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EXCHANGE RATES AND NATIONAL FINANCIAL POLICIES

Notes for remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to the 27th Annual Congress of the
Association Cambiste Internationale
Toronto, Ontario
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I want first, Mr. Chairman, to thank the Forex Association of Canada for inviting me to this important international gathering of specialists involved in foreign exchange trading. Not only do I welcome the opportunity to meet many of you on this occasion, I also have some things I would like to say about the behaviour of exchange rates, and I am not likely to find a more appropriate audience.

I believe that there are serious problems with the way exchange markets have been behaving in recent years. Let me say quickly, just so that you can relax, that in my opinion none of it is the fault of this audience. Or perhaps I should say hardly any of it! The trouble is that for years now foreign exchange markets have been characterized not only by considerable volatility in rates over short periods but also by wide cumulative swings over time. There may be some argument about the extent to which short-term exchange rate volatility has involved extra costs in completing transactions associated with international trade. For reasons that I will mention later, I am inclined

to think it does matter. However, in the case of the cumulative swings, there can be no doubt that there have been, and will continue to be, serious costs for those affected by the resulting shifts in production back and forth between industries, regions and countries. The shifts that have taken place have not been at all closely related to fundamental changes in international competitiveness, the consequences for trade flows have been dramatic, and the pursuit of stable domestic policies has been greatly complicated.

The cumulative movements in exchange rates have been more extreme in recent years than at any time since major currencies began to float against each other in the early 1970s. While the U.S. dollar declined significantly against the currencies of most major countries through much of the 1970s, its rebound since the beginning of 1981 has been a great deal sharper. For example, in terms of the Deutschemark, the U.S. dollar has appreciated by about 60 per cent during this rebound. The Canadian dollar has moved by much less against the U.S. dollar than most other major currencies, but against a trade-weighted average of major currencies other than the U.S. dollar the rise in the Canadian dollar since the beginning of 1981 has been over 40 per cent.

These huge cumulative moves in exchange rates have moreover been accompanied by an extraordinary increase in short-term fluctuations. Let me offer you a couple of statistics. The closing U.S. dollar-Deutschemark exchange rate has moved by more than one per cent on a single day about one-quarter of the time so far in 1985. The movement over four-week periods has been in excess of 5 per cent about one-third of the time. As a basis for comparison, I would remind you that under the Bretton Woods arrangements, which

prevailed in the post-war period until 1972, exchange rates were not allowed to vary in total around their fixed, though of course adjustable, parities by more than plus or minus one per cent. In the initial years of floating exchange rates after 1972, as well as in the earlier Canadian experience, the short-term volatility of rates was much less than it is now.

The current divergences in exchange rate relationships have provided enormous opportunities for firms and industries outside the United States to increase their output and their sales to the United States. These firms and industries have expanded, drawing in labour and other resources from other domestic industries. By contrast, in the United States the traditional export industries and most of those industries that compete with imports have found their situations very difficult with unused plant capacity and high levels of unemployment. This has also been true of Canadian industries that compete with overseas countries. Such large shifts of production and employment do not occur without cost. If the shifts are more or less permanent, the costs associated with the dislocation, temporary unemployment and scrapping of plant and equipment that are involved are bound to be outweighed by the benefits. But if, as I believe, the current pattern of exchange rates is not sustainable, a large part of these shifts of resources is only temporary and is likely to be reversed again at some time in the future. No wonder businessmen who engage in international trade, as well as foreign exchange dealers, are somewhat on edge these days!

One exceedingly unfortunate, if perhaps somewhat understandable, reaction to these dramatic changes in competitiveness caused by exchange rate

movements has been demands for increased trade protection. Protectionist demands have already been on the increase because of the major changes that have been going on in the structure of the world economy, particularly associated with the competitive success of a number of developing countries. While these pressures for protection have been quite general among industrial countries, they have been intensified in the United States by the high exchange value of the U.S. dollar. The efforts to "free up" the world trading system during the post-war period have yielded us large economic benefits -- we must not permit that system to be undermined now because of temporary exchange rate distortions.

Furthermore, it should be recognized that the depreciation of virtually all currencies against the U.S. dollar has been a source of upward pressure on price levels and interest rates in countries other than the United States. The ability of monetary policy to support domestic economic recovery has thus been hampered in a number of countries by the need to resist exchange rate declines. And the capacity of many countries to use fiscal policy to offset the impact on their economies of the higher interest rates has been limited by their accumulated fiscal deficits.

I think a good case can be made that increased short-run exchange rate volatility has also been costly. Volatility has tended at times to exacerbate the misalignments produced by cumulative swings in exchange rates. In addition, uncertainties associated with frequent fluctuations in exchange rates have complicated corporate planning for international transactions and have led to increased resources being spent on monitoring and managing exchange

rate exposure. Actual transactions costs to businesses and to individuals have been increased as a result of the wider spreads between prices at which foreign exchange is bought and sold in volatile exchange markets.

In the light of all these problems associated with the large cumulative swings in exchange rates and with their increased volatility, it is not surprising that people should wonder whether an exchange rate system that yields such results is not in need of major repair. One can moreover point to a number of major changes in the exchange markets over the past decade or so which have made exchange rates more prone to sharp movements. Such changes would include the move by most major countries to floating rates, the dismantling of exchange controls and the innovations in trading practices, instruments and communications. However, I do not believe these changes are the source of our problems; indeed, it is likely that they have contributed to more efficiently functioning markets.

While there is always a tendency to blame ill tidings on the messenger, the real problems have been caused by inappropriate national financial policies. Whatever other reasons are brought forward to explain the exchange rate problems we see around us, they above all reflect fundamental difficulties that have their origin in the failure to control inflation during the 1970s and on the way in which inflation was eventually fought in industrial countries. Far too much reliance was placed on monetary policy and high interest rates and there was insufficient fiscal restraint.

The problem with the mix of monetary and fiscal policies has persisted in a number of industrial countries, and it is particularly serious when it applies to the largest economy. This mix of policies in a dominant economy such as that of the United States is bound to have world-wide consequences for interest rates, international capital flows and exchange rates. The demands for financing associated with the combination of an expansive and dynamic U.S. economy and a large U.S. government deficit have been reflected in upward pressure on interest rates. The incentives thus provided for capital inflows to the United States have resulted in the very strong U.S. dollar. Other countries have as a result had to deal with higher interest rates than warranted by domestic considerations and with weak exchange rates vis-à-vis the U.S. dollar.

In this international economic environment there has been a great deal of uncertainty about the future course of inflation and real economic growth in most major countries and about likely budgetary actions to curb large fiscal deficits. Faced with these uncertainties, exchange markets frequently react rather strongly to new economic information, even to rather transitory economic indicators, and to the most recent and sometimes conflicting statements of officials and prominent commentators. Without firm views about the economic fundamentals, speculative activity in exchange markets has tended not to be stabilizing and has instead contributed to volatility and to severe overshooting of currency adjustments.

The views I have expressed to you, stressing the role of uneven national financial policies in causing exchange market distortions and

instability, are widely shared. International discussions among the industrial countries on ways of improving the functioning of the international monetary system have for the most part similarly emphasized the need to improve underlying national policies rather than to modify the exchange rate system itself. In looking for solutions, the focus of discussions has been on improving multilateral surveillance, especially by the International Monetary Fund, of economic policies of all countries with the objective of ensuring compatible policies and thereby better overall economic performance in the world economy. Surveillance is by no means a panacea but it can, I believe, be viewed as a step in the right direction. I say surveillance is not a panacea because I do not believe for a moment that any of the major countries really need outside surveillance in order to be able to determine what policies would be reasonably appropriate. They are not lacking in analytical capacity, nor are they for that matter kept in the dark as to what the International Monetary Fund or other countries think about their policies. There are enough international meetings and discussions for that to be impossible. The problem for any one government is not so much one of determining what set of policies would fit well with its domestic and international responsibilities; it is much more one of mustering the political support and the political will to carry out those policies. Improved multilaterial surveillance will be useful if it can, as I hope, increase the pressure on elected representatives of the major industrial countries to take account of the external effects of their policies, particularly on international capital flows and exchange rates, where the effect of inappropriate policies can be very disruptive and, in the end, counterproductive for the country originating them. The economic policy of each country must be seen in this interdependent world as an element, however

small, in world economic policy. The larger the economy the greater is its responsibility for overall international economic policy and performance.

Because of its size the policies pursued by the United States are particularly important, and it is for that reason that I draw particular attention to the United States rather than to other countries, even though there is no doubt room in other countries for policy adjustment. Views differ about the extent to which the high level of U.S. and world interest rates and the extreme movement of the U.S. dollar against other currencies can be attributed to the U.S. fiscal deficit. For example, these extremes may well have been exacerbated by the fact that in the past couple of years the U.S. economy has generally performed better than those of its major trading partners. However, there can be no doubt about the direction of the effect of the U.S. fiscal deficit on financial markets. Fiscal action by the United States to reduce its deficit would be an important step towards lowering interest rates and achieving a more balanced financial and economic situation in the world. It would also help other countries to achieve a better balance of policies. I am encouraged by the broad agreement within the United States that deficit reduction is in their own self-interest as well.

Until such time as national policies are adjusted and a more stable financial environment is achieved, exchange rate instability is likely to be a problem. And another focus in the international discussions of exchange rates has been the possible stabilizing role which official exchange market intervention might play. You will appreciate that this is an area in which both opinions and practices vary significantly. I believe that intervention by

central banks can play a useful role in reducing short-run fluctuations in exchange markets provided it is sizeable and provided domestic policies back it up. Some co-ordination among major countries has the potential to make intervention still more effective. In that regard the heavy concerted central bank intervention in late February of this year was helpful, following as it did an extreme upward movement in the U.S. dollar. This intervention was of a scale that instilled among exchange market participants a greater sense of two-way risk and thereby dampened the buoyancy of the U.S. dollar.

By comparison with the authorities in most other countries, we in Canada tend to engage in official intervention more frequently. The Bank of Canada, as fiscal agent for the Government of Canada, is almost a daily participant in the exchange market, resisting sharp fluctuations in the exchange rate in either direction in as evenhanded a manner as the particular circumstances permit. Our objective is to have a steadying influence on market forces, lending a measure of stability to the exchange rate and at the same time contributing to a sound and viable exchange market in Canada. We are very conscious, however, that strong and persistent moves in the rate cannot be countered through intervention alone, and reinforcing domestic actions are typically required as well.

I would like to conclude with a few more general comments on the way in which external factors influence our situation here in Canada.

With an open economy and a large trade sector and with large and unrestricted flows of international capital across its borders, Canada has a

tremendous stake in the proper functioning of the international financial system. The stance and mix of policies elsewhere has a major effect on us. Canada's links with the U.S. economy in particular greatly influence how we manage our affairs. Divergences in interest rates between the two countries have a quick impact on our exchange rate. Other countries with a better history of inflation performance, with more diversified patterns of trade or with structurally coordinated exchange rate and other economic policies -- such as in Europe -- have more leeway, at least in the short run, than we do in adjusting to changes in international interest rates.

The Bank of Canada's response to upward fluctuations in U.S. interest rates that we do not believe to be appropriate to our situation has been, where possible, to encourage some of the resulting impact to be taken on Canadian interest rates and some of it on our exchange rate. At times we have been able for short periods to absorb a greater degree of the pressure of rising external interest rates on the exchange value of the Canadian dollar, leaving our domestic interest rates somewhat lower than otherwise. But the scope for that kind of tradeoff is limited -- it is only temporary and only available under favourable conditions. If the rise in external interest rates is expected to persist or if confidence in the Canadian dollar is lacking, there is unlikely to be any tradeoff. Indeed exchange rate depreciation that risks a loss of confidence in the Canadian dollar is, in our experience, likely to bring about higher rather than lower interest rates in Canada.

Moreover, exchange rate depreciation exposes the economy to rising prices. How inflationary that will be depends on market conditions. This past year the price effects of the decline in the Canadian dollar against its U.S. counterpart have been largely offset because highly competitive markets have led to good performance on our domestic costs. But depreciation erodes the purchasing power of consumers, and it has always been the Bank of Canada's concern to avoid a sharp erosion of purchasing power that would risk a resurgence of demands for inflationary salary and wage increases.

In fact the underlying circumstances of the Canadian dollar are rather good. We have a trade surplus of record size and recent changes in government policy have made Canada more attractive for foreign investment. Our inflation performance is good by international standards, and although our unemployment rate remains high, economic recovery has continued to proceed at a reasonable pace over the past two years. Nevertheless, there is no question that the economic situation in Canada would be much better in a more balanced international environment with lower interest rates and a less distorted pattern of exchange rates.

Finally, to repeat the main point I have been trying to make tonight, the road to that more satisfactory exchange rate performance lies mainly through the achievement of reasonable price stability in the world economy on the basis of domestic fiscal and monetary policy mixes that do not produce large swings in interest rates and, therefore, in exchange rates. Better aligned and more stable exchange rates will help the world economy to function better and increase our chances for sustained economic expansion.

At the same time I am certain that there will still remain sufficient fluctuations in exchange rates because of the ever-changing economic conditions around the world to keep life from becoming too dull for exchange traders.