Transitioning to More Balanced and Sustainable Growth

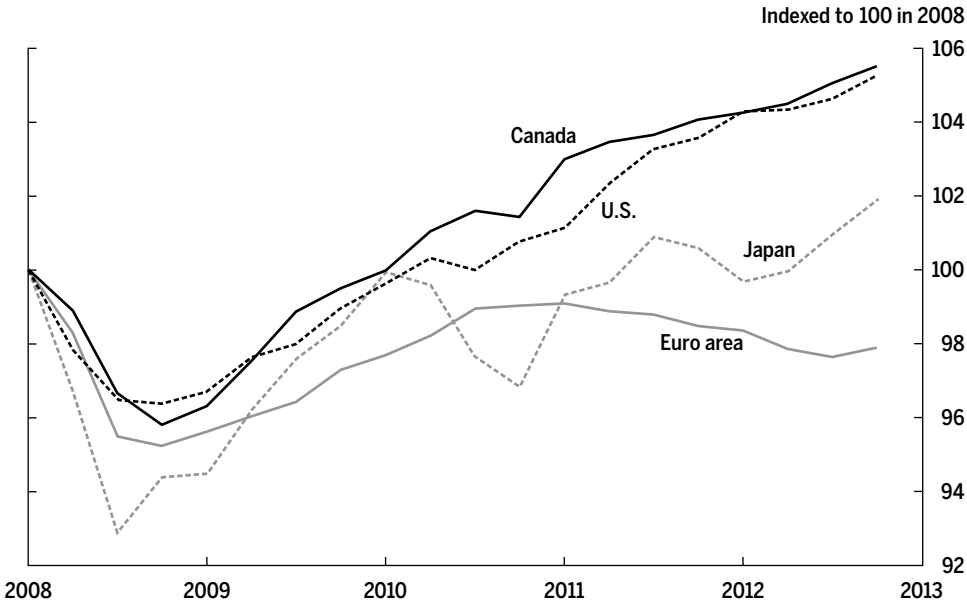
John Murray

Introduction

Canada shares many similarities with emerging market economies (EMEs) in Asia. Indeed, in some respects, we wish we were even more like them—particularly in regard to growth. Like most Asian countries, Canada has a very open economy that is heavily influenced by developments elsewhere, especially those in its southern neighbor. Despite Canada's sound financial system and solid fiscal position, it was seriously affected by the financial crisis and suffered proportionately almost as much as the U.S. economy did over the 2008–09 period, owing to its strong economic and financial links to the United States (Chart 1).

CHART 1

Canada's Economy Was Seriously Affected by the Crisis but Has Recovered



Note: Quarterly data, seasonally adjusted, 2008:Q3=100.

Sources: Statistics Canada, U.S. Bureau of Economic Analysis, Eurostat, Cabinet Office of Japan, and Bank of Canada calculations.

Although economic activity in Canada has now fully recovered and moved well beyond its pre-crisis peak, our economy is in the midst of a difficult rebalancing process and has yet to achieve self-sustaining growth unassisted by exceptionally accommodative monetary policy.

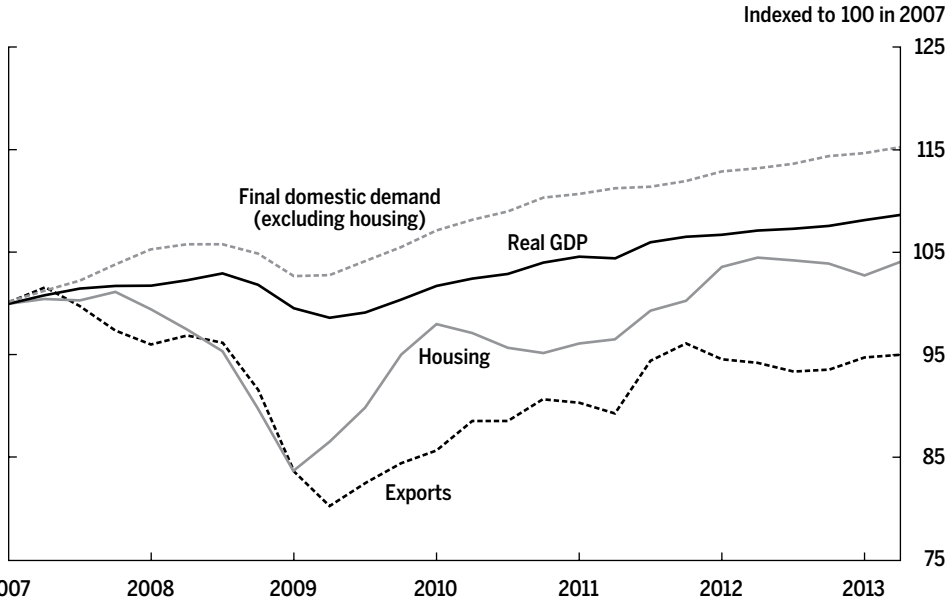
Unlike most Asian economies, Canada hopes to shift away from the excessive domestic demand that it was forced to rely on when its export sector collapsed, and to draw increasing support from external demand (Chart 2).

Unlike many advanced economies *and* EMEs that suffered from serious excesses before the crisis, in Canada's case, this re-equilibration should involve a return to the sort of balanced state that it enjoyed immediately prior to 2007.

There are other important ways in which Canada differs from some of its Asian trading partners. Over most of the post-World War II period, we have operated under a system of freely flexible exchange rates, absent any currency or capital controls. While we are exposed to many of the same external shocks experienced by other open economies, we have always believed that it is better to work with markets rather than against them, allowing the price system to operate. Yet "playing by the rules" has sometimes proven difficult, owing to the contagion created by those who are not. Nevertheless, in the long run, our flexible approach has served us well.

CHART 2

Canada Must Reduce Its Reliance on Domestic Demand



Sources: Statistics Canada and Bank of Canada calculations.

Asia's Phenomenal but Increasingly Unbalanced Growth

Over the past 13 years, the Asia region has experienced phenomenal economic growth, moving from a 7 percent share of global economic activity as recently as 2000 (measured at market prices) to an estimated share of close to 18 percent as of 2013. Measured in terms of purchasing power parity, the latest number would be even more impressive. The process has had some occasional setbacks, of course, and is not without precedent—I am thinking here of the late 19th and early 20th centuries and the emergence of the United Kingdom and the United States. But such growth is nevertheless extraordinary. Emerging Asia has accounted for more than 40 percent of the world's growth over the past 10 years, and hundreds of millions of people have been lifted out of extreme poverty.

Like most episodes of successful development in the postwar period, the Asian miracle has been driven by export-led growth. In many cases this was supported by a fixed exchange rate regime, and an extensive system of currency and capital controls designed to achieve and preserve international competitiveness. Of course, there has been considerable variation across countries with regard to their economic circumstances, institutional arrangements, and development strategies. The simple picture painted above does not apply to all. Nor are Asian countries the only ones in the global economy to enjoy sustained external surpluses. More importantly, for every trade surplus, there must be an equal and offsetting deficit, with many advanced countries eager in the past to play this role.

Such imbalances are not unusual, but the extent to which capital was "flowing uphill" during the pre-crisis period was. This was clearly unsustainable. It is one thing for relatively small countries to play this game, but when they grow too large, they soon run out of space. Foreign reserve accumulation among the EMEs since 2000 has totaled more than US$6 trillion (Chart 3).

The Crisis as a Catalyst for Change

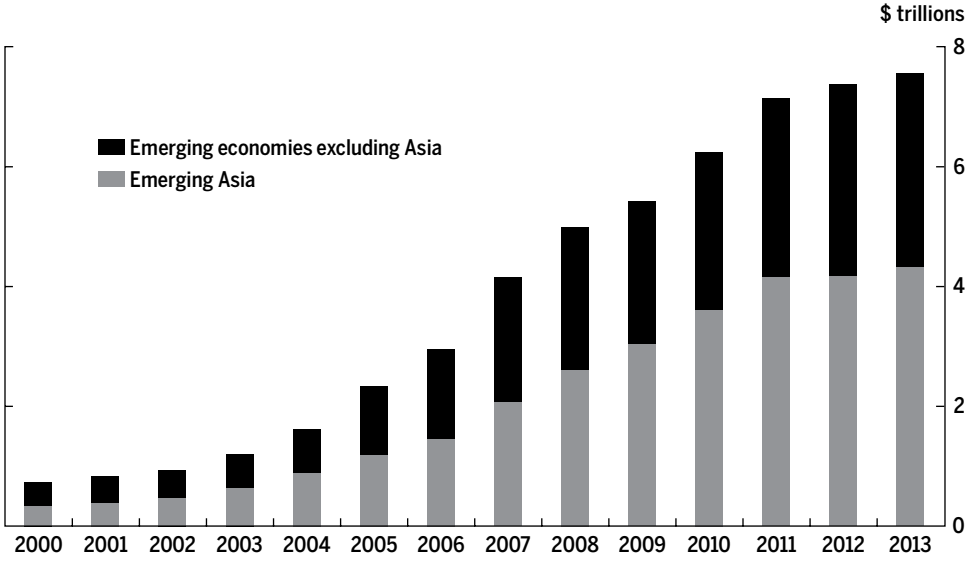
When the crisis hit, export markets for the emerging Asian economies suddenly imploded. Fortunately, many of them had the fiscal and monetary policy space to cushion the blow. However, the crisis merely brought forward a process of global rebalancing that was inevitable. Advanced economies had exhausted their credit lines, and EMEs were running out of foreign customers. Advanced economies were going to have to boost domestic savings to get out of hock, and EMEs were going to have to rely on their own consumers for future growth.

The coordinated and ambitious economic recovery plan that the Group of Twenty (G-20) leaders outlined in the early days of the crisis, the G-20

CHART 3

The Asian Miracle Has Generated Large Surpluses and Large Reserve Accumulations

Emerging Market Foreign Reserves, Annual Data



Source: International Monetary Fund.

Framework, was designed to deliver strong, sustainable, and balanced growth. It had four critical and mutually reinforcing parts: (1) meaningful fiscal consolidation in overly indebted countries; (2) sweeping financial sector reform; (3) wide-ranging structural reforms to boost future growth prospects; and (4) a necessary rebalancing of global demand between deficit and surplus countries, assisted by more flexible, market-determined exchange rates. The first three parts of the plan would inevitably have contractionary effects in the short run, so a domestic-led expansion of demand in surplus countries was a critical component of the G-20 plan if global deflation was to be avoided. Any positive confidence effects that might be associated with promises of fiscal rectitude and substantive structural reform were likely to be small and insufficient, on their own, to correct the widening output gap.

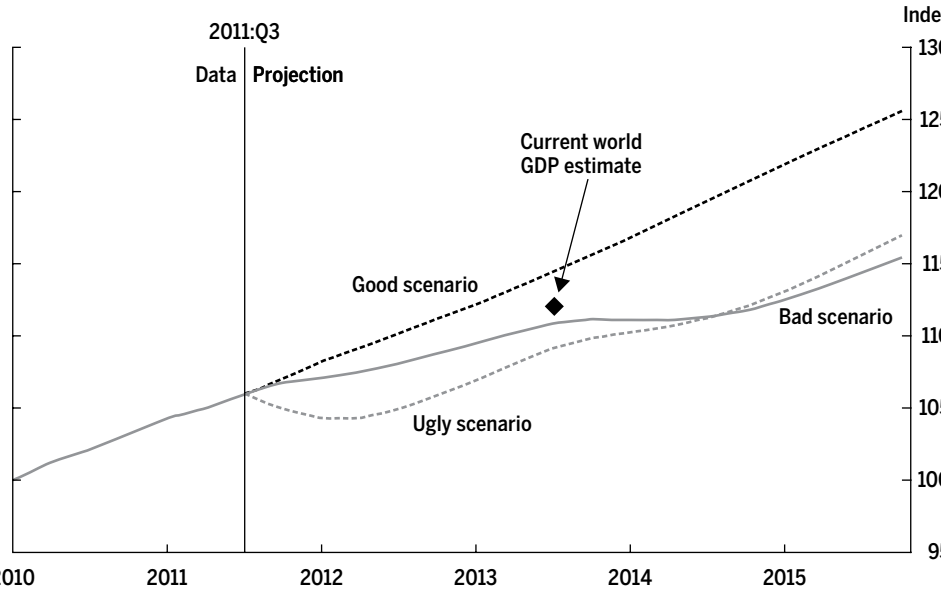
So How Have We Done?

It is safe to say that global economic performance over the past five years has been disappointing. As acknowledged in various G-20 communiqués, growth has been neither strong, nor sustainable nor balanced. Shortly after the crisis and the announcement of the G-20 Framework, economists at the Bank of

Canada decided to use their global model to examine three very different scenarios for how the global economy might unfold. The first was the so-called good scenario, where every player did what it had promised and all four parts of the plan were delivered. It is important to stress, however, that this was not a Goldilocks scenario by any means, just something that, in a rough-and-ready way, would satisfy the requirements of the G-20 Framework. The second scenario was a "bad" one, in which no one initially did what they were supposed to. But it assumed that eventually everyone would come around, after a substantial lag, and do the right thing. Without this assumption the model and, presumably, the global economy would explode. The third scenario was actually worse than the bad one, at least for the first few years of the simulation, and our economists called it the "ugly" scenario. It involved doing only half the job. More specifically, only the first three parts of the G-20 Framework, which were inherently deflationary, were set in motion. The estimated cumulative costs to the global economy from following the bad scenario over 2012–16, as opposed to the good one, were US$16 trillion, or 5.4 percent of global GDP (Chart 4). The estimated cumulative cost for the ugly scenario was even larger, at about US$18 trillion, or 5.8 percent of global GDP.

CHART 4

The "Good," the "Bad," and the "Ugly" Scenarios



Note: All series refer to world GDP.
Sources: GMUSE and BoC-GEM-Fin simulations.

So where is the real world economy now? Our best estimates suggest that we are sitting somewhere between the good and the bad scenarios but, in truth, a little closer to the bad. Performance with regard to the four key elements of the G-20 Framework has been mixed. Significant progress has been made on financial sector reform and fiscal consolidation, with sometimes too much of the latter, but much less has been accomplished on structural reform and global rebalancing. Had it not been for the support provided by exceptional monetary stimulus, the outcome would have been much worse, somewhere between the bad and the ugly scenarios. However, this situation cannot be sustained. Monetary policy provides only a temporary bridge; it cannot act as a substitute for more fundamental reform and economic adjustment.

Hopeful Signs on the Horizon

Happily, there are positive signs on the horizon. The advanced economies seem to be getting their act together. The preconditions for a return to stronger growth are present in the United States. Europe has emerged from a six-quarter recession and is progressing, albeit slowly, with its reforms. Japan has successfully launched the first stage of its "Three Arrows" program. Growth has recently faltered in some EMEs in response to past policy tightening, accumulated supply bottlenecks, and financial market turbulence. However, China appears to have stabilized its economy at a sustainable and solid growth rate of approximately 7.5 percent (conveniently consistent with its target growth rate).

More importantly perhaps, China and several other Asian countries appear to be liberalizing their economies, allowing more flexibility in prices and exchange rates, and otherwise assisting the adjustment process (Chart 5).

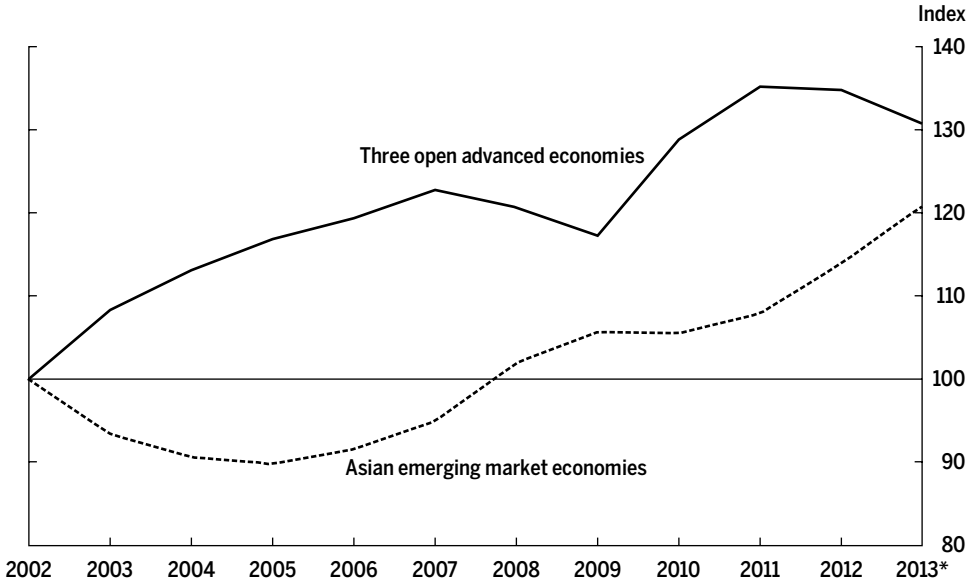
There is a risk, however, that the recent jump in financial market volatility in anticipation of tapering by the United States will tempt some countries to impose additional currency and capital controls and to intervene more aggressively. Indeed, there is newfound sympathy for these tools in the international community, at least when they're applied in a temporary and targeted manner as a form of international macroprudential stabilization. It is important, however, that nothing that is done as a possible short-term palliative be allowed to interrupt the rebalancing and necessary process of normalization that is under way in the global economy. Some may use this more forgiving attitude as cover to continue earlier unhelpful practices, but this would only invite a replay of past unpleasant events.

Exiting from the extraordinary policies that were put in place by several advanced economies to buttress growth is going to be challenging. As many observers have noted, we are traveling in uncharted territory. But at least the

CHART 5

Asian Emerging Market Economies Are Showing More Flexibility in Their Exchange Rates

GDP weighted annual data, 2002=100



*2013 GDP estimates taken from the IMF *World Economic Outlook*, October 2013. The 2013 Bank for International Settlements real effective exchange rates are an average for the first nine months of 2013.

Note: Asian emerging market economies include China, Thailand, and Malaysia. Three open advanced economies include Australia, Canada, and Switzerland.

Sources: Bank for International Settlements, International Monetary Fund *World Economic Outlook*, and Bank of Canada staff calculations.

incentives of the countries that are exiting—and those on the receiving end—should be well aligned. No one should want advanced economies to exit too early or too late, and no one benefits from excessive market turbulence. Some episodes of increased volatility will no doubt be experienced, but advanced economies are committed to being as transparent as possible in order to minimize surprises and smooth the adjustment process.

It is important that countries play by the rules and stand by the commitments that many of them made as part of the G-20 Framework. Displaced pressures from exchange rates that are not allowed to move, from capital flows that are directed elsewhere, and from outsized reserves that are looking for a safe home often squeeze small open economies such as Canada's and, more critically, frustrate the international adjustment process.