BANK OF CANADA

Monetary policy under a floating exchange rate regime: The Canadian experience

Lecture by
John W. Crow
Governor of the Bank of Canada

at the
Stockholm School of Economics
Stockholm, Sweden
22 April 1993

Lecture by John W. Crow
Governor of the Bank of Canada
at the Stockholm School of Economics
Stockholm, Sweden
April 22, 1993

Monetary Policy Under a Floating Exchange Rate Regime: The Canadian Experience

It is a distinct pleasure to have the chance to address you. The topic I have agreed to speak on is certainly close to the center of my professional interests. It is also of course one that will strike a chord in Sweden.

I will not dwell on the similarities between our countries except to note that we both are medium-sized economies near larger neighbours. We both, naturally enough, have large shares of our economies involved in international trade. Both of us are important producers and exporters of commodities, besides engaging in the range of other economic activities that qualify us as advanced industrial nations.

Where Canada has been different is in its typical exchange rate regime. We have had a floating exchange rate for most of the post-war period -- floating from 1950 until the exchange rate was fixed in 1962, and floating again from 1970 to the present.

In our earlier float we were virtually alone. At that time the Bretton Woods peg, albeit an adjustable peg, was very much the exchange-rate standard. However, it is worth recalling that by 1950 Canada had already gone a long way towards freeing its economic system from the wartime legacy of exchange and capital controls. Indeed, all such controls were abolished before the end of 1951. Perhaps we remained at that time an exception, floating, precisely because we had gotten out from under those controls much earlier than most other countries. Their turn to manage their economic affairs in the more bracing, but also more demanding, climate free of such restrictions generally came quite a few years later.

In the second float, in the early 1970s, we were soon followed by quite a few other countries. The Bretton Woods pegged rate regime was breaking down under the pressures of the further build-up of world inflation and the erosion of confidence in the U.S. dollar as the reserve currency. No doubt Canada was seen as evidence that there could indeed be a life after floating, but at no point did Canada profess to be an example for others. Still, we've now had a lot of experience with floating, and we continue to be very much in the business. That, at least, makes Canada's experience of some interest.

In thinking about the plan of these remarks, it was clear that the simplest way to proceed was to take the floating exchange rate as given. Then I could concentrate on discussing the issues faced in conducting monetary policy in this given environment. But while there is certainly plenty to discuss regarding the actual conduct of monetary policy, I think it is also important to set the scene with some broader considerations regarding both exchange rates and monetary policy. In particular, I want to bring out the nature of the issues concerning monetary policy that are posed when decisions are taken regarding the kind of exchange rate regime that is to be followed, even though these issues may not be fully apparent at the time.

Exchange rate regimes and monetary policy

An exchange rate regime is without doubt a serious matter. The word "regime" is a serious word -- implying as it does consistent rules of conduct applied over an extended period. Many considerations can and no doubt will enter into the choice of an exchange-rate regime. The issue, rightly, will be debated intensely in policymaking circles, and quite likely outside. At the same time, the decisions taken -- in particular the classic one whether to fix or whether to float -- are, given the nature of the exchange market, very often triggered by particular pressing circumstances, rather than by debates about appropriate regimes.

For example, in 1950 Canada abandoned its International Monetary Fund parity rate in the context of increased world inflation associated with the Korean War, and in particular strong upward pressure on our dollar stemming from the boom in commodity prices. The decision to float, as opposed to establishing a new IMF parity, was apparently in large part a reaction to not knowing at what higher exchange-rate level to repeg. This agnosticism continued for over a decade.

The decision in 1962 to reestablish a par value was not reached as a consequence of a general review of the merits of fixed versus floating exchange rates. Rather, it came on account of downward instability in the Canadian dollar.

As in 1950, the decision in 1970 to float was once again taken in the context of strong upward pressure on our currency. In this case the pressure came from both a major boost to our trade surplus and large additional capital inflows. As in 1950, the International Monetary Fund was informed that Canada was floating "for the time being." Whether this connoted a shift in regime, as opposed to a transition to another pegged rate to bring ourselves back into conformity with the then prevailing IMF articles of agreement, was left unclear at the time. In any event, I think we may safely say, over twenty years later, that there was indeed a shift in regime.

How does monetary policy relate to all this?

In addressing this question, I believe that it is helpful to bear in mind that views about monetary policy have evolved quite a bit over the postwar period. In the earlier part of the period the role to be played by monetary policy in the economy was for various reasons less central, less prominent than it is today. Indeed, issues of monetary stability, the importance of expectations, the economic damage from chronic inflation and so forth -- in short, the issues relating to how one provides confidence in the value of money in an economy based on the institution of money -- were not as well appreciated as they are now. They were, therefore, not given the importance we now know, having lived through the damaging consequences of chronic inflation, that such issues deserve.

Nonetheless, in the earlier Bretton Woods or fixed-rate period it was appreciated clearly that in the crunch the essential role of monetary policy was to do whatever was necessary to protect the established exchange rate. Monetary policy would do this through its management of domestic liquidity creation, and thereby of short-term interest rates. In contrast to this basic understanding, I think it is fair to say that on both occasions when the Canadian authorities decided to allow the exchange rate to float, there was genuine uncertainty as to exactly what role Canadian monetary policy should play in the new situation.

It is true that in both the early 1950s and the early 1970s it was recognized that in some general way the Canadian monetary authorities would have better control of the domestic financial situation -- in the conventional language of those times, of total liquidity in the Canadian financial system -- by allowing the dollar to float. However, it was perhaps less readily recognized that with a floating exchange rate the financial anchor of the system and, correspondingly, the ultimate responsibility of monetary policy, had shifted in a fundamental way. As I have already indicated, the problem of inflation and issues related to monetary control, indeed, to the monetary character of persistent inflation, did not have very wide recognition -- certainly not in 1950, and only partly so in 1970. So it would not be surprising if the breadth of the challenge presented to monetary policy by shifting to a floating exchange rate was not generally evident. Furthermore, the fact that in each case the float was initially billed as a temporary expedient, rather than as a break with the par value system, would itself have helped to obscure the nature of the shift for monetary policy that was taking place.

Even to the extent that it was recognized that something basic had changed in the monetary policy arena, it would not be surprising if there were some mixed feelings in central banking circles about the shift to a floating rate. At least with a fixed exchange rate that was embedded in the Bretton Woods system, there prevailed a measure of monetary stability and discipline that was internationally sanctioned, and that could be invoked in support of such monetary actions as exchange rate exigencies demanded. Such a measure of stability and discipline, such an anchor, did not exist in an obvious, transparent way with an exchange rate that was floating.

Experience showed that it had to be created. And in this light, since the early 1970s the development of monetary policy in Canada, and in other countries as well of course, has been very much guided by the need to find a way to promote monetary stability in a floating rate regime.

There are of course all kinds of good reasons, having to do with trust in money in an economy based on money, why such stability is important. But let me add a further reason that arises when the exchange rate is floating.

Besides allowing an approach to monetary control and monetary stability based on a monetary policy that is determined at the national level, a floating exchange rate regime does of course offer the very important further advantage of facilitating the adjustment to distinctive real shocks that hit the domestic economy from time to time. But it is also true that the advantages in absorbing shocks that a flexible exchange rate can provide are likely to be realized efficiently only if that exchange rate is anchored by a monetary policy directed at domestic price stability. This is because it is much easier to manage a floating exchange rate if the markets have a clear view that the authorities are committed to maintaining their money's value internally. If the nation's money is not anchored in this way, in my view the exchange rate is more likely to wobble and wander than it is to promote efficient adjustment to shocks.

My final comment before turning to Canadian monetary policy directly has to do with institutional matters.

It is evident that in Europe the issues surrounding the exchange rate regime go well beyond matters of fixed versus floating rates for individual countries. Currency issues have become connected to a broad range of European Community economic and noneconomic goals -- indeed, to the pace of evolution of the Community in its broadest, and deepest, sense. In Europe, the standard arguments from the economic literature in favour of a regime of fixed exchange rates -- particularly those concerning optimal currency areas -- have been widely used. But it is also true that fixed rates, because they are seen as leading to a common European currency and a jointly managed common monetary policy, have taken on a significance that goes beyond economics. In short, there is on the exchange-rate scene an important, perhaps crucial, element of a fundamentally political nature, linked to continent-building.

However, let me point out that there is no parallel among nations in North America. Canada has entered into a free trade agreement with the United States, and an extension of this agreement, the North American Free Trade Agreement that also includes Mexico, is pending. However, those agreements are indeed what they say they are -- free trade agreements -- and they have nothing to say about exchange rates, or about currency arrangements, or, for that matter, about monetary policy. Perfectly logically, these latter subjects were not on the table.

Now to our monetary policy.

Canadian monetary policy under floating exchange rates

Let me begin with some broad considerations about our monetary policy design.

As regards managing monetary policy under a floating exchange rate, I have already noted the crucial need to have a firm, well-understood anchor for policy.

For most of the early 1970s, the Bank's monetary policy research, as for quite a few other central banks, focussed on seeing whether such an anchor could be developed in terms of monetary aggregate targets. And from 1975 the Bank's monetary policy was focussed on a publicly announced intermediate monetary aggregate target, based on a narrow definition of money, M1. The idea was to direct monetary policy actions at progressively slowing the expansion of M1 to rates compatible with low inflation. However, by the early 1980s the M1 target had clearly broken down under the stresses of financial innovation. Even before it broke down, it had shown itself not to be a particularly useful guide to achieving a reduction in inflation. This was because the very high sensitivity of the demand for M1 to interest rate changes meant that a small increase in interest rates would keep M1 on target, but would not be sufficient to prevent demand pressures from developing that would cause inflation to rise. Therefore, in the early 1980s the Bank of Canada found itself back where it had been in the early 1970s. Perhaps, however, with one important difference. It had the experience of the damaging inflationary process of the 1970s and early 1980s, and a much fuller appreciation of the dangers of letting such a process get entrenched.

In the light of all this, the Bank's approach since the mid-1980s has been to make more explicit its central focus on working towards price stability as the appropriate underlying objective of monetary policy. In terms of a path for approaching price stability, we have not seen fit to reestablish any intermediate monetary aggregate targets. This is not because we have any objection in principle to such targets. Rather, we lack evidence that monetary aggregates will be sufficiently reliable in Canada to fill the demanding role of formal targets. We do, however, look at the monetary aggregates carefully as indicators of demand and inflation. We look at them along with all the other economic and financial indicators that any macroeconomist would probably advise us to look at in deciding what we should do in money markets, and how quickly we should do it.

But at the heart of our thinking about monetary policy is the need to make sure that whatever actions we take do pass the broad test of being conducive to an inflation performance that improves over time and, therefore, brings an improvement in confidence in money. This is the declared anchor for our policy.

In this regard, one recent innovation has been the introduction of inflation-reduction targets, agreed formally with the government. These targets were introduced in early 1991 and have served to underline the commitment of monetary policy to bringing down inflation and restoring price stability.

Let me now focus on how the exchange rate fits in with our approach. With price stability as the underlying objective of monetary policy, it is obvious that the exchange rate cannot also be a strategic target for policy. But in an open economy like Canada's, the exchange rate is nonetheless an important variable for demand and inflation.

The point I want to emphasize is that the fact the exchange rate floats by no means implies that those undertaking monetary policy should not pay attention to what is happening to it and, as they judge, react to it. Even if the exchange rate is, when all is said and done, a variable, it is too important a macroeconomic variable in the Canadian economic system and too closely affected by monetary actions to be ignored.

Let me illustrate how we take the exchange rate into account with reference to some recent Canadian financial developments.

From 1976 to 1986 the Canadian dollar had experienced a very large depreciation. But in the period from 1987 to 1991 it tended to appreciate. It moved from trough to peak by about 20 per cent against the U.S. dollar, and by somewhat less on the more appropriate basis of a trade-weighted average against all major currencies.

This tendency of our currency to appreciate was, as you might imagine, a contentious matter in Canada. It was contentious because by and large depreciation of our nation's currency has tended to be more popular than its appreciation. Depreciation is popularly seen as an economic fix, a ready route to higher profits and higher employment. The fact that, for depreciation to work in this way, domestic costs, in particular wages, must not rise along with domestic prices -- that is to say, that depreciation must hold back or reduce the real wage if it is indeed to create jobs -- is far less understood.

In any event, the crucial feature of this latter period from the viewpoint of monetary policy was that it was one of extremely strong spending demands in Canada. Essentially, monetary policy was directed at restraining those demands -- that is, advances in dollar spending in the region of double digits -- and the resulting inflationary pressures. In these circumstances, short-term interest rates went up, and the external value of the Canadian dollar also went up. What can be said about the Bank's actions in that period is that our commitment to resisting any rise in inflation and eventually bringing it down (in other words to providing a domestic financial anchor) meant that we should not, and did not, rule out appreciation of the Canadian dollar.

Let me give you some of the analytics behind this proposition.

In an open economy with a flexible exchange rate, monetary policy will transmit its effects to demand and inflation in the economy through both interest rate and exchange rate channels. In gauging the impact of its monetary policy actions on demand and inflation, the central bank must therefore keep an eye on both interest rates and the exchange rate. We use the term "monetary conditions" to characterize the transmission of that joint interest rate and exchange rate effect.

At the same time exchange markets, and money markets also, can move around significantly in response to shifts in perceptions and/or anticipations about monetary policy as well as in response to the actions themselves. For these kinds of reasons it is not possible to tell in advance the extent to which actions to shift monetary conditions will have their effects via the exchange rate or via interest rates. This means that the process of monetary policy implementation is of necessity an iterative one -- in important part learning from markets by doing.

In any case, when for example monetary conditions need to be tightened, any rise that does take place in the external value of the currency reinforces the impact on aggregate demand of interest-rate effects of monetary policy actions. Looked at another way, to the extent that the exchange rate takes part of the load, less needs to be done through interest rates. Furthermore, the effects of monetary policy are spread across the components of demand more evenly. This is the way the Bank assessed the appreciation of the Canadian dollar in the 1987-91 period in arriving at decisions about the domestic money market actions it needed to take. I can add that this continues to be the way we look at monetary actions and monetary conditions.

Let me also emphasize, however, that such an interest rate/exchange rate gauge is only a convenient way of keeping track of the possible impact on demand of developments in short-term financial markets in general. In particular, the term "monetary conditions," as we use it, does 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. What I mean by this is that the underlying purpose of Bank of Canada policy is not to achieve any particular short-term interest rate or exchange rate, either singly or in combination. Our fundamental interest is in seeing to it that our monetary policy actions, working as they do through money markets and other financial markets, contribute to sustained good economic performance in Canada by helping to maintain confidence in the future value of our money.

I should also point out that, while the exchange rate is one major transmission channel for monetary policy, and exchange rate movements need to be taken into account in arriving at decisions about central bank policy actions, it is important to avoid attributing all exchange rate movements to domestic monetary policy. Besides, obviously, the effects of monetary policy actions in other countries, there are many <u>non</u>monetary factors that affect the exchange rate.

For example, it appears that an important part of the rise in the Canadian dollar in the late 1980s was due to a major improvement in our terms of international trade. There were at the time positive market assessments of the Canadian dollar in the light of the boom in a whole range of the industrial materials that Canada exports. This boom itself resulted in a strong boost to aggregate demand in Canada. The point I wish to emphasize is that a rising exchange rate associated with improved terms of trade and a more buoyant economy should not be taken as a sign of increased monetary restraint in the economy in the same way as an appreciation that can be seen as a result of domestic monetary actions.

In the period since late 1991 there has been a substantial easing in the Canadian dollar's exchange value. In this period, with softness in commodity prices, our terms of trade were down from their earlier highs. However, I should also observe that over this latter period Canadian interest rates have come down a long way as well. Therefore, there has been an easing in monetary conditions that has been of a monetary nature. Inflation is way down from its cyclical peaks and the Canadian economy is picking up -- at a faster pace as time passes.

You will probably have gathered from these remarks that the Bank of Canada is comfortable with its policy approach. In particular, it feels able to integrate the floating exchange rate both into its broad policy design and into the way it implements its policy in financial markets.

This should hardly be taken to imply that our monetary policy course is bound to be smooth sailing. For one thing, and as I suggested earlier in these remarks, interest rates and/or exchange rates hardly ever move in mechanical fashion in response to central bank actions. The market has a major role to play as it constantly reassesses prospects. Furthermore, difficult passages will occur, as they can under a fixed rate regime, on account of shocks to financial markets -- or more precisely, shocks to the expectations of savers and investors. And in a floating exchange rate regime the containment of, and adjustment to, such shocks can be complicated by the dynamics of interacting money markets and exchange markets. This is especially the case if extrapolative expectations begin to take hold. Still, the Canadian dollar exchange rate, as a variable, is in general sufficiently well behaved to enable us to get, over a reasonable timespan, the kinds of monetary conditions appropriate to our broad monetary policy objectives.

The two elements that I believe are crucial in getting this approach to work -- in particular in getting the exchange rate to behave sufficiently well -- are: firstly, and most fundamentally, the fact that our monetary policy is grounded in domestic price stability and perceived generally to be so; and secondly, at the tactical level, that the Bank of Canada is prepared to see offsetting movements between the exchange rate on the one hand and short-term interest rates on the other.

An instance of this latter point is our experience in the autumn of 1992. We were able to cope with a period of extreme exchange market tension because there was a rise in short-term interest rates at the same time that the exchange rate went down. The effect in terms of overall monetary conditions was roughly offsetting. In other words, some of the strain was taken in both markets, with effects on demand that were, in their direction, of a compensatory nature.

An implication of the Bank's approach is that there needs to be flexibility in short-term market interest rates. Accordingly, I believe that it is helpful to have a central bank discount rate that is floating, rather than one that is fixed. This discount rate, in our terminology the Bank rate, floats in correspondence with the average yield at the weekly market tender for three-month treasury bills. Therefore, it can demonstrate quite promptly that the Bank of Canada is prepared to have interest rates take some of the market strain that might otherwise fall entirely on the exchange rate. This contributes to market, and demand, stabilization.

In this context, I will also note that the Canadian dollar can, and does, move in both directions. Therefore, it does not set itself up for the kind of overwhelmingly one-way speculative bet that can shake fixed exchange rates.

Finally, before I conclude, a word on exchange market intervention.

Yes, we do engage in exchange market intervention, even though we have a floating exchange rate. Formally, the Bank of Canada acts as agent for the Minister of Finance in carrying out such intervention, since the country's international reserves are not held on the books of the central bank. More substantively, the longstanding intervention policy of Canada is one of leaning less or more strongly against the wind, as a smoothing device, or as a way of signalling follow-up action through domestic policy. The bottom line is that we do not count on intervention itself to turn exchange rates around.

* * * * * *

Three concluding comments.

My first is in regard to monetary policy operations. In operating day to day, week to week, under a floating exchange rate, our experience is that we need to pay close attention to the way the exchange market interacts with other financial markets, especially the money market, and to how monetary conditions overall are developing.

My second comment is that a good operational sense is not enough. What is really fundamental to the conduct of monetary policy under a floating exchange rate is to have a firm anchor for that policy. The anchor of our monetary policy is preserving confidence in money's domestic purchasing value. In other words, the broad obligation on monetary policy to provide a national money that can be trusted is only intensified under a floating exchange rate regime.

My final observation is on a more international plane.

For harmonious financial and economic relationships among nations in an environment where their currencies float, I doubt if one can make a better monetary contribution from the national side than through monetary policies anchored in price stability. Other policies, notably sound fiscal policies, help as well. But domestic monetary stability still represents a monetary input of the most fundamental kind into broad exchange rate stability. For once, it puts the economic policy horse before the exchange rate cart. Furthermore, such a monetary input, if widely followed, would be important proof against the "beggar-thy-neighbour" concerns about floating exchange rates that got so much attention in the 1930s, and to which the establishment of the Bretton Woods system was in part a reaction.