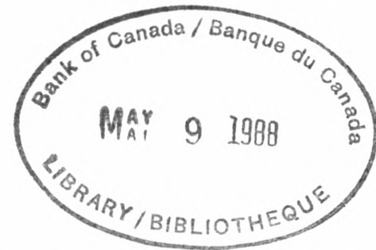
FIB-280



EXCHANGE RATE POLICY AS AN INSTRUMENT OF BALANCE OF PAYMENTS ADJUSTMENT: A CANADIAN PERSPECTIVE

NAME/NOM FI ADDRESS/ADRESSE
FILE COPY SEC 7W LIBRARY

FOR YOUR RETENTION:
A CONSERVER:

BANK OF CANADA.
(SPEECHES): GOVERNOR.

*** QUESTIONS-TEL. 782-8000 ***
R= 004433 I= 0020 C= 001 G= DATE: 880509

Notes for remarks by
John W. Crow
Governor of the Bank of Canada
at the
XXV Meeting of the Central Bank Governors
of the American Continent
Rio de Janeiro, Brazil
May 5 - 6, 1988

Notes for remarks by
John W. Crow
Governor of the Bank of Canada
at the XXV Meeting of the Central Bank Governors
of the American Continent
Rio de Janeiro, Brazil
May 5 - 6, 1988

EXCHANGE RATE POLICY AS AN INSTRUMENT OF BALANCE OF PAYMENTS ADJUSTMENT: A CANADIAN PERSPECTIVE

I appreciate the invitation to make a presentation on this important topic. Right at the start, I should emphasize that Canada operates under a flexible exchange rate system. In other words it has no exchange rate goals. Furthermore, balance of payments adjustment is handled through market forces, and the essential goals of our monetary policy are the domestic objectives of price stability and sustained economic progress.

But of course the orientations of our policy approach that I have just summarized should not be taken to mean that exchange rate movements and balance of payments considerations are unimportant to Canada. On the contrary, these matters are far too important, far too intertwined with the performance of the national economy, to be ignored or simply left to unchecked market forces. Canada often finds it necessary to intervene in foreign exchange markets, and in domestic monetary operations we have to keep in the forefront of our minds that Canada is not only very open in trade in goods and services, but is also fully plugged into the operations of international financial markets.

Also, I should emphasize, the fact that the fundamental orientation of monetary policy is domestic, does not preclude or downplay the desirability of international economic coordination, in which Canada is heavily involved. The essential rationale for these important efforts is to encourage appropriate domestic policies and thereby avoid adverse international spillovers that could hinder the achievement of sound national goals.

What I will do in the rest of my comments is describe the general manner in which exchange rate and balance of payments considerations impinge on monetary policy in Canada.

The Objectives of Monetary Policy

In our view, monetary policy can best contribute to domestic economic progress in what is, after all, an economy based on money, by seeking to achieve and maintain a stable general price level. By fostering confidence in a nation's money, monetary policy can provide an essential underpinning to broad and lasting economic health. Whatever else is necessary in particular circumstances, this confidence will not be achieved if monetary policy does not address it centrally.

In this context, movements in the exchange rate are of concern because of their potential impact on domestic prices, output and income. Exaggerated changes in the exchange rate that are not consistent with market fundamentals and that threaten domestic objectives may require corrective action.

The Bank of Canada, like many other central banks, is charged with responsibility for controlling and protecting the external value of the currency. But as I have already implied, this does not mean that we must operate under a fixed exchange rate system. We have found that such arrangements can be a source of speculative instability in a world that is not always well behaved.

Fixed exchange rates can offer advantages in terms of increased discipline and short-run stability. By eliminating the uncertainty associated with future movements in nominal exchange rates, authorities could no doubt increase international trade in goods and services at the margin, and reduce the time and resources that companies currently devote to monitoring their international operations. However, these advantages could be more than offset by the added pressures that would be imposed on domestic wages and prices by external inflation, and the difficulties that could be encountered in responding to real external shocks. Furthermore, though the exchange rate values that emerge from more flexible systems are not always "right", their movements are often a useful barometer of market sentiment and relative economic performance. As a final thought here, let me note that independent of the exchange rate system that prevails the surest single means of protecting the external value of a country's currency is to maintain its purchasing power internally.

Exchange Rates and Monetary Policy Implementation

Early champions of flexible exchange rates argued that flexibility would insulate economies from external shocks, discourage destabilizing speculation, ensure balance

of payments equilibrium and allow national authorities to pursue independent monetary policies. Those arguments were oversold. The move to flexible exchange rates by most of the major industrial countries in the early 1970s did introduce an element of automaticity to balance of payments adjustment and did provide more scope for adjusting to oil related shocks, for example. But it is fair to say that the system has not performed as smoothly or as reliably as most observers had hoped. Whether a better system is available is of course quite a different question -- one that is beyond the scope of my remarks today.

Because of these difficulties, the Bank of Canada along with other central banks has found it necessary to play a more active role in exchange markets than was originally thought likely when floating became generalized. We have learned from experience that there are two, quite different, sets of reasons for this activity.

In the first set are factors having to do with the tendency of exchange rates to move in an abrupt and volatile manner -- potential inefficiencies possibly requiring central bank action.

To avoid uncertainty feeding on itself, the Bank of Canada, operating as agent for the Government, regularly intervenes in the exchange market by "leaning against the wind" to prevent overshooting and excess volatility.

Let me add here that the arrangements between the Bank of Canada and the Government regarding Canada's Exchange Fund Account are such that intervention is always automatically sterilized. This ensures an entirely appropriate distinction between monetary policy operations

and intervention. It also means that the intervention itself is likely to have at best a very temporary effect on exchange markets, except to the extent that it helps to condition market expectations about future policy actions. But this may be good enough for minor disturbances.

However, an additional and far more serious threat to the performance of the flexible exchange rate system is posed by persistent, speculative bubbles, i.e. the systematic misalignment of exchange rates. There is considerable evidence that the foreign exchange market, just as much as other financial markets, is susceptible to "bandwagon effects" and destabilizing speculative behaviour that can cause rates to remain at evidently unsustainable levels for extended periods. In these circumstances, actions to correct rather than merely smooth the path of the exchange rate may be appropriate. Timely, and perhaps somewhat publicized, interventions can preempt extrapolative movements by bursting bubbles before rates gather momentum and distort domestic prices and real economic activity. In cases where intervention is unable to exert a sufficient influence, interest rate adjustment may also be required to help contain the market.

The other set of reasons for the Bank's involvement in exchange markets has nothing to do with destabilizing speculative behaviour or excess volatility, but focuses instead on the domestic policy objectives that I mentioned earlier. The Bank of Canada might at times in its management of monetary policy attempt to offset strong and steady exchange rate movements with an adjustment to domestic interest rates simply to help maintain steadiness in overall monetary conditions. The amount of offset would vary depending on the state of the domestic economy, the source of

the exchange rate movement and its expected duration. The danger in these circumstances would be that we would stand in the way of a movement that was broadly appropriate in the light of evolving domestic economic conditions.

As a concluding observation in this area, let me note that because the movements of the U.S. dollar against the currencies of overseas countries have been so very large, a proper assessment of the exchange rate position of Canada has increasingly required us to look at the performance of the Canadian dollar not just against the U.S. dollar, although most of our trade is with the United States, but also against the currencies of our major trading partners overseas. For example, since March 1985 the Canadian dollar has appreciated somewhat against the U.S. dollar, but has declined far more against the currencies of third countries. And even though the weight of the U.S. dollar in the trade-weighted index that we publish is some 80 per cent, the steep decline in the value of the Canadian dollar against those other currencies has meant that there has been little change in the overall exchange rate index.

The Balance of Payments

Under normal circumstances there can be no presumption that countries can or should work toward surplus or zero net trade positions. The appropriate balance will vary across countries and over time.

In this context it is worth saying a few words about the trade agreement that was recently negotiated between Canada and the United States. Both countries stand to gain economically, but the extent of this gain in economic

welfare is not related at all directly to what happens to the balance of trade between the two countries. Indeed, it is unclear whether the agreement will have any significant impact on the trade balance. Still, flows of goods, services and investment in both directions will no doubt be affected. As a consequence the effect, if any, on exchange rates must remain uncertain.

Be this as it may, the key point that I wish to emphasize in this area of my remarks is that exchange rate adjustments by themselves are unlikely to be able to correct fundamental imbalances in the use of domestic versus foreign resources if these imbalances are not also addressed through domestic policies. For example, if a country because of large government deficits is consistently absorbing more goods and services than it produces and others are willing to finance, it realistically has only two choices: (i) eliminate the excess demand by achieving better balance in its budget, or (ii) squeeze out sufficient private consumption and investment through high interest rates to accommodate the government spending. Whichever domestic route is taken, and clearly the first is to be greatly preferred, exchange rate movements are to be seen as a complement to, and not a substitute for, substantive domestic action.

Let me turn to a somewhat different but not unrelated problem. Countries operating under a pegged exchange rate system occasionally find that exchange rate adjustments have not kept pace with differences in rates of inflation at home and abroad. This produces misalignments. This problem can turn into what one of my predecessors at the Bank of Canada once referred to as a "dogged defence of the wrong rate". It is of course important to restore a

consistent relationship between the external and internal values of currencies, no doubt seeking guidance from relative rates of inflation. However, exchange rate adjustments alone are not always the answer. A devaluation in the presence of widespread excess demand will simply exacerbate inflationary pressures, neutralizing any benefits that might otherwise accrue from the realignment. Of course, the message is the same for countries pursuing inflationary policies under more flexible exchange rate systems. Then, without domestic correction, the danger is a vicious circle -- domestic inflation provoking exchange rate depreciation, exchange rate depreciation provoking domestic inflation, and so on.

Finally, taking a broader view of the balance of payments, let me emphasize that recent actions taken by the G-7 and official international bodies such as the OECD and the IMF to promote policy coordination give strong recognition to the fact that sound domestic policies and a healthy international monetary system go hand in hand. Through a combination of regular consultations and meetings, indicator exercises and formal analyses, they aim to promote policies that are consistent in regard to overall economic goals and in the best interests of the individual countries concerned.

* * * * * *

The emphasis that exchange rates and balance of payments considerations are given in policy formulation in different countries will reflect their particular needs and circumstances. Nevertheless, certain evident yet often

forgotten economic principles are common to all. First, no international monetary system or exchange rate policy is going to ensure the smooth correction of external imbalances in the absence of sensible domestic policies. Second, and as a consequence, fiscal and monetary policies are best directed at basic domestic objectives rather than at symptomatic problems that may arise on the external side.

This should not be interpreted as uncritical support for free market solutions or the flexible exchange rate system. Certainly there is room for judicious application of exchange rate management techniques, as I have indicated above, to remove or minimize some of the excesses to which the exchange market is prone. However, this must not be done in a way that fails to give full recognition to those fundamental changes that generally must take place.