The Conduct of Monetary Policy When You Live Next Door to a Large Neighbour

Gordon Thiessen has been the governor of the Bank of Canada since 1994, three years after the formal adoption of inflation-control targets. During that time, events outside of Canada—notably Mexico's "tequila crisis" in 1994-95 and the Asian economic crisis of 1997-98—have reminded everyone of the openness of the Canadian economy. These events have also tested Thiessen's resolve at the monetary controls, and required him to speak more about the role of Canada's flexible exchange rate in the conduct of monetary policy. Here is the text of a speech Governor Thiessen delivered in New York in March, 2000.

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BOTH IN CANADA AND ELSEWHERE, much ink has been spilled over the past year on the pros and cons of different exchange-rate regimes and the implications for monetary policy. Interest in the subject was piqued by the difficulties experienced in 1997-98 by a number of emerging-market economies in Asia—difficulties that had a lot to do with unsustainable exchange-rate arrangements. As well, the formation of a large single currency area in Europe, just over a year ago, focused attention on monetary unions. Canada's floating exchange-rate system has itself been the subject of debate, particularly while our economy was adjusting to the effects of falling world commodity prices.

There have been a number of changes in exchange-rate regimes recently. Several Asian countries have abandoned their fixed exchange-rate arrangements for more flexible systems. Last year, Brazil also moved to a floating exchange rate. Conversely, Argentina was seriously debating giving up its currency-board arrangement and adopting the US dollar. And of course this past January, Ecuador embarked on the road to "dollarisation" in an effort to restore political and economic stability there.

In a world of increasingly open markets for goods and services, burgeoning international trade, and massive global capital flows, what can we say about the appropriate exchange-rate arrangements and the scope for independent monetary policies in individual countries?

I believe that Canada is well placed to offer some useful insights, living next to a much bigger neighbour, with whom we have forged very close economic and

financial links over the years. And so today, I would like to talk about the conduct of monetary policy in Canada under a floating exchange-rate system. I will end with a brief summary of the state of the Canadian economy.

Economic and Financial Links Between Canada and the United States

No two other countries share as much as the United States and Canada—and I do not just mean hockey, baseball, or the longest undefended border in the world! Let us look at some basic economic facts.

The value of goods and services that cross the Canada-US border every year amounts to about US$370 billion—40% of our gross domestic product. Canada accounts for nearly one-fifth of US international trade in goods and services, while the United States accounts for close to four-fifths of ours. With the Free Trade Agreement (FTA) of 1989 and the addition of Mexico in 1994 to form the North American Free Trade Agreement (NAFTA), tariffs between Canada and the United States have been eliminated on a large number of goods. Financial flows between our two countries have also generally been free of controls since shortly after the Second World War. Today, the United States accounts for two-thirds of our net international liability position and for approximately half of all Canadian gross international assets and liabilities.

With this much economic and financial integration between our two nations, it is not surprising that there are people who believe that Canada should be in some type of monetary union with the United States (and perhaps Mexico) or that it should peg its currency to the US dollar.

Instead, the Canadian dollar has been floating against the US dollar for all but eight of the last 50 years—the longest time that any industrial country has been on a floating exchange-rate system. Indeed, this coming September will be the 50th anniversary of our first move to a floating rate.

Canada's Floating Exchange-Rate Regime

The main reason for choosing to float is that economic shocks affect our two countries differently. Even when Canada and the United States are hit by the same shocks, the impact on our economies can vary. Movements in the world prices of primary commodities are a classic example.

The main reason for Canada choosing a floating exchange rate is that economic shocks affect Canada and the United States differently.

Although the share of primary products in total Canadian exports has fallen by nearly half since the 1970s—to about 30%—primary-producing industries are still important to us. In the United States, too, the primary sector is significant. But, unlike Canada, the United States is not a net exporter of commodities. Indeed, it is a net importer.

So, when world commodity prices tumbled in 1997-98 in the wake of the Asian crisis, this actually helped a vigorously expanding US economy, by reducing input costs and dampening upward pressure on the general level of prices. In Canada, however, lower commodity prices caused a deterioration of our terms of trade—the prices we receive for our exports relative to the prices we pay for imports. Between mid-1997 and the end of 1998, the US terms of trade rose by about 3%, while ours fell by close to 5%. This had a negative effect on both our national income and the profitability of our primary sector.

When something like this happens, our floating exchange rate helps us to absorb the consequences. This is not to say that it eliminates the effects of a decline in commodity prices. But it does cushion them, and it facilitates the necessary adjustments in the economy. In this instance, the external value of the Canadian dollar fell by about 12% between mid-1997 and late 1998, reflecting a drop of some 20% over the same period in the average world price (in US dollars) of the key primary commodities we produce. Because of this movement in our currency, the price of these products in Canadian dollars fell by less than their world price in US dollars, thus reducing the negative impact on our exporters of commodities. Even more important was the incentive that the lower exchange rate provided to Canadian producers and exporters of non-commodity goods and services to expand their sales abroad.

With the exchange rate moving in response to the commodity-price shock, the negative effects were spread out more evenly across the economy and were less pronounced overall than they might otherwise have been. Yes, real GDP growth slowed from 4% in 1997 to 3% in 1998. But it picked up again to 4% in 1999. Moreover, employment has been rising, and unemployment has continued to fall since 1997. And in response to the acceleration in economic activity and rising commodity prices, the Canadian dollar has strengthened over the past year.

The other important characteristic of a floating exchange rate is that it allows us to have a monetary policy that is separate from that of the United States. Typically, economists express this independence as the ability to choose one's own national objective with respect to inflation. I do not find this to be a particularly useful way of looking at autonomy. And I most certainly would not want to suggest that there are serious shortcomings with the present objectives and approach of US monetary policy that would justify pursuing a fundamentally different policy in Canada. In fact, the objectives of monetary policy in our two countries are very similar.

Monetary policy affects the level of aggregate demand in the economy which, in turn, leads to an ultimate effect on prices and the inflation rate. The real essence of pursuing a separate monetary policy is having the option and the ability to respond to fluctuations in demand

that are unique to our economy. Let me give you an example from recent Canadian history. It goes back to the sharp fiscal tightening that we had to implement in 1995 in order to turn around our large public sector deficits and mounting indebtedness. Of course, fiscal deficits also had to be reduced in the United States during the 1990s, but the relative tightening has been much less than in Canada.

In any event, the dampening effect on aggregate demand of this dramatic change in Canadian fiscal policy called for easier monetary conditions. As progress was made in restoring fiscal credibility, the Bank of Canada was able to lower its policy rate during 1996-97 to levels well below the comparable US Federal Reserve rate. Both market interest rates and the exchange rate moved down in response, helping to stimulate foreign and domestic demand and so moderate the effects of fiscal restraint on economic activity.

For all these reasons, a flexible exchange rate has an important role to play in an open economy like Canada's. Let me now turn to the framework for monetary policy that the Bank of Canada has adopted.

Inflation-Control Targets

The objective of Canadian monetary policy is to keep inflation low and stable. The Bank of Canada pursues this objective by means of an explicit target for inflation control. This target has been the main feature of our monetary order since the beginning of 1991. The current goal is to hold inflation inside a range of 1% to 3%.

However, the Bank of Canada could not have targets for inflation control and be held accountable for achieving them without the flexibility provided by a floating exchange-rate regime. But it is also true that a floating exchange-rate system is more effective and reliable when there is a firm commitment to targets for inflation control. And our ability to have short-term interest rates for monetary policy purposes that are different from US rates is greater in those circumstances.

A floating exchange-rate system is more effective and reliable when there is a firm commitment to inflation targets.

The Bank of Canada's success in meeting the targets over the past nine years has helped to increase public confidence that inflation will stay inside the target range. And this has been true even during periods of turbulence and relatively wide fluctuations in the external value of the Canadian dollar. Moreover, this increased confidence in the Bank's commitment to low inflation has, in turn, helped the operation of financial markets by providing a strong underpinning to the valuation of the Canadian dollar.

One thing is clear from Canada's exchange-rate experience over the past few decades—the importance of credible domestic macroeconomic policies.

This is a relatively new phenomenon for Canada. During the years of high inflation—the 1970s and 1980s—a depreciation of the Canadian dollar would, all too often, raise fears of still higher inflation, which would then lead to further depreciation and higher interest rates.

Needless to say, it is only when expectations of inflation and of the future value of the Canadian dollar are well anchored that an independent monetary policy is possible. For only then will movements in the exchange rate permit adjustments in real (after-inflation) interest rates in Canada that are different from those in the United States.

Put another way, monetary policy actions cannot bring about Canadian real interest rates that remain below US rates for any significant length of time, unless markets have a fair amount of confidence in Canada's commitment to prudent macroeconomic policies, and unless there is a reasonable expectation of a real appreciation of our currency in the future.

In this context, I strongly believe that, without our inflation-targeting framework, we could not have had interest rates in Canada generally below those in the United States, as we have in the past four years. But I should add that neither would this have been possible without the remarkable progress made by Canadian governments during the second half of the 1990s to reduce budget deficits and to bring down the amount of public-sector debt relative to the size of our economy (the debt-to-GDP ratio).

Now, you may ask, How important can inflation-control targets really be if the United States has consistently turned in a strong economic performance and low inflation without them? The key element here is monetary policy credibility. And credibility is not necessarily tied to inflation targets. As US experience shows, a strong commitment to low inflation can do the job. But, where past price performance has not been particularly favourable, inflation targets can help to strengthen confidence in the central bank's commitment to low inflation. From the early 1970s to the early 1990s, on average, Canada had a somewhat higher inflation rate than the United States.

Other factors that matter are the size and importance of the US economy as well as the fact that the US dollar is the pre-eminent international reserve currency. All this incites considerable investment interest and greater market confidence in the US dollar compared with any other currency, especially during turbulent times. The Canadian economy, by contrast, is much smaller and more open. Because of these considerations, we in Canada have had to affirm our commitment to a more concrete monetary policy objective in the form of explicit inflation targets.

The Importance of Credible Macroeconomic Policies

In summary, I would suggest that our experience with a floating exchange-rate system and a "made-in-Canada" monetary policy, despite high economic and financial integration with our much larger US neighbour, provides an interesting example for those exploring the gamut of exchange rate and monetary policy options.

As I look at Canada's exchange-rate experience over the past few decades, however, one thing is very clear to me. That is the importance of credible domestic macroeconomic policies. Without a sound fiscal policy and a strong explicit commitment to inflation control, exchange markets will not have full confidence in the underlying value of the currency. And the ability of a flexible exchange rate to respond to shocks and to facilitate the interest rate movements needed for an independent monetary policy will be seriously compromised.

This in the end says it all. No exchange-rate system is going to bail you out of bad economic policies. That is equally true of a floating exchange-rate system, as it is of the alternatives—a fixed exchange rate or indeed a monetary union, even if that monetary union is with the world's largest, strongest economy.

In today's rapidly changing, increasingly open world economy, there is an even greater need for flexibility than before. I believe that a flexible exchange-rate regime continues to serve Canada well in dealing with the challenges of this new economic reality.

The Current Economic Situation in Canada

Let me finally say a few words about the current economic situation in Canada.

The Canadian economy had a good year in 1999. Our export industries benefited from the strong US economy. And with global economic conditions generally improved, primary commodity prices rebounded. The resulting gains in incomes and employment in Canada led to higher levels of domestic spending. Recently revised statistics now show stronger economic growth in Canada during 1999 than previously estimated.

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And we continue to see strong momentum in our economy so far this year. Indeed, by some calculations, we could be operating at full capacity. However, as has been the case in the United States for some time, Canada has also recently experienced an increased level of investment in machinery, equipment, and technology. This should lead to improvements in productivity and in our economy's production capacity. But we cannot be sure by how much.

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In light of this uncertainty, the Bank of Canada has been concerned about our economy picking up too much speed. There is a risk that we could hit the capacity ceiling too hard, causing supply bottlenecks and shortages that could lead to an ongoing increase in inflation. To reduce this risk, the Bank of Canada increased its Bank Rate twice, in November and February, following similar rate hikes by the US Federal Reserve. The latest data indicate that the external demand for Canadian output, especially from the United States, is stronger than previously expected. Under these conditions, it is essential for the central bank to be vigilant.

Moreover, in view of the uncertainty about the production potential of our economy at this time of structural change, the Bank is now monitoring a wide range of indicators for early-warning signs of pressure on capacity and prices.

Up to now, our inflation performance has been somewhat better than we had expected. While the increase in the total CPI over the past 12 months to January was 2.3%, our core rate of inflation (excluding food, energy, and the effect of changes in indirect taxes), at 1.3%, remains in the bottom half of the 1% to 3% target range.

This good inflation performance bodes well for the continued expansion of the Canadian economy. But what remains to be seen is whether this expansion will bring with it strong productivity gains for Canada similar to those witnessed in the United States.

One thing is clear. The job of the Bank of Canada must be to keep inflation in Canada low and stable. Without that, we will be risking both the economic expansion and the potential productivity gains. ◆