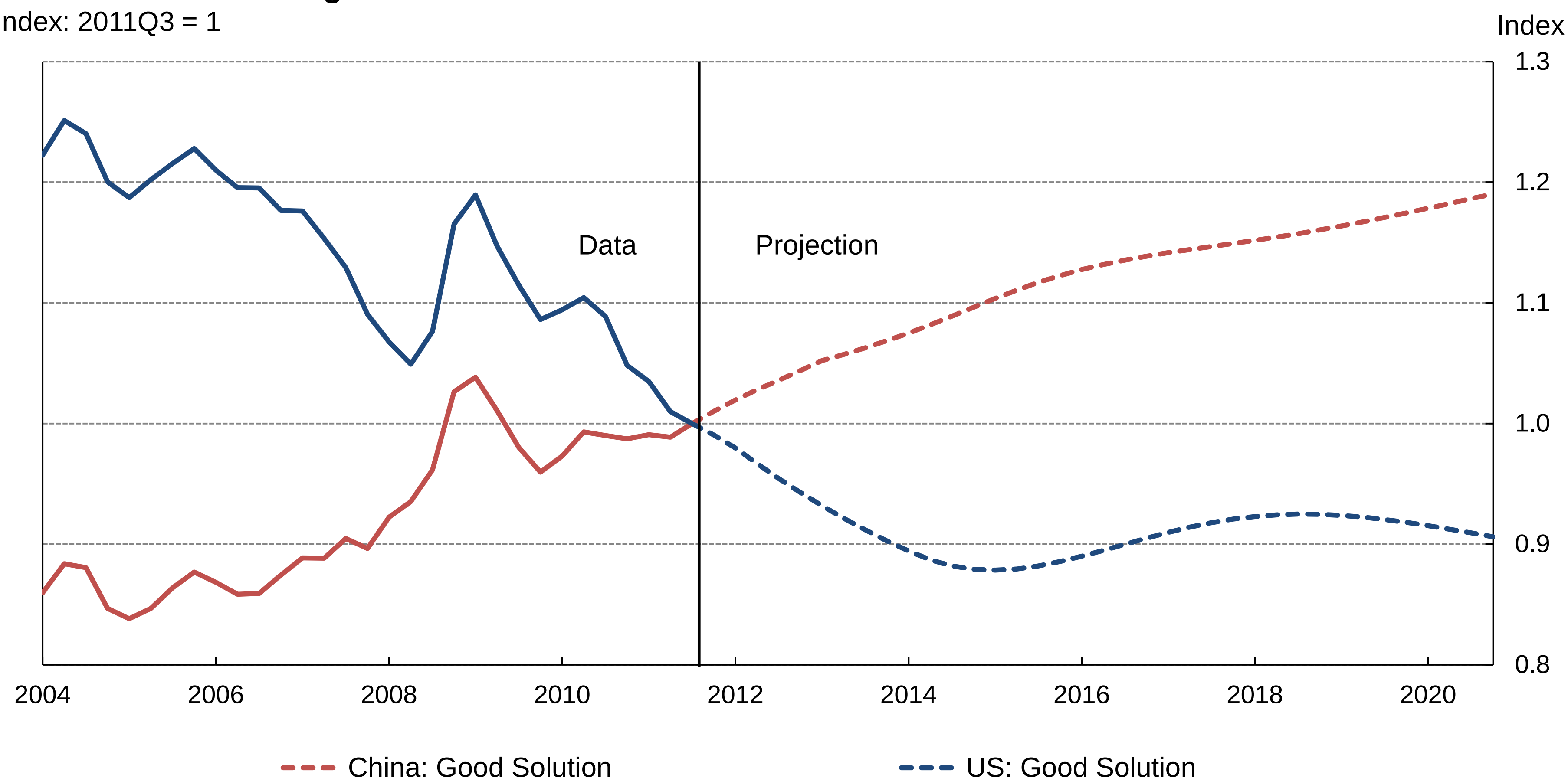
- Carney, M. 2011."Growth in the Age of Deleveraging." Speech to the Empire Club of Canada/Canadian Club of Toronto, Toronto, Ontario, 12 December.
- de Resende, C., C. Godbout, R. Lalonde, É. Morin and N. Perevalov. 2012. "On the Adjustment of the Global Economy." *Bank of Canada Review*, (spring) 1-15.
- Lavigne, R. and S. Sarker. 2012 "The G-20 framework for strong, sustainable and balanced growth: Macroeconomic coordination since the crisis," *Bank of Canada Review*, (winter) 2012-2013.
- Murray, J. 2011. "With a Little Help from Your Friends: The Virtues of Global Economic Coordination." Speech to the State University of New York at Plattsburgh, Plattsburgh, New York, 29 November.
- Murray, J. 2012. "The Great Frustration: Hesitant Steps Toward Global Growth and Rebalancing." Speech to the New York Association for Business Economics, New York, New York, 27 November.

Thank you

Chart 1: The "good" solution: adjustment in exchange rates

Real effective exchange rates in China and the United States

Index: 2011Q3 = 1



Sources: GMUSE and BoC-GEM-Fin simulations

Last observation: June 2011

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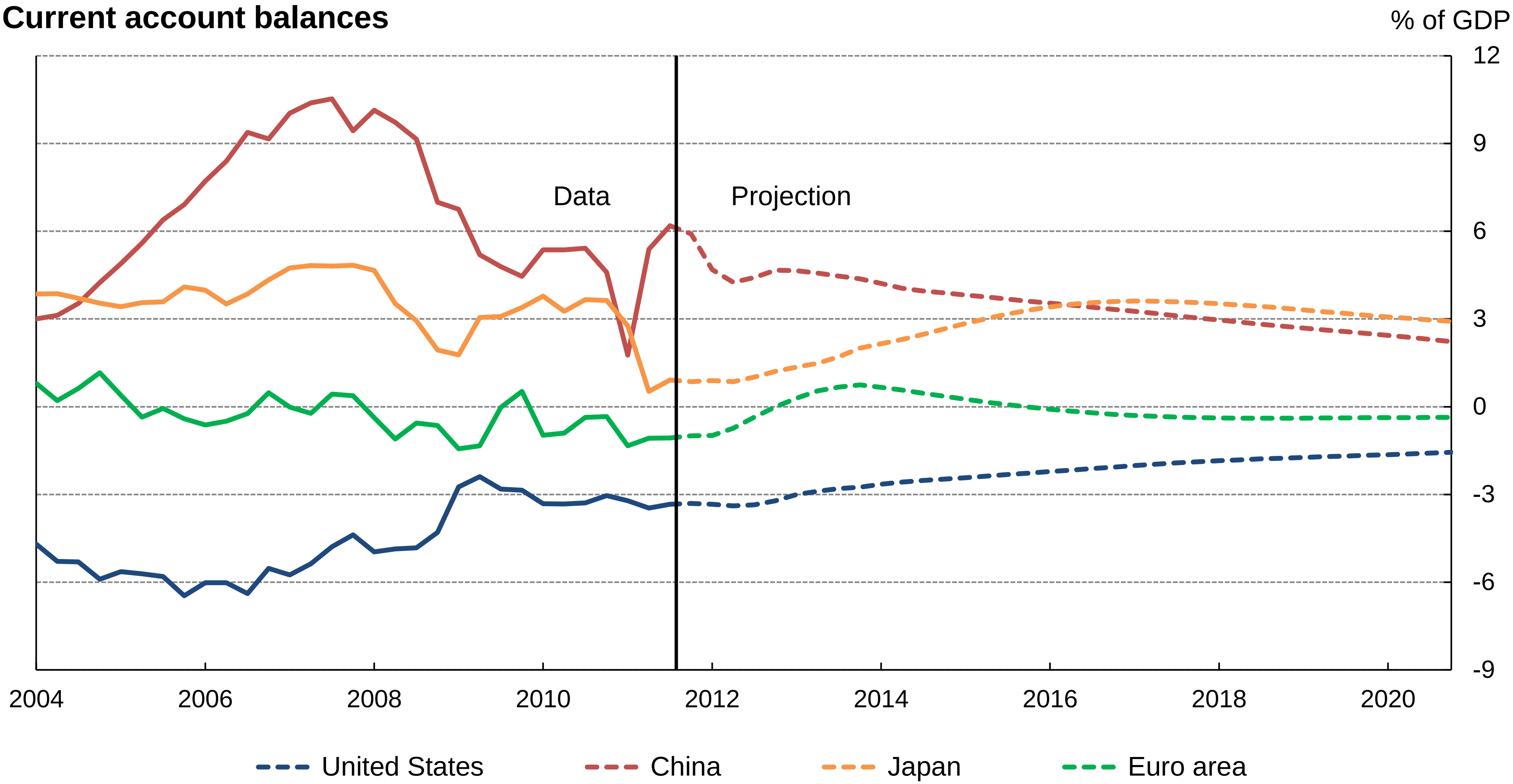
Chart 2 - The “good” solution: global imbalances resolved

Current account balances

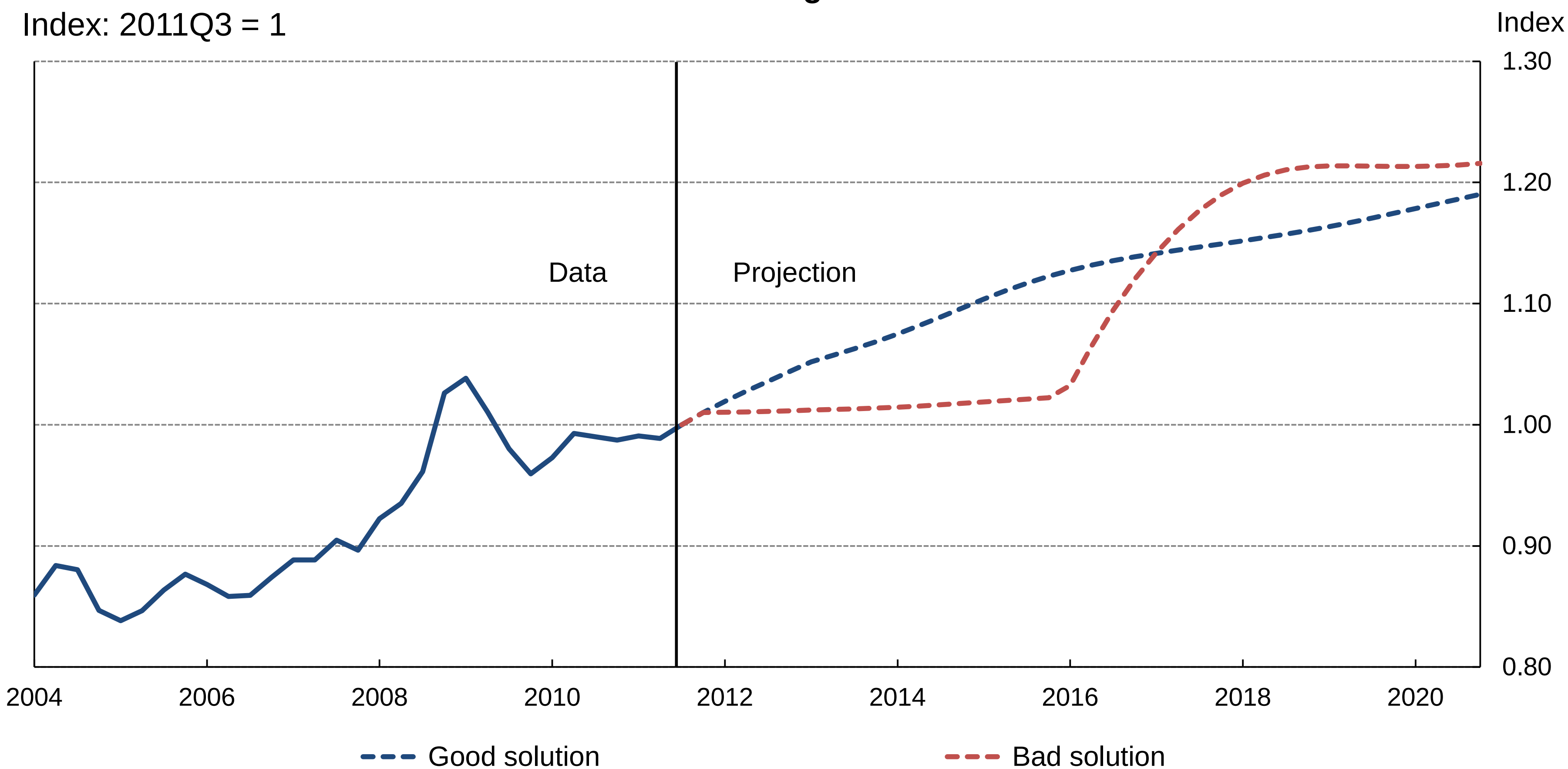


Sources: GMUSE & BoC-GEM-Fin simulations

Last observation: June 2011

Chart 3 - The “bad” solution: adjustments are delayed

The “bad” solution – Chinese real effective exchange rate
Index: 2011Q3 = 1



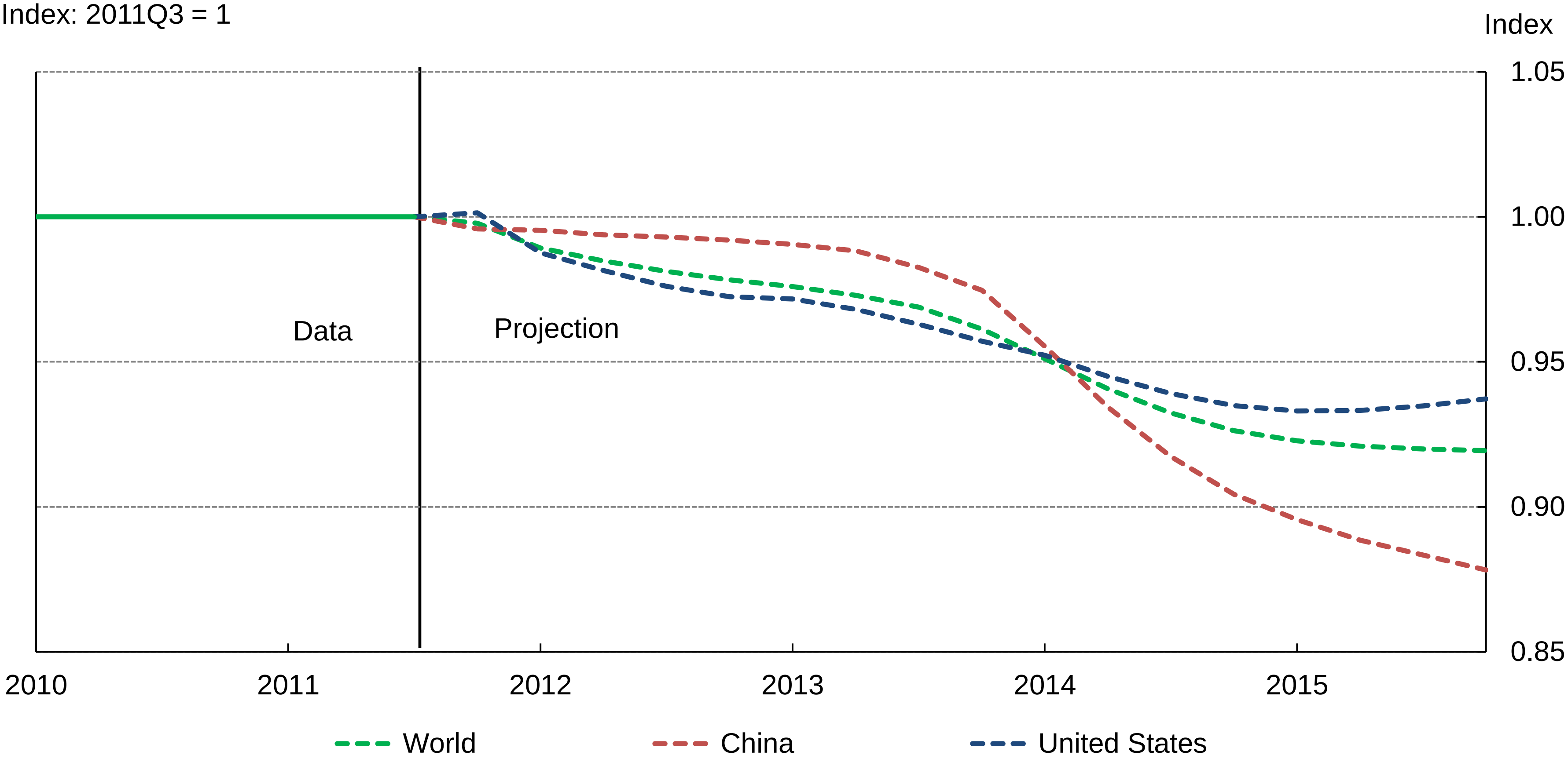
Sources: GMUSE and BoC-GEM-Fin simulations

Last observation: June 2011

Chart 4 - The “bad” solution: 6 trillion USD loss in global GDP by 2015

The “bad” solution—GDP relative to the baseline scenario

Index: 2011Q3 = 1

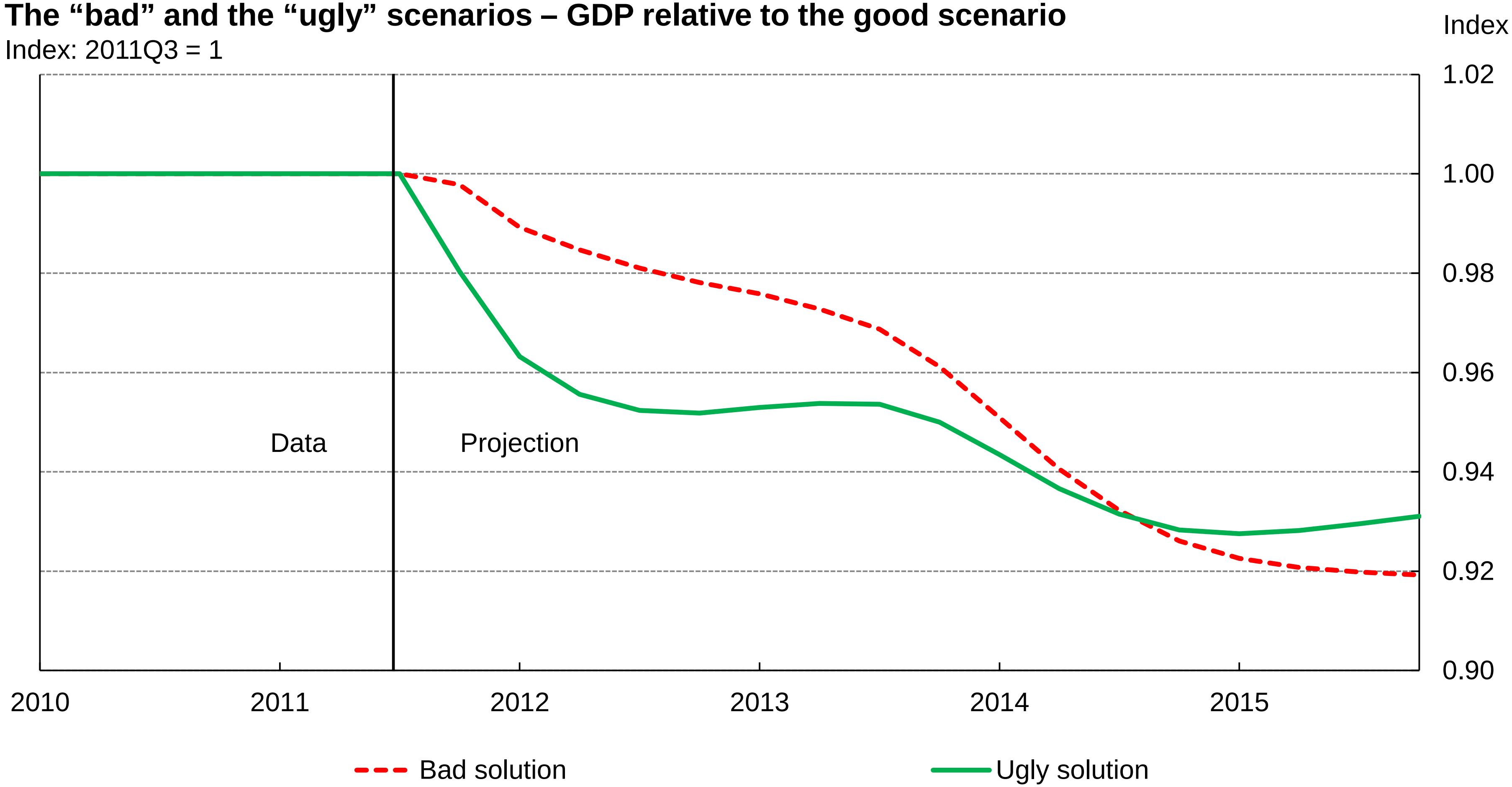


Sources: GMUSE and BoC-GEM-fin simulations

Last observation: June 2011

Chart 5 - Doing half the job could be even worse...

The "bad" and the "ugly" scenarios – GDP relative to the good scenario
Index: 2011Q3 = 1



Sources: GMUSE and BoC-GEM-Fin simulations

Last observation: June 2011

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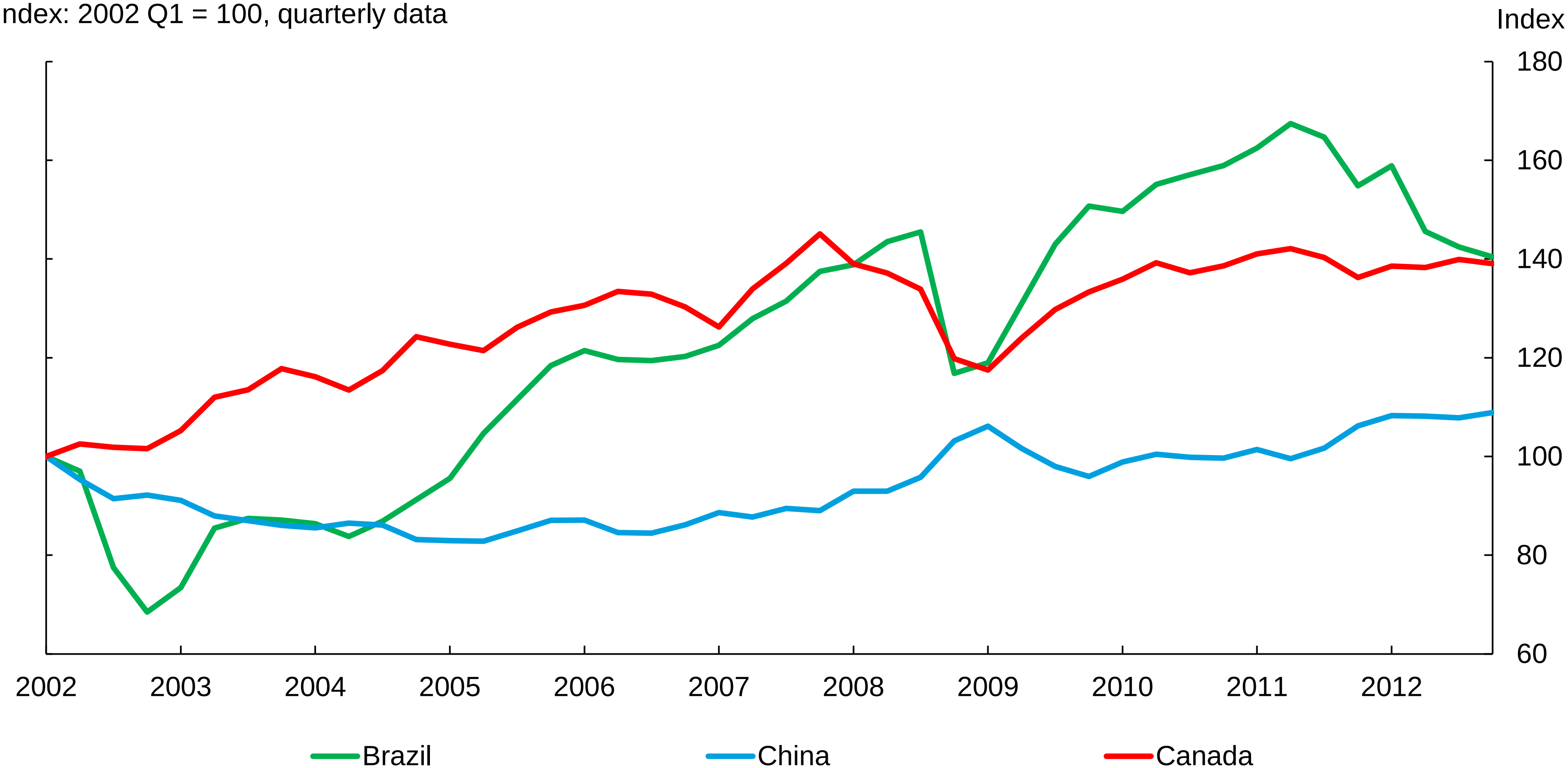
Chart 6 - Adjustment has been displaced

Real effective exchange rates
Index: 2002 Q1 = 100, quarterly data



Source: Bank for International Settlements

Last observation: 2012Q4

Quotes

What are the rules of the game?

Article IV, Section I, paragraph iii of the IMF's Articles of Agreement states that members shall:

> "avoid manipulating exchange rates or the [international monetary system] in order to prevent effective balance of payments adjustments or to gain unfair competitive advantage over the members."

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What are the rules of the game? (cont'd)

2007 Decision on Bilateral Surveillance over Members' Policies broadened members' obligations (paragraph14):

"C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

D. A member should avoid exchange rate policies that result in external instability."