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Monetary Policy and the Exchange Rate in Canada

It is an honour to be in Beijing and to have the opportunity to speak to you. My purpose today is to talk about what I know best—the conduct of monetary policy in Canada. I want to discuss Canada's experiences—both positive and negative—in moving from a fixed to a floating exchange rate regime, and our subsequent search for a monetary policy anchor. In doing so, I hope that I can provide some insights that may prove useful as China makes its own important decisions about its exchange rate and monetary policy regimes.

Canada's experience is interesting and potentially insightful for two important reasons. First, Canada has more experience with a flexible exchange rate than almost any other country. The Canadian dollar has floated for all but eight years since 1950. Canada is also one of the few countries to have moved, twice, from a fixed to a flexible currency without either an economic crisis or a rapid depreciation of its currency.

A second reason why Canada's experience may be relevant is that the Bank of Canada has had considerable experience in conducting monetary policy independently and in controlling inflation through a system of inflation targets. In 1991, Canada became the second country to introduce inflation targets. I'm pleased to say that this monetary policy framework—with inflation targets and a flexible exchange rate—has proven to be very successful in delivering high, sustainable levels of output and employment in an environment of low and stable inflation.

Moving from Fixed to Flexible Exchange Rates

So, let me talk first about our experiences of moving from a fixed to a floating exchange rate. As I just mentioned, Canada did this twice during the postwar period. The first time was in 1950, and the second was in 1970, following an eight-year period during the 1960s when we again fixed our currency to the U.S. dollar.

In both cases, our decision to float was driven by the desire of the Canadian authorities to do what was best for our own economy. We felt that trying to keep the exchange rate fixed at a time of large capital inflows would have had two serious domestic consequences. First of all, it would have generated large inflationary pressures in Canada. Second, and just as important, it could have created a "boom-bust" economic cycle.

But Canada’s decision to float in 1950 was not an easy one to make, particularly because we had been very active in the founding of the Bretton Woods institutions and the global fixed-rate system. Canada had struggled to stay within this system during the late 1940s. But by 1950, sharply higher commodity prices and strong capital inflows into our resource sector led to upward pressure on the Canadian dollar. In addition, there were speculative short-term capital inflows, which added to the upward pressure on the currency. To maintain the fixed exchange rate, the Canadian authorities first intervened on a massive scale. Foreign exchange reserves rose by 40 per cent in less than three months, and the money supply grew rapidly at a time when the domestic economy was already operating at capacity.

Given the desire to both maintain stable domestic prices and to avoid an economic boom that could lead to a bust later on, Canadian authorities felt that they had two options. One was to revalue the Canadian dollar; the other was to let the Canadian dollar float. The IMF strongly favoured a revaluation—but to what level? It was impossible to know exactly what the correct level for the currency should be. So Canada chose to float the dollar. We allowed the market to set its own level for the currency, with the intention of re-fixing the Canadian dollar at a new level later on. What was surprising was just how quickly the speculative flows eased once we floated our currency. As it turned out, the Canadian dollar appreciated by just 5 per cent during the following three months.

While the IMF was very critical of Canada's decision to float, it accepted our action on the condition that this move would be temporary. The IMF expected Canada to return to the Bretton Woods system as soon as a new equilibrium rate for the Canadian dollar was found. But the flexible exchange rate worked better than almost all observers had expected, and the “temporary period” lasted for 12 years.

With the exchange rate allowed to float freely, the Bank of Canada was able to direct monetary policy to the needs of the Canadian economy. We were able to deal with the inflationary threat posed by rapid economic growth and strong investment flows. With the appreciation of the Canadian dollar and with the end of the speculative flows, inflation came down from more than 10 per cent in 1950 to under 3 per cent by 1952.

Like most other countries at the time, Canada had extensive foreign exchange controls in place when it floated the Canadian dollar. But with growing confidence in the functioning of currency markets, capital controls were essentially eliminated in 1951, well before this occurred in most other countries. Moreover, the elimination of controls and the move to a flexible exchange rate facilitated the development of our domestic financial markets. And this, along with the floating exchange rate, helped the economy to make the necessary adjustments at a time when large numbers of Canadians were leaving farms and moving into the cities.

Now let’s look at 1970, the second time we floated our currency. Canada's reasons for floating then were similar to those in 1950; that is, there was upward pressure on the Canadian dollar and a rapid buildup of international reserves. This pressure came from high commodity prices, renewed capital inflows, and strong foreign demand for Canadian goods—demand associated with a strong global economy and very loose fiscal policy in the United States. These pressures again led to concerns that an inflationary buildup in Canada could lead to a boom-bust economic cycle. And once again, there were fears of speculative short-term inflows that would make the problem worse.

The authorities looked at a number of alternatives, including the setting of a new higher value for the Canadian dollar against the U.S. dollar and a revaluation with a wide band. But these options were rejected because they might have invited further speculative pressures. It was clear that the least risky option for Canada was to return to a floating currency.

Domestic Policy Anchors

The floating exchange rate again proved to be useful, because it eased the immediate inflationary pressures. But at the time, we did not understand that a flexible exchange rate alone does not provide a complete monetary policy framework. What was missing was a nominal anchor. What I mean by the term "nominal anchor" is a clear target for monetary policy, a way to give people confidence that policy is on track, and a way to tie down or "anchor" expectations of future inflation. The Bank of Canada searched for such an anchor throughout the 1970s and 1980s. The outcome of that search was our eventual adoption of inflation targets.

In February 1991, the Bank and the federal government announced a series of inflation-reduction targets. The authorities saw explicit inflation targets, with a clear time frame to achieve them, as a way to shape inflation expectations. This would make it easier to reduce inflation and, at the same time, make the central bank accountable for its actions. The inflation-control agreement has been extended three times, and since 1995 it has called for the Bank to aim to keep inflation at 2 per cent, the midpoint of a 1 to 3 per cent target range.

Let me stress a few points about our inflation-targeting system. First, our commitment to inflation control is the best way that the Bank of Canada can contribute to high sustainable growth of output and employment. In other words, inflation targeting is a means to an end, not an end in itself.

The second key point is that we operate in a symmetric way. We care just as much about inflation falling below target as we do about inflation rising above target. If demand for goods and services pushes the Canadian economy against the limits of its capacity, and inflation is poised to rise above the target, the Bank will raise interest rates to cool off the economy. And when the economy is operating below its production capacity, and inflation is poised to fall below the target, the Bank will lower interest rates to stimulate growth.

Finally, inflation targeting is very important in terms of the Bank's accountability to the Canadian public. If inflation persistently deviates from the target, we must explain why this has happened, what we intend to do to bring inflation back on track, and how long we expect the process to take.

With the adoption of inflation targets, we have gained all the expected benefits, and even gained some that we weren't expecting! Let me list some of them. Inflation has become more stable, averaging very close to 2 per cent, and private sector inflation expectations have become well anchored. Importantly, our symmetric approach has also worked as an economic stabilizer, helping to smooth the peaks and valleys of the business cycle. Businesses and individuals can make long-term economic plans with increased confidence about the future. And scarce economic resources are no longer wasted in efforts to hedge against the threat of either high inflation or deflation.

Moreover, with inflationary expectations well anchored, we have found that movements in the exchange rate have much less impact on inflation than in the past. This is because markets know that the central bank is committed to protecting the domestic value of the Canadian dollar.

Because we have a clear objective, and because we explain publicly how we plan to meet that objective, financial markets can now better predict how the Bank will react to different circumstances. At the same time, inflation targeting has brought increased discipline and clarity to policy deliberations inside the Bank.

Let me make two more points about our inflation-targeting framework. First, our experience with inflation targets has also allowed us to see the importance of having an anchor for fiscal policy. After the adoption of inflation targets in 1991, short-term inflation expectations came down quickly. But long-term expectations adjusted much more slowly, for a couple of reasons. It took some time for the Bank to earn its credibility. But more importantly, the federal government also needed to address its fiscal problems. Indeed, the Bank of Canada found that it could not be as accommodative as it wanted to be in its monetary policy during the first half of the 1990s because of the difficult fiscal position at that time. But by the middle of the 1990s, the government committed to ending a series of budget deficits and to putting Canada's public debt-to-GDP ratio on a sustainable, downward track. With that commitment, Canada finally had anchors for both its monetary and fiscal policies. This now allows us to gear monetary policy more directly to our domestic economic conditions.

The other point I want to make is that with these two policy anchors in place, the floating exchange rate can work more effectively for the Canadian economy. It performs a very important function by helping the economy adjust to changing conditions. Movements in the exchange rate send appropriate signals to businesses and consumers, helping the economy to adjust to changing circumstances. To take a recent example, when there is increasing world demand for Canadian goods and services, this tends to lead to a stronger Canadian dollar. The stronger dollar, in turn, tends to restrain exports and to encourage imports. In doing so, the floating exchange rate helps to maintain a balance between total supply and demand in the economy and that helps keep inflation under control. This process also works in reverse. The point I want to emphasize here is that with these policy anchors in place, a floating exchange rate can be a tremendous asset for an economy by helping to keep total supply and demand in balance.

Conclusion

In closing, let me say again that Canada has been a pioneer both in having a floating exchange rate and in operating with inflation targets. As a consequence, we have a lot of experience that may be of use to others who are contemplating changes to their monetary policy framework. Canada's long experience with flexible exchange rates has been very favourable, and a floating exchange rate continues to be a key part of our monetary policy framework.

But our experience has also taught us that a flexible exchange rate on its own is not enough. A country also needs a domestic anchor for its monetary policy. After trying a number of different approaches, we have now settled on a monetary policy framework based on inflation targeting and a floating exchange rate. This framework helps the economy handle both external and internal shocks. These policies, together with a fiscal policy based on keeping our public debt-to-GDP ratio on a sustainable downward track, have helped to stabilize output and employment at a high level. At the same time, they have delivered low and stable inflation.

Finally, let me say that the recent transformation of the Chinese economy has been nothing short of remarkable. The Chinese authorities and the Chinese people should be congratulated for their efforts to raise living standards and to become a dynamic part of the global economy. But there remains much work to do. So, I hope that my description of Canada's struggle to develop the appropriate policy framework for our country will yield some insights that may prove useful as China makes its own decisions about its own policies.