Statement prepared for the appearance of

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Governor of the Bank of Canada

before the

House of Commons Standing Committee

on Finance, Trade and Economic Affairs

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Monetary Policy and the Exchange Rate

The basic view on which the Bank of Canada has been operating is that any lasting improvement in the functioning of the domestic economy and in Canada's external financial position will require much greater stability in the value of money -- that is, much lower rates of inflation -- than Canada has experienced in recent years.

In order to help gear down inflation in Canada the Bank has for some time now been gradually moderating the trend rate of monetary expansion. Within this medium-term policy framework, the actions taken by the Bank of Canada during the course of the last twelve months gave special weight to the concern it felt about the potential inflationary impact of the movement of the foreign exchange value of the Canadian dollar. In acting as it did, the Bank was prepared to run the risk that its Bank Rate increases might cause the rate of monetary growth to fall somewhat below its current target range for a while -- though not so far below, nor for so long a time, as to prejudice seriously either its medium-term objectives for monetary expansion or Canada's prospects for continuing economic growth. This risk has not yet materialized, although it still remains a possibility. In terms of the main indicator of money supply growth that the Bank uses -- currency and demand deposits, or M1 -- monetary expansion in Canada, after a temporary bulge late last year, is now running well within our current target range of 6 to 10 per cent a year measured from a June 1978 base.

The reason for concern about the speed and magnitude of the exchange rate movement is the degree of upward pressure it is putting on Canadian costs and prices. A substantial decline in the value of the Canadian dollar relative to the United States dollar had become inevitable because of the higher rate of price and cost inflation in Canada than in the United States earlier in the 1970's. In the circumstances a considerable exchange rate adjustment was both necessary and desirable to help restore Canada's international competitive position. The substantial depreciation of the Canadian dollar that has now occurred, together with an improved performance to date in controlling our domestic costs, has re-established Canada's competitive position at least for the time being.

It must be a major objective to safeguard our newly-won competitive position. I need hardly point out how much there is to be gained by being strongly competitive: more exports, more import replacement, a lower current account deficit, less dependence on foreign capital, more output, more jobs, even higher government revenues and lower government deficits than we would otherwise have. I cannot think of a more attractive way to move our economy forward. However, if we are to reap the benefits from the maintenance of this competitive position we have to be careful about putting further upward pressure on Canadian costs and prices at this time. Our costs and prices are already under unusual pressure from food prices, from catch-up attempts following the termination of AIB controls and from the exchange depreciation that has already occurred. We must not allow this pressure to become intolerable and thereby set off a renewed acceleration of inflation with leap-frogging price increases and wage settlements. We must not follow the example of countries that have fallen into a vicious circle of inflation, then depreciation, then more inflation and so on. It is to avoid this danger and to keep the rate of price and cost inflation declining in Canada that the Bank of Canada has been concerned about the exchange rate.

Many factors go into the determination of the exchange rate, one of which is the level of interest rates in Canada relative to interest rates in the United States. When Canada has, as it now has, a large deficit in its international trade in goods and services, and when therefore foreign capital must flow into Canada to finance that deficit, it is very important to maintain a level of interest rates in Canada high enough to attract funds from foreign sources and high enough to encourage Canadians to keep money here. Otherwise the impact of the interest rate differential on capital flows puts downward pressure on the exchange rate.

During 1978 interest rates in the United States rose rapidly. If interest rates in Canada had risen less rapidly, interest rate incentives would have emerged that added to the downward pressure on the Canadian exchange rate. That is the state of affairs that the Bank of Canada has wanted to avoid. At the same time, because of our concern for the disadvantages in other respects of rising interest rates in Canada at this time, the Bank of Canada has not gone beyond preventing the interest rate situation from becoming a strong independent source of downward pressure on the exchange rate. In the event, for many months now the increase in interest rates in Canada has barely kept pace with that in the United States. When assessed in that perspective our interest rate actions have been moderate, and not in any sense extreme. Had we not taken those initiatives the exchange rate would unquestionably have fallen faster and further than it has. Under present conditions anyone who advocates lower interest rates in Canada is, whether he realizes it or not, advocating that the Canadian dollar should be still weaker. Conversely, anyone who feels that the objective of monetary policy should have been to halt or reverse the decline in the exchange rate before it had gone nearly so far as it has is advocating that we should have pushed up interest rates a good deal further and faster.

Another way of influencing the movement of a floating exchange rate is for the authorities to intervene in the country's foreign exchange market. The usual way this is done is for the authorities to respond to movements in the rate, satisfying in part any excess demand for the national currency by selling it in return for foreign exchange, or satisfying in part any excess demand for foreign exchange by selling it in return for the national currency. Such intervention moderates the movement of the exchange rate from hour to hour, and if the movement of the rate in either direction continues, such intervention will cumulate as it moderates the speed of the movement. The degree to which exchange rate changes are moderated by such intervention varies with the scale of the intervention.

Exchange market intervention of this kind has been carried out in Canada during all of the time that Canada has had a floating exchange rate. The intervention is carried out by the Bank of Canada as agent for the Minister of Finance, in whose name Canada's official international reserves are held. When on occasion during the last year it has become desirable to replenish Canada's international reserves, that has been done by the Government of Canada borrowing foreign exchange through various channels.

I believe that the intervention policy followed has been reasonable in the circumstances. I am certain that it has resulted in an appreciably less steep decline in the exchange value of the Canadian dollar than would have occurred over the last couple of years had there been no intervention. I am well aware that the announcement on occasion of the use of a rather large quantity of reserves in satisfying the demand for foreign currency can have adverse psychological effects that tend to offset some of the benefit gained. It would be a mistake, however, to suppose that the effect on expectations of a "hands off" policy would not be more serious, since such a policy would create the impression that the authorities do not care about the exchange rate and this in turn would arouse widespread fear and concern. My judgment is that on balance intervention has had a worthwhile stabilizing effect on the exchange market. I might add that a similar view is shared by the authorities of other nations as a result of their experiences in recent years. The same basic principle of using monetary policy and intervention policy together to moderate exchange rate movements is employed, for example by Germany, Switzerland, Japan and the United States, as well as other countries. The first three countries have intervened very heavily to resist too rapid an appreciation of their currencies. In 1977 and 1978, Germany accumulated $U.S. 19 billion in reserves, Switzerland $U.S. 8 1/2 billion and Japan almost $U.S. 17 billion in the pursuit of this objective. The fact that they continue to use this approach even though their currencies have strengthened a good deal is clear evidence that they regard it as worthwhile. These three countries have, of course, also used interest rate policy. The United States has used both intervention policy and interest rate policy to resist the decline in the exchange value of the U.S. dollar. Moreover, in recent months the United States Government has taken action, just as we have in Canada, to acquire additional reserves by borrowing abroad. It has been selling Deutschemark-denominated securities in Germany, Swiss franc-denominated securities in Switzerland and has indicated that it will enter the Japanese yen market later. The Federal Reserve has also, of course, pushed up interest rates in the United States to very high levels.

It is not just the example of other countries that lends support to the approach followed in Canada in order to moderate the movement of its exchange rate. One can also look at the possible alternatives, all of which seem to me to have their own difficulties.

Intervention is sometimes criticized because of its alleged cost. What cost? The exchange reserves, including those that have been borrowed, are when used simply exchanged in the market for Canadian dollars. The total amount of Government borrowing and the total interest cost to the Government is not necessarily increased. And for the country as a whole the net external debt burden is not necessarily increased. What is important in this connection is the size of the current account deficit in our international payments because that is the measure of the net foreign borrowing that the country as a whole must do. The net cost to the country of servicing its increased foreign debt is thus related mainly to the size of the current account deficit. The cost is only marginally affected by who does the external borrowing, and the fact of the matter is that the Government of Canada can borrow more cheaply than other Canadian entities. The ultimate cost of foreign borrowing is of course affected by future movements in exchange rates which may produce either gains or losses that are not anticipated in advance.

It is my judgment that the monetary and intervention policies followed have considerably moderated the decline in the exchange value of the Canadian dollar. There is no point in saying that they have been ineffective solely because the exchange rate has not turned around and has declined somewhat further in recent weeks. What has to be taken into account is what would have happened if these policies had not been used. As we have seen it takes considerable time for trade flows to change and in the meantime how would a deficit of close to $5 billion have been financed except with a really drastic fall in the exchange rate? I am somewhat disappointed that the Canadian dollar has come down as far as it has and I regret its effect on our prices and costs. It is true that firmer action could have been taken. Interest rates could have been pushed up higher. That option continues to be available; it can be used if necessary. The Bank of Canada does not want to impose on the domestic economy any higher interest rates than necessary, and we have therefore had to weigh that against the consequences of exchange rate movements that we would prefer not to see. I believe that we have achieved a reasonable balance in this regard. The situation would of course have been much easier to deal with if U.S. interest rates had not risen so sharply.

I would like to conclude by saying that although the Canadian dollar has come down somewhat further than many of us hoped it would, we should not exaggerate the difficulties or be frightened of the future. There is much to reassure us. The Canadian economy is now very competitive with the rest of the world. It will take time for us to reap the full benefits although I think they are already in evidence to some degree. One promising sign is the remarkably strong growth in employment that we have been experiencing recently. The main point is that we still have a reasonably good chance of emerging from our present difficulties in a strongly competitive position, with lower rates of inflation, and in time with lower interest rates. Will we fail to take advantage of this opportunity? I do not think so. I think it unwise to sell Canada short.