Canadian Exchange Rate Policy

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"Exchange rate policy" can mean different things to different people — even something as relatively minor as intervention tactics in a floating currency. However, in this paper I understand it to mean something more fundamental, that is, the kind of regime or framework that is judged appropriate for a country's currency. And the issue on the table is: What kind of exchange rate regime best suits Canada?

Some critics of a floating currency advocate a pegged exchange rate policy — a semi-tough kind of fix that would find expression in the Canadian government's supposed unilateral willingness to intervene at a fixed point. This is not a regime, however. "Regime" is always a serious word, even if "policy" might not always be. Above all, it connotes commitment; and in the exchange rate context, commitment to a sufficient extent that it shapes market expectations about the future behaviour of the currency. In this light it is not credible to argue that mere exchange rate pegging (*à la* Bretton Woods, but now without even the multilateral seal of approval of the International Monetary Fund [IMF] Bretton Woods Agreement which went up in smoke in the 1970s) is a regime. The hard evidence from around the world, whether in Europe or outside — e.g., Asia, Latin America — is very clear on this. Furthermore, this is what one should expect in view of the basic ambiguity in exchange rate pegging. The ever-present question, since in deciding to go only so far in fixing as to peg the authorities have indicated that they have not resolved it in their own minds, is: When things get rough on the currency front, should policy tough it out or should it move off the peg? Should, for example, liquidity be tightened enough to raise short-term interest rates to the sky, even when the markets know full well that the authorities might fold and markets are therefore prepared to bet heavily on that prospect?

Of course, one can try to crowd angels on the head of a pin and ruminate about weak pegging, middling pegging, and strong pegging. At which point proponents of pegging as a regime will point to plucky Netherlands and Austria as examples of countries that were able to get by with a peg, before entering the safer harbour of the European monetary union (EMU) — ignoring, of course, all the pegging failures that did take place in the 1990s. However, what I conclude from all this is that in fixing one either has to go further than pegging to have any serious hope of market credibility or do what Canada now does, that is, float.

A Word on the Canadian Exchange Rate Experience

Canada has essentially been a floater for the past 50 years or so — with a brief interval of fixing (for less than a decade) in the 1960s.

That being said, I am not so sure that Canada had the policy implications of floating that well figured out — at least the domestic monetary policy implications. In the end, those implications come down to establishing a clear and, hopefully, solid domestic monetary regime — a regime that would, in other words, establish a *domestic* nominal anchor for expectations. This is something that a floating exchange rate by definition cannot provide. At the same time, it should be stressed that a floating exchange rate regime does *not* mean exchange rate instability. Such instability would be a function of unstable domestic policies. More globally a "Voltairean" regime, where each country focuses on cultivating domestic monetary stability, provides a thoroughly consistent and economically attractive basis for general exchange rate stability.

I think that now Canada has the monetary policy part pretty well figured out — at least, that is, it has been figured out at the Bank of Canada. Whether the Government of Canada has it figured out is a more open question. In this regard it is, for example, disquieting when Canadian political figures, on the few occasions when they comment on the dollar (as they did in 1998, for example), leave the impression that the basic reason Canada has a floating exchange rate is so that its currency can depreciate against the US dollar. This simply cannot be the basis if the float is to work properly. However, on balance we should be quite comfortable with floating as it is now practised — though it might just as well be useful to check comfort levels again when we have some inflation pressures, to see whether floating is seen in Ottawa as a safety valve for a more inflationary monetary policy.

Now this assessment, or at least the floating rate part of it, is being challenged. It is always good to challenge conventional wisdom, but the question still remains of whether the challenge is a good one. Let us turn to that question.

There are two aspects to the challenge. One is that floating damages Canada's economic performance, and the other is that this is a golden opportunity to fix — in a serious way, one trusts, if a fix is to be worth discussing at all.

As regards the charge that floating leads to a weaker economic performance, the arguments have been coming in a number of guises. And when one is exploded another pops up. This raises the question of whether there is some other agenda here — as there might well have been, for example, in regard to the Quebec government's espousal recently of the lagging productivity argument (dealt with a little later).

One such argument has been that even if our inflation performance was better than that of the United States, Canadian interest rates could not go below theirs — presumably because of some kind of "Keynesian" market myopia. The consequence of this unhappy situation would be an excessively high real rate of interest and cost of capital in Canada and a consequential drag on economic performance. Indeed, this contention was put forward as recently as this spring, at the Senate hearings on the Canadian dollar. But in earlier periods, at that time and since then also, Canadian interest rates have been in fact distinctly below those in the United States, and that is true all along the interest yield curve. No guarantee can be given that this will always be the case. Such a situation largely depends on how we run our inflation affairs and how the United States runs its affairs. Still, the basic charge can now be discarded.

Another argument has been that a floating Canadian dollar allows fiscal policy to be irresponsible — on the grounds that its irresponsibility is somehow floated off by depreciation. I must admit that I find this argument hard to take, having been criticized roundly when in office for not having cut enough slack for fiscal policies to continue on the path they were on, and that *with* a floating exchange rate. The critics are trying to have it both ways. And in any event, those who have looked at the matter generally (e.g., see the discussion by Maurice Obstfeld 1995) have concluded that there is no evidence of any link between exchange rate regimes and fiscal policy. Furthermore, most observers would think that Canadian fiscal policies overall have improved, and we are still floating.

Another argument, and the one that has been most prominent in recent months, has been that based on the notion of the "lazy manufacturer" — that is to say, our manufacturing productivity performance lags that of the United States because the Canadian manufacturer is not compelled, because of the cushion of a depreciating currency, to take tough, productivity-enhancing decisions. Clearly, the productivity statistics are crucial here, and in that regard we now, after some to-ing and fro-ing over those statistics, have, based on the statistical evidence, to let the Canadian manufacturer off the hook. Productivity does not seem to be so bad against that in the United States — when measured properly, on a multifactor basis. Furthermore, even if the statistics had in the end turned out to be more favourable to the lazy manufacturer hypothesis, there would still be the question of the direction of causation — is it (assuming for the moment that there could be a strong link) from exchange rate to manufacturer or from manufacturer to exchange rate? The latter direction, with poor economic performance leading to exchange rate depreciation, is economically plausible. Furthermore, and this is very much to the point, it cannot be ruled out by the statistical tests that have been conducted on the link between manufacturing productivity (inadequately measured, we should note, solely as *labour* productivity and not as multifactor productivity!) and the exchange rate. The whole argument, we must conclude, is one of pretty casual empiricism that cannot be taken seriously.

Finally, there is a deeper but more speculative argument about the drivers, and need, for structural transformation in the Canadian economy. The argument is that we should get out of commodity production for our own long-term good (i.e., embrace just as fast as possible the “new economy” because that is where the money is), and a depreciating currency in response to commodity price weakness only holds up this transformation. One can bolster this argument a bit statistically by looking at what happened to the exchange rate and commodity prices over the past ten years or so. In this period, commodity prices were down roughly 20 percent in US dollar terms and the Canadian dollar was also down about 20 percent against the US dollar. In that sense, Canadian commodity producers were “made whole.”

This argument and its view of “exchange rate policy” is, however, an inaccurate characterization of Canadian policy (at least, as regards the Bank of Canada) over that period. The basic strategy was neither one of trying to prop up Canadian dollar commodity prices nor, on the other hand, one of holding up the Canadian dollar at, say, around 80 cents US, until the pips squeaked domestically. Rather, the strategy was one of establishing and sustaining a decent domestic nominal anchor — domestic price stability — in part at least so that exchange rate flexibility could also work decently. (There were other, broader reasons such as ensuring confidence in Canadian money in an economy based on the Canadian dollar.) And that, with some reservations about the institutional durability of the monetary policy framework, is what has been done. Furthermore, the floating exchange rate has worked the way it should have been expected to in relation to shifts in our external trading fortunes, that is, shifts in our international terms of trade (prices of exports relative to prices of imports). At the moment the Canadian dollar, like our terms of trade (because of poor commodity export prices), is on the low side.

Dollarization and the Euro

Now let me turn to the second set of issues, that this is a golden opportunity to fix — in other words, the US dollarization train is leaving the station and we have to be on board. There are two aspects — one has to do with the progress of dollarization on this continent, and the other has to do with the example afforded to us, and to the United States one supposes, by the entry into force of the Euro. Neither contention is at all persuasive.

The dollarization argument is a kind of call to “catch the wave,” with Argentina possibly leading the way — following the example of Panama on this continent. The fundamental economic problem with this kind of argument is that it is premised on a given country not being able, for whatever domestic reason, to secure and sustain a decent domestic monetary policy. As Argentina's central bank governor suggested not so long ago, countries are good or not so good at different things, and Argentina has demonstrably not been so good at monetary policy. The same seems true of quite a number of South American countries. Now that is a terrific argument in principle for fixing. Why would anyone seriously argue for an inflationary float if there is another, politically acceptable, less erratic monetary regime at hand — that is, dollarization? However, whatever the attraction of this argument in Latin America (where, by the way, the standard optimum currency area arguments based on similarities to economic structure and freedom of movements of labour are extremely weak), it is not one that is at all credible for Canada — at least not yet.

Turning to the argument from the precedent of the Euro, the basic point to make is that this is, institutionally, not at all a precedent. Even setting aside the politics, one should note — and any knowledge of American thinking on this issue will confirm this — that there is not going to be a central bank of North America with representation for Canada, Mexico, or Argentina for that matter. So the analogy with EMU falls straight away. Perhaps the United States, intrigued and flattered by the fact that we want to use its currency, would be kind enough to give back to us (and to Mexico and Argentina also, no doubt) our "fair share" of the seigniorage on the note issue. This is about a billion dollars a year, or about one-half of 1 percent of total federal government revenues. But that is, in the end, just a taxation issue, and obviously hardly an important one in rationally deciding such matters. However, there is no doubt that we would have to finance dollarization ourselves — acquire or borrow enough US dollars to cover the currency substitution that is involved.

But how many US dollars would we need to get hold of? Here we would need to look beyond just covering the note issue, because, barring still further transfer of institutional authority to the United States, we would have to be our own lender of last resort to the Canadian financial system. That is to say, we could not expect the US authorities to do much as lender of last resort to Canadian financial institutions unless we were willing to give them significant jurisdiction over our financial system as well. I do not see anyone recommending this. Accordingly, we would have to seek additional US dollars to be prepared for any lender-of-last-resort contingency. There are costs attached to this, of course, even for contingent liquidity lines.

Finally, two economically fallacious arguments that should not be left unaddressed. Sometimes one hears the argument that adopting the US dollar would bring US tax rates. However, the tax question is not particularly at issue on one side or the other in relation to fixed or floating exchange rates. It is just a different order of question, having to do essentially with the freedom with which capital and labour can flow across the border. Capital can flow pretty readily across the Canada-United States border, but labour considerably less so, notwithstanding the North American Free Trade Agreement (NAFTA) provisions. And this situation (bearing in mind also that the free flow of labour is an important condition for flexibility in an optimum currency area) is unlikely to change with the advent of dollarization. That is to say, there will still be a national border, as there will also be presumably for Mexico. The same kind of reasoning applies to the argument now made that "free trade and flexible exchange rates are inherently inconsistent." Free trade and exchange rate flexibility are, analytically, quite different things, and to put them in the same economic box amounts to a confusion of categories.

Conclusion

Because we have a floating exchange rate regime that works perfectly sensibly and in no way disadvantages the economy, the time for a currency board, for a monetary union, and for dollarization (you name it) is, I believe, still far in the future. Indeed, the whole idea is far-fetched.

Reference

Obstfeld, M. (1995), "International Currency Experience: New Lessons and Lessons Relearned," *Brookings Papers on Economic Activity* 1 (25th Anniversary Issue):119-220.