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Why a Floating Exchange Rate Regime Makes Sense for Canada

As I near the end of my term as Governor, I find myself looking back more and more, focusing on the broad, longer-term trends in our economy and in financial markets and on what those trends may imply for the future.

One of the issues that has often surfaced over the years is the exchange rate for the Canadian dollar. Indeed, over the past couple of years, it has been a topic of considerable public discussion. That discussion has revolved around such questions as: Should we continue floating, or should we peg our currency to the U.S. dollar? In fact, should we even keep our own currency, or should we adopt the U.S. currency?

That there is such interest in our exchange rate is hardly surprising. Some of the more recent attention no doubt stems from public concern about the relatively low value of the Canadian dollar in comparison to the U.S. dollar. But the fundamental reason for this interest is that the exchange rate is an important price in an economy, particularly in one as open as ours. Exports represent about 40 per cent of total Canadian output. And if we add imports, this proportion doubles to 80 per cent. In addition, more than 80 per cent of this trade is with the United States. So the value of our currency in terms of the U.S. dollar has always been particularly important for us. But we must be careful not to exaggerate this point, because when it comes to exports, we compete with many other foreign countries for a share of the U.S. market. And so the exchange rates of those currencies relative to ours also matter a great deal.

In 1950, after the Second World War, Canada became the first major country to adopt a floating exchange rate. In 1962, we went back to a fixed exchange rate only to float our currency again in 1970. In all, the Canadian dollar has floated for 42 out of the past 50 years. No other major country has had as much experience with a floating exchange rate.

This does not mean that our floating exchange rate regime has somehow outlasted all its critics! For the most part, though, the debate over the years has been about the market value of the Canadian dollar—whether it has floated too high or too low, especially from the viewpoint of certain exporters and importers.

More recently, however, and certainly here in Montreal, some of the discussion has focused more on whether a floating currency is the right exchange rate regime for Canada. This particular debate has been kindled by the advent of the euro and its adoption by 11 members of the European Union at the beginning of 1999.

I entered that debate early in 1999, arguing that the introduction of the euro was a remarkable achievement, but that it did not provide a useful role model for Canada and for our position in North America. Since then, with increased interest in the subject internationally, there has been considerable discussion of exchange rate alternatives for Canada and for other countries.

In Canada, the debate about exchange rate regimes has been mainly among academic economists. But, with the decline of our currency against the U.S. dollar through the 1990s, the exchange rate has also been raised as a concern in the business community when comparing our less-impressive economic performance with that of the United States.

Outside Canada, the debate on exchange rate regimes has also become more active, especially in parts of Latin America that have had a long history of high inflation and exchange rate crises. Indeed, in some of these countries, commentators have argued in favour of the outright adoption of the U.S. currency.

Today, I would like to return to the issue of the right exchange rate regime for Canada. Having again considered the advantages and disadvantages of our current arrangements, I can tell you at the outset that I remain convinced that a floating exchange rate continues to make sense for us at this stage of our history. I propose to examine the different sides of the argument with respect to a floating currency in as simple and straightforward a manner as possible.

The transactions costs of a floating currency

When the amount of cross-border trade and financial transactions is as large as ours is with the United States, the need to exchange currency raises the cost of such transactions. Moreover, if the currencies involved are floating, so that the future level of the exchange rate is uncertain, there is also a foreign exchange risk to consider and to hedge against. For example, investors and borrowers must take into account not only the level of interest rates in Canada and the United States, but also potential movements in the exchange rate over the term of their investment or loan. So, yes, there are certain transactions costs in having a separate currency.

A fixed exchange rate between the Canadian and U.S. currencies, such as we had from 1962 to 1970, does not do away with all these transactions costs. Conversions between the two currencies would still be required. Moreover, a fixed exchange rate does not eliminate currency risk. If there were any perceived risk of a future devaluation of the fixed rate for the Canadian dollar, the result would be persistently higher interest rates in Canada than in the United States to compensate for that risk.

Even where countries have gone beyond a fixed exchange rate and have tied their currencies rigidly to the U.S. dollar—as Hong Kong and Argentina have, through a currency board—the costs, in terms of risk premiums in domestic interest rates, have not completely disappeared.

So, in fact, the only way to eliminate cross-border transactions costs with the United States *and* eliminate premiums in our interest rates for potential exchange rate risk is not through a fixed exchange rate but through some sort of currency union with the United States. In reality, this would mean “dollarization.”

Dollarization versus monetary union

But why not a common-currency arrangement, as in Europe? Wouldn’t that be better?

On the face of it, of course, a currency union would be better than dollarization. Under such an arrangement, we would, in principle, still have some say in determining a North American monetary policy. Presumably, we would also be able to keep some of the revenue (or seigniorage) from issuing that common currency.

But we must understand what a North American monetary union would mean in reality. The European experience is rather enlightening in this respect. Economic and monetary union in Europe is the product of 50 years of increasing political and economic integration. The recent adoption of a common currency, which was a further step on the road to European integration, was taken mainly for political, rather than economic, reasons. And when it comes to decision-making at the European Central Bank, the three large countries in the euro area (Germany, France, and Italy) have agreed to a “one country–one vote” rule with their other eight medium- and small-sized partners.

I do not see how we could possibly have similar arrangements in North America, given the clear dominance of the U.S. economy. In effect, a monetary union with the United States could only mean that Canada would adopt the U.S. dollar.

The advantages of a floating exchange rate

So far, I have been focusing on the costs of cross-border transactions and the exchange rate regimes that could reduce those costs. But that is not all that matters. The real world is a more complicated place, as I shall explain in a moment. And that is why a floating exchange rate regime makes sense for Canada.

The case typically made for a floating rate for Canada is that it gives us the chance to run an independent monetary policy. That is true. But these days, there is really very little difference in the low-inflation objectives of industrial countries. The real value of a floating exchange rate for Canada is that it allows us to have different monetary conditions than the United States—monetary conditions appropriate to our own economic circumstances, even as we pursue the same general objective of low and stable inflation. The significance of having this option is our ability to respond to external economic shocks that affect us differently from our southern neighbours, or to respond to differences in domestic economic policies.

Let me give you a couple of examples of economic shocks and policies that have reflected these differences.

Fluctuations in world commodity prices are an important first example. Although our reliance on primary commodities has diminished substantially through the years, such goods still account for 30 to 40 per cent of Canada's exports. The United States, on the other hand, is a net importer of commodities. The Asian financial crisis of 1997–98, which led to a 20 per cent decline in the prices of the key primary commodities that we export, was a major negative shock for Canada. In contrast, the United States benefited from these lower prices.

The decline in the value of our currency against the U.S. dollar at the time was in *response* to that economic shock. And it helped Canadian manufacturing and other non-commodity sectors to increase their exports to the United States. In this way, the impact of falling employment and incomes in our primary sector because of the lower commodity prices was largely offset by greater expansion in these other sectors.

Another example involves the fiscal restraint measures that were undertaken by our federal and provincial governments, beginning in the mid-1990s, to deal with persistent deficits and the resulting unsustainable accumulation of public debt. The United States also had a budgetary problem. But the need for fiscal tightening was much greater here and so was the effect of the corrective measures on total demand in our economy. To help the transfer of resources from the public to the private sector and so support overall demand in Canada, we needed lower interest rates here than in the United States. These lower rates were maintained through most of the period from 1996 to the present. In today's globalized financial markets, such persistent interest rate differences in the circumstances I have described are possible only with a floating exchange rate.

In both these examples, the exchange rate acted as a shock absorber between the U.S. and Canadian economies, helping to facilitate the needed adjustment in response to differing shocks and differing policy requirements. Even though our two economies are closely linked, they can move in different directions. And when that happens, the shock-absorber role of a floating exchange rate is invaluable.

Although these recent examples involved downward adjustments in our currency, this has not always been the case. Indeed, there have been times when economic shocks and policy differences in the two countries have worked in the opposite direction, leading to increases in the value of the Canadian dollar.

It is, of course, possible to cope with unexpected shocks and policy differences under a fixed exchange rate or a monetary union. But the adjustment process will take longer, will be more difficult, and will cost more overall.

Imagine the adjustment in our economy that would have been required in 1997–98 in response to the fall in commodity prices, if the Canadian dollar had not been floating. To maintain a fixed exchange rate throughout that period, much higher interest rates would have been necessary to resist the downward pressure on our currency from the falling receipts for commodity exports. In effect, this would have meant a more serious economic slowdown to bring wages and salaries down to a level that would make other industries more competitive and allow them to increase their exports.

Even under a common-currency arrangement, we would still have had to go through much the same adjustment over the longer term. But under such an arrangement, more of the short-term pain—in terms of declines in employment and incomes—would have been felt in the primary industries and in regions of Canada with a higher concentration of such industries.

The bottom line is: There is no escaping the need to adjust to real economic shocks regardless of the currency regime. But a floating-rate regime does help to facilitate and smooth the adjustment process.

Before concluding, I would like to quickly deal with a couple of common misconceptions about flexible exchange rates.

The first one relates to the incentives for business to innovate and invest in new technology. If the argument here is that a low exchange rate gives exporting firms easier profits and blunts their motivation to innovate and become more efficient and competitive, I am inclined to say that this suggests a rather serious problem of corporate governance. Surely, the job of company directors is to ensure that management is doing everything necessary to maximize profits and stock values, no matter what the circumstances. Any company that does not operate this way will soon find itself losing to the competition.

Another misconception is that a relatively low exchange rate puts a country at a disadvantage in terms of foreign takeovers. Here, I would say that if Canadian companies became more attractive in recent years to U.S. corporate buyers, it was primarily because of high stock market valuations in the United States, not because of a lower Canadian dollar. High stock prices essentially provided U.S. companies with very cheap financing for corporate takeovers in countries where market valuations were lower. We saw a similar process involving Canadian takeovers of foreign companies more recently, when stock market valuations hit very high levels in this country.

Concluding thoughts

Let me summarize my main points. In view of our close economic and financial links with the United States, I recognize the attractions of the reduced currency uncertainty and lower transactions costs that would be part of a fixed exchange rate arrangement with the U.S. dollar.

Nonetheless, I believe that for Canada, the macroeconomic advantages of a flexible exchange rate continue to far outweigh the lower transactions costs of a fixed rate. As long as we remain a major producer of primary commodities, and as long as we want to pursue separate economic policies that are suited to our own circumstances and that require differing monetary conditions, the shock-absorber element of a floating currency will serve us well.

Does a floating exchange rate regime mean that we are likely to have a persistently weak currency? No, it does not.

Through the second half of the 1990s, we have seen a U.S. dollar that is strong against virtually all other currencies, reflecting the remarkable performance of the U.S. economy. In the process, however, the United States has also built up a very large cumulative deficit in its transactions with the rest of the world. At some stage, this external deficit will have to be reversed, and a lower U.S. dollar will be part of this adjustment.

Here in Canada, after a slow start in the early 1990s, the fundamentals of our economy have improved. Growth has been more robust in recent years, employment and incomes have been rising, and inflation is low and stable. Government budget deficits have been eliminated, and the public debt relative to the size of our economy has been shrinking. Moreover, as part of a major restructuring effort by the private sector, businesses have been investing heavily in machinery, equipment, and technology. We may now be starting to see the payoff of these efforts, in the form of some larger productivity gains, which I hope will grow and continue, thereby providing the basis for improved standards of living for Canadians in the future.

All in all, the prospects for our economy are very positive. If these prospects are realized, we will also see a stronger Canadian dollar over the medium term.