Mr. Thiessen looks at flexible exchange rates in a world of low inflation

Remarks by the Governor of the Bank of Canada, Mr. Gordon Thiessen, to the FOREX '97 Conference held in Toronto on 30/5/97.

There is a good deal of discussion these days about Economic and Monetary Union (EMU) in Europe -- about the benefits and difficulties of organizing such a union. However, today I would like to examine a somewhat different issue, one that is at the other end of the spectrum; namely, How is the international system of flexible exchange rates working these days?

This is not to denigrate or deny the importance of the challenges surrounding the EMU initiative, nor its relevance for those who will be directly or indirectly affected by its debut. But while many European countries have operated under a fixed exchange rate regime during the post-Bretton Woods period, most other industrial economies have chosen to operate under a flexible currency arrangement. The three major currencies, those of the United States, Japan, and Germany, float against one another. So I thought what I might do this morning is focus on flexible exchange rates and discuss, in particular, how they have performed over the past few years.

The main message I would like to convey to you is that, when all is said and done, the flexible exchange rate system has not done badly over the past 25 years. And in the last three or four years, it has done rather well in an environment characterized by low inflation and improved fiscal performance across the major industrial countries. Exchange rates have, for the most part, moved in the "right direction." And short-run exchange rate volatility has diminished, notwithstanding some evident cyclical swings of the U.S. dollar.

Why are the major currencies floating?

The initial reason for adopting floating exchange rates was more a matter of circumstance than a considered choice. The Bretton Woods system, which was established shortly after the Second World War, collapsed in the early 1970s, forcing most industrial countries onto a flexible exchange rate regime as an "interim measure." Attempts to rescue the Bretton Woods system in the summer of 1971 and the fall of 1973 proved unsuccessful.

The reputed reasons for the collapse of the system were the inflationary macropolicies pursued by the United States during the late 1960s and early 1970s and the unwillingness of other countries either to inflate their economies to the same extent or to allow the U.S. dollar to devalue. But the true reasons for its demise were more deep-seated. This system, which had been viable, although prone to periodic crises, throughout the 1950s and 1960s, was clearly unable to cope in a world of liberalized trade and international capital mobility. The Bretton Woods system, while laudable in concept, proved to be flawed in practice.

The main problem was that the imbalances that the system was supposed to address, through discrete changes in the parity value of the affected currencies vis-à-vis the U.S. dollar and gold, proved to be much larger and more intractable than the architects of the system had ever envisaged. Moreover, countries were reluctant to adjust their currencies, even when the problems were shown to be fundamental. Thus, authorities would often subvert domestic economic objectives, such as price stability, economic growth and full employment, in order to protect outdated parities. As a result, the system was in disequilibrium more often than not. And its adjustable nature did not prove flexible enough to help countries deal with the shocks that regularly hit the international financial system.

While the adoption of floating exchange rates may have been more a matter of necessity than choice, floating rates did promise greater independence in the conduct of monetary policy and better insulation from external shocks. Advocates of a floating regime, partly influenced by Canada's favourable experience with such a system in the 1950s, suggested that exchange rates would automatically adjust to correct external imbalances in an orderly and continuous manner. And this would give domestic policymakers greater freedom than under the pegged rate system as well as obviate the need for official intervention and large international reserves.

Experience with the floating rate system

Needless to say, experience under the floating rate system has not been problem-free. Events did not unfold quite as its proponents had suggested, and the past 25 years have been characterized by volatile short-term movements and sizable long-term swings in most of the major currencies.

The magnitude of these currency movements and our evident inability to explain them in a comprehensive, precise manner, led many observers to presume that such movements were driven by market speculation and that they were largely disconnected from economic fundamentals.

There is no simple way to resolve this issue. Nonetheless, it is possible to identify some of the forces that have influenced exchange rates through this period, either by shaping their broad movements or, at times, by contributing to uncertainty and hence to excessive volatility in these rates. I would stress, in particular, the uncertainty over the future course of monetary and fiscal policies, which made it difficult for financial markets to cope with the macroeconomic pressures of the day.

What forces am I talking about? In the 1970s, we had the two oil shocks, one at the beginning and one at the end of the decade. These may have been precipitated by political developments in the Middle East, but the initial shock was encouraged by the pursuit, among the major industrial countries, of higher output and employment through monetary ease and a willingness to tolerate increased inflation. Subsequently, the monetary accommodation of the price effects caused by the oil shocks added to the turbulent environment that followed. The 1970s and early 1980s turned out to be a period of high and variable inflation in many countries.

High inflation, balance-of-payments difficulties arising from the oil shocks, and the large fiscal transfers necessary to support economic activity in energy-dependent countries, were the catalyst for much of what followed in the 1980s. Excessive government spending and rising public indebtedness were coupled with tighter monetary policy, as authorities struggled to maintain social services, restore full employment, and dampen the inflationary pressures that had been allowed to grow in the 1970s. The effects of this uncomfortable policy mix hit the major industrial countries with varying severity and triggered a debt crisis in the developing world. Success on the inflation front was mixed, adding to the strains that the exchange rate system was expected to cope with.

While the problems in the industrial countries were generally less severe than those in the developing world, they nevertheless caused serious dislocations. Because of differences in the mix of fiscal and monetary policies in the United States compared with Germany and Japan, the U.S. dollar appreciated sharply against the deutschemark and the yen through the first part of the 1980s. In turn, these developments led to an accumulation of very

large current account imbalances among these three major countries. In these circumstances, the flexible exchange rate system did not perform as well as it might have. But it is not obvious that any other alternative would have been practicable, and I doubt very much that a fixed exchange rate system for the U.S. dollar, the mark, and the yen could have survived these strains.

The three major currencies were not the only ones subjected to tensions. Uncertainty about whether and how fiscal imbalances might be corrected, and considerable cross-country differences in actual and expected inflation contributed to major exchange rate pressures among other currencies in the 1980s and early 1990s. By 1992-93, these pressures had reached the breaking point in continental Europe and the United Kingdom, putting extreme stress on the Exchange Rate Mechanism (ERM). As well as causing the United Kingdom and Italy to leave the arrangement, the situation necessitated a widening of the ERM intervention bands.

What is the current situation?

Although it is still early days, conditions in exchange and asset markets have improved considerably since 1993. Short-term exchange rate volatility, and even the trend movements in bilateral rates, while still significant, are much smaller than those of the previous two decades.

I believe that this improved perfomance has a lot to do with the convergence we have seen in recent years towards low and stable rates of inflation among the major industrial countries. But progress on the fiscal front has also been essential, helping to reduce risk premiums and stabilize expectations, both with regard to the long-run viability of the fiscal track in many countries and the prospects for continued low inflation.

Thus, I would argue that consistently low inflation and improved fiscal positions have brought about more stable, “better behaved” exchange rates, just as theory would have predicted. This is not to say that exchange rates have remained absolutely stable over the past four years. They have not. But movements have been more orderly, unlike those of the earlier periods, and most of the observed trends can be explained by the different cyclical positions of countries, the different monetary and fiscal responses, and by changes in world commodity prices.

Exchange rate movements have, at times, appeared to contribute to trade imbalances or exacerbate existing ones. But this should not be interpreted as evidence that markets are pushing rates in the wrong direction. Indeed, imbalances often reflect the fact that economies are at different points of the business cycle. For example, Japan has, until very recently, seen the value of its currency decline, on balance, against the U.S. dollar, even though the country is running a large and growing trade surplus. It is obvious that much of the recent movement in the U.S. dollar/yen exchange rate has been driven by the different cyclical positions of the two countries. Thus, the relatively low yen has been helping to rejuvenate demand in Japan. Meanwhile, a strong U.S. dollar has been helping the United States to counter inflationary pressures that would otherwise require stronger doses of interest-rate medicine.

Of course, it is possible for exchange rates to overreact, even in the benign environment I described a moment ago. But the chances of a serious misalignment are much lower when markets are operating in a climate of greater predictability, provided by a monetary policy grounded in domestic price stability. When exchange rates are not anchored by a credible

commitment to price stability, it is difficult, if not impossible, for markets to perform the tasks that are expected of them.

The operation of the flexible exchange rate system in Canada

As you know, Canada has been one of the strongest proponents of a flexible exchange rate system. We were the only major industrial country to operate under such a system in the 1950s and early 1960s, and we were the first major country to adopt it again in the 1970s. As a medium-sized open economy that relies on exports of primary commodities more than our principal trading partners, we are vulnerable to external shocks and appreciate the "shock absorber" effect provided by a flexible exchange rate.

Let me tell you briefly how the Canadian economy has performed under the flexible exchange rate system and describe the main forces that have been acting on our exchange rate. The most significant trend movement occurred over the 1976 to 1986 period, when the Canadian dollar experienced a large depreciation vis-à-vis the U.S. dollar, falling from roughly parity to a low of 69 cents (U.S.) in February 1986. During this time, annual inflation rates in Canada exceeded those in the United States by about one per cent, on average. While on a yearly basis this may not sound like much, cumulatively the differential was rather significant and can explain most of the trend depreciation in the Canada-U.S. exchange rate over this period.

As for the cyclical swings that accompanied the trend depreciation of the Canadian dollar, they reflected a number of factors. Among these, the most significant has been the variability in the world prices of primary commodities, which remain an important component of our exports. But the most worrisome factor during the 1980s and 1990s was the growth of the fiscal deficit and the destabilizing effect that this had on financial markets, including the foreign exchange market. Rising public debts and deficits contributed importantly to the risk premiums in interest rates on Canadian dollar assets and were the catalyst, if not the cause, of unsettling episodes in 1986, 1992, and 1994. Fiscal policy concerns, at times coupled with political uncertainty, proved to be a volatile mix and led to serious financial market turbulence and speculative pressures, complicating the task of monetary policy.

Fortunately, the situation has recently improved considerably. Inflation in Canada is stable, at its lowest level in decades. And it has been somewhat below that in the United States since 1992. This implies a potential appreciation of the Canadian dollar vis-à-vis the U.S. dollar over time, if the inflation differential persists.

But other factors also tend to favour a stronger Canadian dollar. First, deficit reduction by Canadian governments has eased the uncertainty that had pervaded financial markets, thereby shrinking risk premiums in interest rates and reversing the currency weakness caused earlier by these premiums. Second, Canadian industries are in a stronger competitive position than they have been for years, and this has contributed to a sharp reduction of the persistent deficit in the current account of our international balance of payments. Third, primary commodity prices are firm and likely to move higher with the pickup in global economic activity.

In light of all this, it is not surprising that several analysts, as well as the Bank of Canada, expect a stronger Canadian dollar in the future and think that the currency is currently undervalued relative to its longer-term fundamentals.

Why, then, has the Canadian dollar not been stronger? The explanation lies mainly in the different cyclical positions of the Canadian and U.S. economies. The more accommodative monetary conditions pursued in Canada during the past two years have been consistent with the needs of an economy characterized by considerable excess capacity and an inflation rate that has tended to be in the lower half of the current 1 to 3 per cent target range. Thus, lower interest rates and a relatively low Canadian dollar have been temporarily appropriate for economic reasons.

While no central bank ever wishes to have a weak currency, since late 1995, the Bank of Canada has encouraged easier monetary conditions -- conditions that, at times, have taken the form of lower interest rates and a somewhat softer dollar. Put another way, the Bank did not purposely push the dollar lower, but simply aimed for the path of monetary conditions that seemed appropriate given sluggish domestic economic conditions. The particular mix of interest rate and exchange rate adjustments necessary to achieve the desired path of monetary conditions is not under the direct control of the Bank of Canada. It is essentially determined by the markets.

However, the Canadian economy has been gathering momentum lately, and prospects are good for continued robust expansion through 1997 and into 1998, in response to the substantial past monetary easing. With the margin of excess capacity in the economy still fairly wide, there is ample room for strong growth in coming quarters without a resurgence of inflation. However, as the slack is absorbed, the Bank will need to pursue less stimulative monetary conditions, consistent with a durable, low-inflation economic expansion.

In other words, for cyclical as well as for more fundamental reasons, the prospects are good for a stronger Canadian currency.

****

In summary, I would say that the exchange market for the Canadian dollar has worked rather well in recent years, interpreting and responding to both the fundamental trends in our economy and the cyclical differences between Canada and the United States. I believe that fiscal discipline and a credible commitment to low inflation are key ingredients of that good performance.