EXPERIENCE WITH FLOATING RATES OF EXCHANGE

Remarks prepared for
XI Meeting of the Governors of the Central Banks
of the American Continent
Caracas, Venezuela, April 29-30, 1974
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For more than a year now the currencies of most of the major countries have been floating. Although a year is not a long time in economic affairs it is, I believe, possible to pass some initial and tentative judgments on this experience. Canada has, of course, had a considerably longer history of living with a floating exchange rate and I will also comment on this experience.

I imagine that if a few years ago one had asked a representative group of financial officials to give their views on the consequences of a move to floating exchange rates by the major countries the replies would have reflected a good deal of distress and alarm. Although many economists working outside government circles would perhaps have welcomed the prospect, few officials would have come at all close to sharing a sanguine view. What worries would have been uppermost in their minds?

They would, first of all, have feared that the absence of declared parities between major currencies would lead to great uncertainty for international traders as to the prices on which they should plan their business. Some would have feared that these uncertainties would seriously

disrupt the international flows of trade and capital with harmful consequences for the growth of the world economy.

The belief that prospective movements in floating exchange rates would be large and highly unpredictable reflected in considerable part a view that the rates would be pushed around, sometimes quite violently, by capital movements. The concern here was primarily about the possibility of speculative or other abnormal capital flows, especially between industrialized countries, large enough to push their exchange rates to levels that would be wrong in relation to their "underlying" external positions.

A second type of concern related to the notion of discipline and order in economic affairs - discipline and order both with respect to international relationships and with respect to the management by individual countries of their internal economic affairs. In international economic affairs the obligation to defend declared parities against all but 'fundamental' pressures and the requirement that parity changes be sanctioned by the international economic community were seen as essential to a co-operative world economic order. It was sometimes thought that a decision to abandon these obligations, even temporarily, indicated that the country in question had become less committed to responsible international behavior. On that view of the matter, the prospect that a number of the major countries would have floating exchange rates at the same time would be deeply worrying.

So far as domestic policies are concerned, the worry about floating rates sprang from the view that the abandonment of declared parities would remove a strong element of support for sound policies. In the absence of an obligation to defend parities, governments and central banks might feel less need to keep their domestic situation under control. The consequence of a weakening of external discipline would be a reinforcement of inflationary pressures.

The circumstances that led up to the abandonment of parities by major countries a year ago and developments since then enable us to put these concerns in some perspective. It has not, of course, been a tranquil time in exchange markets. Early in 1973, just after the Swiss franc had been floated against the U.S. dollar, the dollar itself was effectively floated as the defence of parities for the lira, the yen and the European currencies that joined in a common float were abandoned. In due course about a dozen other currencies were floated. The major currencies moved quickly apart in two groups, with the yen, the Swiss franc and the snake currencies appreciating sharply relative to the U.S. dollar, the pound sterling and the lira. (The behavior of the Canadian dollar is discussed later.) By mid-July the U.S. dollar had depreciated by about 15 per cent in terms of the weighted average of its exchange rate against other major currencies. Subsequently there was some reversal in the rates which was reinforced in the unsettled markets

resulting from decisions taken by major oil exporting countries with respect to the price and supply of petroleum. The yen and most European currencies weakened against the U.S. dollar, but since mid-January of this year they have mainly tended to strengthen again. In the meantime, the great majority of currencies of developing countries, and a few of those of more industrialized countries, were maintained in fixed relationships to the U.S. dollar and moved with it, though the rates in question were changed in a number of instances.

All in all it has been an exciting time for exchange traders. The extent of exchange rate changes has not, however, been a consequence of the fact that currencies were floating. Initially the changes in rate relationships largely reflected the response of markets to the persisting serious imbalance in the payments positions of major countries. Subsequently, the pressures in exchange markets and resulting changes in the structure of rates have reflected further dramatic changes in the current and prospective payments positions of major countries against a background of inflation and varying efforts to deal with it. In these circumstances no particular structure of exchange rates could have survived.

What can one say on the basis of these developments about the fears of widespread floating to which I referred a moment ago?

First of all, the period has hardly been one in which world trade has faltered. Last December, the OECD published preliminary estimates indicating that the total volume of world trade had risen by no less than 14 per cent in 1973, or more than in any other postwar year, and that trade between the industrialized and developing countries had grown just about as strongly as that amongst the industrialized countries. These estimates are subject to revision, but even so there would seem to be little if any evidence to suggest that the extraordinary boom in world trade that began in 1968 has been at all dampened so far by the floating of major currencies. One would not have expected any inhibiting effect of exchange rate uncertainty on world trade to develop at once, particularly when output and trade were surging ahead with the full momentum of boom conditions in so many countries. Nonetheless it is worth noting that the floating of major currencies and the volatility of many exchange rates have apparently not caused the major problems for traders that some observers feared.

A second observation is that by and large exchange rates have moved in appropriate directions. The initial movements facilitated a trend towards better balance in the external positions of major trading countries and therefore diminished the risk of actions that would have inhibited trade. Other factors contributed to the redressing of major imbalances - particularly in the external position of the United States

and Japan - but the exchange rate changes were certainly in the right direction to sustain this improvement. It is still too early to assess the implications of all the changes in the petroleum situation. However one can observe that at least the initial impact of this major shock to the world economic system has so far been absorbed remarkably well by exchange markets. Exchange markets have, of course, been nervous and volatile but they have not been chaotic.

Thus throughout the period since March of last year the structure of exchange rates seems to have altered in a manner helpful to the correction of existing imbalances in payments positions and to have survived the initial shock of petroleum developments extremely well. While individual currencies have been affected from time to time by the pressure of capital flows, I do not see evidence that the general relationships between major floating currencies have been significantly distorted by waves of speculation.

The second broad area of concern about the floating of exchange rates related to the role of declared parities in a co-operative world economic order and to the 'discipline' on domestic financial policies traditionally attributed to the obligation to defend par values. Have the decisions to float been symptomatic of attempts to escape from responsibility in either of these senses? I would say that to a very considerable extent the opposite has been true.

So far as international co-operation is concerned I detect no weakening of the conviction that countries must work together in the solution of common monetary and payments problems, and must do so within an agreed framework of consultation. With all the differing views on details of monetary reform, there is no difference of view on that fundamental point. New forms and procedures must evolve to assist countries to take full account of their international responsibilities. The will is there and, that being the case, the forms and procedures will be developed.

With regard to the management of domestic policies I would also dispute any suggestion that the decisions to float reflected a desire to escape from a sound 'discipline'. In a number of countries, Canada among them, the reverse situation arose. That is to say a situation was reached in these cases where continued defence of the currency against upward pressure would have required excessively expansionary monetary policies. Countries in these circumstances were not seeking to escape from external discipline on their domestic financial policies. In the case of the major country whose currency has declined in relative value since last spring, the United States, this has not been associated with a relaxation of domestic financial policies. Nor has it reflected an attempt to achieve an excessive depreciation for competitive reasons.

In fact it was the way that the Bretton Woods system itself had been operated that had come to stand in the way of constructive international co-operation and of reasonable control over their domestic monetary situations in many countries. We had reached a situation of imbalance in international payments and of world-wide inflation such that the intended advantages of the old system became serious disadvantages. It seemed clear that the return to better international balance without resort to measures that would inhibit trade, and the return to a less inflationary environment, could be assisted by a period of floating exchange rates.

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I would like now to make some comments on Canadian experience with a floating exchange rate. The Canadian dollar had, of course, been floating for almost three years when the decisions to adopt the same solution to their exchange market problems were taken by other countries last year. Nor was this a new experience for us. The Canadian dollar was floating for extended periods before the Second World War, and again for twelve years between 1950 and 1962. For good or ill we have had a long exposure to floating rates.

In early 1970, upward pressure on our dollar arising in part from uncertainty about the external position of the United States was sharply reinforced by a major upswing in our trade balance. It seemed clear

that an attempt to continue defence of the existing parity would have required an easing of financial policies well beyond what was seen as appropriate to the domestic situation. Thus an increase in the exchange value of the Canadian dollar was called for. Canada was, of course, urged at the time and thereafter to pick a new higher parity, but we felt unable to do so. The change in our external trade position had been so abrupt, and the prospects for our balance of payments as well as for the international system looked so uncertain, that we were not able to pick a new rate with any reasonable confidence that it could be defended in the context of policies suited to our domestic economic circumstances. It would not have been helpful to Canada or to the international community if we had before long been knocked off a new parity. So we decided to float, not out of doctrinaire attachment to floating rates but because we could see no responsible alternative. This was the position in which many other countries found themselves last year.

It was anticipated that the Canadian dollar would initially float upward, and it did so. Although we do not of course view the adoption of a floating rate as a means of achieving a particular movement in the exchange rate, one cannot simply disregard so important a price as the exchange rate, and that is as true of a floating rate as of one that is fixed. The course of the exchange rate will be influenced by all of the factors bearing on a country's external position. These include the settings of domestic economic policies, and decisions about domestic

policies must necessarily take account of their implications for the exchange rate.

It will be useful, I think, to digress for a moment in order to describe the way in which the Canadian exchange market works. We have in Canada a well developed private market in which the Canadian dollar trades principally against the U.S. dollar. The bulk of foreign exchange requirements is handled by the commercial banks. The banking system is dominated by a few very large institutions that operate branches throughout the country. The banks funnel transactions from their branches to central foreign exchange departments so that purchases of foreign exchange are in large part matched against sales within each bank.

Canadian banks have traditionally avoided any sizeable exposure to exchange risk, although they may have sizeable offsetting spot and forward positions. As net positions arise in individual banks in the course of handling customers' business, the banks seek to eliminate them by trading with each other. This interbank market is the core of the domestic exchange market. Banks deal with each other exclusively through salaried brokers. Given the relatively small number of banks in Canada - there are only ten and five of them account for a very high proportion of the business - the brokerage system provides for a highly efficient internal exchange market. In periods of uncertainty the absence

of a brokerage commission may tend to increase the responsiveness of the exchange rate as banks instantly cover every transaction as it arises, but the low transaction cost also works to encourage continuous participation in the market in a way that normally tends to smooth the movement in the rate. The market trades both spot and forward exchange, and the existence of a good forward market undoubtedly contributes to the smooth operation of the spot market.

Through the operation of this broad and efficient market in foreign exchange, the exchange value of the Canadian dollar is a price determined essentially in a private market. This fact is relevant to the possibility of having a truly floating exchange rate and influences the manner in which it operates in practice. With due account taken of institutional differences I imagine that broadly the same situation prevails in many other countries, including those that have floated their exchange rates. In many other countries, however, private exchange markets of that character do not exist and private purchases and sales of foreign exchange through banks tend to be settled directly with the official account.

Because Canadian banks deal with one another only through the broker, it is possible for the amount and price of each transaction in the interbank market to be reported quickly to all participants in the market - including the Bank of Canada. This detailed reporting facilitates official intervention as it enables the authorities to assess any rate

movement against the precise volume of activity in the market. In Canada official intervention is carried out by the Bank of Canada on behalf of the Minister of Finance through purchases from the interbank market and sales into that market of U. S. dollars from the Minister's Exchange Fund Account.

Under the floating regime in Canada official intervention is directed to the maintenance of orderly conditions in the exchange market. This involves intervention to ensure that a reasonable volume of business is done at one rate before the market moves to a significantly higher or lower rate, and in general to moderate the extent of the total change taking place within any one day or from day to day. At times of particular turbulence in exchange markets official purchases or sales may be undertaken with a view to steadying the rate. The official intervention needed to achieve these objectives has been quite small in relation to the total foreign exchange business being transacted.

Let me now complete the account of what has happened in the exchange market for the Canadian dollar since May 1970. The strong upward pressure that had developed over the early months of that year and that led to the decision to float pushed the rate up sharply as soon as the parity limits were abandoned. Within a few weeks, however, the market settled down and the appreciation of the Canadian dollar over the first month, though rapid, was also comparatively steady.

By the end of June 1970, the rate had risen more than 3 1/2 per cent. It reached 98 U.S. cents by the end of September, 5 per cent above the mid-May level, and remained close to that level for the remainder of that year.

For the whole of 1971, in spite of the unsettled conditions in all world markets that were associated with the U.S. measures in August and the uncertainties which led to the Smithsonian Agreement in December, the Canadian dollar remained quite close to the 99 cent level.

Most major exchange markets experienced occasional periods of intense pressure in 1972, the year that followed the Smithsonian realignment. The Canadian market was not totally immune from these, but the movements in the Canadian exchange rate which resulted were of comparatively brief duration and limited extent. More important were somewhat longer-run and largely autonomous movements in the value of the Canadian dollar in terms of U.S. dollars. There was a pronounced strengthening beginning in March 1972 and gathering force in late April, which carried the rate up to a peak of 102 1/2 U.S. cents in mid-June. Heavy inflows of both long and short-term capital were the principal cause. After weakening by about a cent in the following weeks, and then showing very little change for several months, the value of the Canadian dollar started to decline significantly from late October onwards.

It was in 1973, however, that the Canadian dollar was put to its most severe test since the float began. During that very difficult year in international currency markets the value of the Canadian dollar did not vary greatly in terms of U.S. dollars: the rate moved almost entirely within a range of 99 to 101 U.S. cents. In common with the U.S. dollar, therefore, the Canadian dollar moved quite widely against the currencies of Canada's other major trading partners. In terms of its weighted value against the currencies of all our major trading partners, the Canadian dollar fluctuated in a range of about 3 per cent. At the end of the year this weighted value of the Canadian dollar was about 6 per cent above its value in May 1970, compared to an appreciation of 8 1/2 per cent in terms of the U.S. dollar alone.

The early weeks of the present year have seen upward pressure on the Canadian dollar exchange rate once again. The rate against the U.S. dollar has risen by about 3 1/2 per cent from its year-end level of 100.4 U.S. cents. Although sales of foreign exchange have been required on occasion during this period there has been a fairly substantial net accumulation of reserves.

While the floating Canadian dollar has understandably moved fairly substantially during the past four years, its behavior has not been disruptive either to the Canadian economy or to others. Our international trade has grown strongly. From time to time there has been concern

about the level of the exchange rate, particularly in important exporting industries, but there has been virtually no suggestion that the fact that it was floating was inhibiting our international commerce. An important reason for the demonstrated ability of Canadian businesses to operate happily with the floating exchange rate is that the existence of a good forward exchange market enables them to cover exchange risk on future commitments for at least a year ahead.

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I have had no intention in these remarks of preaching the merits of floating exchange rates for all countries at all times. One cannot generalize for other countries from Canada's particular circumstances and experience. Nor should one be too ready to draw conclusions from one brief year of world experience with floating rates, particularly when that year has been one of unusual strength in demand, output and trade. The story might have been different if many countries had been faced with the opposite problems of faltering demand and unemployment.

Nevertheless, one should not exaggerate the significance of mechanical differences between fixed and floating exchange rate regimes, or imply that the two "systems" involve fundamentally different principles, problems, drawbacks and benefits. The good functioning of the international monetary system requires that each country's exchange

rate should be reasonably stable at a level that is consistent with fundamental equilibrium and a structure of the country's balance of payments that is acceptable to itself and to others. What matters most to the international community is whether the level of a country's exchange rate is or is not appropriate in that sense, not whether it is fixed or floating. The nature of international interest in and surveillance of a particular country's exchange rate practices should thus be essentially similar whether a country's exchange rate is fixed or floating, and should be directed towards ensuring the least possible disruptive impact on other countries.