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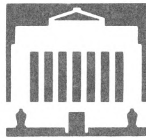

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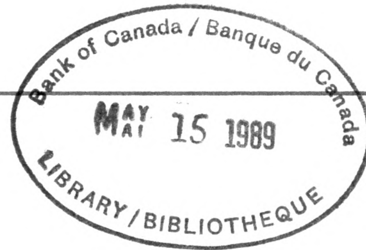


# National Monetary Policy in a Financially Integrated World

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Notes for remarks by
John W. Crow
Governor of the Bank of Canada

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## National Monetary Policy in a Financially Integrated World

Given the Bank of Canada's responsibility in formulating and conducting Canadian monetary policy, the questions underlying the topic on which I will address you are ones that we find of major importance. I therefore very much welcome the opportunity your conference offers to discuss them before an audience that is both knowledgeable and interested in the answers.

Many of you come from outside Canada. You will judge how closely my remarks relate to experiences with which you may be more directly familiar. In any event, what I have to say does in quite a few respects carry beyond the Canadian experience and a Canadian perspective.

Still, let me set my stage for the benefit of our visitors. When we welcome you to Canada, we welcome you to a country that is, economically speaking, quite large, although not of course one of the very largest. However, for my topic what is particularly relevant is that the Canadian economy is very open to international exchange and international economic and financial influences. More than a quarter of our total production of goods and services is traded internationally. We have no exchange controls of any kind, and our two-way flows of capital are large by any yardstick.

Indeed, the fact that Canadian savers and investors, borrowers and lenders, and the financial institutions that serve them, operate in the mainstream of world financial markets is part of the fabric of our economic history. So the reality and the challenges of the international connection are long familiar to the Bank of Canada. And with our proximity to the huge New York financial centre, we came to terms with this reality and these challenges well before they were posed to many other central banks by the rise of the Eurodollar market and the lowering of barriers to the flow of capital.

But in any event, whether we got there earlier than others or not, there is no doubt that the influence of powerful international economic and financial forces is now keenly felt everywhere. The opening up of trade, the removal of external capital controls, the deregulation of financial systems, and the diffusion of economic and financial muscle around the world have meant that all industrial economies, including the very largest, are now sensitive to the international dimension. And no policy area has a closer affinity to the international financial dimension than does monetary policy.

In tackling the broad topic of national monetary policy in a financially integrated world, I want to focus on some main questions first from a national, and then from an international, perspective. On the national side, the key issue as I see it is the relationship between the openness of money and capital markets that now prevails and the capacity of monetary policy to contribute to the sound evolution of the national economy. From an international perspective, an important question is the role and consequences of international economic coordination. The major industrial

nations are presently engaged in an exercise of international economic cooperation and coordination that is quite unlike any previous experience in its regularity and intensity, and in the scope of its agenda. This exercise has implications for all kinds of policies, including monetary policy.

Let me open with a question. How can monetary policy best contribute to the sound evolution of the national economy? I believe the answer is very clear. National monetary policy should be addressed centrally to maintaining the domestic purchasing power of the national currency unit -- in other words working towards and sustaining national price stability. It is difficult to see how this goal, essential for the health of a monetary economy, could be achieved if monetary policy did not give it top billing. Other policies, particularly fiscal policies, can of course be helpful, or even in some circumstances vital, in securing monetary stability. But it is clearly asking too much to count on other policies to carry the main load in this area.

With this starting point, the key issue is what economic and financial openness can mean for achieving monetary stability. And in this regard, there is no doubt that a crucial element is the exchange rate and what it, in turn, can mean. To help focus my remarks I will consider the role of the exchange rate against the background of two somewhat different landscapes -- monetary policy in Canada and, more briefly, monetary policy in the European Community.

In Canada, we have a flexible exchange rate system. Historically, this propensity for a flexible exchange rate has reflected as much as anything the fact that our economy, and in particular our exports, have depended greatly on

resource-based production. Given the highly cyclical nature of markets for these products, we have been subjected periodically to big swings in our international terms of trade -- the prices we receive for our exports compared with those we pay for our imports.

In these circumstances it is certainly useful to consider how adjustment of the real, or inflation corrected, exchange rate might be facilitated. This is because a shift in the real exchange rate has the potential for helping to absorb domestically -- that is, with as little disruption as possible -- an economic shock coming from a swing in the terms of trade. A shift in the real exchange rate can, for example, be helpful in evening out across the entire economy the inevitable impact on real incomes of large movements in the terms of trade.

From this viewpoint, the issue that confronts monetary policy is to what extent changes in the nominal exchange rate are in fact constructive in facilitating adjustment in the real exchange rate. This was indeed an issue that the Bank of Canada had to deal with in the first part of the 1980s in the face of a major downward shift in Canada's terms of trade. Given the potential feedback from exchange rate changes to domestic inflation, the risk, in an environment where inflation apprehensions are high, is that the change in the nominal exchange rate will be unconstructive -- producing not so much adjustment in the real exchange rate as more domestic inflation.

A more fundamental focus of monetary policy than that I have just outlined is its effect on the pace of total dollar spending in the economy. In this regard, it is important to stress that the exchange rate, like short-term

interest rates, should be regarded as a channel of monetary policy. Put another way, in the shorter run the impact of a given monetary policy impulse of easing or tightening on total spending, is transmitted through the foreign exchange market as well as through the money market.

This is far from saying that the transmission will work like clockwork. Indeed, we know from much experience that it is extremely difficult to tell in advance how much of any policy impulse will be felt in one market as opposed to the other. What happens at any time has a lot to do with the particular state of financial market expectations. Still, because central bankers give close and continuous attention to what is happening in short-term financial markets, we do develop a good understanding of the dynamic of those expectations. This, in turn, helps us to gauge what is likely to happen in those frequent instances when the money market and the exchange market are both responding, but not necessarily at the same pace, to what we have done.

Another useful qualification is that at any given time monetary policy is not the only, or even necessarily the dominant, factor behind movements of the exchange rate. Fiscal policy can also, of course, have an impact on the currency, as can other elements as well. Let me cite a couple of additional factors that have been important for Canada in the recent past. Firstly, there has been the substantial improvement in our international terms of trade over the past two years as a result of strong gains in commodity export prices. Another element has been the perception that the benefits to Canada from the free trade agreement with the United States will be substantial.

However, the most important point that I want to make about the short run is that while movement in the exchange rate is clearly an important, if at times jerky, channel in the transmission of monetary policy, neither a particular movement of the exchange rate nor its level should be seen as a key objective of monetary policy. Even in the short run we need to keep firmly in mind that the main goals of monetary policy are to promote domestic monetary confidence and stable prices by ensuring moderate monetary and demand expansion.

In a more long-run sense, what happens to the exchange rate over time will probably depend more than anything else on a country's inflation performance compared with that of its main trading partners -- put in more absolute terms, on its success in achieving domestic monetary stability. In this regard let me cite, not to our advantage, what happened to the Canadian dollar in the 1970s, when our currency depreciated a great deal against the U.S. dollar. This decline was essentially a reflection, it must be conceded, not of adverse movements in Canada's terms of trade, but of a persistently higher rate of inflation here than in the United States. Of course, the depreciation did not help matters, but it was not the source of the problem. The real problem was Canada's failure to keep made-in-Canada costs and prices under better control.

In my view there are two main conclusions to draw from the Canadian experience. Firstly, the exchange rate can, and of course does, move for various good reasons connected with the impact of real shocks on our economy. But secondly, the Bank of Canada needs to ensure that any such movement takes place only within a framework of monetary

policy that is consistently and unambiguously anti-inflationary.

Now let me look at the question of monetary policy and exchange rate relationships through what I think of as the opposite end of the telescope. From that end the exchange rate can be seen as the tie that binds monetary policies in different countries. Thus, a country may, in pursuit of price stability for its own very important sake, or for other reasons, aim to fix its exchange rate in relation to a partner with a demonstrably better domestic inflation performance -- a better domestic monetary anchor. In that case, the role of monetary policy becomes more one of helping the economy to hold to the given exchange rate as the crucial means of preserving price stability. This latter example is of course relevant in regard to the evolution of the European Monetary System (EMS).

As regards the EMS, there is now no doubt that it has evolved with Germany setting the standard of monetary performance to which other countries adapt by virtue of the relative, and apparently increasing, fixity of exchange rates within the exchange rate mechanism. This, in turn, has helped to counter any inflationary bias in other countries. At the same time, I should also note that because the EMS is only one part of a more general integration of national economies and institutions in Europe, the EMS exchange rate targets tend to have more credibility than might be possible in other fixed exchange rate arrangements. This means that the European monetary experience to date provides no strong guide as to how appropriate or successful fixed exchange rate targets might be more generally.

Let me now shift from the European experience to the still broader question of international economic coordination, the relative emphasis in this exercise on exchange rates, and its relationship to national monetary policies. In fact, in important respects the coordination process implies a view of exchange rates that is somewhere between the two cases that I have just outlined.

The exercise of international economic coordination spearheaded by the G-7 countries can be thought of as providing something of a new international economic policy framework, following in the wake of the collapse in the early 1970s of the fixed exchange rate Bretton Woods system and the less than totally satisfactory experience with exchange rate floating since then. The focus on coordination stems from recognition that the economic policies of large countries spill over. They spill over not only onto small countries but also onto other large countries. It also recognizes that if those spillovers are not taken into account, and if policies are not modified in appropriate ways, there is potential for major economic strife and economic damage. One very apparent danger is that wide swings in exchange rates could cause countries to retreat into protectionism.

The coordination exercise, its underpinnings and its results to date, have received a great deal of discussion. Furthermore, its framework is continuing to evolve. However, my purpose is not to review this whole territory but to focus on some issues for monetary policy.

Since the circumstances in which the world has found itself in the past few years have featured major payments imbalances and exchange rate volatility, it is understandable that there should be considerable focus on how

best to manage exchange rate movements. This focus has had two main goals. In the first place it has aimed at facilitating the necessary adjustment in the largest countries' balance of payments on current account, bearing in mind the role in such adjustment of both exchange rates and a more compatible balance of domestic policies among countries. Secondly, it has aimed at avoiding along the way the excessive exchange rate swings that could jeopardize world economic expansion and the open international trading system.

Now, the point I want to emphasize is that monetary policies in various countries have often been very much oriented to these worries that exchange rates might move too much. Certainly, the very flexibility of monetary policy and its undeniable repercussions on the exchange rate make it a rather obvious candidate for the role of exchange rate guardian. Nonetheless, a question that is always present to some degree, and I would argue increasingly so with the passage of time, is how underlying price stability is to be preserved if international exchange rate stability becomes the dominant preoccupation of monetary policies.

It might be thought that exchange market intervention can provide an extra degree of freedom in this regard. Through intervention, it might in principle be possible to hold back exchange rates that were showing an unwelcome tendency to move. This restraint could ease the burden on monetary policy to corral exchange rates. We certainly now know that intervention, especially when concerted among countries, has a strong signalling content as to what the authorities would like to see as regards the relative values of their currencies. It has proven a useful tool in shaking out speculative pressures. However, let me inject some words of caution. It is equally evident that

intervention is far from capable of doing the whole job. More often than not, a follow-through with monetary policy actions is needed if the authorities really expect to get their way in exchange markets. Therefore, intervention cannot provide a fully satisfactory answer to concerns about the prospects for price stability when exchange rate stability becomes a prime monetary policy objective.

Let me underline the point with two examples. More than one commentator has drawn attention to the highly inflationary consequences, in the circumstances of the early 1980s, that would have developed if U.S. monetary policy at the time had been more expansionary in the interests of holding down the U.S. dollar. Such an easing in monetary policy would have come in the face of the upward push in the exchange value of the U.S. dollar on account of the very large dose of U.S. fiscal stimulus that had been introduced. But it may not be too far-fetched to wonder whether such a policy could have been rationalized, and pressed for, in our current framework as being in the overriding cooperative interest of maintaining exchange rate stability.

We can take a more up-to-date example as well, and one that is right here at home. The Canadian economy in the past couple of years has been facing very strong demand pressures both domestically and from abroad, together with the real income gains from the substantial improvement in our international terms of trade that I mentioned earlier. In these circumstances the Canadian dollar has risen substantially. If monetary policy had been aimed primarily at holding down the value of the Canadian dollar to some preconceived level, particularly in real terms, this would have had frighteningly severe inflationary consequences. In such circumstances, it is not at all difficult to generate a

vicious inflationary circle of a chronically weakening currency and chronically high interest rates -- at the same time. This is not in the interests of good economic performance.

A particular lesson that can be drawn from the first of these examples is that increased focus on the roles and international implications of national fiscal policies is well placed. Furthermore, in thinking about the international financial and exchange rate system as a system, that is, with rules and obligations, it is salutary to think about fiscal policies and the international system in a way different from the usual order. The emphasis has traditionally been on the impact on capital flows and exchange rates of national, and presumably autonomous, fiscal policies. Now, however, increased attention is being given to whether and how the international financial system can itself usefully condition the way national fiscal policies should be conducted if we are to mitigate payments imbalances and exchange rate swings. Progress is slow, however. While these issues have received quite a bit of study, the conclusions to date provide no basis for believing that the required international discipline on fiscal policies will be readily forthcoming.

The second example, drawn from the Canadian experience, underlines the fact that in addition to the relative inflation, or "nominal", component of exchange rate change, there is indeed a "real" component that has to be reckoned with.

Evidently, we need to continue to think hard about where any truly international anchor for monetary values and monetary stability could possibly reside. As we have learned

from ample experience, national price stability is not achieved if national monetary policies do not seek it, and it is not yet evident what sort of international stability arrangement can be expected to take the place of national monetary policies.

In my remarks today I have touched on quite a few problems. That, after all, is only fitting for a keynote speaker at a conference whose theme is "Challenging the 90s." Let me also note, however, that problems exist to be tackled, redefined, transformed and overcome. Furthermore, along the lines of the old saying, a problem shared is a problem halved. And that, perhaps, is what much of international economic cooperation and coordination is about.