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

to the
First Pan-American Regional Congress of the
Association Cambiste Internationale
Montreal, Quebec
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Welcome to Montreal and to Canada!

Given the business that most of you are in, this is an excellent occasion to talk about the exchange market and exchange rates. So what I want to do this evening is share some of the Bank of Canada's thinking on these matters as we go about conducting monetary policy.

Of course the exchange rate is important for the economy and, therefore, for monetary policy. But the question I want to explore with you is the way in which it is important. In other words, how, given our monetary policy responsibilities, does the exchange rate fit in?

I don't think it will come as a surprise if I acknowledge at the outset that the exchange rate is a difficult topic from any angle. One reason it is difficult is because it is complex. It is complex because the external value of a nation's currency is the product of a whole range of factors, from the political to the technical. The exchange rate, a ratio after all, is affected as much by developments coming from abroad as by ones grown at home. Expectations and confidence matter a lot in exchange markets. As you very well know, all these elements are jostling in the exchange market, more or less intensely, all the time.

Nor will it astonish you to learn that at the Bank of Canada we work hard at assessing what is happening. We are continually striving to improve further our understanding of the forces shaping exchange rate developments. And we are always on the job of monitoring and analyzing the way the exchange market is filtering and processing the constant stream of information coming through.

In this light, what we value in particular from the exchange market is that it can provide an independent view of the underlying situation. This of course is not the same as saying that the market always gets it right. There is no reason to

believe that a market providing a quote every moment of the business day, and beyond, should be definitive. However, what the market does provide, in its collective assessment, is a check against loose or wishful thinking about what constitutes good value in financial terms.

In turn, at the Bank of Canada we know that participants in the exchange market have got an eye on us. In deciding what they think about the Canadian dollar, participants of course want to know what we are doing and aiming to do in terms of monetary policy.

As regards our underlying monetary policy goals, I will be brief on the grounds that I believe that by now they are well known -- at the Bank we certainly want them to be well known! In a nutshell, the foundation of Canadian monetary policy is our responsibility to provide a national money that Canadians can trust. A monetary policy directed at achieving and maintaining price stability does this, and it is also the most effective contribution that monetary policy can make to sustained good performance in an economy where markets and money play a crucial role.

In terms of my theme, what this foundation means is that while the Canadian dollar may indeed vary against other currencies, it does so within the framework of a monetary policy that has a clear and solid anchor in domestic financial values.

Admittedly, the purposes for monetary policy that I have just laid out do not in themselves say anything very specific, even from a monetary viewpoint alone, about how the exchange value of the Canadian dollar develops over time -- at least not until one takes into account what other countries are doing in regard to <u>their</u> monetary policies. In other words, it is <u>relative</u> monetary policies that matter.

Still, it is worth recalling that the extended decline in the Canadian dollar, from the mid-1970s to the mid-1980s, against the currencies of other major industrial countries was accompanied by a comparatively high rate of inflation in Canada. Now, it is increasingly recognized that Canada has been enjoying a comparatively low rate of inflation and, at least as important, has a monetary policy directed at reaching and keeping price stability.

Correspondingly, interest rates in Canada are now comparatively low. From the mid-1970s to mid-1980s they were generally high against those of our peers.

Indeed, through monetary policies that steadily build confidence in our money by preserving its domestic value, the Bank of Canada can undertake to seek, and in due course deliver, low interest rates in Canada. In that particular, though

strategic and anti-inflationary, sense our policy is a low interest rate policy. As I discuss in more detail later on, the Bank is of course always concerned in its operations about the exchange rate, confidence in the Canadian dollar, and the implications for demand and inflation. What the Bank does not, as a matter of logic, undertake to do on this same strategic basis is seek to deliver a particular external value for the currency.

The underlying monetary influences that I have just been describing interact with a range of exchange rate influences from the non-monetary side. So, in implementing monetary policy we have to be alive to these other influences and how they might affect demand, output and inflation.

For example, changes in Canada's international terms of trade -- the relative price of exports compared to imports -- have at times been a major factor influencing our currency, above and beyond what perceptions might be regarding monetary policy. The best recent example of this was the rise in the value of the Canadian dollar in 1987 and 1988, when our terms of trade improved markedly because of a sharp rise in the world prices of a range of industrial materials.

Such a "terms of trade" effect on the exchange rate is in principle neither surprising nor unwelcome. If exports become more valuable, it is appropriate that productive resources move into this area. A real appreciation of the currency facilitates the shift from non-export sectors.

As regards the other exchange-rate element that I mentioned, perceptions regarding Canadian monetary policy, it is worth bearing in mind that the rise in the external value of the Canadian dollar over the period 1987 to 1988 took place even though the prevailing differential of Canadian short-term interest rates over, say, corresponding U.S. rates was not very large. And, although the Bank had by then clearly spelled out the principles underlying monetary policy, the pace of monetary and credit expansion in Canada was at that time accelerating into double digits. Total spending in the Canadian economy was also climbing extremely rapidly, at close to double digits.

Despite this inflationary situation, the rise of the Canadian dollar in the late 1980s provoked much domestic criticism of Canadian monetary policy. In regard to the Bank of Canada's responsibilities, the criticism was in effect a recommendation that despite mounting inflationary pressures we should seek to spur further the pace of monetary expansion. In operational terms, we were being asked to add still more central bank liquidity in order to ward off the appreciation of the currency that was occurring and so seek to avoid the implied tightening of monetary conditions. Naturally, we did not oblige.

You may have noticed that in these latter comments I have already begun to shift the focus from underlying exchange rate influences such as trends in inflation and developments in the terms of trade towards considerations with a more operational slant. Let me continue in this vein, starting with exchange market intervention policy.

In the Canadian system the country's international exchange reserves are not held on the books of the central bank and, in regard to official intervention, the Bank of Canada formally acts as agent for the Minister of Finance.

Leaning against the wind more or less strongly is the rule. This longstanding intervention policy seeks to ensure that the Canadian dollar exchange market is orderly.

More broadly, intervention, however it is done, is in our view seen more as a tactical device than as something that will by itself have a lasting effect on exchange rate levels. In other words, any sustained impact comes from the anticipated (and actual) follow-through to intervention from monetary and/or fiscal policy.

The Bank, in going about its regular money market operations, is of course very aware how the exchange market is evolving. And given our responsibility for monetary policy, we are particularly interested in how the exchange market interacts with the domestic money market. The extremely close and continuous attention that we pay to developments in financial markets is motivated as much as anything by our need to maintain an up-to-date view of market expectations and how those expectations might impinge on our operations. Furthermore, there is a useful sense in which we can look at developments in both short-term interest rates and the exchange rate to gauge the overall direction and intensity of changes in monetary conditions. You may recall that I used the term "monetary conditions" -- the combined effect of short-term interest rate and exchange rate developments -- when referring to the Bank's stance in the context of terms of trade, demand and exchange rate developments in 1987-88.

Let me emphasize, however, that such an interest rate/exchange rate gauge is only a convenient way of keeping a tally of the possible impact on demand of developments in short-term financial markets in general. In particular, monetary conditions, as we use the term, do not for us <u>define</u> in any lasting sense monetary policy and its purposes any more than do interest rates by themselves or does the exchange rate by itself. Monetary policy is centrally about monetary expansion and the contribution monetary expansion can make to sustained good economic performance in Canada, and not about trying to achieve a particular combination of short-term interest rates and exchange rate.

My commentary up to now has taken for granted that in Canada we have a floating exchange rate regime. In the remainder of my remarks I will step back a bit from that presumption.

I hasten to add that it is not my purpose tonight to review the whole range of issues surrounding the matter of fixed versus flexible exchange rates. A book or a conference might begin to do justice to the many facets, but hardly a speech. However, a few comments from me are in order since the matter has major implications for monetary policy -- and vice versa.

My first comment is rather basic -- namely, that only with a floating exchange rate can one begin to talk about a domestic monetary policy. With a fixed exchange rate, what one might talk about instead, as for example has been done in Europe recently, is how individual central banks or countries could get any say in the monetary policy decisions at the hub that affect the pace of their national monetary expansion. This is not the same as a domestic monetary policy because the hub is not necessarily domestic.

The second point is that exchange rates can only be discussed in a serious way in regard to their monetary policy implications when indeed one considers them as _regimes_. By the term "exchange rate regime," I understand an exchange rate arrangement that can be expected to last indefinitely, certainly for a long time, because it has been chosen with ample recognition of its implications, in particular its tradeoffs as regards the kinds of national policies that might then be feasible -- or not feasible. This is for example the context within which discussion of the European Monetary System and Economic and Monetary Union takes place -- as it has to. Naturally, this kind of discussion, especially after Maastricht and the Danish reaction, brings into focus the important issues of political economy, as well as the purely technical matters, that are involved.

However, exchange rate commentary and criticism in Canada generally does not address the matter of exchange rate regime. This incompleteness makes the commentary difficult to evaluate. As I have already indicated, the particular bone of contention recently has seemed to be more the alleged inappropriateness of a monetary policy that allows the exchange rate to rise. Implicitly, then, the argument is that monetary policy should have been more expansionary -- or less anti-inflationary.

I have already noted that the Canadian macroeconomic facts of the late 1980s, when the Canadian dollar did experience a sizable appreciation, do not bear out this criticism of monetary policy. I pointed out that it was not only a time of substantial improvements in our international terms of trade but,

more broadly, a period of intense expansion of total spending in Canada and a clear increase in inflation pressures.

Still, this particular episode, while interesting and significant, is not the heart of the matter. The heart of the matter is the importance for Canada of keeping to a monetary policy that aims to ensure that Canadians have a trustworthy money as a basic contribution to a well functioning economy.

From the standpoint of monetary policy at least, a case might be made for a fixed exchange rate regime: if the centre to which one fixed enjoyed monetary stability; and if it were not possible, for whatever reason, to generate a trustworthy money through domestic monetary policy. Let me just note that Canada's monetary policy and inflation performance in recent years clearly belies the latter contention.

My final observation on exchange rates and monetary policy relates to international monetary coordination. It is that such coordination has to begin at home. What I mean by this is that without sound policies domestically, it is difficult to see how the international outcome can be sound. This has to be the basis on which international economic coordination is built. Without this basis, what we have is the grin on the Cheshire cat -- lots of grin and very little cat.

Sound policies are also essential for exchange rates to behave reasonably well. Exchange markets can indeed be volatile. At the same time, it is undeniable that exchange markets have had to cope with plenty of difficulties related to macroeconomic policies around the world. In particular, if markets have no clear sense about the resolve to resist inflation or the determination to maintain fiscal discipline, it is not surprising if those markets flare up from time to time.

I have covered a lot of territory this evening, but in concluding I will bring you back to where I started -- the Bank of Canada. In the preamble to the Bank of Canada Act, our governing legislation, one of the tasks that we are given is to "protect the external value of the national monetary unit." The thought I leave with you is that the best way for the central bank to do this, and, more fundamentally (again quoting from the preamble), "generally to promote the economic and financial welfare of Canada" is by aiming to protect our money's internal value. This is what we shall continue to do.