A statement by
Gerald K. Bouey
Governor of the Bank of Canada
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I understand, Mr. Chairman, that you have asked me to come here today mainly to respond to questions that the Committee may have about recent developments in the exchange market. It might be helpful if I were to make a brief introductory statement and I am prepared to do so if that is the wish of the Committee.

Members of the Committee will appreciate that the policy governing the operations of the Exchange Fund Account is a responsibility of the Government, while the Bank of Canada, as fiscal agent for the Government, carries out the actual operations. This naturally puts us in a position to act as an adviser in this area. I would like to tell you how I look at two matters that I think will be of interest to you: first, the nature of the recent problem in the exchange market and, second, the kind of exchange rate system that we have in this country.

I want to begin by saying a few words about our underlying balance of payments position. Our competitive position in international trade has improved considerably as a result of some important adjustments in the economy over the last three years. Our performance so far as costs are concerned has improved as rates of increase in money incomes have come back down to about the U.S. level, the expenditures of governments have been coming under much better control, the money supply is certainly under control, and we have had a very large exchange rate adjustment, one that, provided we contain the fall-out from it on costs and prices, produces a sutstantial improvement in our competitive position. Our merchandise trade balance has already improved considerably. Despite the continuing increase in our non-merchandise deficit, it is not unreasonable to expect our over-all current account deficit to decline from last year's level. On the capital account side, foreign borrowings by provinces and others are resuming on a substantial scale after a brief quiet period earlier this year.

This is not a picture of a country faced with a major balance of payments problem. On the contrary, the underlying balance of payments situation has been and is improving for the reasons I have just mentioned. But there have been problems. The lull in foreign borrowing a few months ago occurred at the time when the current account was weak for seasonal reasons and when the widespread weakness of the U.S. dollar may have been affecting attitudes toward our own currency. After a while the cumulative movement in the Canadian dollar itself became the most important aspect of the problem as it began to generate real concern about the immediate future value of the currency. Evidence for this could be seen in a number of developments, including a rapid build-up of foreign currency deposits of

Canadian residents who were switching out of Canadian dollars and in the circulation of completely unfounded rumours of exchange controls.

How should a problem of this kind, basically a problem of confidence, be dealt with? Not I believe by standing completely aside and letting the Canadian dollar fall as far as it might on the basis of market forces that had become heavily influenced by concern, or fears, about the immediate future of the currency. Although a floating exchange rate system has many advantages, and is indeed the only practicable system in today's world, it is asking a lot of the exchange market to move the rate a very long way without overshooting because of a developing problem of confidence. The trouble with standing aside was that the greater the fall in the exchange rate the greater the impact on our prices and costs, and thus the greater the danger that the progress we have made over the past three years would be undermined. We do not want to see a situation where exchange rate depreciation produces more inflation which, in turn, results in further depreciation -- a vicious circle.

At the same time, as I have already indicated, it was clear that Canada was far from having a balance of payments problem that required drastic measures of the kind traditionally relied on where the problem arises from excessive demand pressures overloading the Canadian economy. Nor were we obliged to take severe measures to defend an exchange rate pegged at some particular level.

The way to deal with the problem of confidence in the exchange market, while being as protective of domestic activity as possible, was to provide assurance that there would be a continuing inflow of capital to Canada adequate to finance our current account deficit since that deficit clearly could not be eliminated overnight. One way of achieving this objective was for the Government of Canada to take on, to the extent necessary, part of the job of raising capital abroad and to make arrangements that would leave no doubt about its ability to do so. That has been the purpose of its borrowings abroad and the establishment of its large standby credit arrangements. Another way was for the Bank of Canada to act to move short-term interest rates somewhat higher relative to rates abroad.

The increases in the Bank Rate in March and April were undertaken with a degree of reluctance because neither the present state of the domestic economy nor the recent pace of monetary expansion would, in the normal course of events, have seemed to call for any marked upward adjustment of short-term interest rates in Canada. However, the trade-off that was involved -- the avoidance of undue exchange rate depreciation with its inflationary consequences against somewhat higher short-term interest rates than would otherwise have prevailed for a time at least -- was, I believe, clearly worthwhile.

What has been accomplished has been the re-establishment of confidence that the bottom will not be allowed to fall out of the dollar, and the floating exchange rate system has been preserved, with that system operating within a framework that has been modified at least for the time being by foreign borrowing by the Government.

I would like now to say a few words about how the exchange rate system operates. The first point I want to make is that no exchange rate system operates in a policy vacuum. Any exchange rate system operates within a framework of economic policies, including monetary and fiscal policies, and policies regarding the amount of foreign exchange reserves that are held and the extent of ready access to additional reserves. All of these factors have a bearing on the performance of the exchange rate regardless of the particular system.

The spectrum of possible foreign exchange regimes is a broad one but in general language "fixed" means a declared rate with small margins around it (the declared rate may be changed from time to time in discrete steps) and everything else is "floating". "Floating" does not mean that the authorities are barred from having an influence on the level of the exchange rate but normally their influence is exerted mainly by affecting the economic environment within which the market operates.

Possible "floating" exchange rate regimes can, in principle, range all the way from a position in which the rate floats freely without any official buying and selling of foreign exchange in the market to one where the degree of direct intervention can be so great as to prevent, on occasion and for a time, virtually any movement in the rate. What one sees around the world are countries at different points in this spectrum at different times.

As a general principle it can be said that if the mix of monetary and fiscal policies, and other economic policies, is appropriate for the domestic economy, taking into account the objective of encouraging economic expansion while keeping inflation under control, the exchange rate that is thrown up by market forces operating within this environment should tend to settle down in an appropriate range. Changes in economic conditions, both here and abroad, and in the policy framework may well give rise, and often should give rise, to a change in the exchange rate. So long as the exchange rate is being determined within the over-all policy framework by normal market forces, any direct intervention in the exchange market by the authorities is likely to be designed only to smooth out short-term fluctuations but not to alter the underlying trend.

The scale and technique of intervention are always matters of judgment but in general the more volatile the rate, the larger the intervention. In most circumstances it is possible to conduct intervention with agnosticism about the rate. Various strategies are possible. One is that intervention may be carried out on a relatively moderate scale, and in a way that is symmetrical in the sense that the same degree of resistance is offered to movements that represent a weakening in the rate as to those that represent a strengthening. The result is that foreign exchange reserves decline when the exchange rate is weakening, rise when it is strengthening, and show little net change if the exchange rate returns to its starting point. This has in fact been the strategy for most of the two periods since the war that Canada has been on a floating rate system -- 1950 to 1962 and again since 1970 -- and I believe it has worked well.

It does not follow that this strategy will work satisfactorily in exceptional circumstances. As I have said, experience here and in other countries indicates that a substantial movement in an exchange rate over a relatively short period tends itself to produce excessive expectations about the future of the rate, and can give rise to an unusual amount of speculative activity as well. In such circumstances the exchange market looks increasingly to the authorities to give some indication of the limit to the movement. Indeed, the market appears to expect that at some point the authorities will take action of the kind traditionally used to defend a fixed rate. A rather curious situation can develop in which the authorities continue to look to the market to determine the rate while the market insists on probing further and further to find out how far the rate will be allowed to move before the authorities step in. A stage can thus be reached where the authorities have little choice but to become more heavily involved.

If the exchange rate is judged to be moving too far too fast the authorities have certain options as to how to react. The environment in which the market operates can be influenced by changing the policy framework; for example, an adjustment to short-term interest rates can be brought about. Another possibility is to change the scale and pattern of official intervention in the market in order to provide resistance that becomes stronger the further movements in the exchange rate go. If this is done in a period in which the exchange rate is weakening, reductions in the level of reserves will become greater relative to any given decline in the rate; the rate continues to float but it encounters increasing resistance as it floats down.

A reduction in the level of foreign exchange reserves can be described as a way of supplementing the inflow of capital into Canada because the Government is supplying foreign currency to the market in exchange for Canadian dollars. The Government can use its existing currency reserves for this purpose and it can also acquire additional reserves by borrowing abroad.

Unless the Exchange Fund Account "digs in" at a specific point to halt any further movement in the rate, and it has not done so, the views of the market continue to play an important role in the determination of the rate for the rate continues to be free to move over time. The ability and willingness of the authorities to be more active in the market, and to put foreign currency resources into the market, naturally influences the market's view of what exchange rate will balance the market. Once a reasonable degree of confidence that extreme cumulative movements in the exchange rate will not occur has been firmly re-established, it may well be that the need for large scale intervention will disappear and the exchange market will operate more in the way to which we have been accustomed.