Rising domestic inflation led to the establishment of the Prices and Incomes Commission in 1968 and to the introduction of a restrictive stance on monetary policy. This occurred at a time when the United States was pursuing expansionary policies associated with the Vietnam War and with a major domestic program of social spending. Higher commodity prices and strong external demand for Canadian exports of raw materials and automobiles led to a sharp swing in Canada’s current account balance, from a sizable deficit in 1969 to a large surplus. Combined with sizable capital inflows associated with relatively more attractive Canadian interest rates, this put upward pressure on the Canadian dollar and on Canada’s international reserves. The resulting inflow of foreign exchange led to concerns that the government’s anti-inflationary stance might be compromised unless action was taken to adjust the value of the Canadian dollar upwards. There was also concern that rising foreign exchange reserves would lead to expectations of a currency revaluation, thereby encouraging speculative short-term inflows into Canada.

On 31 May 1970, Finance Minister Edgar Benson announced that for the time being, the Canadian Exchange Fund will cease purchasing sufficient U.S. dollars to keep the exchange rate of the Canadian dollar in the market from exceeding its par value of 92½ U.S. cents by more than one per cent (Department of Finance 1970).

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90. Consumer prices were rising at about 4 to 5 per cent through 1969 and early 1970. Wage settlements were also rising, touching 9.1 per cent during the first quarter of 1970.
Canadian authorities also informed the IMF of their decision to float the Canadian dollar and of their intention to resume the fulfillment of their obligations to the Fund as soon as circumstances permitted. The Bank of Canada concurrently lowered the Bank Rate from 7.5 per cent to 7 per cent, an action aimed at making foreign borrowing less attractive to Canadian residents and at moderating the inflow of capital, which had been supporting the dollar.

The government made the decision to float the Canadian dollar reluctantly. But Benson believed that there was little choice if the government was to bring inflation under control. He hoped to restore a fixed exchange rate as soon as possible but was concerned about a premature peg at a rate that could not be defended.

As in 1950, other options were considered but rejected. A defence of the existing par value was untenable since it could require massive foreign exchange intervention, which would be difficult to finance without risking a monetary expansion that would exacerbate existing inflationary pressures. A new higher par value was rejected, since it might invite further upward speculative pressure, being seen by market participants as a first step rather than a once-and-for-all change. Widening the fluctuation band around the existing fixed rate from 2 per cent to 5 per cent was rejected for the same reason (Beattie 1969). The authorities also considered asking the United States to reconsider Canada’s exemption from the U.S. Interest Equalization Tax. Application of the tax to Canadian residents would have raised the cost of foreign borrowing and, hence, would have dampened capital inflows. This, too, was rejected, however, because of concerns that it would negatively affect borrowing in the United States by provincial governments (Lawson 1970a).

While recognizing the need for a significant appreciation of the Canadian dollar, the Bank of Canada saw merit in establishing a new par value...
at US$0.95 with a wider fluctuation band of ±2 per cent (Lawson 1970b). A new fix was seen as being more internationally acceptable than a temporary float, and since the lower intervention limit of about US$0.9325 would have been the same as the prevailing upper intervention limit, such a peg would have been accepted by academics who favoured a crawling peg. A new peg was also viewed as desirable because it would preserve an explicit government commitment to the exchange rate consistent with its obligations to the IMF. There was also some concern that a floating exchange rate might “encourage, as it had in the late 1950s, an unsatisfactory mix of financial policies” (Lawson 1970a).

For its part, the IMF urged Canada to establish a new par value. Fund management was concerned about the vagueness of Canada’s commitment to return to a fixed exchange rate, fearing that the float would become permanent as it had during the 1950s. The IMF also feared that Canada’s action would increase uncertainty within the international financial system and would have broader negative repercussions for the Bretton Woods system, which was already under considerable pressure. Canadian authorities declined to set a new fix, emphasizing the importance of retaining adequate control of domestic demand for the continuing fight against inflation.

The dollar in the 1970s

Immediately following the government’s announcement that it would allow the Canadian dollar to float, the currency appreciated sharply, rising roughly 5 per cent to about US$0.97. It continued to drift upwards through the autumn of 1970 and into 1971 to trade in a relatively narrow range between US$0.98 and US$0.99. By 1972, the Canadian dollar had traded through parity with its U.S. counterpart. It reached a high of US$1.0443 on 25 April 1974.

The strength of the Canadian dollar through this period can largely be attributed to strong global demand, which boosted the prices of raw materials. There were also large inflows of foreign capital, partly reflecting the view that Canada’s balance of payments was expected to be less affected by the tripling of oil prices that occurred through 1973 than that of other major industrial countries, since it was only a small net importer of oil.

During the early 1970s, the dollar’s strength was also due to the general weakness of the U.S. currency against all major currencies as the Bretton Woods system of fixed exchange rates collapsed. With the U.S. balance-of-payments deficit widening to unprecedented levels, the U.S. government suspended the U.S. dollar’s convertibility into gold on 15 August 1971 and imposed a 10 per cent surcharge on eligible imports. This action followed a series of revaluations of major currencies. On 18 December 1971, the major industrial countries agreed (the Smithsonian Agreement) to a new pattern of parities for the major currencies (excluding the Canadian dollar) with a fluctuation band of ±2.25 per cent. The U.S. dollar was also
devalued by 8.57 per cent against gold, although it remained inconvertible. This last-ditch attempt to save the Bretton Woods system failed. By 1973, all major currencies were floating against the U.S. dollar.

The strength of the Canadian dollar against its U.S. counterpart during this period concerned the authorities, who feared the impact of a higher dollar on Canada’s export industries at a time of relatively high unemployment. Various measures to rectify the problem were examined but dismissed as being either unworkable or harmful. These included the introduction of a dual exchange rate system, the use of moral suasion on the banks to limit the run-down of their foreign currency assets, and government control of the sale of new issues of Canadian securities to non-residents. None of these options was ever pursued (Government of Canada 1972). However, under the Winnipeg Agreement, reached on 12 June 1972, chartered banks agreed, with the concurrence of the minister of finance, to an interest rate ceiling on large, short-term (less than one year) deposits. The purpose of the agreement was to reduce “the process of escalation of Canadian short-term interest rates” (Bank of Canada Annual Report 1972, 15). Lower Canadian short-term interest rates and narrower rate differentials with the United States helped to relieve some of the upward pressure on the Canadian dollar.

**Introduction of monetary targets**

In reaction to “stagflation,” the combination of high unemployment and inflation that prevailed during the early 1970s, most major economies, including Canada, embraced “monetarism.” Based on work by Milton Friedman, who argued that inflation was always and everywhere a monetary phenomenon, it was maintained that by targeting a gradual deceleration in the growth of money, inflation could be brought under control with minimal cost. Accordingly, in 1975, the Bank of Canada adopted a target for the growth of M1, a narrow monetary aggregate, which it hoped, if met, would gradually squeeze inflation out of the system. Money growth would subsequently be set at a rate that would be consistent with the real needs of the economy, but would also ensure price stability over the long run. While appealing in theory, monetarism failed in practice. Despite the Bank of Canada hitting its money-growth targets, inflation failed to slow as expected. Monetary targets were abandoned in Canada in 1982. See page 77 for more details.
Monetary policy was also more accommodative than it should have been through this period, as the Bank of Canada sought to moderate the upward pressure on the currency and to support aggregate demand as the global economy slowed because of the oil-price shock. In hindsight, the Bank failed to “recognize the extent to which the economy in general and the labour market in particular were coming under strain” (Bank of Canada Annual Report 1980, 17). In other words, the Canadian economy was operating closer to its capacity limits than was earlier believed. Fiscal policy was also very expansionary through this period. While the 1974–75 slowdown in Canada was relatively shallow compared with that in the United States, where policy was less accommodative, inflationary pressures intensified.

To address these inflationary pressures, an anti-inflation program, including wage and price controls, was introduced by the government in late 1975, and the Bank of Canada adopted a target for the narrow monetary aggregate, M1, with the objective of gradually reducing the pace of money growth and thus inflation. After weakening temporarily in 1975 and falling below parity with the U.S. dollar, the Canadian dollar recovered in 1976. Wide interest rate differentials with the United States provided considerable support for the currency, with provinces, municipalities, and Canadian corporations borrowing extensively in foreign capital markets. Foreign appetite for Canadian issues was enhanced by the removal in 1975 of the 15 per cent federal non-resident withholding tax on corporate bonds of five years and over. Foreign borrowing helped to mask the effects of deteriorating Canadian economic fundamentals on the Canadian dollar.

The currency moved up to the US$1.03 level during the summer of 1976 in volatile trading, but the election of a Parti Québécois government in Quebec on 15 November 1976 prompted markets to make a major reassessment of the Canadian dollar’s prospects. Political uncertainty, combined with softening prices for non-energy commodities, concerns about Canada’s external competitiveness related to rising cost and wage pressures, and a substantial current account deficit, sparked a protracted sell-off of the dollar.
Over the next two years, the Canadian dollar fell significantly, declining to under US$0.84 by the end of 1978. This occurred even though the U.S. dollar was itself depreciating against other major overseas currencies and despite considerable exchange market intervention by the Bank of Canada on behalf of the federal government to support the Canadian dollar. To help replenish its international reserves, the federal government established a US$1.5 billion stand-by line of credit with Canadian banks in October 1977. This facility was increased to US$2.5 billion the following April. A similar US$3 billion facility was organized in June 1978 with a consortium of U.S. banks. The federal government also borrowed extensively in New York and in the German capital market to assist in financing the current account deficit and to support the currency. The Bank of Canada tightened monetary policy through 1978, with the Bank Rate rising by 375 basis points to 11.25 per cent by the beginning of January 1979. Early in 1979, the federal government undertook additional foreign borrowings, this time in the Swiss and Japanese capital markets.

Notwithstanding the tightening in monetary policy, inflation pressures did not abate, even though the rate of monetary expansion was kept in line with announced targets, and the Bank Rate touched 14 per cent by the end of 1979. Against this backdrop, however, the Canadian dollar steadied and ended the year close to US$0.86.

The dollar in the 1980s

Throughout the 1980s, the Canadian dollar traded in a wide range, weakening sharply during the first half of the decade, before staging a strong recovery during the second half. Early in the period, the Bank’s policy was to moderate the effects of large swings in U.S. interest rates on Canada, taking some of the impact on interest rates and some on the exchange rate (Bank of Canada Annual Report 1980). For the Bank to react in this way, it needed more flexibility, and in March 1980,
the Bank Rate was linked to the rate for three-month treasury bills, which was established at the weekly bill auction.\textsuperscript{91} Canadian short-term interest rates rose sharply through 1980 and into the summer of 1981, with the Bank Rate touching an all-time high of 21.24 per cent in early August 1981, before moderating through the remainder of the year. At the same time, the Canadian dollar came under significant downward pressure. Important factors behind its depreciation included political concerns in the lead up to the Quebec referendum in May 1980, weakening prices for non-energy commodities, and the introduction of the National Energy Program by the federal government in October 1980, which prompted a wave of takeovers of foreign-owned firms by Canadian-owned firms, particularly in the oil sector. By mid-1981, policy-makers became concerned that the exchange rate slide would begin to feed on itself. Consequently, the minister of finance asked the chartered banks to reduce their lending to finance corporate takeovers that would involve outflows of capital from Canada.

Nevertheless, confidence in the Canadian dollar continued to erode through 1982 on concerns about the commitment of Canadian authorities to an anti-inflationary policy stance, and the cancellation of a number of large energy projects. With the dollar falling below US$0.77, the Bank of Canada allowed short-term interest rates to rise to prevent the increasing weakness of the Canadian dollar “from turning into a speculative rout” (Bank of Canada Annual Report 1982, 20). The Bank also reluctantly announced in November 1982 that it would no longer target M1 in its fight against inflation. Among other things, financial innovation had undermined the link between money growth and inflation. Research also revealed that the small changes in interest rates needed to keep money growth on track were insufficient to really affect prices or output. In testimony before the House of Commons Finance Committee, Governor Bouey said “We did not abandon M1, M1 abandoned us” (House of Commons 1983, 12). In other words, narrow money growth had failed to provide a reliable monetary anchor.

While the currency recovered to about US$0.82 on the Bank of Canada’s actions and on positive market reaction to the introduction of a restrictive budget by the federal government, the respite proved to be short-lived. Although for the most part, the Canadian dollar held its own against its U.S. counterpart through 1983, it weakened sharply in 1984 and the first half of 1985, as did other major currencies, as funds were attracted to the United States by high interest rates and relatively favourable investment opportunities.

In September 1985, amid growing concerns about global external imbalances and speculative pressures in favour of the U.S. dollar, the G-5 major industrial countries agreed in the Plaza Accord to bring about an orderly depreciation of the U.S. dollar through a combination of more forceful concerted exchange rate intervention and domestic

\textsuperscript{91} The Bank Rate had previously been set in this manner between late 1956 and early 1962.
The Plaza and Louvre Accords

Named after the Plaza Hotel in New York, the Plaza Accord was a 1985 agreement among France, West Germany, Japan, the United States, and the United Kingdom aimed at correcting large external imbalances among major industrial countries and resisting protectionism. In addition to encouraging an orderly depreciation of the U.S. dollar, each country agreed to specific policy measures that would boost domestic demand in countries with a surplus, notably Japan and West Germany, and increase savings in countries with deficits, especially the United States. Two years later in Paris, the G-5 countries, along with Canada, agreed to intensify their economic policy coordination in order to promote more balanced global growth and to reduce existing imbalances. It was also agreed that currencies were now broadly in line with economic fundamentals and that further exchange rate shifts would be resisted. The success of policy coordination among industrial countries remains a hotly debated issue. While global protectionist pressures were averted, overly expansionary policy in Japan contributed to a speculative bubble in asset prices that subsequently collapsed, causing considerable and lasting damage to the Japanese economy. The ability of concerted exchange rate intervention to influence the value of the U.S. dollar has also been the subject of considerable controversy.

policy measures. Although the overseas currencies began to appreciate against the U.S. dollar, the Canadian dollar continued to depreciate against its U.S. counterpart on concerns about weakening economic and financial prospects in Canada and falling commodity prices. The failure of two small Canadian banks—the Canadian Commercial Bank and the Northland Bank—may have also temporarily weighed against the Canadian dollar.

After touching a then-record low of US$0.6913 on 4 February 1986, the dollar rebounded, following
a concerted strategy of aggressive intervention in the foreign exchange market, sharply higher interest rates, and the announcement of large foreign borrowings by the federal government. Initially stabilizing at about US$0.72, the dollar began an upward trend against the U.S. dollar, which lasted through the remainder of the decade.

In February 1987, Canada joined other major industrial countries in the Louvre Accord aimed at intensifying policy coordination among the major industrial countries and stabilizing exchange rates. Pursuant to this Accord, Canada participated on several occasions in joint interventions to support the U.S. dollar against the German mark and the Japanese yen. Although the Canadian dollar dipped briefly following the stock market “crash” in October—the Toronto Stock Exchange (TSE) fell 17 per cent over a two-day period—it quickly recovered.

Through 1988 and 1989, the currency continued to strengthen owing to various factors, including a buoyant economy led by a rebound in commodity prices, expansionary fiscal policy at both the federal and provincial levels, and a significant tightening of monetary policy aimed at cooling an overheating economy and reducing inflationary pressures. Positive investor reaction to the signing of the Free Trade Agreement (FTA) with the United States in 1988 also supported the currency. The Canadian dollar closed the decade at US$0.8632.

The dollar in the 1990s

While the Canadian dollar began the 1990s on a strong note, it weakened against its U.S. counterpart through much of the decade, declining from a high of US$0.8934 on 4 November 1991 to close the decade at US$0.6929.

Through 1990 and most of 1991, the Canadian dollar climbed against its U.S. counterpart (and against major overseas currencies). This was largely due to a further tightening of monetary policy within the context of inflation-reduction targets announced in February 1991, and widening interest rate differentials that favoured Canadian instruments.

After cresting in the autumn of 1991 at its highest level against the U.S. dollar since the late 1970s, the Canadian dollar began to depreciate, falling sharply through 1992 to close the year at US$0.7868. The gradual, but sustained decline in the value of the Canadian dollar, which continued through 1993 and 1994, reflected various factors. With inflation falling to—and for a time below—the target range established in 1991 and with significant unused capacity in the economy, the Bank of Canada sought easier monetary conditions through lower interest rates. Downward pressure on the currency also reflected increasing concern about persistent budgetary problems at both the federal and provincial levels, softening commodity prices, and large current account deficits.

92. The appreciation of the Canadian dollar following the signing of the FTA gave rise to a myth at that time that the Canadian government had secretly agreed to engineer a higher value for the Canadian dollar as a quid pro quo for the free trade agreement with the United States.
The international environment was also unfavourable. The Exchange Rate Mechanism in Europe came under repeated attack through 1992 and 1993, followed by rising U.S. interest rates through 1994. The Mexican peso crisis of 1994 and early 1995 also drew investor attention to the weakness of Canada’s fundamentals, especially its large fiscal and current account deficits.

A degree of stability in the Canadian dollar was temporarily re-established through 1995 and 1996 for a number of reasons. These included higher short-term interest rates (at least early in the period), evidence that fiscal problems were being resolved, a marked improvement in Canada’s balance of payments, partly because of strengthening commodity prices, and a diminished focus on constitutional issues. The Canadian dollar traded in a relatively narrow range close to US$0.73 through much of this period.

Renewed weakness in the currency began to emerge in 1997 and became increasingly apparent in 1998, despite strong domestic fundamentals—very low inflation, moderate economic growth, and solid government finances. Once again, the slide of the currency could be partly attributed to external
factors in the form of lower commodity prices. Commodity prices began to soften in the summer of 1997 but subsequently weakened significantly, owing to a financial and economic crisis in emerging markets in Asia. In this regard, the weaker Canadian dollar acted as a shock absorber and helped to mitigate the impact of lower commodity prices on aggregate demand and activity in Canada.

The large negative interest rate differentials that had earlier opened up between Canadian and U.S. financial instruments also weighed against the Canadian dollar, as did the U.S. dollar’s role as a safe-haven currency during times of international crisis. Rising U.S. equity prices, reflecting a pickup in productivity growth and large capital flows into the high-technology sector, were another background factor that supported the U.S. currency against all others, including the Canadian dollar. This factor persisted though the rest of the decade.

During the summer of 1998, the crisis in emerging-market economies widened and intensified with a debt default by Russia and growing concerns about a number of Latin American countries. The Canadian dollar touched a low of US$0.6311 on 27 August 1998, before recovering somewhat following aggressive action by the Bank of Canada, including a 1 percentage point increase in short-term interest rates and considerable intervention in the foreign exchange market. While a lower Canadian dollar was not surprising, given the weakness in global commodity prices, the authorities had become concerned about increased risk premiums on Canadian-dollar assets and a potential loss of confidence on the part of holders of Canadian-dollar financial instruments. Interest rate reductions by the Federal Reserve Bank and
the return of a modicum of stability in financial markets following action by the Federal Reserve to calm markets after the collapse of Long-Term Capital Management (LTCM), permitted the Bank of Canada to reduce Canadian interest rates without undermining confidence in the Canadian dollar.93

The final year of the decade saw the Canadian dollar recouping some of its earlier losses against the U.S. dollar as the international financial situation improved, and investors focused on Canada’s strong economic fundamentals, including a narrowing current account deficit and strengthening global commodity prices.

The dollar in the 21st century

The Canadian dollar resumed its weakening trend in 2000 and 2001, and touched an all-time low of US$0.6179 on 21 January 2002. Through much of this period, the U.S. currency rose against all major currencies, reaching multi-year highs, supported by large private capital flows in the United States owing to continued robust U.S. growth and further strong productivity gains. A decline in commodity prices in 2001, caused by an abrupt slowdown of the global economy, led by the United States, also undermined the Canadian currency. In addition, markets were temporarily roiled by the terrorist attacks in the United States on 11 September.

In this economically and politically uncertain environment, central banks around the world lowered interest rates to support demand and provide liquidity to markets. The Bank of Canada reduced short-term interest rates by 375 basis points through 2001 and early 2002.

Through 2002, the Canadian dollar stabilized and then began to recover as the global economy picked up and as the U.S. dollar started to weaken against other currencies. It appreciated sharply through 2003 and 2004, peaking at over US$0.85 in November 2004, a level not seen for thirteen years. This was a trough-to-peak appreciation of roughly 38 per cent in only two years. The Canadian dollar’s

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93. LTCM was a well-respected hedge fund that included on its board two Nobel-Prize-winning economists, Myron Scholes and Robert Merton. It was highly leveraged, with assets of about US$130 billion on a capital base of about US$5 billion. The fund incurred large losses on trades in the swap, bond, and equity markets that occurred when market liquidity dried up and spreads between government bonds and other instruments unexpectedly widened sharply. LTCM also incurred losses on its portfolio of Russian and other emerging-market debt following the Russian default.
rise reflected a robust global economy, led by the United States and emerging Asian markets (particularly China), which boosted the prices of Canada’s commodity exports. As well, growing investor concerns about the widening U.S. current account deficit, undermined the U.S. unit against all major currencies. While the Canadian dollar settled back somewhat during the first half of 2005 as the U.S. dollar rallied modestly against all currencies, underpinned by rising U.S.-dollar interest rates, it began to strengthen again through the summer, supported by rising energy prices. Strengthening against all major currencies, the Canadian dollar touched a high of US $0.8630 on 30 September 2005. In late October, it was trading for the most part in a US $0.84–0.85 range, off its earlier highs as energy prices retreated.
Chart 6
Canadian Dollar in Terms of the U.S. Dollar

A: 25 April 1974: Canadian-dollar recent high US$1.0443
B: 4 February 1986: US$0.6913
C: 4 November 1991: US$0.8934
D: 27 August 1998: US$0.6311
E: 21 January 2002: All-time Canadian-dollar low US$0.6179
F: 30 September 2005: US$0.8630

1. 31 May 1970: Canadian dollar floated
2. December 1971: Smithsonian Agreement
4. 15 November 1976: Election of Parti Québécois in Quebec
5. 20 May 1980: Quebec Referendum
7. September 1985: Plaza Accord
8. February 1987: Louvre Accord
9. 3 June 1987: Meach Lake Constitutional Accord
10. 26 June 1990: Ratification of Meach Lake Constitutional Accord fails
11. 26 October 1992: Defeat of Charlottetown Accord
13. 30 October 1995: Quebec Referendum
16. 11 September 2001: Terrorist attacks in the United States

Source: Bank of Canada