Explaining a Seeming Inconsistency: The Exchange Rate and the Bank of Canada

By Christopher Ragan

This issue of *Canadian Business Economics* contains several articles debating whether Canada should continue to have a flexible exchange rate or, instead, peg the value of its currency through some mechanism to the US$. This debate has a long history in Canada and, given its importance, will probably have an active future.

My purpose here is not to engage in the "fixed versus flexible" debate. Rather, it is to clarify the role of the exchange rate in the conduct of the Bank of Canada's monetary policy. I take as a point of departure that the Bank of Canada is committed to a policy of maintaining a flexible exchange rate. Within this broad policy setting, I hope to clarify why the bank is sometimes seen to "defend" the C$ whereas at other times it appears to be content to let the Canadian currency depreciate. Both events occurred in close succession in the spring of 1998 and the bank was accused of being inconsistent, confused, or both. I disagree on both counts. In my view, both types of response can be part of a sensible overall monetary policy. My basic argument is that the appropriate response by the Bank of Canada to a change in the exchange rate depends crucially on the cause of the exchange-rate change.

The exchange rate is not a policy variable

The exchange rate plays a central role in the operation of Canada's monetary policy. This is equally true in any country that relies as much as Canada does on international trade, both in goods and assets. But this does not mean the Bank of Canada views the exchange rate as a policy variable. The exchange rate is important to monetary policy for the same reason longer-term interest rates are important. Both are asset prices the bank's actions can influence and that ultimately affect the level of aggregate demand. But just as the central bank rarely enters the financial markets to influence the rate on 10-year Treasury bills, it also rarely enters the foreign-exchange market to significantly influence the Canadian exchange rate. This absence of intervention, after all, is the essence of a flexible exchange-rate system.

It is crucial to recognize that both the exchange rate and interest rates are market prices, whose values change daily because of changes in supply and demand conditions. Investors' sudden perception that Canadian bonds are a better deal than previously thought would lead to a rise in their price and thus a fall in their yield. The same event would lead to an appreciation of the C$ (because Canadian dollars are generally needed to purchase Canadian bonds). Conversely, the perception that Canadian bonds are higher-risk assets than previously thought would lead to a rise in yields, a capital outflow and a depreciation of the C$.

Because the exchange rate is determined by market forces, the bank correctly believes there is no "right" value for the exchange rate. Or, more correctly, it sees the current value of the exchange rate as the "right" value. The rate may rise or fall tomorrow as events change, both in Canada and abroad. But when it is determined in free markets by the actions of millions of participants in hundreds of countries, it makes little sense to think of today's rate as being either "too low" or "too high". It is one thing to suggest that events in the near future are likely to raise the value of the C$; it is quite another to assert, as many people have done throughout 1998 and 1999, that the C$ is "undervalued".

None of this suggests Canadians should be indifferent about changes in the value of their dollar. If foreign consumers or investors decide to buy fewer Canadian goods or services or assets, and the C$ depreciates as a result, Canadians are worse off. As a country, we are obviously made better off when the world favours those things we make and sell, the reverse is true when the world turns against our products or assets.

The Bank of Canada is also not indifferent to changes in the exchange rate. It views any change as symptomatic of some underlying change in world markets. Since its policy goal is to keep inflation within the announced target range, it needs to know the source of any persistent change in the exchange rate so it can understand how the underlying shock will affect the future path of inflation. Only then can it hope to design a policy that can, if necessary, offset the effects of the shock. But the Bank of Canada does not view the exchange rate as a policy variable. Rather, it views it as an important market price whose changes provide valuable information about the economic environment, information central to the design of monetary policy.

Should the bank "attack" or "defend" the dollar?

This brings us to the crux of the matter. Why does the bank sometimes appear to be content to let the value of the C$ fall on foreign-exchange markets, whereas at other times it seems to intervene to "defend" it.

In February and March, 1998, the C$ fell dramatically in foreign-exchange markets. The bank claimed the drop in world commodity prices was the underlying cause of the decline and it was content to let the dollar find its own level. A few weeks later, as the C$ continued to fall, though less dramatically, the bank argued it was necessary to intervene in foreign-exchange markets to defend the dollar. It was criticized sharply in the financial press for reversing its policy. It was also criticized for not explaining to the public how it viewed the exchange rate within its overall policy framework.

I agree the Bank seemed unclear about its intentions in the spring of 1998 and thus deserved the criticism. But I am also convinced it is not guilty of reversing its policy. On the contrary, a strong argument can be made that the bank had (and still has) a consistent policy approach, but that this approach involves responding differently to a depreciation of the C$ depending on the cause of the depreciation.

Current account shocks

Beginning in the summer of 1997, Malaysia, Indonesia, Thailand and South Korea (and some other Asian countries) fell into a serious recession, sparked by the collapse of their pegged-exchange-rate regimes. As these countries are large users of raw materials, their recessions led to a significant fall in the world's demand for raw materials, and thus a large decline in raw materials prices. In the next year or so, the average prices of raw materials fell by about 30 per cent. All countries that export raw materials experienced a sudden decline in demand for their currencies, which lost value as a result — Canada, New Zealand, Australia, and South Africa among them.

This type of shock is a negative current-account shock, because it reflects a reduction in the demand for Canadian goods or services, the transactions of which are recorded in the country's current account of the balance of payments. How should the Bank of Canada react to such a shock?

If the central bank believes the depreciation is caused by the reduction in raw materials prices, its appropriate response is to let the C$ depreciate. Given the prominence of raw materials in Canada's exports, the significant decline in the world's demand for raw materials is a significant reduction in demand for Canadian exports, and thus a reduction in the level of Canadian aggregate demand. The short-run effect of this shock is to reduce gross domestic product and increase the size of the recessionary output gap. The eventual effect of the shock, if it persists, is to reduce inflation, possibly below the target range.

In response to such a negative current-account shock, the appropriate policy for the Bank of Canada is to let the C$ depreciate. By allowing the dollar to fall, the negative effect on aggregate demand can be dampened by making our other exports more competitive in world markets. Actually, we can go further than this. If the shock is expected to persist, as it was at the time, the bank should actually try to offset the effects of the negative shock by implementing an expansionary monetary policy. The reduction in the overnight

interest rate will lead to a reduction in longer-term interest rates, an outflow of financial capital, and a further depreciation of the dollar.

In other words, in response to a persistent negative current-account shock, the appropriate bank policy will be interpreted by some observers as one "attacking" an already weak C$. This may sound counter-intuitive or simply incorrect. But remember the goal of monetary policy is to keep inflation relatively stable within its target range, and this goal is achieved by keeping GDP close to potential GDP. Thus, if an external shock depresses aggregate demand, the right policy is to offset that decline. It may seem odd that it involves "attacking" an already weak dollar, but so be it. The value of the exchange rate is not the focus of monetary policy, and it should not be.

Capital account shocks

Consider then what happened to the C$ in another context – a capital-account shock. In 1996, Canadian short-term interest rates fell below U.S. rates and remained considerably below them for the next two years. According to the theory of uncovered interest parity, a staple of international economics, Canadian interest rates can only persist below the rates on similar U.S. assets if the C$ is expected to appreciate relative to the US$. In 1996-98, the lower Canadian inflation rate was the primary reason the C$ was expected to appreciate. So the low Canadian interest rates appeared to be sustainable.

In this context, consider what happened later in the spring of 1998. The world economy was looking quite fragile and, as a result, raw materials prices showed no obvious sign of reversing their earlier decline. Moreover, the U.S. inflation rate, surprisingly to some, had fallen and partially closed the gap between it and the lower Canadian inflation rate. Thus no significant forces on the horizon could be expected to produce an appreciation of the C$ — certainly not enough to justify the large interest-rate differential between Canadian and U.S. short-term bonds.

Faced with low Canadian yields and no obvious prospect of an appreciating C$, bondholders in Canada and elsewhere did the sensible thing — they sold their Canadian assets and acquired U.S. ones instead. Add to this the general "flight to quality" that typically accompanies any serious pessimism regarding the world economy, and you have a good reason in the spring of 1998 for investors to dump their Canadian bonds. Not surprisingly, the dumping of Canadian bonds led next to a dumping of the C$ as investors tried to acquire foreign assets. The weakness of the C$ continued.

This type of shock is a negative capital-account shock, because it reflects a reduction in the demand for Canadian assets, the transactions of which are recorded in the country's capital account of the balance of payments. How should the Bank of Canada react to such a shock?

A capital-account shock is a different creature from a current-account shock, and the appropriate response of monetary policy is therefore also different. The key point is that the shock itself is not directly related to the demand or supply of Canadian goods and services — instead, it is a shock to the asset market. Thus the direct effect on the level of Canadian aggregate demand is nil. But the indirect effect, through the change in the exchange rate, is potentially important. Specifically, the investors' dumping of Canadian assets causes a depreciation of the C$. This depreciation, in turn, stimulates Canadian exports and reduces Canadian imports.

Thus the negative capital-account shock actually leads to an increase in Canadian aggregate demand and thus, eventually if the shock persists, to an increase in Canadian inflation. In this situation, the appropriate action for the Bank of Canada is to implement a contractionary monetary policy. Such a policy will raise interest rates, help to reverse the capital outflow, and thus lead to a strengthening of the C$.

In other words, faced with a negative capital-account shock, like the one that appeared in the late spring of 1998, the appropriate monetary policy is one that appears to "defend" the C$. But don't think of the policy as being one designed to "defend" the dollar, because that is not its main purpose. Confronted with a shock that increases aggregate demand, the appropriate monetary policy is a contractionary one. The result will be higher interest rates and a stronger dollar (which is central to the success of the policy), but the exchange rate is not the focus of the policy.

Final remarks

So what is the role of exchange rate in the Bank of Canada's monetary policy? That simple ques-

tion defies an equally simple answer. The exchange rate is a market-determined price. Changes in that price, occurring every day and many times a day, reflect all kinds of changes in the economic environment, in Canada and elsewhere. As the exchange rate changes, the Bank of Canada has the task of interpreting the cause of the change, the likely persistence of the change, and its likely effects on the Canadian economy. Despite the volume of data being examined by the bank, and despite the considerable skills of its analysts, the bank's job is not an easy one.

I am not trying to be an apologist for the Bank of Canada. Nor am I arguing that the bank has not made some mistakes in how it has responded to changes in the exchange rate. No doubt it has. But my interpretation of events in the spring of 1998 suggests it did not make any obvious mistakes, and certainly is not guilty of reversing its policy.

Where the Bank of Canada can be justifiably criticized is in its unwillingness or inability to explain to the public, and especially to the financial press, how the exchange rate fits in its overall policy framework. Appearances matter. The events in the spring of 1998 make it clear the bank appeared to be indecisive and, even worse, confused about the role of the exchange rate. In actual fact, I do not think the bank was confused, and it was probably no more indecisive than it ought to have been, given the fact its information about the world economy is inevitably incomplete and imperfect. But it should have spent more effort explaining itself to the public.

My central argument can be summed up in one sentence: the Bank of Canada's appropriate response to a change in the exchange rate depends crucially on the cause of the change. I believe the financial press can be educated to understand this argument. Only then will the message eventually trickle down to the public. Perhaps then we will not have to listen to the often-heard statements from financial experts such as "the Bank of Canada's primary purpose is to defend the C$." This is simply nonsense.

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