Keynote Address

Canada and Flexible Exchange Rates

Milton Friedman

The last time I had an extensive talk with an official of the Bank of Canada about exchange rates was on 13 April 1948. The official was Donald Gordon, at the time the Deputy Governor. The occasion was a University of Chicago round table. The round table was a regular Sunday morning radio broadcast under the auspices of the University of Chicago. It was the most popular Sunday radio talk show. At the time, Canada was experiencing a large balance-of-payments deficit, thanks in part to having appreciated the dollar two years earlier. It was trying to defend the rate by using exchange controls, and it was having great difficulty.

That was a topic for our round table. It was broadcast from Toronto. The program itself was only half an hour but, as usual on all round table programs, the participants met the night before for dinner and a discussion in order to determine the content of the program. So I was able to have a very extensive discussion about the exchange rate problem with Donald Gordon and the other participant, Professor W.A. Mackintosh.

My impression was, hard as this may be to believe at this stage, that this was the first time that Donald Gordon had ever heard a serious defence of flexible exchange rates as a way to organize the international financial arrangements.

The next year, 1949, Canada devalued the dollar, and when that didn't work, a year later, on 30 September 1950, Canada floated the dollar. Another year later, exchange controls were dropped, and the Bank of Canada stopped intervening in the market.

By 1952, Canada was on a clean float. From 1952 to 1960, floating exchange rates worked very well; the rate didn't move around a great deal. There was short-term fluctuation but no serious crises. Speculation was clearly stabilizing. The Bank of Canada largely stayed out of it.

Why, then, did Canada go back to a pegged rate in 1962? That's a very interesting question, and I think it's very instructive experience. I discussed this question in the course of a public debate in 1967, and here is an edited version of what I said.

> . . . floating rates are not a guarantee of sensible internal monetary policy. You can have silly internal monetary policy with fixed rates, you can have silly internal monetary policy with floating rates. All floating rates do is to make it possible for you to have a sensible internal monetary policy without considering the rest of the world. . . .
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> The reason Canada went off floating rates was because they were working so well, and their internal monetary policy was so bad.

That bad monetary policy led to high levels of unemployment and a big fight in 1961 between J.E. Coyne, Governor of the Bank of Canada at the time, and the government. The government called for his resignation. After a long argument, James Coyne finally left in mid-1961.

When he left, "there was an attempt to do something effective about the unemployment problem in Canada. But instead of correcting their bad monetary policy internally, which would have been a sensible thing to do, they [decided to] force the rate down and stimulate employment inside Canada by discouraging imports and encouraging exports"—a competitive currency devaluation, the bugbear of the 1930s.

> And so what happened? The Bank of Canada announced that it was going to try to force the price of the Canadian dollar down by exchange speculation. The speculators didn't believe it. The Bank of Canada speculated against the Canadian dollar, and the speculators absorbed the funds, and nothing happened. The Canadian rate stayed fairly fixed. So the Bank of Canada said, "We haven't been doing this on a big enough scale; we're going to do it yet." Then the Bank made bigger and bigger announcements and engaged in larger and larger speculative actions.
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> Finally, it started the rate moving down. Once the rate started moving down, the speculators said to one another, "The government's really going to do it." So what do the speculators

> do in that case? They jump on top of the government speculation and, all of a sudden, the rate started to go down much faster than the government had intended it to go down.
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> Now the government was stuck. "We've got a tiger by the tail," they said. "How do we stop this downward slide of the rate?" When they initially started this operation, they had no intention of pegging the rate. What they were trying to do was drive it down.
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> When, under this stimulus, there was a rapid movement down, obviously the sensible thing for them to have done would have been to announce that they had made a mistake, that they were getting out of the market, and that they were going to let the dollar resume its former behaviour.

But, as I said then—remember I'm quoting from what I said in 1967—"no government in the world has ever done a thing like that. The key principle of a government is that you make a different mistake each time, not the same one. And you never admit that what you did before was wrong."

So, "instead of simply undoing [their mistake], they said, 'Well, the way we'll stop the rate from going down is by pegging it.' So they announced that they were going to peg it at 92.5 cents. As it happened, it took very large operations at that stage to break the speculative movement and to peg it. But they finally succeeded in pegging it at 92.5 cents. Then they were stuck with it there [until 1970]."[1]

That's the end of my quote. Now we come back to the question: Why did they float in 1970?

In 1970, expansionary policies in the United States and the international demand for Canadian goods—this was, remember, at the time of the Vietnam War—led to large surpluses in the balance of payments, which added to inflationary pressures. To counter these, the government reluctantly decided to refloat the Canadian dollar, the only major country to do so.

Then President Nixon closed the gold window on 15 August 1971. A Smithsonian agreement that was reached shortly thereafter collapsed, and floating became universal among the major countries in 1973.

Since 1970, the Canadian dollar has continued to float, with only minor intervention by the Bank of Canada. It has fluctuated widely from a trifle

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1. Quotes from Milton Friedman and Robert V. Roosa, *The Balance of Payments: Five versus Fixed Exchange Rates*, AEI Rational Debate Seminar (Washington, D.C.: American Enterprise Institute, 1967), pp. 122–25.

over one U.S. dollar to a Canadian dollar in the 1970s, to a low of around 65 cents (US) in recent years. For the most part, the short-run fluctuations have been mild, and the larger changes have occurred gradually and corresponded to the changing international position of Canada.

Over the 30 years, Canadian inflation has averaged about one-half of 1 per cent a year higher than U.S. inflation. That accounts for somewhat more than half of the decline in the Canadian dollar relative to the U.S. dollar in the past 30 years.

Canada's experience reflects very clearly the lesson that has been taught much more dramatically by the exchange crises of the 1990s. Pegged exchange rates controlled by an independent central bank are a standing invitation to balance-of-payments trouble. Every crisis in the 1990s, just as every crisis in Canada's past, was in a country with a pegged exchange rate.

Japan had very serious, and still has very serious, internal difficulties and had them all through the 1990s. But Japan has a floating exchange rate and, in consequence, it had no external balance-of-payments crises.

That raises an interesting question. Given that fact, which I think is demonstrable, why have most central banks—and here Canada is a major exception—until the last few years, been so enthusiastic about fixed, compared with floating, rates?

If a country has a truly fixed rate, the central bank has nothing to do. It simply has to let the money supply move up and down so as to maintain the exchange rate, if it's got a hard fixed rate. So you would think the central bankers wouldn't want to be put out of existence.

On the other hand, when you have a floating exchange rate, central banks serve a real function. They have to try to manage internal monetary policy in such a way that keeps the price level relatively stable, or whatever their internal objectives are. And, under those circumstances—as we can see in recent years—central bankers become important people.

I've always been puzzled by this fact, because it would seem to me that it's in the self-interest of central bankers to favour floating rates.

Questions and Answers

John Crow: Over recent years, Canada has experienced slower productivity growth than the United States. Some proponents of a fixed rate for Canada have argued that the floating rate, which has depreciated in both real and nominal terms over the 1990s, is in part responsible for this slower growth. Do you believe a floating nominal exchange rate can have an impact on productivity?

Milton Friedman: That's a very good question, a very important one. In my opinion, they are attributing to the floating rate something that is really arising from other sources. There is no reason whatsoever why a floating rate would in any way reduce your productivity. I rather think they are attributing to the floating rate what has been suggested by Michael Walker, among others, what is really attributable to your higher rates of taxation and regulation than exist in the United States and to a situation in which there is a drain of able people from Canada to the United States.

And so I suspect that if you tried to peg the rate and raise it to a higher level, you would have more trouble, not less. You would eliminate the automatic adjustments that now occur to the differences between internal conditions in Canada and internal conditions in the United States.

The point you are making is tied to why the Canadian exchange rate is depreciated relative to the United States by considerably more than can be accounted for by the difference in inflation. And that remaining difference has to be explained by differences in productivity.

In some way, it must be that Canada has had a slower rate of productivity increase than the United States has. Again, you have to ask what the cause of that is. And the cause is strictly internal. It's not going to be solved by fooling around with the exchange rate.

Charles Freedman: Recently, Ecuador and Costa Rica have dollarized. In your view, would dollarization make any sense for a country like Canada?

Milton Friedman: I think that it makes most sense for those countries who would otherwise have a very bad internal monetary policy.

My position has always been that a small country should do one of two things: eliminate its central bank and really hard peg—that is, unify its currency with the dominant currency the way Argentina has done with its currency board and Hong Kong has done with its currency board; or it ought to float completely.

Now, it makes no sense for Canada. At the moment, it seems to me that if I were a Canadian, I would not want to integrate the Canadian dollar with the U.S. dollar. U.S. monetary policy hasn't always been so good. We're in a very good patch right now, but looking over our history, Canada did much better in the 1930s than the United States did, and it did better in the 1970s, as well.

I would say that for a large country like Canada, it makes much more sense to float than it does to try to peg, to try to unify your currency with the dollar.

Lawrence Schembri: What is your opinion of the use of inflation targeting by Canada and other countries as a nominal anchor for monetary policy in conjunction with a flexible exchange rate?

Milton Friedman: It's an appropriate means. It's really a question of experience. We'll have to see how it works. So far, it seems to have been working quite well.

New Zealand, which was in some ways a pioneer in introducing inflation targeting, has been able to have a great deal of success. Britain has also inflation-targeted. On the other hand, the United States has not been an inflation-targeting country, and it also has done very well.

I think the more important fact is that all central banks have begun to learn some lessons from past experience, and they have learned to take it easy, that they shouldn't think that they are going to be able to fine-tune the economy.

The virtue of inflation targeting, in my opinion, is that it is a sort of pronouncement: we are not going to fine-tune. And that gives them some credibility in the market.

Now, my preference, of course, would be to abolish the central bank altogether and to simply have a computer that would churn out—well, I have two variants of it. In one of them, I would freeze the amount of the high-powered money and let the market go. In the other, I would assist the market by printing out a specified amount of high-powered money every month or quarter and have a steady rate of monetary growth.

In recent years, that has not looked as good as it did much earlier, because the actual relationship in the world between monetary growth and inflation in the economy has become much worse in the last 10 or 20 years. But, that's partly because there's been so much financial innovation and adaptation and, ultimately, it is the money supply that rules the roost and that will determine what long-term inflation will be.

Michael Bordo: Do you think the recent introduction of the euro will lead to the formation of other common-currency areas?

Milton Friedman: That's an extremely interesting question. I think that the euro is one of the few really new things we've had in the world in recent years. Never in history, to my knowledge, has there been a similar case in which you have a single central bank controlling politically independent countries.

The gold standard was one in which individual countries adhered to a particular commodity—gold—and they were always free to break or to leave it, or to change the rate. Under the euro, that possibility is not there. For a country to break, it really *has* to break. It has to introduce a brand new currency of its own.

I think the euro is in its honeymoon phase. I hope it succeeds, but I have very low expectations for it. I think that differences are going to accumulate among the various countries and that non-synchronous shocks are going to affect them. Right now, Ireland is a very different state; it needs a very different monetary policy from that of Spain or Italy.

On purely theoretical grounds, it's hard to believe that it's going to be a stable system for a long time. On the other hand, new things happen and new developments arise.

The one additional factor that has come out that leads me to raise a question about this is the evidence that a single currency—currency unification—tends to very sharply increase the trade among the various political units. If international trade goes up enough, it may reduce some of the harm that comes from the inability of individual countries to adjust to asynchronous shocks. But that's just a potential scenario.

You know, the various countries in the euro are not a natural currency trading group. They are not a currency area. There is very little mobility of people among the countries. They have extensive controls and regulations and rules, and so they need some kind of an adjustment mechanism to adjust to asynchronous shocks—and the floating exchange rate gave them one. They have no mechanism now.

If we look back at recent history, they've tried in the past to have rigid exchange rates, and each time it has broken down. 1992, 1993, you had the crises. Before that, Europe had the snake, and then it broke down into something else. So the verdict isn't in on the euro. It's only a year old. Give it time to develop its troubles.

Malcolm Knight: Countries with a flexible exchange rate need a nominal target for monetary policy to anchor expectations. Do you feel that inflation targeting provides a useful nominal target?

Milton Friedman: As I mentioned earlier, I think it's a good thing to have a nominal target, to say that you're not going to try to fine-tune, and to indicate what you aren't going to do. The problem I have is this: the current mechanism for all of the central banks who are inflation targeting is a short-term interest rate—as in the United States—in all of the central banks.

We know from the past that interest rates can be a very deceptive indicator of the state of affairs. A low interest rate may be a sign of an expansive monetary policy or of an earlier restrictive policy. And similarly, a high rate may be a sign of restriction, of trying to hold things down; or it may be a sign of past inflation.

The 1970s offer the classical illustration in which there were high interest rates that were reflecting the Fisher effect of inflation expectations. So I'm a little leery of operating primarily, or almost primarily, via interest rates. But, I think that having a given inflation target is a good objective. The question is, how long will you be able to keep it?

David Laidler: Many commentators are claiming that, in Japan, with short interest rates essentially at zero, monetary policy is as expansionary as it can get, but has had no stimulative effect on the economy. Do you have a view on this issue?

Milton Friedman: Yes, indeed. As far as Japan is concerned, the situation is very clear. And it's a good example. I'm glad you brought it up, because it shows how unreliable interest rates can be as an indicator of appropriate monetary policy.

The Japanese bank has supposedly had, until very recently, a zero interest rate policy. Yet that zero interest rate policy was evidence of an extremely tight monetary policy. Essentially, you had deflation. The real interest rate was positive; it was not negative. What you needed in Japan was more liquidity.

During the 1970s, you had the bubble period. Monetary growth was very high. There was a so-called speculative bubble in the stock market.

In 1989, the Bank of Japan stepped on the brakes very hard and brought money supply down to negative rates for a while. The stock market broke. The economy went into a recession, and it's been in a state of quasi-recession ever since. Monetary growth has been too low. Now, the Bank of Japan's argument is, "Oh well, we've got the interest rate down to zero; what more can we do?"

It's very simple. They can buy long-term government securities, and they can keep buying them and providing high-powered money until the high-powered money starts getting the economy in an expansion. What Japan needs is a more expansive domestic monetary policy.