David Dodge: The importance of appropriate exchange rate regimes

Remarks by Mr David Dodge, Governor of the Bank of Canada, at the 46th ACI Financial Markets Association World Congress, Montreal, Quebec, 4 May 2007.

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Thank you and good morning. It's great to be here and to have an opportunity to talk about some key issues that relate to your meeting's theme of convergence. I think that it is very important that economies all over the globe converge towards becoming part of a market-based, liberalized trade and financial order.

Why do I think that such an order is so important? Well, in part it's because history has helped to demonstrate its virtues. But it's also extremely important to bear in mind the context, that is, the world in which we live today. This is a world in which adjustment is perpetual, where change is driven by the development of new technologies, where sectors and nations continually attempt to secure some new advantage. And in this world, price signals from markets help us to understand what adjustments are needed.

So, this market-based, liberalized trade and financial order is really the best that we have found for promoting growth and prosperity. But it is critical that members of this system adhere to a common set of rules or policies that operate for the benefit of all. In this way, we can encourage a healthy pace of global economic growth.

Of course, many policies are necessary to move an economy towards converging on a market-based, liberalized trade and financial order. I'll elaborate further in my remarks on some of those policies. But today, I will focus on one particular policy. That is the vital role that a flexible exchange rate regime can play for many countries in helping their economies to operate for the maximum benefit of all citizens.

Why a flexible exchange rate is the right choice for many

Now, I should be clear right off the top that I'm not saying a floating exchange rate is the one and only choice for all countries at all times. A fixed exchange rate can be the right choice for economies – especially small economies – where an independent monetary policy is difficult to execute. In such a situation, the costs associated with having a flexible currency may outweigh the benefits. But for many – and indeed, for most large economies – a flexible exchange rate can bring important economic benefits, benefits that clearly outweigh the costs.

A flexible rate supports a market-based, liberalized financial order, an order that has the great advantage of providing for continuous adjustment in response to price signals. A flexible exchange rate adds one more market-determined price. It not only absorbs shocks, but it uses prices to facilitate changes.

At the same time, we must always remember that a flexible exchange rate is just one of several key policies that are critical to achieving economic efficiency. But a flexible rate is crucial if a country is to pursue an independent monetary policy aimed at price stability.

During my remarks, I will illustrate some of my points by drawing on Canada's lengthy experience with a floating exchange rate. Our experience can be very instructive for others, even though 57 years have passed since Canada broke with the Bretton Woods system and implemented a flexible exchange rate regime. We have had more experience with this type of exchange rate mechanism than almost any other country in the world, so we have a deep understanding of how it works.

Canada's bold – some might say radical – decision in 1950 to break with the Bretton Woods system was driven by a couple of problems. Some of these problems still plague many emerging-market economies today. In the late 1940s, Canada was dealing with a large inflow of foreign capital and postwar investment, as well as strong household demand. Following an earlier revaluation of the Canadian dollar, short-term capital was flowing heavily into the country amid speculation about another revaluation. Rising commodity prices were also adding to upward pressure on the dollar. All of this led to concerns about inflation, as well as worries that capital inflows might lead to a sizable increase in the country's foreign debt. Unfortunately, the fixed exchange rate meant that policy-makers

had to focus monetary policy on exchange rate stability, rather than on steps that would have been appropriate to stabilize domestic prices.

To give the Bank of Canada the freedom to pursue policies aimed at stabilizing prices, authorities took the critical step of allowing the dollar to float at values set by the market. I'd also like to remind everyone that this policy continues: the Bank of Canada today still has no specific target for the dollar, because we believe that market conditions should determine the currency's value.

The 1950 decision to float the currency was controversial, especially with the International Monetary Fund and most of its member states, which subscribed to a fixed exchange rate regime. But in the postwar years, experience proved that a floating exchange rate was truly beneficial for domestic policy.

However, during the 1970s and 1980s, the Canadian-dollar foreign exchange market was quite thin. As a result, the Bank of Canada had to intervene on a day-to-day basis with the aim of providing liquidity and reducing volatility. This strategy of "leaning against the wind" was pursued symmetrically, with the goal of smoothing fluctuations in either direction. By the 1990s, however, markets had become deep enough that daily interventions were no longer helpful. Government policy now restricts such interventions to the most exceptional circumstances and, in fact, Canada hasn't intervened to influence the Canadian dollar since 1998.

Uncertainty under fixed and flexible exchange rates

Despite Canada's success with a flexible exchange rate system, there are still critics who find it hard to deal with the uncertainty that can come with a floating dollar. Large currency movements, such as the roughly 35 per cent appreciation in the Canadian dollar since early 2003, can be hard for businesses to deal with. A floating currency does entail somewhat larger transactions costs and, in the short run, additional risks for business. In this regard, the development of deep and well-functioning forward foreign exchange markets is extraordinarily important in assisting businesses to hedge their foreign exchange risk. Such well-developed markets, along with financial institutions geared to providing business – especially small business – with the opportunity to hedge at low transactions cost, minimize the additional exchange risks that businesses face under a floating exchange rate regime.

But even with well-developed foreign exchange markets and the ability of firms to hedge, some still fear that a flexible exchange rate will introduce undue risks and uncertainties. They argue that fixed exchange rates are the solution. But a fixed exchange rate is no panacea. Over time, a fixed nominal exchange rate can actually heighten uncertainty and, eventually, add to volatility. A fixed rate limits the actions of central bankers because monetary policy must be aimed at protecting the fixed level of the exchange rate.

Under a regime of fixed nominal exchange rates, the economy is forced to absorb the full effect of changes in world prices through changes in domestic nominal wages and prices. To bring this about, the burden initially falls on output and employment and, eventually, spreads to most wages and prices. And because domestic wages in particular tend to be "sticky," changes in output and employment need to be quite large. Thus, adjustment tends to be more difficult and more costly for many individuals, businesses, and the economy, than would be the case under a flexible exchange rate regime.

In economies where domestic wages and prices are not perfectly flexible, it's not only central bankers who face constraints under a fixed exchange rate regime. Controls on financial transactions will often be required, and eventually, controls over parts of the real side of the economy may be needed to maintain the fixed nominal exchange rate. Authorities who ignore these constraints, or who lack the fiscal discipline required by a fixed exchange rate regime, can end up creating uncertainty and the very volatility that they were trying to avoid.

Economic benefits of a flexible exchange rate

Let me just say that the greatest benefit Canada has found with a floating currency is the way in which it helps the economy deal with economic shocks. Perhaps this is a good time for me to take a moment and explain in more detail just how the floating exchange rate system now fits into Canada's monetary policy framework. Our monetary policy aims to protect the domestic purchasing power of our currency

by keeping inflation low, stable, and predictable. We aim to keep inflation, as measured by the consumer price index, at a 2 per cent target. By doing so, we support the conditions necessary for strong, sustainable economic growth.

Of course, there will always be economic shocks that require a response and adjustment. As a medium-sized, open economy and an important producer of commodities, our terms of trade can shift significantly as the relative prices of commodities, manufactured goods, and services change. Such changes in relative prices are a signal to shift real resources out of sectors with declining profitability, and into sectors where profits are rising. Under a floating rate regime, movements in the currency help to smooth that process and to minimize the adjustments in other areas of the economy.

This all serves to demonstrate why it has been very important to us to maintain our flexible exchange rate, rather than fix our currency to the U.S. dollar. The United States is certainly our closest neighbour and by far, our largest trading partner. But the structures of our two economies are very different. This means that each of us often requires different adjustments and different policies in reaction to shocks. Canada's floating exchange rate facilitates these adjustments without forcing our economy through some very difficult changes in the overall level of output, wages, and prices.

Let me put this in more concrete terms and, in so doing, share a valuable lesson learned from the Asian crisis of 1997. As a commodity-producing nation, we were hit pretty hard by the dramatic fall in commodity prices. Our floating dollar fell sharply and thus, helped with the significant but necessary adjustment. With the decline in the nominal exchange rate, our non-commodity sectors saw their competitive positions improve. They were therefore able to absorb some of the resources that were being quickly shed by the commodity producers. Our floating exchange rate allowed us to achieve a decline in *real* wages without a decline in *nominal* wages and to hold inflation near our target.

Let me give you another example. In recent years, the demand for and the prices of Canadian commodity exports have been rising sharply. This has helped to create an economic boom, and investment flows into Canada have increased. Our floating dollar has appreciated sharply and thus, has forced some necessary adjustments. As their competitive positions improved, our commodity producers have been able to absorb some of the resources that were being shed by the non-commodity sectors, which have seen their competitive positions deteriorate. As a result, we've seen a shift in relative wages without fueling inflation. Thus, the flexible exchange rate has again helped the economy to absorb shocks and has allowed the Bank of Canada to keep inflation near the 2 per cent target. Adjustment is never easy, but on balance, a flexible exchange rate regime has definitely helped Canada to maintain production close to full capacity and to minimize the effects of the boom-bust cycles in various sectors.

A floating exchange rate can bring a number of important benefits, but as I said, there are other important components of a sound policy framework. A well-functioning domestic financial system is crucial to achieving efficient domestic allocation of capital and to dealing with external shocks. That is why policy-makers around the world have been putting a lot of emphasis on improving domestic banking and financial systems. Organizations such as the G-7, the G-10, and the Financial Stability Forum have all examined ways to improve financial system stability. And for his hard work in this area, I'd like to congratulate Tim Geithner of the U.S. Federal Reserve, who is also your next speaker. With all of these efforts, we have seen some real improvements in financial system stability in recent years.

Since the 1990s, countries have also found that it's very important to develop domestic markets for debt, for their own protection, as well as for the good of the global economic system. And in this area, we have also seen some real signs of progress. A decade ago, with the peso crisis still fresh in people's minds, who would have believed that Mexico would be in a position today to issue long-term, fixed-rate, peso-denominated bonds at such narrow spreads over U.S. Treasuries?

Fiscal policy is also important. Governments must behave in a fiscally responsible manner. That doesn't mean that the books must be perfectly balanced each and every year. But it does mean that governments must maintain, and be committed to maintaining, a manageable debt-to-GDP ratio and avoid running up debt that will tie the hands of future governments.

Conclusion

Let me conclude by going back to where I started my remarks. I have spoken about how a liberalized, global trade and financial order is important for promoting economic growth and prosperity. And I have focused on the importance of a floating exchange rate regime, which is a key element in promoting

good performance, both domestically and globally. For systemically important countries, we should be promoting floating rates supported by well-developed and well-functioning domestic financial markets.

But it has to be acknowledged that it can take some time for emerging-market economies to put these well-developed markets in place. And along the way, some management of capital flows and a degree of intervention in foreign exchange markets may be needed, in these economies. These capital controls and foreign exchange interventions are awkward, and over time, they can lead to a lot of problems. So they must be eliminated as quickly as possible. But, to the extent that countries are making progress towards more flexible exchange rate regimes, those of us with well-developed markets already in place will have to have some tolerance for this awkwardness. And those of you in the ACI will have to continue to trade in this somewhat awkward environment.

In the meantime, I can say that we at the Bank of Canada will be doing all that we can to provide assistance and to persuade countries in transition to move as rapidly as possible, to facilitate the desired convergence.